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Steel Sector Outlook

Expectations for the industry in today's economic context

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Following a massive global economic downturn, the steel industry is preparing for strong growth in 2010 and beyond. The industry's main challenge now is to meet increased demand while maintaining profit margins in the face of rising input costs. With the right strategies and processes, steel producers and distributors can better position themselves for today's rapidly expanding global markets.

Foreword

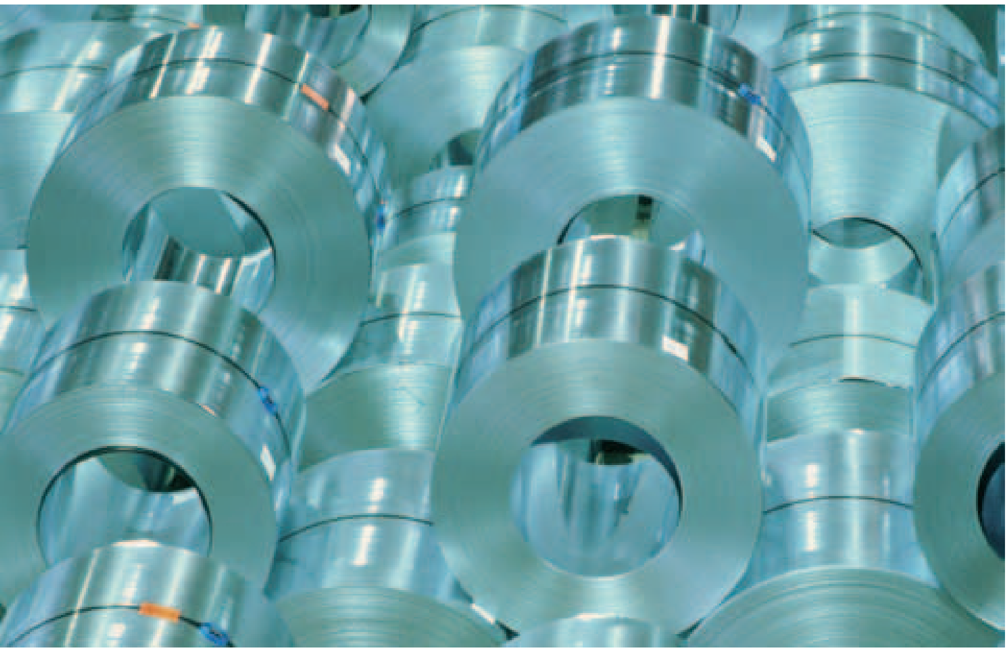
Two years ago, the steel industry was reeling from the sharpest economic contraction in over 75 years. By mid-2009, world steel output had declined by 21.3 percent compared with the first half of 2008.[1] Plant shutdowns and bankruptcies were not uncommon, and mitigating financial risk meant liquidating inventories.

The pace of contraction in steel production began to slow by the second quarter of 2009, and by 2010 output was returning to levels not seen since 2008. However, the speed of recovery has created problems of its own. Companies that reduced capacity and lowered their inventory levels during the global recession are now struggling to fill customer orders. At the same time, prices for iron ore, coal, and energy are rising, and this trend is expected to continue.

We can begin to build a comprehensive picture of the current and future state of the global steel industry by tracking and analyzing key indicators such as steel production and capacity levels, steel pricing, the state of merger and acquisition (M&A) activities, input prices, and new approaches to demand forecasting and supply chain management.

Mark Barrus
Global Head of Metals

[1] *June 2009 Crude Steel Production*, World Steel Association.



