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Weak steel demand and overcapacity are squeezing steel prices, writes **Thomas Biesheuvel**

ArcelorMittal stuck between behemoths

LAKSHMI Mittal, whose $46bn takeover in 2006 created ArcelorMittal as the world's largest steel maker, is getting pushed around.

The UK's richest person can't stop his iron-ore suppliers from raising prices and can't pass on higher costs to customers like Volkswagen, after the Luxembourg-based company's market value fell to its lowest since 2009. The company's stock slid to a record low last month and yields on debt issued this year are close to their highest relative to benchmark bonds.

Even after years of consolidation, today's five biggest steel makers including ArcelorMittal and South Korea's Posco control no more than 19% of the $960bn global market, too little to defend their prices. In contrast, BHP Billiton, Vale and Rio Tinto mine about 63% of iron ore exported as the main ingredient in making steel, while the five biggest car makers that buy ArcelorMittal's steel make about 51% of the world's cars.

"They really are between two behemoth industries," Tim Cahill, an analyst at J&E Davy in Dublin, says. "They are just one cog in a chain between suppliers and customers...."

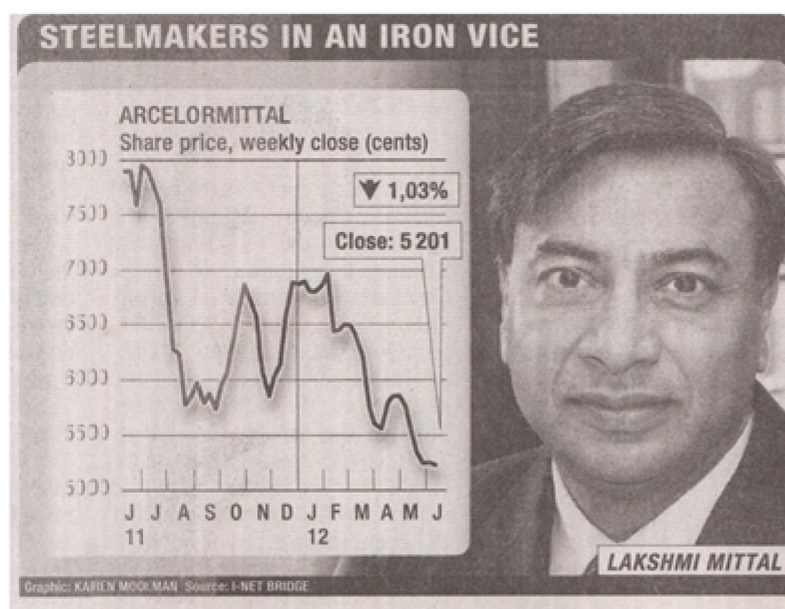
ArcelorMittal reported an operating margin of 5,2% last year, compared with 49% at Vale, the world's biggest iron-ore exporter. The steel company's €500m of 4,5% bonds due in 2018 yield about 375 basis points more than benchmark German government debt. The gap was at a record 387 basis points last week.

ArcelorMittal is fighting to increase its market share from 6,2% last year as the industry faces a 1,8% earnings growth forecast in the next 12 months. That compares with an average 6,7% among Europe's largest 500 companies.

Mr Mittal has seen his market share eroded by the financial crisis, slipping from 9,5% in 2006, when he created a steel maker with $88,6bn in annual sales. ThyssenKrupp said last month its earnings were being curbed by intense competition.

Global steel capacity use is about 80%, according to Macquarie Group, a level too low to give steel makers pricing power. Growth in world demand this year is forecast to slow to 3,6% from 5,6% last year, and in Europe there may be a 1,2% contraction as the sovereign debt crisis saps purchases.

"We are still suffering from the party hangover from the 2005 to 2008 years," Christian Georges, an analyst at Olivetree Securities, says. "It was a once-in-a-lifetime situation where the steel suppliers had the upper hand on desperate buyers," he says.



ArcelorMittal "gives one the impression that there is a relatively high degree of consolidation", Mr Georges says. "The truth is that one big guy can't change the logic of the industry. What does change it is when you have an oligopoly of three or four guys."

Under Mr Mittal the company cut output about 20% from the 116-million tons produced in 2007, while Chinese mills have more than doubled volumes since 2004 to 684-million tons last year.

Global steel sales totalled about $960bn in 2010, according to a report by Research & Markets, a Dublin-based research company.

Rio Tinto, Vale and BHP posted record operating profit last year, driven by earnings from their iron-ore units. Steel makers have struggled to adapt to changes in raw-material pricing introduced two years ago as mining companies ended a decades-old system of annual contract talks in favour of quarterly accords or spot pricing.

That means steel makers have lost the ability to negotiate the price of their biggest cost base, eroding margins as too much steel-making capacity and competition for sales makes it difficult to pass on cost increases to their customers.

"There's no doubt that having three guys controlling the world's low-cost iron ore means that they have the upper hand," says Mr Georges.

To be sure, ArcelorMittal has focused on buying and building its own iron-ore and coal mines to reduce dependence. The company plans to produce 100-million tons by 2015, up from 54-million tons last year.

"Steel production is essentially a conversion business now, and the days when raw materials made up only 30%-35% of costs, compared to 75%-80% now, are long gone," Macquarie says. Given weak demand and overcapacity, "the coming months and even years are set to see relatively tepid price action and thin margins". *Bloomberg*