SECTOR UPDATE

Flat Steel Products

February,2019

Industry Structure

The Flat Steel industry in Pakistan comprises two local producers International Steels Limited (ISL) and Aisha Steel Mills Limited (ASL). Flat steel producers import Hot Rolled Coil (HRC) and convert it into Cold Rolled Coil (CRC), Galvanized and Color Coated sheets. Currently, ASL only produces CRC while ISL also produces Galvanized and Color Coated Sheets in addition to CRC. At end-FY18, ISL had an 82% (FY17: 70%) market share in terms of installed capacity in Pakistan, which increased on account of its new plant installed in June'2018. During FY18, ISL produced 470,841 MT (FY17: 464,023 MT) of CRC of which 330,259 MT (FY17: 312,886 MT) was further processed into galvanized steel. During FY18, ASL produced 217,370 MT (FY17: 209,524 MT) of CRC reporting higher utilization levels of 99% (FY17: 95%) as compared to the preceding year.

Table 1: Industry Capacity Utilization

CRC strip (tons)	Current Capacity (at end June'2018)	Production (FY18)	Production (FY17)	Capacity Utilization (FY18)	Capacity Utilization (FY17)	Post-expansion Capacity
Aisha Steel	220,000	217,370	209,524	99%	95%	700,000
International Steel (expansion online in June'2018)	1,000,000	470,841	464,023	84%	84%	1,000,000
Siddiqsons Tin (expansion online in FY20)	-	-	-	-	-	200,000
Total CRC Industry	**1,220,000**	**661,152**	**673,547**	**87%**	**87%**	**1,900,000**

Expansion

Given the healthy demand outlook, both ISL and ASL announced expansions in FY16. Capacity expansion announced by both players stood at similar levels at around 450,000 MT. ISL's expansion came online in June'2018 thereby providing it a competitive edge in the market. Expansion announced by ASL also includes a galvanizing line which will represent around 36% of ASL's total installed capacity and facilitate in diversifying revenue streams. Operational dates for ASL's galvanizing and CRC line is expected in 3QFY19 and 4QFY19, respectively. ISL's expansion plan comprises a line for CRC only and not for galvanized coils. Siddiqsons Tin Plate Limited has also announced backward integration at its plant with planned CRC capacity installation of 200,000 MT, expected to come online by 4QFY20.

Demand and Supply

Total demand for Flat Steel products (Cold Rolled and galvanized sheet) in the country is estimated in the range of 1.1m-1.3m MT. Demand for Flat Steel products is supported by widespread usage in terms of industries being catered by ISL and ASL including autos (motor cycles), consumer durables, pipes and construction material. Overall demand for Flat Steel products has depicted healthy double digit growth over the last three years with sales increasing by 17% during FY18 and amounting to 1.29m MT (FY17: 1.1m MT). Within Flat Steel products, growth in sales of galvanized coils stood at 24% outpacing increase in sales of cold rolled coils (CRC) remaining at 11%. As per industry estimates, demand is projected to grow at around 10%, going forward.

Table 2: Use of CRC products

Automotive	Motor cycle frame, fender, muffler, chain cover, fuel tank, rim, seat pan, shock cover, precision tubes, auto door panels, various members/pillars/ brackets etc.
Consumer Durables	Refrigerators, deep freezers, split a/c, washing machine, ceiling lights, tube lights, ceiling fans, bracket fans, exhaust fans.
Others	Roof and wall systems (industrial, commercial, and agricultural buildings) steel racks, structural members, corrugated sheets or profiles for roofing, telecom towers, shelters, filters and tubes etc.

With both local players operating at near full capacity, shortfall in supply in order to cater to growing demand was met through imports. Despite increased duty protection and full year impact of anti-dumping duty (ADD) imposed in 3QFY17, imports continued to be sizeable in FY18 and recorded an increase of 34% in FY18. Imports of CRC have primarily been from China, Ukraine and Russia. ISL and ASL recorded volumetric sales growth of 10% and 1%, respectively.

Table 3: Industry sales data

Flat Steel Industry	FY16	%	FY17	%	FY18	%
CRC Sales (MT)						
ASL	181,259	27%	214,313	36%	217,045	33%
ISL	124,010	19%	190,629	32%	194,000	30%
Imports	359,000	54%	183,000	31%	240,000	37%
Sub-total	**664,269**		**587,942**		**651,045**	
HDGC Sales (MT)						
ASL	-	0%	-	0%	-	0%
ISL	240,528	47%	300,375	59%	346,000	54%
Imports	270,000	53%	212,000	41%	290,000	46%
Sub-total	**510,528**		**512,375**		**636,000**	
Total Flat Steel						
ASL	181,259	15%	214,313	19%	217,045	17%
ISL	364,538	31%	491,004	45%	540,000	42%
Imports	629,000	54%	395,000	36%	530,000	41%
TOTAL	**1,174,797**		**1,100,317**		**1,287,045**	

Duty Structure

Regulatory Duty

Local players importing HRC under SRO 565 enjoy a 5% duty advantage compared to CRC imports from countries where a Free Trade Agreement (FTA) is in place with Pakistan. The advantage increases to 11% if imports are made from countries without a FTA with Pakistan.