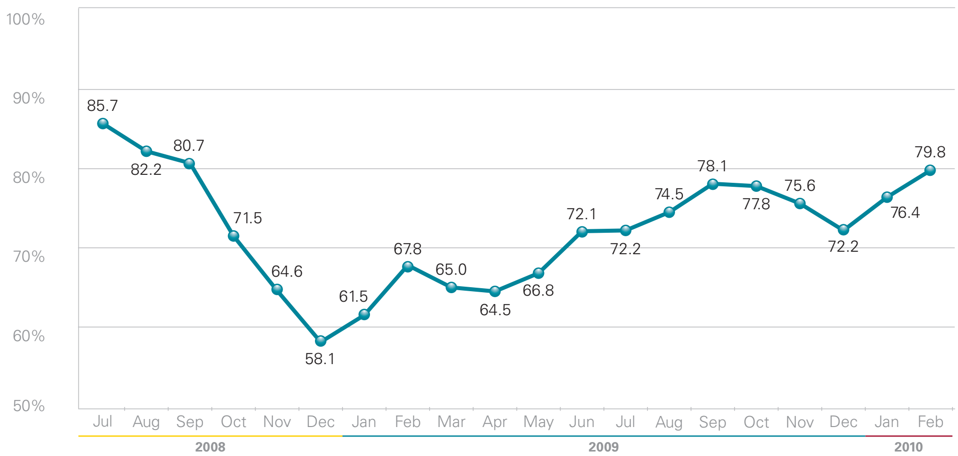
> "Companies can take greater advantage of today's changing environment by finding new ways to operate leaner, improving risk management in their supply chain, and developing new strategies to forecast demand more precisely."
>
> — **Mark Barrus**
> Global Head of Metals,
> KPMG in the US

Steel production on the rise

The severity of the recent global recession is reflected by the sharp decline in steel production worldwide between 2008 and 2009. Steel production dropped steadily through 2008, reaching its lowest point in the last quarter of that year, which was also the period when steel capacity utilization fell to 71.6 percent. In 2009, the total world crude steel output had dropped 8.0 percent compared to 2008.[2]

Early indications of a recovery began in the first quarter of 2009 when capacity utilization began to improve.[3] By the second trimester of 2009, the world steel capacity utilization rate had increased to approximately 75 percent. Total world crude steel production has also shown relatively steady month-on-month increases since April 2009.[4]

