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Caged in by the competition

Local firms are finding it difficult to compete in international markets

Industrial mining heavyweight and the largest steel producer on the African continent, ArcelorMittal SA's (Amsa) financial woes are indicative of how competitive the global steel manufacturing landscape has become.

There is about 10 Mt of steel capacity in the country but only 6 Mt-7 Mt was utilised in 2011. Amsa reported earlier this year that its capacity utilisation last year was only 71% for flat steel and 61% for long products.

The increase in energy costs and transport constraints have made it difficult for companies like Amsa to compete in international markets. There was also a surge in imported supplies, presenting serious competition for the local steel maker.

The group reported a dismal set of results for the year to December as a result of significant price escalations for raw materials and electricity, planned stoppages for repairs and the structural failure of the blast furnace dust catcher at Newcastle. This was further worsened by European economic concerns and the continued weakness in key steel consuming sectors.

Revenue increased marginally by 4% to R31,4bn, driven by a 12% increase in average net realised prices rather than higher volumes. Adjusted operating profit fell by 94% to R124m, as operating costs surged, with imported coking coal, pellets, iron ore, scrap and electricity costs increasing by double digit figures. Ultimately, a headline loss of R52m was recorded compared with R1,4bn the year before. No final dividend was declared either, while cash generation remained poor due to a working capital increase of R2,8bn.

"A major issue is that the industry's plants are old – the last new steel facility was Saldanha Steel, which was completed in 1998. When production problems cause supply disruptions, customers will turn to imports," Nedbank Capital Securities analyst Mohamed Kharva told the *FM* earlier this year.

Amsa CE Nonkululeko Nyembezi-Heita said in December she expected earnings for the first quarter of 2012 to improve significantly. Unfortunately, her prediction proved too ambitious with Amsa's first quarter update released in May rather disappointing. Nyembezi-Heita attributes the below par performance to a decrease in demand from local ferrochrome producers and international customers. She says input costs continue to exert pressure on operations.

According to the update the poor performance in output is with the exception of long steel products, which improved slightly due in part to Newcastle attaining full production in January, following its failure in August. Sales of long steel products on hand also increased marginally to steer the segment's overall sales upward. Realised prices for flat and long steel went up by 19% and 23% respectively.

Operating profit and net profit of R458m and R157m respectively is better than the R298m and R84m in the first quarter of 2011. EPS of 70c translated into 280c/share on an annualised basis. I-Net bridge analysts forecast 499c/share for the full year to December 2012.

Management has changed its tune in its outlook for the second quarter of the year, highlighting that earnings are expected to be substantially lower than the first quarter. This is due to a decline in domestic demand, softer steel prices, higher costs and a drop in commercial sales as a result of the shutdown by the ferrochrome industry during the winter months.

Robbie Tshabalala

Nonkululeko Nyembezi-Heita

Shihepo Kavambi, an analyst at Imara SP Reid, says management's view begs the question as to what will happen in the second half – but right now prospects are muted for the firm. "There are stocks in the resources sector with better visibility to which we would recommend investors to switch," he says.

Fellow bigwig in the industrial metals and mining sector is Kumba Iron Ore. It is

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TOP 12 INDUSTRIAL METALS & MINING

Ranked by net profit	Name	Net profit Rm	Total assets Rm	Market cap Dec '11 Rm	Equity funds Rm
1	Kumba Iron Ore .	13 636,0	27 379,0	169 418,9	9 378,0
2	ArcelorMittal SA . .	1 438,0	31 959,0	24 944,3	25 151,0
3	Palabora Mining .	658,0	6 573,0	7 634,9	1 790,0
4	Hulamin	42,4	7 302,0	2 426,0	5 495,3
5	BSi Steel	37,3	961,0	575,9	393,3
6	Metmar	28,4	1 272,0	604,3	533,1
7	Insimbi Refractory	9,3	247,0	174,2	37,5
8	Afr Eagle Res Plc .	-11,6	194,0	341,3	190,5
9	ZCI	-27,9	1 017,0	399,2	866,7
10	Ferrum Crescent . .	-59,9	62,0	149,4	-13,8
11	First Uranium Corp	-357,6	5 445,0	254,5	1 660,2
12	Evraz Highveld . .	-583,0	4 009,0	2 683,0	2 456,0

Source: McGregor BFA

also Amsa's legal counterpart in the suit against the department of mineral resources (DMR), regarding the granting of a prospecting right at Sishen to Imperial Crown Trading (ICT).

