ARCELORMITTAL SA

Bending to the pressure

An array of problems puts the squeeze on Amsa's margins

Steelmaker ArcelorMittal SA (Amsa) has attracted attention because of a controversial black economic empowerment deal and a dispute over the pricing structure for its supplies of iron ore from Sishen Iron Ore. But these are just two of the problems the company has had to contend with over the past few years.

There have been many others, including steep increases in raw material costs, production setbacks, a slack domestic market, industry overcapacity, weak international steel prices, rising import competition and continuing investigations by competition authorities.

Like many other steel producers, Amsa has experienced a margin squeeze over the past year, but it was affected more than most because of local cost increases and the company's lower production and sales volumes. Over the past two quarters, it reported headline losses totalling R720m. For the year to December, it reported a R52m headline loss, compared with earnings of R1,4bn in 2010.

WHAT IT MEANS
> Margins should rise as production normalises
> A longer-term margin squeeze could continue

Its earnings could recover strongly in the first half of this year. CE Nonkululeko Nyembezi-Heita says earnings for the first quarter are expected to "improve significantly" due to production stability and higher sales volumes, though lower steel prices will reduce the benefits.

Analysts are also expecting a recovery. On the I-Net Bridge consensus forecast, the group could produce headline EPS of 418,7c in 2012, followed by growth of 45%, to 606,4c, in 2013. That gives forward p:e ratings of 14,8 and 10 over the next 12 and 24 months. But uncertainty about forecasts beyond the next two quarters must be particularly high.

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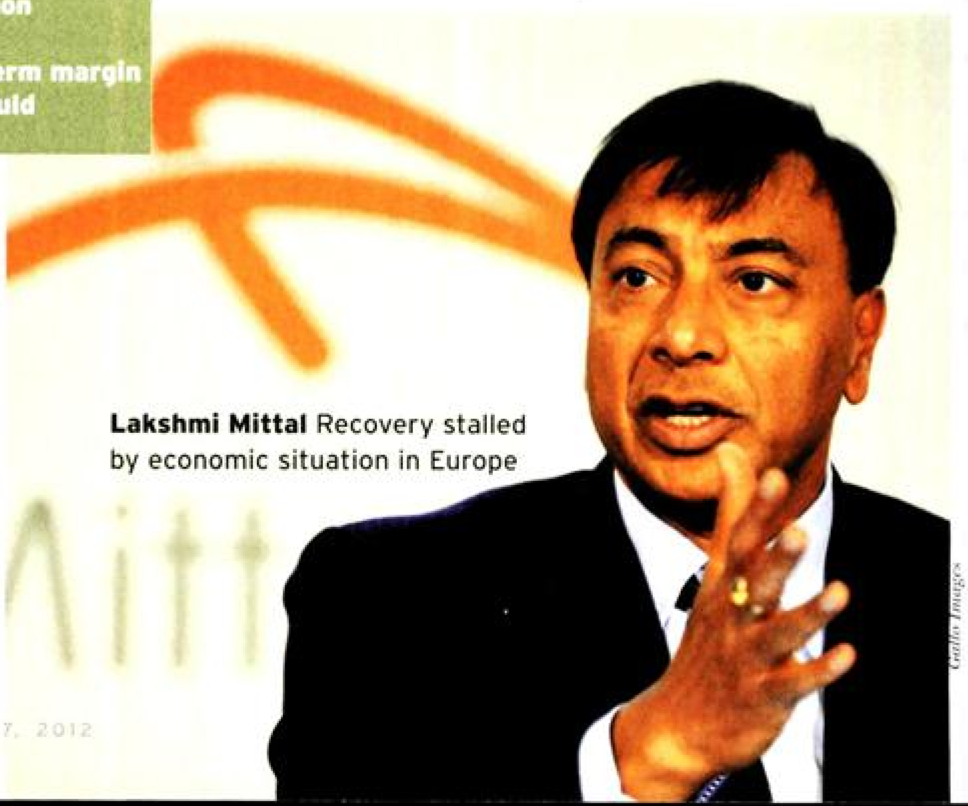
Costs of raw materials and other inputs are in a steeply rising trend, in real terms, and world steel prices are weak, with the outlook uncertain, due to industry overcapacity and the downturn in Europe. Conditions could improve as global growth continues, but for now the cost trend and limited pricing power seems reminiscent of the margin squeeze that has beset industries such as graphic papers in Europe (Sappi) and platinum.

Amsa's cost increases in 2011 are striking. In total, its main "cost drivers", in R/t, rose by 23%. The largest, coking coal and other fuels, at almost 29% of the total, increased by 25%. Iron ore and pellets, at 16,7% of the total, rose by 20%. Energy, mainly electricity, accounted for 8% of the main costs, after rising by 31%. Scrap and similar items was up by 73%. Most of these, other than efficiencies, were outside the company's control. Costs of transporting raw materials have also risen in real terms, as inbound freight increased by 11% and 18% for road and rail respectively.