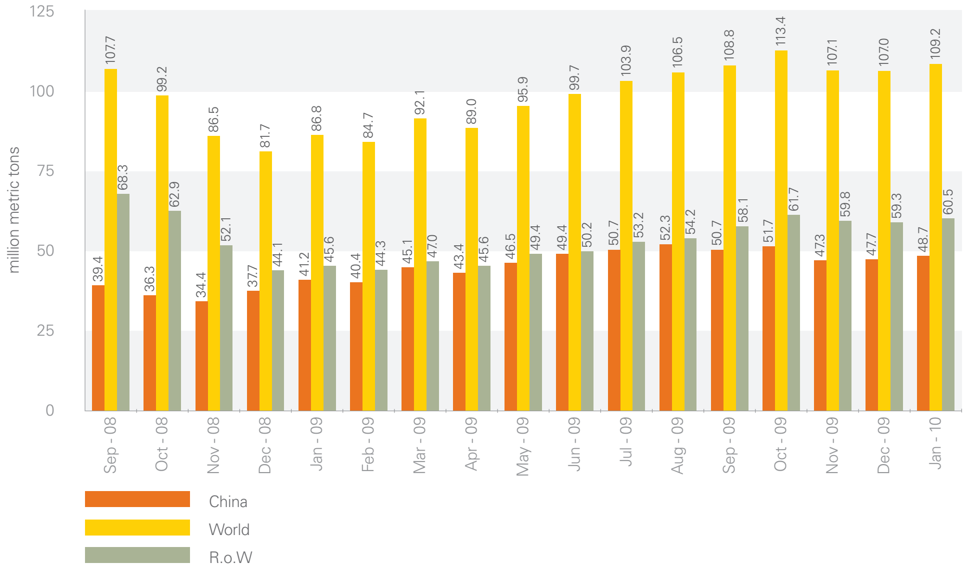
World steel capacity utilization ratio



Source: World Steel Association

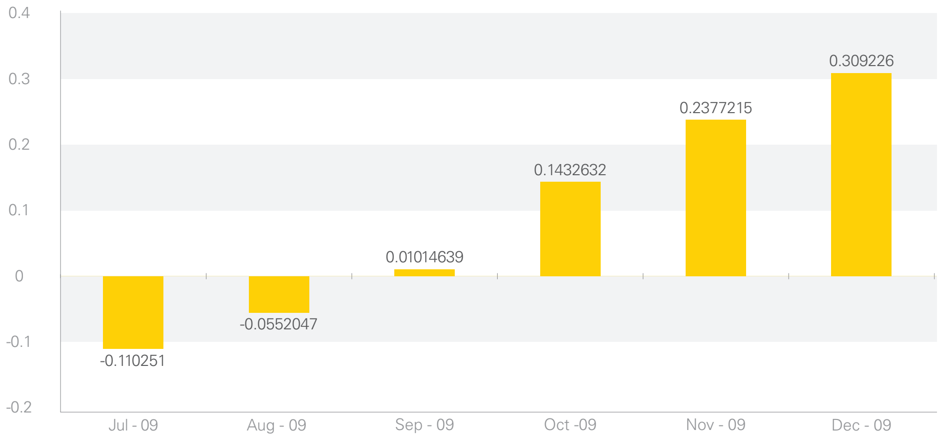
[2] *World crude steel output decreases by –8.0% in 2009*, World Steel Association News, January 22, 2010
[3] MEPS, quoted in *Steel capacity utilisation – the worst is over*, Steel Grips, July 16, 2009
[4] *September 2009 Crude Steel Production*, World Steel Association News, October 23, 2009

World crude steel production: Sept. 2008–Jan. 2010



Source: World Steel Association

World crude steel production: H2 2009, Year-over-Year



Source: World Steel Association

The global steel industry appears to be solidly in growth mode. On March 22, 2010, the World Steel Association reported that world crude steel production had increased 24.2 percent in February over the same month in 2009.[5] The outlook is positive worldwide. As we can see from the following table, this increase in global production is not confined to any particular country or region. The same report noted that the world crude steel capacity utilization ratio in February 2010 had climbed to 79.8 percent, the highest in 15 months.[6]

Global steel production: February 2010 over February 2009

Country	Production (Million Metric Tons)	Increase Year-over-Year
China	50.4	22.5%
Japan	8.4	54%
US	6.0	51%
South Korea	3.9	25%
Germany	3.4	34.3%
Brazil	2.4	47.9%
Italy	2.2	28.5%
Spain	1.3	35.8%
Australia	.5	89.6%

Source: World Steel Association

[5] *February 2010 crude steel production*, Steel Grips, March 22, 2010
[6] Ibid.

A balancing act: supply and demand

Against low inventory levels and increasing demand for steel products, producers are faced with the challenge of accessing raw materials and manufacturing finished products to keep pace with customer orders. In this environment, it becomes more important than ever to have a flexible and responsive supply chain to support the achievement of growth objectives. As various steel-intensive industries continue to recover, this will become increasingly critical to the success of steel businesses. According to Ian Christmas, Director General of the World Steel Association, Brazil, Russia, India and China, collectively the BRIC countries, will be significant steel consumers, accounting for some 60 percent of the global steel demand this year, compared to 58 percent in 2009 and 50 percent in 2008.[7]

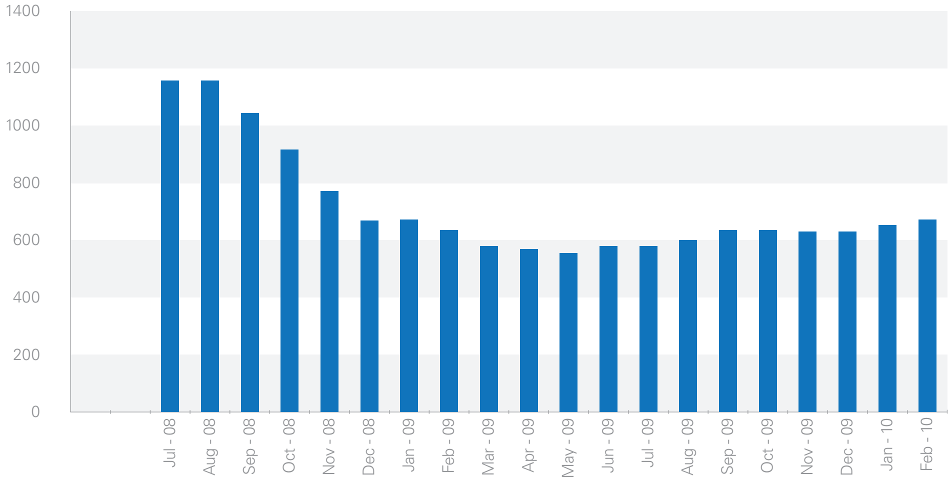
As an example of this, in its 2011 federal budget, India has allocated 1.73 trillion rupees to infrastructure development, a move that will "spur on steel demand," says Indian Steel Secretary Atul Chaturvedi.[8]

Getting to the bottom line: input costs and their effect on prices

Perhaps the greatest challenge facing steel producers and distributors is a sharp increase in costs for ore and coal that have not yet been matched by price increases for customers.

