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Market Analysis Research of the Russian Steel Industry

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Part I. Standing of Ferrous Metallurgy of the Russian Federation

Introduction

Russia is one of leading producers of steel in the world. In latest years, Russia was traditionally the 4th greatest producer of steel in the world (after China, Japan and USA). But in 2009 most of country-steelmakers, except for China, India, Iran and some other sharply decreased steel output. On results of 2009, Russia became the 3rd greatest producer of steel in the world (after China and Japan), but on results of 8 months of 2010, Russia became the 5th (after USA (the 3rd place) and India (the 4th) in addition).

Around 3.3% of trade turnover in the country and 5.3% of proceeds from export sales of Russia belonged to Russian ferrous metallurgy sector in 2009 (4% and 4.9%, respectively, in 2008).

Until recently, share of state in pattern of ownership in the sector was below 2%. But in 2007-2009, the share began to increase. For instance, State Corporation Russpetsstal' acquired Volgograd metallurgical plant Krasny Oktyabr'. In conditions of the global economic crisis, some Russian metallurgical companies will possibly be incapable to pay off taken credits (often from State-controlled banks – Bank of Savings (Sberbank), VTB and so on)) and, thus, their shares (partially and completely), being in pledge for the credits, may change to state ownership.

For instance this fate was expected to become actual for some enterprises of holding company Estar. There was a possibility of change of JSC Zlatoust metallurgical plant under control of the Russpetsstal'; but actually the Zlatoust plant was acquired by Mechel Group.

The Government introduced some restrictions of imports of many types of rolled steel, for instance, for building sector.

Notice that, in spite of weak domestic demand for steel products, rather active exports of the products allowed leading Russian steelmakers to earn money and to survive under impact of the global financial-economic crisis.

Until recently (even in early 2000s), the features of standing of Russian ferrous metallurgy as a whole were as follows:

- Improper grade and competitiveness of production owing to availability of outdated and worn productive facilities;
- Too high material and power consumption of the production;
- Misbalance between distinct branches of ferrous metallurgy sector, aggravated by breaking economic ties between enterprises of the ex-USSR countries;
- Extremely unfavorable environmental situation around metallurgical enterprises.

The main negative tendencies, making themselves evident in Russian ferrous metallurgy in early 1990s, to a large extent arose from features of Soviet economy, in which political reasons dominated over economic ones. For instance, the task was

become the greatest producer of iron and steel in the world, to construct the largest in capacity steel-making facilities, etc. As the result, great steel-making facilities proved located irregularly; in addition, they, as rule, were closely specialized in distinct products.

Resulted disproportion in production and consumption of steel by territories caused too high transport costs, too complicated power and transport lines, surplus expanding auxiliary productions.

Soviet policy tending to only extensive production growth resulted in the fact that, by mid-1990s, productive capacities in Russian ferrous metallurgy proved extremely obsolete and worn owing to delay in production reconstruction and modernisation (degree of depreciation reached 60-70%).

That is why in 1990s Russian ferrous metallurgy was characterised by availability of obsolete and worn facilities, consuming too much power, fuel and raw materials - by 20-30% (in specific consumption) more than in developed countries.

According to German consulting company UBT/Wolfgang Ruoff&Partner, which analyzed standing of Russian ferrous metallurgy, the main problems of this sector were inefficient utilisation of productive capacities, obsolescence of facilities and high environmental damage from the operating facilities.

When changing to market economy, Russian ferrous metallurgy, being too large-scale, inertial, non-flexible, showed its inadequacy: instead of reducing production costs, the sector demonstrated increasing price on products, growing nonpayments and cutting production volume.

Low competitiveness of production of Russian steel-making sector was owed, first of all, by obsolescence of productive capacities and weak management.

At the same time, according to EU experts, advantages of Russian ferrous metallurgy are great resources base, availability of modern know-how in metallurgy (high level of scientific-research works), rather qualified and cheap working force, relatively low production costs. On the other hand, among its disadvantages are obsolescence and wearing of productive capacities, high specific consumption of power and resources and unfavourable location of steelmakers (too far from consumers).