The court case was initiated by Kumba's subsidiary, Sishen Iron Ore Co (SIOC), to set aside the minister's grant of a prospecting right of 21,4% at the Sishen mine to ICT. This was after Amsa failed to apply to convert its share in line with the 2004 Mineral & Petroleum Resources Development Act. Kumba and ICT applied for it on the same day.

Amsa joined Kumba as an interested party in the case, arguing that since the law did not allow for "fractions" of rights, this was a single right in which both Kumba and Amsa had a partial interest. Kumba, however, took the line that after Amsa allowed its stake in the mine to lapse, Kumba could apply for it and secure sole control of the iron ore, with the freedom to sell it all at market prices.

For the past two years Amsa has been buying iron ore from Kumba on an interim pricing arrangement, which is higher than cost plus 3% and lower than market prices.

The North Gauteng court ruled in December that SIOC had a "sole and exclusive right" to mine iron ore and bauxite on the property. Amsa interpreted the judgment as a reinstatement of the group's rights to preferentially priced iron ore, but Kumba remains convinced that the contract lapsed and this judgment does not change that. The issue must still be decided through arbitration.

However, both the DMR and ICT have been granted leave to appeal against the high court ruling. SIOC was also granted leave to cross-appeal if the court is convinced by either the department of mineral resources or ICT to set aside the high court ruling. The supreme court of appeal hearing is expected only in the first half of next year.

Meanwhile, Kumba and Amsa have reached an interim pricing agreement with regard to the supply of iron ore to Amsa from the Sishen mine until the end of July.

Unlike Amsa, Kumba reported strong results for the year to December, benefiting from a weighted average export iron ore price increase of 26% and a 3% increase in volumes. Total revenue came in 25% higher at R48,6bn, while total mining revenue increased by 28% to R45,8bn. Adjusted operating profit grew 26% to R31,4bn, as increased volumes, higher average export iron ore prices and a strong performance from the shipping unit were marginally offset by increased operating expenses, as a result of mining volume growth.

A substantial increase in waste mining costs at Sishen and Thabazimbi, inflationary pressures and significant increase in the cost of diesel are other factors that had an effect. This was made even worse by the marginally strong R/US$ exchange rate.

Ultimately, headline earnings grew 19% to R22,3bn. A final dividend of R22,50/share was declared, 7% higher than the year before, bringing the total dividend up to 442c/share. Cash generation remained strong, supported by improved working capital management.

According to research company Independent Financial Research, the growth rate for steel materials is expected to moderate to a more sustainable level. This will be as a result of the introduction of monetary tightening measures to control inflation in emerging economies and the cooling down of China's industrialisation.

Kumba CEO Chris Griffith said in December he expects iron ore supply to remain tight in the short term. Also, ongoing challenges faced by producers in delivering new supply are expected to lead to increasing capital intensity and underpin the long-term pricing outlook. He said the group expects waste mining to increase at the Sishen mine. Annual production volumes at Sishen are also expected to increase back to design capacity.

Sales volumes are expected to be enhanced through the ramping up of the Kolomela mine, offset by the fact that excess finished product stockpiles at the Sishen mine have been depleted to operating levels. Domestic sales volumes remain dependent on the off-take requirements from Amsa.

Furthermore, Kumba's operating profit remains highly sensitive to the R/$ exchange rate and commodity prices. Management says it will focus on executing the group's strategy by optimising the value of current operations, capturing value across the value chain and delivering on the group's growth aspirations. **Ruan Jooste**