Steel prices have seen a gradual turnaround since the middle of 2009 when world steel prices rose for the first time in 11 months.[9] Since that time, price levels remained relatively steady in the first quarter of 2010, but as steel producers run down already low inventory levels and have to absorb rising input costs, prices are expected to increase.[10] These rising input costs can be attributed to the increased global demand for commodities, the capital investments required to access increasingly hard-to-reach commodities, and rising energy costs, among other factors.

Global composite carbon steel prices (US$/tons)

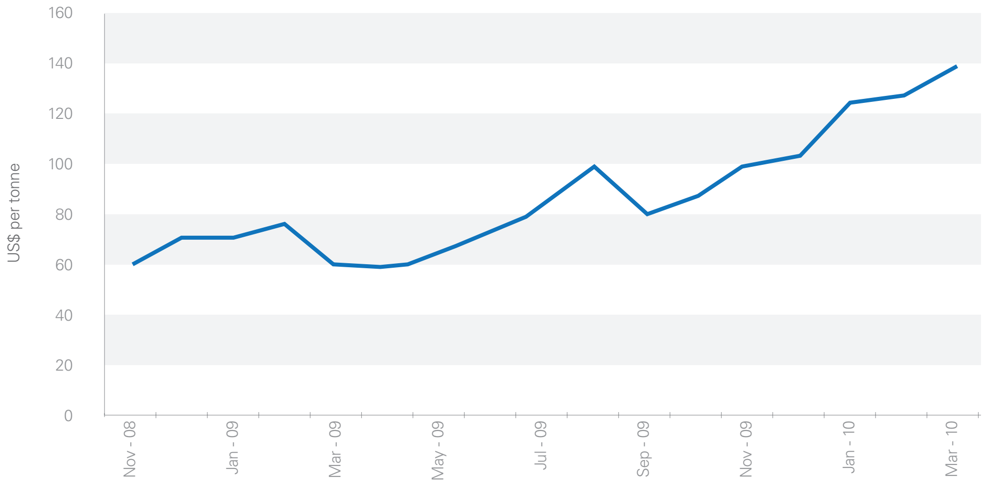


Source: World Steel Association

[7] *European steel demand to bounce 20% in 2010 – WSA,* Reuters, March 8, 2010.
[8] *New road funds to help lift India steel demand,* Reuters, March 3, 2010
[9] *World carbon price increase again in July,* Steel Grips, August 3, 2009.
[10] *Steel Prices to Gain on Low Inventories, Costs, Baoshan Says,* Bloomberg BusinessWeek, March 25, 2010.

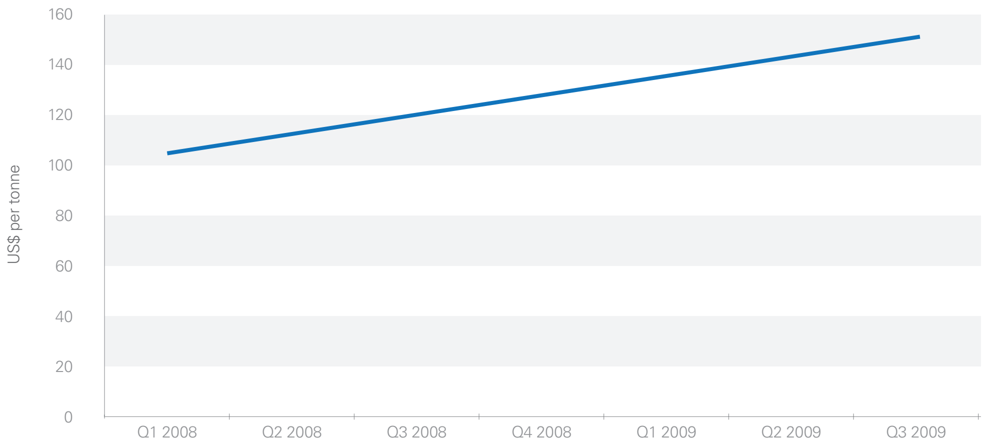
Steel producers in China, for example, are concerned about iron ore price hikes demanded by international mining companies, and the producers have asked the government for changes to the import licensing system.[11] Coking coal prices are expected by some analysts to rise to US$200/tonne, placing additional pressures on margins such that, as noted above, prices begin to reflect input costs and start to rise themselves.[12] This spread in metals pricing due to higher input costs and the limitations to passing along finished product price increases to consumers in a still weak global economy are critical issues for steelmakers.