In latest years, standing of Russian ferrous metallurgy began to change (to improve) considerably with changing ownership pattern: new owners increased investments in production development, modernising production facilities and improving grade and competitiveness of products (this is true, first of all, for great steelmaking companies, but in latest time for smaller enterprises too). For instance, the Russian steelmaking facilities depreciation (as a whole) decreased to around 48% owing realizing large-scale modernization projects in 2007 and further, to below 43% in 2009.

Greatest Russian metallurgical companies invested growing funds, especially in 2005-2007, in manufacture of high-value-added products, including coated steel, metalware and steel pipes. Nevertheless, even before the global crisis, when demand for high-value-added products increased steadily and sharply, share of semis in total Russian steel exports exceeded 50%.

To a large extent this is owed by restrictions (quotas, prohibiting import duties, etc.), imposed on supplies of the high-value-added products from Russia to markets of developed countries, first of all, EU and USA.

For instance, quota on supplies of Russian steel products to EU gradually increases, but remains discriminative and obviously too small. Question of abolition of the restrictions can be discussed after Russia will enter WTO.

Policy of developed countries is aimed at ousting Russian steelmakers from world market of high-value-added steel products – role offered for Russia is to be supplier of iron and cheap semis (production of which is restricted in the developed countries by strict environmental regulations).

1. Economic standing of Russian ferrous metallurgy

2009 became unique year for Russian metallurgy owing to a number of reasons, formed in conditions of the global financial-economic crisis:

- Increasing global demand for ferrous metals mainly for the second half of 2009 that owed gradual increasing domestic production of the metals;
- Some increasing prices on ferrous metals for January-first half of February (mainly owing to trader speculation expectations), followed by following decreasing for several months and then gradual growth by the end of 2009;
- Deepening impact of the global crisis in the first half-year and some improving the situation in the second half-year;
- Large debts of leading Russian steelmakers on previously taken credits and their need in state support and giving them the state support;
- Sharp worsening financial results of Russian steelmakers in Q4 2008 and early 2009 and gradual improving the financial results by the end of 2009;
- Keeping low demand and prices on steel products at domestic market for 2009;
- Introducing custom restrictions in Russia on imports of some steel products (for instance, the products for building sector) – measures in favor of domestic steelmakers.

For the first time Russian ferrous metallurgy faced large-scale crisis in 1996 after considerable worsening world conjuncture of rolled steel, aggravated by introducing "currency corridor" in Russia (fixing top and bottom levels of fluctuation of RR/USD exchange rate). As a result, the sector profitableness dropped from 22% in 1995 to 5% in 1996 and 3.6% in 1997.

To stabilise financial standing, Russian steelmakers increased domestic prices on rolled steel; shortage of working capital was compensated by taking credits from resources suppliers; in addition, share of barter transactions increased considerably. But this all did not allow to overcome crisis radically, and in 1996-1997, most of the steelmakers faced sharp decline in their working capital, and their financial standing became unstable.

In early 1998, the situation was aggravated by weakening export sales owing to financial crisis in South-East Asia. Volume of sales was partially kept by reorientation of the export to North America.

In 1998, on the whole, financial standing of the steelmakers was unsatisfactory, that was connected with nonpayments for shipped production, too high consumption of resources, fuel, power owing to high wearing and obsolescence of facilities, aggravated by high credit interest rate. In 1998 a share of unprofitable enterprises increased from 42% in 1997 to 45% in 1998, and, among unprofitable enterprises, most of greatest Russian steelmakers proved: NLMK, ZapSib, NKMK, NTMK, NOSTA, Mechel, OEMK. Notice, however, that this was partially owed by the fact,

that negative difference in rates of exchange, arisen in the 3rd - 4th quarters (Q3-4) of 1998 owing to falling Ruble/USD exchange rate, were included in structure of losses.

Devaluation of Rubles after August 1998 crisis resulted in sharp rise of effectiveness of export of steel and rolled steel. In addition, domestic demand for rolled steel also increased owing too high growth of prices in rubles on similar foreign products. On the results of 1998, share of unprofitable steelmakers were around 45%, but in 1999 and 2000 the share decreased to 28.3% and 28.1%, respectively. From Russian Goskomstat (Russian Statistic committee or Russian Federal Statistic Service (Rosstat) now) data, profitableness of the sector as a whole was 38.7% in 1998, and 29.9% and 29.1% in 1999 and 2000, respectively.

