

Australian Steel Institute Address
by Kirby Adams, Managing Director and CEO, BlueScope Steel

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Title: Global steel industry: Is the perception the reality?

Introduction

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Good morning, and thank you for coming today.

It is four years since I first spoke to this Institute. So this occasion leads me to reflect on the dramatic changes we have witnessed in the steel industry over this period.

If we cast our minds back to the time of the Sydney Olympics, and recall the mood that shrouded our industry, who among us would have predicted that we would be sitting here today amid such optimism, such buoyancy?

Who would have expected our industry to inspire confidence in the investment community in such a short time?

It has indeed been a surprising and remarkable turnaround. Now, while it can be argued that such a shift in industry fortunes only enhances our sector's reputation for volatility, I believe that there is a strong case for a sustained positive outlook for the global and Australian steel industry.

In my roles at BlueScope Steel, and with the IISI, I have had the opportunity to make some observations, and draw some conclusions about trends in the global steel industry.

Of course, these observations are not exclusively mine. Ray Horsburgh and Bob Every are also involved with the IISI, and many others here have involvement overseas, in areas like importing, investment, exporting and so forth. I am sure you have all been thinking about the implications of the current situation.

I think we would all agree that while we sit here at the ASI, we are also part of the fabric of the global steel industry. Therefore, it is in all our interests to examine global trends, and draw our own conclusions about how these trends might impact on our particular businesses here in Australia.

So I am grateful to offer my observations on what is going on in our industry. I will try to put these trends in an Australian context, and I hope these ideas stimulate thinking and discussion among us all.

Two of the challenges faced by the steel industry have been to improve performance, and to attract investment. The first was necessary for the second.

Steel industry stocks have had amongst the lowest earnings multiples of companies on stock exchanges.

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Investors had seen our business as delivering poor long-term returns.

Factors such as volatility, relatively small size, and constrained liquidity have moved the steel sector to the fringe of the equity investment universe.

As we know, our industry had been characterised by poor returns, which were caused by structural issues.

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Our industry's historical performance had been inhibited by over-capacity, over-production, long term price decline, marginal pricing, price volatility and poor returns.

Factors such as low demand growth, fragmentation, and the others you can see here have driven poor returns.

So, in the light of the steel industry's history, how do we explain the recent dramatic increase in global steel prices?

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We might conclude that recent price increases suggest some degree of structural improvement.

Pricing is certainly the most tangible evidence of the new world in which steel finds itself.

But this graph of global steel prices also serves to remind us that tough times were not so long ago. We need long memories in our business.

So, if we reflect on our industry's history, then consider our current pricing situation, we are inevitably led to ask some questions.

1. Are we witnessing a sustainably higher performing steel industry?
2. Where will our industry go from here?

It is my opinion that there is a case for a sustained positive outlook in our industry. I think that current favourable conditions may prove to be long-lived.

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As I mentioned, poor returns have been caused by ongoing structural issues. So, if recent pricing suggests a structural improvement, we should ask ‘what has actually changed?’

During my recent travels to North and South America, and in my role with the IISI, I have had a number of conversations about this issue. I think there are six factors that explain the recent transformation of our industry. Considered together, these factors may make a case that changed conditions in the global steel industry will persist for some time.

Here are those six factors:

- Global economic growth
- Demand for steel as a material
- China
- Industry consolidations and alliances, along with privatisations
- Increases in input costs
- Changing patterns for new capacity

(i) Global economic growth

The first factor that has supported recent pricing upswings is the outlook for strong global economic growth.

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The consensus view of the IISI is that, for the remainder of the decade, global economic growth is expected to be positive. And at the present time, growth is particularly strong.

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Importantly, we are seeing synchronised economic growth in the world’s major regions.

This graph shows the concurrence in growth between US, Europe and Japan. Such simultaneous growth has not occurred for a long time. So you might say that the world is firing on all eight cylinders.

In my recent discussions with leaders of the global steel industry, they have all shown a degree of optimism about their domestic economies.

Material demand is strong and not confined to the steel sector.