Iron ore fines (62 percent iron) prices in US$/tons



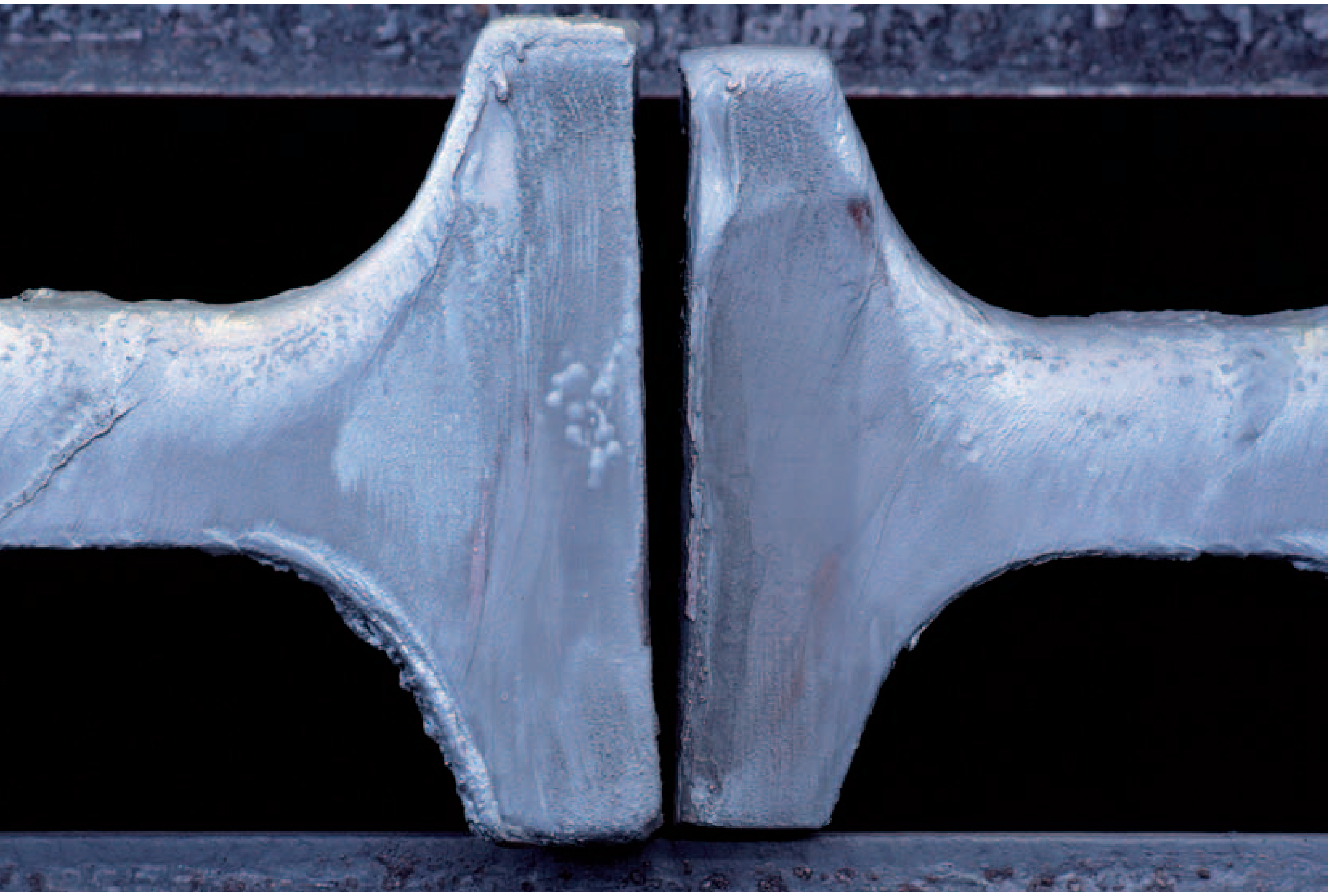
Source: Steelmaking Commodity Prices, Steelonthenet.com, accessed on March 29, 2010