For 1999-2000, financial standing of most of the greatest Russian steelmakers estimated to be stable, their profitability remained high, although demonstrated downtrend.

In 2001, profitability of Russian steelmakers dropped in 1.5-2 times, whereas share of unprofitable companies increased again, to 37% of the total, that was connected, first of all, with increasing power, power resources and railage tariffs and reform of VAT. In early 2002, the profitability decreased further, in connection with the same reasons as in 2001, aggravated by unfavorable world market conjuncture (notice that around 55% of Russian steel products are exported). However, in the second half of 2002, improving the conjuncture produced positive effect on the profitability, which constituted, for 2002, 16.5% (average annual figure), that was higher than in developed countries and comparable only with profitability of developing markets, for instance, South America.

In 2003-2007, financial standing of Russian steelmakers, especially the greatest ones, was rather stable and favorable. Production profitability of the steelmaking sector was around 22% in 2003, 36% in 2004, 24% in 2005, 2006, 2007. Increasing world prices and volume of sales resulted in increasing profits of Russian steelmakers, which grew in 2006 in above 7.5 times compared with 2002 (cost of commodity products for the period grew about 3 times); in 2007, these tendencies remained in force.

In 2008, world prices on steel products reached historical peak in the beginning of the 2nd half of the year, demand steadily grew, and this all resulted in considerable improving financial results of the steelmakers in Q1-Q3 2008. But sharp drop of the demand and the prices in Q4 2008 owing to sharpening the global crisis owed considerable losses of the companies in Q4. Nevertheless, on the results of the whole 2008, the Russian steelmaking sector remained profitable, but the profitability decreased to 15%; at the same time, profit of the sector increased by 9% compared with 2007.

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In 2009, situation in Russian economy was radically different compared with late 1990s.

Unlike the crisis of 1998, which was local – default with following great devaluation in Russia, which stimulated import substitution with corresponding development of local industries, and large increasing receipts in local currency (Ruble) from exports, that was also true for steelmakers, the current global financial/economic crisis produced much more destructive and heavy impact on Russian economy as a whole and steelmaking sector as its part. First, in 1998-1999, crisis was not global, and it was healthy demand for steel semis and products from developed western countries that allowed Russian steelmakers to survive and then to grow. On contrary, currently global (export) demand for steel is weak all over the world, maybe, except China, but the country actively develops own steelmaking industry, and will hardly provide stable long-term demand for Russian steel. Second, that time (1998) the Ruble devaluation was fast and deep – 3-3.5 times for a month or slightly more, and actually launched both import substitution, i.e. created domestic demand, including for steel, and owed sharp growth of export revenues and profitability of exports (in Rubles) that improved considerably financial standing of Russian steelmakers. On contrary, the devaluation (in November 2008-January 2009) was around 40% only that was enough neither for development of import-substitution projects (with corresponding stimulation of domestic demand) nor for marked increasing export revenues of the steelmakers. Moreover, in 1998 (and this is true to a large extent for the whole 1990s, the governmental financial/economic policy was determined by honest charismatic leader – Boris Yel'tsin, and aimed, on the whole, at development of the country economy, and was implemented by high-qualified and decent persons (E. Gaydar, A. Chubais, S. Kirienko and other), and measures taken to overcome that crisis, were chosen and implemented in favor of Russia and its people (on the whole). On contrary, now, in the opinion of some experts, Russian financial/economic policy is determined and implemented by weak and low-competent persons and aimed, first of all, at surviving of oligarchic capital (because this is the same as the state now) – i.e. their policy is aimed at own surviving as authorities and keeping their money and power. So, for instance, huge financial support, declared to be allocated for “real sector” (‘i.e. actual production sector) – more than 100 bln Rubles - got trapped in banks, which used these money not for crediting industrial enterprises, but for speculations at currency exchange. In addition, refinancing rate of Central Bank of Russia was raised in November 2008 up to 13%, decreased in April 2009 to 12.5% and remained above 10% until the end of 2009 that closed the way for cheap credit for industrial enterprises, which, as a result, faced shortage of working capital and investments for development. As a result, Russia received stagflation – high inflation – above 10% (in per annum equivalent), with great production setback (much above 10% (estimations vary in rather wide range) per annum. For comparison, all healthy authorities all over the world decreased refinancing rates to almost zero – to encourage development of domestic economy by

acceptability of cheap credits. Only in the end of 2009 the refinancing rate of Central Bank of Russia decreased slightly – to 8.75% and then to 7.75% in mid-2010.

