TRADE & INDUSTRIAL POLICY STRATEGIES

POLICY BRIEF: 7/2020

COVID-19: The South African steel industry

INTRODUCTION

South Africa's economy was already weak at the start of 2020, coming from a technical recession and the forecasted low growth. The decision to lock down the country as part of the COVID-19 response to protect the health of the South African population has put further pressure on the steel industry. Depending on the length of the lockdown and the rate at which business and consumer confidence return, economic impacts could be less or more severe. This policy brief looks at the possible economic consequences of COVID-19 for South Africa's steel industry.

BACKGROUND

The current view in the steel industry, also illustrated in the PwC report[1] on the subject is the so called "U-scenario", with a sustained recession, return to previous gross domestic product (GDP) levels over several quarters, the overall growth of at least two full years being affected, and a postponement along, in part, with sustained restriction of investment and consumption. Based on the interpretation of the outcome modelled by the PwC economists, the impact of COVID-19 will influence the following steel-consuming sectors:

- Mining and quarrying – Negative
- Manufacturing – Slightly negative
- Electricity, gas and water – Very negative
- Construction – Very negative
- Transport – Very negative

The following conclusions from the economic modelling results are important to consider in the policy interventions:

- Key countries where South Africa will be exposed as a result of reduced export demand, that will need support in some form or alternative markets, include: China, Germany, United States, United Kingdom, and India, excluding countries in the Southern African Development Community (SADC).
- Key sectors where South Africa will be exposed as a result of reduced export demand that will need support in some form or alternative markets, include: platinum, gold, diamonds, iron ore, manganese ore, coal, vehicle exports, machinery and equipment exports, steel exports and fruit exports. The most lasting and damaging impact on the economy is likely to come from a lack of business confidence and the resulting reduction in business investment, in response to reduced consumer demand.
- Potential for job losses in the formal sector is significant. However, many more jobs in the informal sector are also on the line.

IMPACT ON THE STEEL INDUSTRY

The global steel industry is in a disastrous situation, far worse than anything experienced since the beginning of this millennium, with serious implications for domestic steelmakers. This time around the implications for the short, medium and long term are particularly negative.

In the short to medium term

Global steel prices are most likely to plummet to US$330 per tonne, free-on-board at the port of export, versus the US$505 per tonne at the beginning of the year. Furthermore, global steel production may decline by 13.3% to 1.63 billion tonnes, with China's forecast to be down only 6% to 940 million tonnes. China's steel production will account for an astonishing 58% of the world output.

The situation in South Africa could be even worse. Domestic steel prices, on an international parity basis, are poised for a significant fall while domestic steel consumption is expected to be below 3.3 million[2] tonnes for 2020 (26% cut), down from the 4.5 million tonnes in 2019, this as the major part of the forward order book is cancelled. The estimated steel capacity utilisation rate is now around 65% with negative contribution to the cost of production. The five-week lockdown is devastating, with an estimated accumulative negative cash cost implication around R1 billion inclusive of labour and fixed costs.

Trade & Industrial Policy Strategies (TIPS) is a research organisation that facilitates policy development and dialogue across three focus areas: trade and industrial policy, inequality and economic inclusion, and sustainable growth

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Specifically, and on a high level, the lockdown is disrupting demand in a market where demand was already weak and shrinking. However, more urgently, the loss of sales over the short term is impacting the cash flows of every industry in the supply chain.

Liquidity is the most significant issue that the steel industry is facing. Working capital is stuck due to lack of industrial activity. Non-payment by first-tier steel users is caused by their customers (second and third tiers) not paying, such as the construction companies, component manufacturers and mines. This lack of liquidity will force a spate of defaults and possibly some parts of the industry will not survive this crisis, not because they are bad businesses, but simply because the flow of cash dries up. Manufacturing companies integral to the supply chain of SA Inc. may not recover, which will have a longer-term impact on the competitiveness of some of sectors. **This area of cash flow and liquidity is critical for government to provide urgent support interventions.**

Over the medium to long term

Global steel in 2021 is expected to recover by about 6%, which is still 7% below the 2019 production levels of 1.87 billion tonnes. With steel production far below the global capacity levels, steel prices internationally will remain under severe pressure.

Domestic capacity use could fall to around 50% for long steel, with dwindling steel demand in the wake of poor business confidence levels. An extended recovery is expected, to the prior-COVID-19 industry performance levels, which will most probably only be realised beyond 2021 and with consolidation and restructuring on the agenda.

What will hold steel prices back?

- Steel buyers will hold orders back as they fear further price cuts and are apprehensive of their own demand outlook. The crisis is first and foremost a demand issue!
- Globally, steel mills have failed to cut back production fast enough as the magnitude of order cancellations was unexpected, leading to high inventories at the mills.
- A growing number of mills will seek to sell their excess inventory at extraordinary low prices to raise cash. Expectation that steelmakers' raw material costs will come down in Q2 will put further downward pressure on steel prices and further widen the cost of production gap between the scrap converters and the integrated steel mills.

[1] *The possible economic consequences of COVID-19 for South Africa*. PwC. April 2020.

[2] The estimation, based on discussions with downstream steel users and information from other steel markets around the world, is that South African steel demand in Q2 will be 50% of what it would have been without COVID-19 and the lockdown. While Q3 and Q4 may be stronger than Q2, they are still expected to be weak at 30%-40% lower than normal.

- Chinese and Russian steel mills will resume their low-price steel offering, especially Russia, given that the country was the lowest cost producer even before the devaluation of the ruble.