Coking coal prices in US$/tons



Source: Steelmaking Commodity Prices, Steelonthenet.com, accessed on March 29, 2010

[11] *China facing huge iron ore benchmark hike – Wuhan Steel,* Reuters, March 7, 2010.
[12] *Macquarie sees Chinese coal price rising further in 2010,* Steel Guru, March 16, 2010



Growth prospects: M&A activity

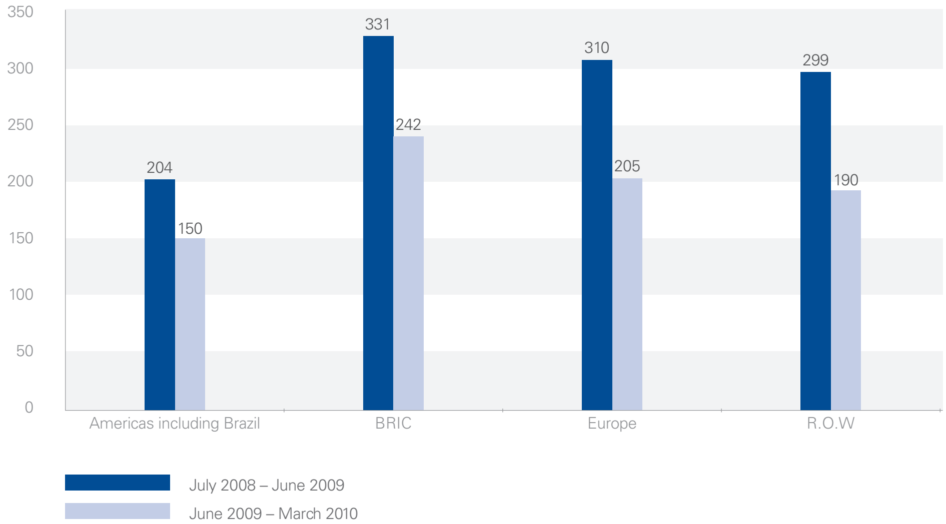
In the context of a recovering economy, increasing demand and a more productive steel industry, merger and acquisition (M&A) activity is a given. The Central Asia/Asia-Pacific region remains a major focus for deal activity, with China now the leading acquirer.[13] China's leadership recognizes that the domestic metals industry is still characterized by the prevalence of old, inefficient companies run by individual, provincial governments. The national government is, therefore, encouraging consolidation of these companies as a way to both increase efficiency and help meet China's huge demand for steel products.

In 2009, China imported 627.8 million tons of iron ore, raising the country's reliance on imported ore to 63.9 percent of its needs.[14] To help alleviate that dependency, Chinese companies are looking overseas for acquisitions that will ensure a more reliable supply of raw materials.

As an example, Chinese industry leaders such as Wuhan Iron & Steel and Shanghai Baosteel Group have acquired or made significant investments in Australian companies producing iron and coal.[15] In Brazil, the East China Mineral Exploration and Development Bureau has agreed to buy the Itaminas iron ore mine from its owner, Bernardo de Mello.[16]

[13] *Race for rare metal–and China is winning,* CommodityOnline.com, July 17, 2009
[14] *China near-term steel demand high, growth low,* China Daily, March 25, 2010
[15] *Australia Mining Report 1Q 2010,* Business Monitor, January 2010. See also table, "China M&A activity (completed deals)"
[16] *China Snaps Up Brazilian Iron Ore Mine For $1.2B,* Manufacturing.Net, March 25, 2010

Global M&A activity by geographical region



Source: Thomson SDC

China M&A activity (completed deals)[17]

Acquirer name	Target company – Raw material producer/supplier	Headquarters of target company	Transaction deal in US$ million	Date of announcement
Wuhan Iron & Steel Group Corporation (WISCO)	China Africa Development-Iron Mine	Liberia	68.46	March 15, 2010
Shanghai Baosteel Group Corporation	Aquila Resources Ltd.	Australia	240.49	August 28, 2009
Wuhan Iron & Steel Co. Ltd.	MMX Sudeste Mineracao SA	Brazil	400.00	June 8, 2009
Wuhan Iron & Steel Co. Ltd.	MMX Mineracao e Metalicos SA	Brazil	120.00	May 19, 2009
Wuhan Iron & Steel Group Corporation (WISCO)	Consolidated Thompson Iron	Canada	240.00	March 30, 2009
Lingyuan Iron & Steel Co. Ltd.	Linggang Grp Beipiao Baoguo	China	210.98	October 15, 2008