Negative tendencies in Russian economy remained in force in the first half of 2009. By mid-2009, the situation was stabilized to some extent – more exactly, production setback was stabilised. In the first half of 2009, industrial production volume proved 85.2% of the level of H1 2008. Official governmental forecasts expected the industrial production setback in Russia in 2009 of around 11-13%, and the setback of 15-17% in manufacturing sector.

In August 2009 the Russian government announced completing recession in Russian economy. It is rather interesting that this positive evaluation of standing of the economy coincided with maximal monthly drop of power consumption in Russia of around 8.3% in July and 10.4% in August (8.2% in June) month-on-month. Notice that power consumption, especially in summer months, when share of communal utilities in the consumption is minimal, is rather reliable indicator of actual level of industrial production volume. The power consumption drop allowed to conclude that recession in Russian industry remained in progress.

In metallurgical industry and manufacture of finished metal items production volume in H1 2009 was 74% of the level of the same period of 2008. The government expected the greatest production setback in metallurgical industry, production of building materials and machine building sector in 2009.

In latest years (until mid-2008), favorable market conjuncture allowed Russian steelmakers to increase profitability of operation; share of the sector in total volume of profit of Russian industry grew from 6% in 2001 to 9.5% in 2002 and 16.5% in 2003; in 2005, the share reached 20%. In 2008, the share decreased to 17%. Share of unprofitable enterprises in Russian steelmaking sector remained rather large: for instance, around 40% by the end of 2003, 45% in the end of 2005. In December 2008, the share, in spite of the global crisis, was 31%, less than in previous years that was connected with profitable work during Q1-Q3 2008.

Notice that the growth of profit was demonstrated, first of all, by the greatest steelmakers, financial results of which in 2007-2009 are shown in Table 1.

Table 1: Financial results of leading Russian Steelmakers in 2007-2009, mln Rubles

Company	Proceeds from sales			Pre-tax profit			Net profit		
	2007	2008	2009	2007	2008	2009	2007	2008	2009
MMK									
Severstal									
NLMK									
NTMK									
ZapSib									
Mechel									
NKMK									
Ural Steel									
OEMK									

Source: annual reports of the companies

The heaviest period for Russian steelmakers was Q4 2008 – Q1 2009, when all the steelmakers incurred losses. Only in Q2 2009 operation of a number of the enterprises became profitable again. Nevertheless, for the whole 2009, most of the leading steelmakers (except for MMK) decreased profit considerably compared with 2008, and some of them, for instance, JSC ChMK, proved in the red.

Among measures, encouraging development of Russian steelmaking sector, were abolishing of export duties on ferrous metals and introducing measures, restricting imports of some steel products, for instance, steel pipes from Ukraine, stainless flat steel from EU, etc, as well as subsidizing interest rates for crediting exporters of steel products, enlarging list of steel products, for which state warranties are provided; in addition, political support in negotiations with states and international organization was also provided by the Government. Besides, special protecting and anti-dumping probes were conducted to restrict imports of steel products, an special 15% preferences were given to domestic steelmakers in governmental purchases.

To support investment activity in the sector, the government abolished import duties and VAT on unique in Russia production facilities, provided acceleration of export VAT refunding process, provided support and state guaranties in taking credits by steelmakers, etc.

For instance, state guaranty to the sum of 30.75 bln Rubles was given to LLC MC Metalloinvest (managing Lebedinsky GOK, Mikhailovsky GOK, Ural Steel, OEMK) in taking credit of 61.5 bln Rubles.

In January 2009, 15% import duty was imposed on hot-rolled rebar (TNVED Codes 7213914100, 7213917000 and 7213991000). But even strengthening measures on protection of domestic market of steel from imports (import duties were introduced for a number of steel-rolled products) could not improve standing of Russian steelmakers – owing to sharp drop of domestic demand for steel. Namely, in January 2009 rolled steel consumption in Russia dropped 50% year-on-year to 1.65 mln t; production of rolled steel decreased 34% y-o-y, exports – by 17% y-o-y, and imports by 66% y-o-y. In February the consumption slightly increased month-on-month, but in March dropped again 10% m-o-m.