Table 4: Regulatory Duty Structure

For Importers	With FTA duty		Without FTA duty	
Item	**Duty %**	**RD%/ADC%**	**Duty%**	**RD%/ADC%**
Hot Rolled Coils (Alloy Steel)	5%	12.50%	11%	12.50%
Cold Rolled Coils (Non Alloy Steel)	5%	5.00%	11%	5.00%
For Aisha Steel	**With FTA duty**		**Without FTA duty**	
Item	**Duty %**	**RD%/ADC%**	**Duty%**	**RD%/ADC%**
Hot Rolled Coils (Alloy Steel)	5%	12.50%	11%	12.50%
Hot Rolled Coils (Non Alloy Steel) under SRO 565	5%	0.00%	5%	0.00%

Anti-dumping duty

Domestic companies had filed cases with the National Tariff Commission (NTC) for the imposition of anti-dumping duties (ADD) on cheaper influx of imports. To shield the domestic industry from dumping, NTC has imposed a definitive ADD in the range of 13-19% on CRC and in the range of 9-40% on imports of Galvanized Coil from China and Ukraine for a span of five years. Given sizeable rupee depreciation, dumping margins have reduced on a timeline basis.

Table 5: ADD on Chinese and Ukrainian players

Country/Exporter/Foreign Producer	Definitive Antidumping Duty Rate (%)
China	
Shougang Casey Steel Company Limited	19.04
Shouganag Jingtang United Iron & Steel Co. Limited	19.04
Beijing Shougang Cold Rolling Company Limited	16.27
Handan Iron & Steel Group Han-Bao Co. Limited	13.17
Maanshan Iron & Steel Company Limited	19.04
All others	19.04
Ukraine	
Zaporizhstal Integrated Iron-and-Steel Works	18.92
Ilyich Iron and Steel Works of Mariupol	18.36
All others	18.92

Business Risk Factors

Pace of growth in volumes expected to slow-down in line with weaker economic growth and stressed economic indicators of the country

- Auto (motor cycles) and consumer durables segment has recorded growth over the last two years (FY17 & FY18) while construction activities have also picked-up pace with initiation of infrastructure projects under CPEC and introduction of affordable mega-housing schemes initiated recently. These segments have been major contributors to volumetric growth. However, going forward, JCR-VIS expects demand growth to slow down in the short-term in the backdrop of slower economic growth, increasing interest rates and sizeable current account deficit. This is also evident from dip in sales of auto assemblers in recent months.

Volatility in HRC and CRC prices is the single largest business risk factor

- JCR-VIS considers Flat Steel sector to be of high business risk given the significant volatility in HRC and CRC margins and threat of dumping. This is also evident from significant volatility in gross margins of both players over the last 8 quarters. HRC prices represent around 80%-85% of total cost of goods sold. With raw materials representing the major cost component and significant volatility in prices, efficient procurement and inventory management are critical to gross margins and profitability levels. During FY18, significant improvement in HRC-CRC margins supported gross margins for both ISL and ASL. Same has witnessed pressure during 1HFY19 but are expected to witness some rebound given the noticeable decline in HRC prices during recent months.

Quantum of imports expected to continue despite imposition of anti-dumping duty

- Despite regulatory duty protection, dumping from China and other countries where ADD has not been imposed continued to pose a significant pressure on profitability of local players. Industry players expect quantum of imports to witness a noticeable decline given the duty advantage and convenience for customers in case of procurement from local players. However, landed cost of imports is currently only slightly higher or even at par vis-à-vis local players.

Competition amongst existing players to intensify post expansion

- Currently, ASL only caters to CRC customers while galvanized coils are major contributors to ISL's sales thus limited competition exists currently. With ISL significantly increasing CRC capacity (already commenced operations in June'2018), Siddiqsons announcing new CRC capacity of 200,000 MT expected to come online in 4QFY20), and ASL entering into the galvanized steel segment, competition amongst existing and new players will intensify post capacity expansion. Price under-cutting in an excess supply scenario will create pressure on profitability.

Excess capacities coming online may necessitate tapping export markets

- Assuming imports volume to stand at 395,000 MT and annual demand growth of 6% (in line with sector growth being higher than historical GDP growth), capacity utilization levels will decline to 57% (FY22: 65%) in FY19 from 98% currently. Utilization levels may fall further in case of imports exceeding assumed level. Both industry players will look to tap export markets in order to improve utilization levels. Imposition of 25% duty on import of steel products into United States is expected to act as a challenge in this regard. Given the sizeable exportable surplus in steel producing countries, steel prices are expected to witness pressure going forward.