Source: World Steel Association

M&A activity can also support wider change management and performance improvement initiatives. One KPMG member firm client recently leveraged its acquisitions to streamline business operations and find efficiencies in its supply chain to generate substantial financial benefits:

- Overall plant capacity utilization increased by more than 20 percent
- Freight cost was reduced by over US$4.3 million.

[17] *Thomson One Banker* – Accessed on March 26, 2009

Case study

How effective business integration can help enhance the supply chain

Recently, a major steel manufacturer acquired four industrial products and building companies in order to gain stability and efficiency across the entire supply chain. Acquiring and integrating even one of these companies would present a challenge, but integrating four at the same time introduced a new level of complexity and management requirements.

The manufacturer turned to KPMG member firms for assistance with this massive project. Working closely with the steel manufacturer, KPMG professionals developed an integration program governance structure and a broad-ranging plan for the effective integration of the new assets into the existing operations. KPMG also helped analyze projected demand to help ensure that the new organizational structure put the right resources in the right places at the right times to meet customer needs. This comprehensive approach helped enhance the synergies between the business entities during the integration to generate value for the steel manufacturer.

The project implementation was designed around a comprehensive pre- to post-close integration plan and was divided into three carefully structured phases:

- **Phase One** began with preparatory planning and analysis to gain control of the integration program, mobilize the integration effort and develop senior leadership alignment around the goals of the project.
- **Phase Two** involved incorporating business cases by functional group, establishing tracking templates to capture the benefits of synergies and designing the future-state operating model to help control and stabilize the business transitions.
- **Phase Three** supported ongoing integration implementation activities as defined by the results from the preceding phases, as well as additional requests from the manufacturer.

Key client benefits

Based on this comprehensive plan, the manufacturer was able to integrate the companies in an efficient, well-coordinated manner that leveraged the assets of the newly acquired business units. Using KPMG-tested tools and methodologies that assisted in assessing and managing business performance, this company was able to meet or exceed its original synergy targets. Through the integration program, the steel manufacturer also benefited from substantial cost savings. It is estimated that overall plant capacity utilization increased by more than 20 percent and that freight cost was reduced by over US$4.3 million.

New strategies for a new economy

Steel companies can develop or adopt a number of approaches to take full advantage of today's opportunities and better position themselves should the progress of recovery slow or stall.

For example, companies can examine and enhance their forecasting systems to better anticipate product demand or materials requirements. This will help determine what products should be produced where, when and in what quantities to avoid having to carry high inventories. Forecasting accuracy and thoroughness can also be increased through the implementation of enterprise-level customer relationship management (CRM) systems. These systems can be used to develop a global outlook on customer demand that can help drive strategic planning and development. CRM data can also be integrated with financial information such as debt maturities, liquidity levels and cash-flow requirements to improve balance-sheet flexibility and working capital management for the company.

One of the key lessons being drawn from the events of the last 18 months has been to "expect the unexpected." To mitigate the impact of high oil prices, sudden currency fluctuations, and work stoppages due to economic, political and environmental upheavals, suppliers and manufacturers can develop strategic agreements or joint ventures that give increased stability to both parties. In the steel industry, access to raw materials is the critical hub upon which business continuity depends. Manufacturers can seek financing — which is becoming more readily available now — to acquire key suppliers, thereby gaining improved access to raw materials. Manufacturers can also enhance materials planning, purchasing and replenishment by developing supply policies that stipulate supply lead times, reliability, batch sizes and supply source.

KPMG member firms can help steel companies respond to rapid changes in the global steel industry with methodologies and services designed to help reduce risks in terms of financing, tax liabilities, supply chain development, project management and transitions to new products and markets.

We also have the insight and leading practices gained from our extensive industry experience to help steel companies identify new business opportunities that may improve their performance and overall competitiveness.

For more information, contact your local KPMG representative or visit www.kpmg.com.

"Forecasting systems can be used to develop a global outlook on customer demand that can help drive strategic planning and development."

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