By mid-2009 the situation at domestic market was slightly improved, and even in Q3 2009 actual signs of improving demand for steel products arose. Nevertheless, on results of the whole 2009, domestic consumption of steel in Russia decreased almost 8 mln t compared with 2008 to around 25.3 mln t of finished rolled steel.

Until recently, one of the most serious problems of the sector was also too heavy taxation. Among the heaviest taxes were profit tax and estate tax, constituted together above 60% of profit (notice that in develop countries profit tax is below 30-40%). Finally this resulted in shortage of working capital of steelmakers and arising tax debts and, that is the most important decrease competitiveness of the enterprises production. Fortunately, in latest time, the government decreased the profit tax from 35% to 20% (as of early 2009) and optimized taxation system to facilitate capital investments. Overall taxation of Russian steelmakers decreased.

Another problem is difference between Russian and Western bookkeeping (accounting) standards. To overcome this problem, currently, with support of TACIS program, Russian steelmakers are shifting to Western bookkeeping (IAS) that will allow making all costs transparent and comparable with western ones. From InfoMine data, all leading Russian steelmakers, including Severstal, Magnitogorsk (MMK) and Novolipetsk (NLMK) have already shifted to Western bookkeeping standards.

Growing tariffs of natural monopolies (suppliers of natural gas, power and railage services) remains a serious problem, hindering development of Russian steelmaking sector. Share of the tariffs in prime cost of the steelmakers increases steadily, and, in fact, growth of the tariffs practically neutralized positive effect of the Ruble devaluation of 1998.

In 2003, the natural monopolies tariffs increased again. For instance, railage tariffs provided profitability of domestic railage up to 250% (!).

Notice that metallurgy is one of the greatest consumers of natural monopolies products: 20% of railage, 32% of consumed power, 10% of oil and oil products and 25% of natural gas consumption belong to the metallurgy. But permanent active growth of rates of prices and tariffs on the natural monopolies products and services results in increasing prime costs of Russian steelmakers and decreasing profitability of their products and competitiveness, correspondingly.

Experts of the Governmental Center of Economic Conjuncture distinguish 4 periods in price policy of the natural monopolies for 1992-2005. In 1992-1994, rates of growth of the tariffs outstripped considerably those of release prices of industrial producers; in 1995-August 1998, the rates were in equilibrium; until 2000, the rates of natural monopolies tariffs were restricted by administrative measures; and, since 2000, the tariffs outstrips the release prices again, same to early 1990s situation.

Only in 2006 prices on steel products grew at higher rate - by 27% y-o-y, than rates of the prices on the natural monopolies services (power, railage, natural gas, etc.), which were around 9-10%. In 2007 the prices on power and power resources outstripped again the prices on rolled steel – 18% (power) versus 8%. In 2008, the situation remained the same - the prices on power and power resources and railage outstripped again the prices on rolled steel (in spite of considerable growth of the latters).

Similarly, in 2009, the power and railage tariffs growth rates outstripped the prices on rolled steel rates: above +20% for power, +10.1% for railage against +4.1% for steel products (for December 2009 y-o-y; notice in addition that the December 2008 level was very low)

Russian steelmakers voice complaints to monetary policy of the Government, consider Central Bank of Russia, instead of placing its reserves (much above \$100 bln) at international market (for instance, in US treasuries), could invest them in domestic economy; they also offer to invest budget proficite in the economy instead of freezing it at special accounts (as future security fund). Notice that these are rather dubious complaints, with fallible arguments, according to independent experts, not affiliated with owners of Russian steelmaking industry. Besides, the government can

not introduce effective measures to restrict removal of capital from Russia and to attract savings of people for internal investments.

In 2003 the government decreased rate of Central Bank credit (refinancing rate) from 21% to 12% that encouraged investments in Russian metallurgy modernisation. Further, until February 3, 2008, the rate decreased to 10%, but then the rate growth began again, to 13% since December 2008. Slight decreasing this share to 12% by mid-2009 did not make credits more acceptable for Russian enterprises, including metallurgical ones. Impossibility of taking credits depresses development of Russian industry and, in turn, depresses domestic demand for steel.