Plans for reopening

Given the problems in both the domestic and the export markets (for products other than medical/health), plans for reopening mean:

- After the lockdown, the steel mills can immediately start delivering finished goods which are already produced, awaiting delivery. The rolling mills will be restarted to transform work-in-process steel into finished products with a lag of around two days to stabilise the production process.
- Steelmaking is different: although electric furnace operations could be up and running within a week from lifting the lockdown, the restarting of blast furnaces and liquid steelmaking could have a longer response time and will depend on the demand seen from the market, based on both the market's appetite for finished goods and the forecast demand from the customers. The blast furnaces were idled to allow a flexible restart date.
- Some of the mini mills will require some emergency funding on reopening; however, consolidation/rationalisation will be required if the plants are going to reopen and be sustainable and this needs to happen quickly.

How do firms see recovery?

Feedback from the downstream steel fraternity is extremely pessimistic from both demand and cash flow perspectives.

- South African steel demand comes from a departure point of progressive weak demand due to a faltering economy. There was already insufficient demand to justify the fixed costs of the installed base of capability and jobs. Just as COVID-19 and the lockdown will reduce the GDP, the demand for steel will fall even further and even faster.
- Cash flow, always a concern, has been fundamentally disrupted, with many customers reporting that they cannot pay as they have not been paid. The treadmill of cash flows depends on this month's sales receipts being used to pay for last month's raw materials purchases. With no sales during the lockdown, the cash is not coming in to pay the bills.
- The mismatch between product/service supply and demand and the cash flow issues will accelerate the retrenchments or closure of companies whose balance sheet is not capable of dealing with the stress test caused by COVID-19.

The halting of steel production, even if only for one or two months, will have a significant impact on suppliers to the industry. Demand for services and consumables which are part of ongoing operations (for example the supply of refractory bricks) is zero when steel-production is halted. Many small and medium-sized companies that are part of the eco-sphere of a steel plant will suffer without ongoing production and some will close.

- Multiple local suppliers pose an opportunity for consolidation.
- Where there is just one local supplier against large international competition, this could be the end of domestic supply.
- In both the above, competitiveness decreases and the costs of steelmaking increase.

Have firms been able to continue operating?

Have some firms supplying essential medical and/or health products been able to continue operating, and if so would there be potential in growing the export market given the global demand for such items?

- Packaging companies are considered essential services because they are selling steel drums to transport alcohol used in hand sanitisers. Firms received steel in April to keep production running during the lockdown. One of the firms consulted has enough steel in stock to last through April and May. They are also active exporters in this market space.
- The export potential, from a steel perspective, has not yet been fully exploited and there might be potential not visible now. There are steel manufacturers looking into the supply of hospital beds and ventilators. The application of light steel-frame building techniques could help with the speedy erecting of buildings for the use of hospitals and clinics, especially in the rural areas.

Support for recovery

This section considers government support for the recovery different from Master Plan interventions, taking in specific remarks from industry players.

1. Liquidity and cash flow is the most significant area where government can support the industry. Such an intervention is urgent. A possible solution: the **IDC creates a temporary lending/bridging facility to provide payment-term relief** to customers of the steel industry, possibly administered by one of the industry bodies.

- This will allow steel mills to offer **extended payment terms** to customers of 60/90/120 days rather than the standard 30 days.
- This will allow South African-based manufacturing to weather the short-term impact to cash flows.
- A possible mechanism to unwind the credit could be a 5% repayment a month for next 24 months, with a payment holiday in December/January. Repayments could start in July 2020 or three months after the end of the lockdown.

2. The interventions need to cater also for large businesses with a turnover in excess of R50 million a year, as these businesses are not coming from a position of strength because of the difficulties the steel industry has encountered over the past 11 years.

3. The upstream steel industry needs exemption from the Competition Commission to work together to save whatever is possible to save.

4. Urgent action is needed from government to protect the manufacturing industry and keep capacity, which may need to include an immediate review of imports to prevent a flood of products into the market from countries that have opened up earlier, and have excess stock which is then dumped into South Africa's market.

5. Ready-for-dispatch export cargo for several companies is at the Port of Saldanha and Port of Durban. The products are ready to ship but Transnet, at the time of preparing this brief, was unclear if this cargo is part of the so-called allowed activities. The mines are all operational and, for example, chrome is exempted for exports, but value-added product ferrochrome is not allowed to be exported. Similarly, value-added coil products in cold rolled, galvanised and colour coated are waiting shipment. In addition, there are examples of vessels with imported raw materials bypassing Durban and Saldanha, and will only be allowed to offload in Walvis Bay. There are significant costs, time and logistics implications in bringing the cargo back to South Africa.

6. The lack of clarity on exports has further had cost implications for firms. A specific example from a firm interviewed was that it had a container train bring up 40 containers from Durban to Johannesburg. However, the firm was unable to load 40 export containers, to be stored for later export at a service provider in Durban, as this was refused by Transnet and the train returned empty to Durban.

7. Service providers at the ports report confusion and inconsistent practices when dealing with non-essential cargo, with some being allowed and others not.

8. The rand depreciation will have an impact on imports, with a reliance on local supply. If capacity is shuttered, or firms use their monopoly position, this could exacerbate problems in the industry.

9. The scrap smelters have reported that they are running out of scrap, and have stopped steel production over the lockdown period. The ramp-up is expected to be slow after the lockdown period.

10. The Master Plan process under way for the steel industry would need to be reshaped to ensure that it supports structural improvements for an industry that has been severely impacted by COVID-19.

Information for this brief comes from the following companies: SCAW Metals; Columbus Stainless; AMSA; SAFAL; Duferco Steel Processing; Pro-Roof; Agni SA/Coega Steels; and Macsteel.