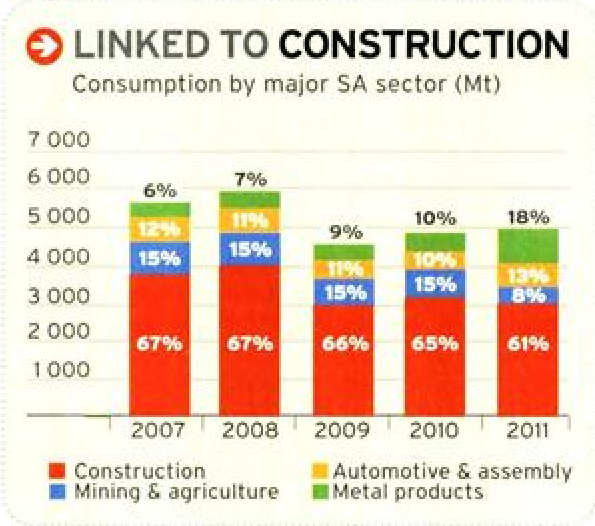
With the impact of other local costs such as high electricity tariff increases, Amsa's international competitiveness is slipping. A few years ago, says Nyembezi-Heita, it was ranked in the bottom quartile in the global cost and efficiency curve; it's now just below the median.

International prices of coking coal and iron have slipped from recent highs, which will provide some short-term relief, though these markets have also become more volatile, making planning more difficult for steelmakers, as large producers have moved from the traditional contractual pricing to quarterly and, now, monthly pricing. Miners such as BHP Billiton and Kumba Iron Ore have expressed confidence in long-term fundamentals for coal and ore, despite expected short-term corrections.

Steel prices have also fallen. When ArcelorMittal, the world's largest producer and Amsa's controlling shareholder, published results last week, chair-



Lakshmi Mittal Recovery stalled by economic situation in Europe



SOURCE: SAISI

man Lakshmi Mittal said the progressive recovery the group was experiencing was stalled by growing uncertainty over the economic situation in Europe.

In December, Edwin Basson, director-general of the World Steel Association, an industry body, said growth was expected to slow in 2012, "presenting the industry with more challenging market conditions". Risaburo Nezu, chairman of the OECD steel committee, said the steel market outlook was marked by "rising uncertainty"; steelmaking capacity was continuing to grow out of line with demand, raising concerns about supply and demand imbalances. A report on the global steel sector by Ernst & Young says successful steelmakers will need to become more nimble in their approach to changing market conditions.

"We are not yet calling steel a low-margin industry, but it is a concern," says Nyembezi-Heita. "The industry is in a difficult period, but it is a cyclical industry and it would be wrong to write steel off." Amsa's management is striving to secure raw material supplies, and improve internal efficiencies by drawing on resources in the ArcelorMittal group.

A return to more normal production levels this year should help lift Amsa's margins sharply. Its operational performance last year was hit by an unusual combination of events, including structural failure of the blast furnace dust catcher at its Newcastle plant, a planned 43-day stop to repair the corex tap-hole at the Saldanha plant, both in August; and chilled hearth conditions at blast furnaces in Newcastle and Vanderbijlpark early in the year.

Its sales of long steel products, which contributed about a third of its total steel sales in 2010, fell last year by 409 t, or 24%. Because of the shortfall, Amsa imported almost 200 000 t of steel on behalf of local customers. Capacity usage of plant making long steel products fell from 81% to 61%. Nyembezi-Heita says the company's sales to the domestic market could rise this year by at least 10%, depending partly on demand.

That, and the medium-term sales outlook, will depend largely on progress with infrastructure and related investment. Building and construction forms the largest component of domestic steel usage, at 61% (see graphic). Activity in the sector has continued to disappoint but should improve as work on new projects continues. President Jacob Zuma referred last week to other new projects, in rail and ports. These could also lift steel demand, when they occur.

On the consensus forecast, Amsa's share is rated a hold. Given the market uncertainty, it does not look cheap.

Andrew McNulty

TARNISHED PROFITS

	2008	2009	2010	2011
Revenue (Rbn)	39,31	25,60	30,22	31,45
Operating profit (Rm)	12 159	229	2 151	297
Headline earnings (Rm)	9 484	-440	1 377	-52
Headline EPS (c)	2 128	-104	343	-13
Market cap (Rm)*	39 427	45 913	35 313	30 569

* As at December 31

SOURCE: I-NET BRIDGE