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Importantly, growth is not confined to the OECD. We all know that China is growing strongly, but we are also seeing strong activity in emerging economies. The forecast for India, Russia and Brazil is also positive.

The shift of the Russian economy has had significant effects on the supply of metals.

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And here in Australia we see a continuation of the extremely good, consistent economic performance we've shown since the early 1990s. The last 14 years of economic growth are being reflected in current interest rates and a 23 year low in unemployment. This is flowing into investor confidence, particularly for building and construction.

So we have strong, and importantly, synchronised growth across much of the world, and here in Australia we are part of it.

(ii) Demand for steel

The second factor to consider is demand for steel.

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Looking again at IISI figures, we can see the base case for international steel consumption over the next 3 years, with a forecast for 2010, and compare this to the amount that China will consume over the same period.

Briefly, in 2003, China's share of world steel consumption was 27%. By 2010, this is expected to rise to 35%. At the same time, demand growth is expected to remain strong in the rest of the world.

So we're seeing real growth in the world steel market because demand around the world has increased. And while this reflects the underlying economic activity, it can also be seen as evidence of the success steel has had in taking intermaterial market share.

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We might ask ourselves: 'is this a blip in demand?' It is interesting to consider the last time the world experienced synchronised economic growth. This was before the oil price crash of 1973. Preceding the crash was a sustained period in which steel demand, driven especially by Western Europe and Japan, was growing strongly. Could we be seeing a return to such long-term high growth trends?

With oil today priced at over \$40 per barrel, we might ask whether we are seeing signs reminiscent of 1973.

The push from China and other emerging countries today is creating a similar pattern to that caused by the emergence of Japan and Korea, and the rebuilding of Europe in the post-war period prior to 1973.

Note also the 200 million tonnes consumed by the former USSR and Eastern Europe in the 1980s (shown in pink on the chart) – could this occur again?

As an industry, I believe we are succeeding in building new applications for steel, and continued effort in R&D should lead to more innovation, and more new applications.

A good example of industry focus is the IISI project that aims to increase the use of steel in construction applications.

We are driving our products into new applications, and creating a consequent increase in demand. Increasingly, steel's recyclability is widely recognised.

The astute marketing of steel has also helped to make steel fashionable.

Australia and New Zealand have helped to lead the way in many of these advances.

(iii) China

The third factor affecting the steel business is China.

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At the top of this slide, there is a prophetic quote from Napoleon: "Let China sleep, for when she wakes she will shake the world". I'm sure that many of us now feel that the giant is indeed awakening.

The next couple of charts talk to the sharp increases in production in China, as well as in total imports. China now accounts for massive proportions of consumption and production, with demand outstripping Japan, Korea, and the USA combined.

Of course, this enormous growth in Chinese consumption over the past five years has been a major factor in the industry's improved fortunes world-wide.

Despite the recent growth, there appears to be plenty of 'headroom' in China.

In fact, China may only be reaching the 'take-off point' in steel consumption. At BlueScope Steel we have somewhat of a vantage point from which to view China - although China accounts for less than 5% of our overall sales. We, as an organisation, are optimistic regarding China's continuing demand for steel and other materials.

I also believe that recent indications that the Chinese administration is keen to rein in the rate of growth in China will prove to be healthy for China and for the steel industry. We welcome a move from recent growth rate levels of 9-10% to a more manageable 6-7%.

To put China's growth in perspective - current forecasts assume a 7% growth in demand, but growth rates between 2000 and 2003 were actually a compound 24 percent.

We need to be aware of the speed with which China can expand its own capacity.

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This slide shows estimated steel capacity expansion in China. It is predicted that China will make 267 million tonnes of steel by 2006. More than 50 Port Kembla Steelworks.

Will China quickly become a large steel exporter? No – I don't think so. China will be constrained by global costs and availability of iron ore, coal, scrap and transportation.

My prediction is that the exports we will see from China will be of finished manufactured goods, many of them – hopefully – produced inside BlueScope Butler buildings.

(iv) Industry consolidation and alliances.

The fourth factor is industry consolidations and alliances and also privatisations.