Table 6: Demand Supply Dynamics

	FY17	FY18	FY19	FY20	FY21	FY22
Demand	1,100,317	1,287,045	1,364,268	1,446,124	1,532,891	1,624,865
Imports	395,000	530,000	395,000	395,000	395,000	395,000
Demand - Ex Imports	705,317	757,045	969,268	1,051,124	1,137,891	1,229,865
Supply	770,000	770,000	1,700,000	1,900,000	1,900,000	1,900,000
Capacity Utilization	**92%**	**98%**	**57%**	**55%**	**60%**	**65%**

Rupee depreciation has increased working capital requirements and also increased expansion cost

- With sizeable depreciation of PKR against USD, domestic manufacturers faced the challenge of funding cost overruns in the expansion project through internally generated cash flows. Moreover, working capital requirements have increased which along with higher benchmark rates will increase finance cost for CRC manufacturers.

Gas price increase may likely impact margins and profitability, particularly for ISL

- Recently, the ECC has accepted the proposal to increase gas rates across the board on all segments. Consequently, gas sale price for general industrial and captive power shall be increased from Rs. 600 to Rs. 780/MMBTU reflecting an increase of 40%. The impact of the aforementioned will be comparatively higher on ISL given its captive power plant operating solely on gas. ASL purchases power from KE.

Financial Profile

Improvement in financial profile of both flat steel producers during FY18 is a function of improved capacity utilization, sales and higher gross margins. Going forward, JCR-VIS expects profitability to decline in FY19 given the lower margins as compared to FY18 levels, pressure on volumes and higher finance cost with increase in interest rates and growth in quantum of borrowings on the back of debt draw down for expansion. The pressure on margins is evident from the financial results of 1HFY19.

With an increase in profitability and cash flows (cash flows tend to be better than profitability due to sizeable depreciation charge), liquidity profile has showcased improvement. ISL has healthy cash flows in relation to outstanding obligations while ASL's cash flows (42% growth in FFO in FY18) are now adequate for debt servicing given improvement in cash flows and the extended repayment period that the company enjoys. Despite high retention of profits by both players, gearing ratio remains on the higher side due to significant increase in short-term borrowing of both players.

Table 7: Financial Indicators

Rs. In m	FY14	FY15	FY16	FY17	FY18	1QFY19*
Company Name	**International Steel Limited**					
Rating	**A+/A-1**					
Net Sales	21,291	17,938	20,492	33,733	47,621	11,232
Gross Profit	2,248	1,485	2,906	5,906	7,573	1,619
Gross Margin	11%	8%	14%	18%	16%	14%
PBT	874	236	1,654	4,609	5,803	1,142
PAT	690	202	1,179	3,044	4,365	841
Net Margin	3.2%	1.1%	5.8%	9.0%	9.2%	7.5%
FFO	1,007	559	1,916	5,413	7,240	1,475
Short Term Debt	4,876	4,069	3,524	5,039	8,462	13,770
Long Term Debt	3,751	6,591	4,744	4,818	7,970	8,000
Total Debt	8,627	10,660	8,268	9,858	16,432	21,771
FFO/Total Debt	12%	5%	23%	55%	44%	27%
FFO/LTD	27%	8%	40%	112%	91%	74%
Leverage	2.13	2.72	2.24	2.34	2.18	2.90
Gearing	1.66	2.14	1.34	1.30	1.51	2.09
Dividend Payout %	63%	0%	46%	50%	45%	0%
Stock in Trade	3,667	4,438	5,314	9,538	14,133	19,320
Trade Debts	1,186	362	521	764	645	397
Total Liabilities	11,109	13,545	13,842	17,817	23,768	30,196
Total Equity	5,206	4,978	6,168	7,600	10,883	10,424

** Ratios Annualized*

Rs. In m	FY14	FY15	FY16	FY17	FY18	1QFY19*
Company Name	Aisha Steel Limited					
Rating	A-/A-2					
Net Sales	9,259	9,492	9,634	14,076	18,904	3,091
Gross Profit	59	41	980	2,087	3,314	499
Gross Margin	1%	0%	10%	15%	18%	16%
PBT	(409)	(1,488)	(192)	882	1,916	156
PAT	(347)	(1,211)	(155)	1,020	1,284	121
Net Margin	-3.7%	-12.8%	-1.6%	7.2%	6.8%	3.9%
FFO	(1,358)	(988)	204	1,426	2,028	268
Short Term Debt	3,369	3,876	3,870	2,435	5,045	9,204
Long Term Debt	5,504	5,618	5,827	5,289	5,390	6,047
Total Debt	8,873	9,494	9,697	7,724	10,435	15,251
FFO/Total Debt	-15%	-10%	2%	18%	19%	7%
FFO/LTD	-25%	-18%	4%	27%	38%	18%
Leverage	7.22	5.18	5.59	2.10	1.72	2.32
Gearing	4.66	3.92	4.27	1.41	1.51	2.16
Dividend Payout %	0%	0%	0%	0%	0%	0%
Stock in Trade	3,347	2,434	2,814	3,716	4,312	6,561
Trade Debts	192	76	77	152	105	436
Total Liabilities	13,746	12,526	12,697	11,484	11,935	16,384
Total Equity	1,905	2,420	2,273	5,476	6,933	7,066

** Ratios Annualized*

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