Considerable progress of Russian ferrous metallurgy was mainly based on sharp increasing investments in production modernisation in latest years until 2009 (at that, 80% of the investments were based on operational profit and depreciation funds). The capex in ferrous metallurgy of Russia reached peak in 2006 and 2007 – around 125 and 128 bln Rubles, respectively – in around 5.5 times above the 2000 level. In 2008, the global crisis resulted in sharp decreasing volume of the investments in the 2nd half of (most of investment projects was postponed). Total capex in 2008 reached peak level for the latest years – 199 bln rubles, but this was connected with high investment activity in the first half (H1) of 2008 and considerable devaluation of Russian ruble (against USD and Euro) in H2 2008. In 2009, the capex sum was 159 bln rubles (at Ruble/USD exchange rate considerably below the level of mid-2008).

All leading Russian steelmakers launched large-scale investment programs (funded both internally and from loans), aimed at modernizing production up to the most modern world level. This activity is to be accelerated taking into account forthcoming entering Russia to WTO. The steelmakers scheduled the development (investment) programs up to up to 2010-2012, 2015 or even 2020, and the large planned investments require correction of state depreciation policy (rates) to stimulate capital investments. For this purpose, the steelmakers offer also to optimize system of VAT return in capital construction and to abolish customs import duties on key equipment, not produced in Russia, and to introduce a number of amendments in Tax Code of Russia, concerning:

- Introducing profit-tax-free period of 3-5 years since commissioning new productive capacities;

- Restoring preferences in tax on profit, spent on capital construction;

- Introducing differentiated rates of tax on mining mineral resources.

For instance, JSC MMK program, scheduled up to 2020, costs up to \$10 bln, only in 2007 the investments exceeded R22 bln. But at present time most of MMK's projects has been frozen or postponed; other Russian steelmakers proved in the same situation. For instance, construction of Prioskol'sky GOK (basic project for or provision of the Works with iron ore resources) was postponed. Nevertheless, other key projects, for instance, the 5000 mm Mill construction, were in progress even in the most difficult period of late-2008-early 2009.

Similar situation took place at other steelmaking Works. But since mid-2009 and in H1 2010 the investment activity began to grow again, with resuming -re-

launching postponed projects, including construction of new mini-plants notice that number of the mini-plants to be constructed now even increased).

In 2002, a State Concept of development of Russian metallurgy was elaborated; by now, similar Development Concept up to 2020 have been prepared, but actual activity is not aimed at the sector development as yet. The new Concept provides for steelmaking volume of 90 mln tpy by 2020, but this requires marked increasing domestic demand, but no actual prerequisites for this are available as yet.

2. Analysis of production and capacities utilisation

From political reasons, USSR steadily increased output of steel and rolled steel, constructed new enterprises, commissioned new capacities. By 1990, USSR production of steel and rolling steel increased to almost 90m (mln) tonnes and 64m tonnes, respectively (Table 2). At the same time, according to experts, steel and rolled steel production and consumption in the USSR was surplus, estimated up to 40% of total production.

The USSR breakage, shift to market economy, collapse in defense industry resulted in sharp setback in steel and rolled steel production and consumption, that was aggravated by breaking previous economic ties between enterprises of the ex-USSR.

We consider the 1990-1994 setback in steel production was connected with overall setback in production in steel-consuming sectors. Later, with development of economic reforms, availability of solvent demand for steel became the main acting factor. Possibly this owes wave-like dynamics of steel and rolled steel output in Russia in 1994-1999.

Considerable increasing steel and rolled steel output in Russia in 1999 was connected with both high profitableness of export and improving domestic demand for rolled steel. In 2000, output of steel and rolled steel continued to grow, but in 2001 rate of the growth dropped considerably. This is largely owed by worsening standing of Russian steelmakers at world market and saturation in domestic market.

In early 2002, further decreasing rate of growth of steel products output happened in connection with introducing anti-dumping measures at export markets and worsening domestic market conjuncture. However, in mid-2002, abolishing a number of the anti-dumping measures and improving domestic market conjuncture owing to steps, taken by the government, the situation was improved, and overall output of steel products in 2002 exceeded that of 2001 by 3% (below the growth rate of 1999-2001). Further growth of the production was hindered by weakening domestic demand.