Governments, thankfully, have been progressively getting out of steel mill ownership. Private capital rates of return are now required.

Consolidation, in my opinion, has enabled the industry to deal with financial legacy issues and improve its cost position.

We have seen other industries become revitalised by consolidation. Aluminium and oil in the 1990s are cases in point.

Steel has only recently emerged from the national identity paradigm of the last century, where every country wanted at least one major steel company.

Governments no longer see this as a priority.

Europe has led the way in steel industry consolidation, while there have also been consolidations in the USA and North Asia. A next phase might see large-scale consolidations in China.

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This slide of the production share of the top 3 steelmakers in each region, shows the reduced fragmentation of the steel industries in the USA, Europe and Japan.

The significant industry rationalisation that has occurred in USA, Japan and Europe has been very positive for the industry's state of health. There has been a real focus on change management and on generating returns on capital.

The steel industry has also benefited from the formation of alliances.

Partnerships within the industry are assisting in demonstrating and creating the scale required to attract capital and giving our customers the steel solutions and level of specialisation they need.

Cross regional alliances and acquisitions have also occurred, resulting in the emergence of steel companies with over 40MT capacity. I predict that within this decade we will see at least two companies emerge with capacity of greater than 100MT.

I think we have become a far more rational, informed and disciplined global steel industry.

Consolidation is leading to a greater ability and willingness to flex production as demand levels change. The steel industry today is more market responsive.

However, we remain significantly disadvantaged in the face of our consolidated and powerful raw materials suppliers.

(v) Increases in input costs

The fifth factor is increased input costs

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Scrap markets dramatically demonstrate the trend. This graph is representative of the pattern of scrap markets around the world.

There is a finite amount of high quality ready scrap, and scarcity has driven quite remarkable pricing levels.

It is notable that scrap prices have already come off from the peak levels of a couple of months ago, as some customers have found it simply uneconomic to purchase and convert at the peak levels.

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Input costs for the major steelmaking raw materials have exploded, reflecting the pricing power of raw material suppliers, and limited supply in the face of rising demand from the steel industry.

A recent USA report said that, since 2002, raw material and energy costs for integrated mills have risen by between 53 and 74 percent, depending on the level of integration.

The price of scrap is just one factor that has caused mini-mills to experience raw material and energy cost increases of between 116 and 119 per cent.

A few months ago at IISI, I/we initiated a major global report on raw materials and freight costs, and the Working Group reported back at our Executive Committee meeting in Rio in April. The next chart is just one example of the work of that Group, which developed some very interesting insights and conclusions.

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A number of factors explain the explosion in raw material prices.

The first is the stronger demand we have just been discussing.

Another is that new capacity for these materials cannot be switched on overnight.

Demand has just hit practical capacity limits in many markets, as this slide demonstrates with respect to seaborne iron ore capacity.

Seaborne ore demand is forecast to rise to 709 million tonnes by 2010. You'll notice this is driven almost exclusively by China.

If we were to review the various demand growth projections that were made for these materials over the past decade, it would be clear why suppliers had not been planning to bring on major new capacity.

And even though the suppliers are moving now, it will take some time for new capacity to be delivered.

Meanwhile, the consolidation of the raw material supply sector means that even when new mines come on-stream, suppliers may well endeavour to maintain pricing at quite high levels.

Clearly, too much of the rent of the global steel industry is heading in the direction of raw materials suppliers.

The long term health of the steel industry and its customers requires this to change.

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Shipping costs have risen in an even more extreme manner.

The capacity of the global shipping fleet has not increased in line with demand.

And there has been a significant increase in port congestion. Available capacity is being wasted, sitting, in particular, at Australian coal-ports like Newcastle.

A lot of new ships will need to be built. The good news is that those shipyards will consume steel.

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In addition to scrap, pig iron, DRI, iron ore, coal and shipping, natural gas, fuel oil, coke, zinc, aluminium, and paint are also supply constrained, with high prices resulting .

Cumulatively, these represent major cost increases for the steel industry. Steelmakers are facing real inflationary pressures.

For downstream businesses in the steel industry, the prospect is that input costs of slab and HRC feed stock will remain very high.

These cost factor increases are likely to be structural and need to be reflected in the pricing of finished steel products.

(vi) Changing patterns for new capacity

Finally, the sixth factor behind the transformation of the steel industry is a changing pattern for new capacity.

For two decades, Electric Arc Furnaces have filled the incremental capacity void in the steel industry, but they can no longer keep pace. The high levels of scrap prices, and scrap availability, are major constraints, diminishing the cost edge that mini-mills once had. So we have seen EAF costs equalise with, or surpass, integrated plants.

Incremental 1-2 MT facilities cannot cater for increasing demand, while in western nations, major new 5MT+ integrated facilities face significant regulatory approval issues, so I think it is unlikely that we will see these new integrated facilities built in western nations at a rapid rate, if at all.

Also, in recent years the Western World has shown good supply side restraint– unlike the capacity explosions of decades past.

The reduction of uneconomic excess capacity, and discouragement of subsidies for new inefficient capacity, means we are seeing fewer headlines that say ‘protectionism,’ and ‘trade dispute.’

New capacity should only be built where there are strong growing markets, such as China and India. And the only role for Government subsidies is to assist with plant closures.

This makes economic sense, and it is likely we will continue to see the reductions in capacity in the OECD that we have seen in the USA and Europe, as well as in Russia.

Here in Australia, I believe the steel industry is healthy. We are importing around 20% of our steel needs, including products that we do not produce here. In total, we are exporting about 20 per cent of our production.

Conclusion

To sum up, we have looked at six factors that I believe are underpinning a transformation in the global steel industry. Once again, these are

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- Synchronised global economic growth
- Increased demand for steel as a material
- Ongoing growth in China
- Industry consolidations and alliances and privatisations

- Increases in input costs
- Changing patterns for new capacity

We've also looked at some of the circumstances behind each of these factors. My feeling is that they will not change in the short term. I think the outlook for the steel industry remains positive for some time.

What, then, are the implications?

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We should not expect a weak Chinese economy any time soon. A growth rate of around 6 -7% is still very strong and quite satisfactory, and will have economic benefits for other nations. We all stand to benefit from a strong and growing Chinese economy, and from the world's demand for our products.

Steel prices are likely to remain high for some time because of high demand, a demand supply tension not seen in 30 years , and sustained high input costs.

There will be pressure for the price of steel inputs to be passed on in finished product pricing. It is likely we will see structural change in the pricing of finished products.

In broader terms, we may also ask whether we are moving into an inflationary phase. Steel is one of a range of products, which includes oil, that have shown a sharp upward price trend.

At some point, these costs must be reflected in products pricing.

As for Australia and New Zealand, I think many aspects of our industry are admired by the rest of the world.

Our steel businesses are seen to work. They are among the most progressive and profitable in the world. Others look with some envy at our efficiency, productivity, cost competitiveness, and the new market applications we have developed.

Perhaps we lack scale, but even if our top three steel companies were one, the resulting organisation would not be all that large in world terms.

Therefore, I think the strategies we have all been pursuing - becoming niche players, focussing on new product segments and market development, and to improve our distribution channels, are all logical and appropriate business models for our local, and our regional, industry.

There is still much more to be achieved in the area of new applications, and we should continue to pursue this as a major goal.

The global steel industry is undergoing a transformation in its fortunes. The factors underlying this are real.

The perception may be that it is a temporary change. The reality is that there is a strong likelihood that this transformation is sustainable.

Close

So, to finish, I would like to thank the ASI for the opportunity to come here and discuss some of the trends I have observed during the course of doing my job.

As I previously said, there are many here who can offer their own understanding of the global steel business, and how it might affect us here in Australia.

For my part, I hope that my contribution to this forum will stimulate some thought, and maybe trigger a few lively discussions.

I also hope that this forum will lead you to insights that could help in your relationships with your own stakeholders.

That is the spirit in which I share these thoughts.

I thank you for being here, and for listening.