market monitor

The steel/metals industry in:
The UK, the Netherlands, Australia, Japan, India and Russia

November 2011

Steel outlook good – on two conditions…

… and those two conditions, according to the World Steel Association, are, firstly, that dynamic demand from the world's developing economies continues and, secondly, that the EU's handling of its debt crisis calms the volatility in equity and financial markets. On these assumptions, the forecast is for global growth in steel use of 6.5% this year and 5.4% in 2012.

That's not to say that Europe's steel industry doesn't have its challenges. Steel production has decreased in H2 of 2011 as steel traders and customers are playing a waiting game: wary of buying more stock until the outlook becomes clearer. As this month's Market Monitor shows, in the UK and the Netherlands the problems are compounded by depressed demand from key consumers: notably the construction industry.

Up till now, the industry's saviour has been booming demand from China, and it is to be hoped that the Chinese government's measures to curb inflation don't overly depress that demand. As reconstruction work begins in Japan following March's tsunami and earthquake, a major beneficiary will be its steel industry. What's more, the recently announced merger of two leading Japanese steelmakers, Nippon Steel and Sumitomo Metals, will put the new entity in serious contention with global competitors like India's ArcelorMittal.

On the subject of India, its steel industry remains in good shape and, even though the World Steel Association has recently dropped its growth forecast for Indian steel, that forecast remains at an enviable 7.9% rate of growth. In contrast, Australia's steel industry struggles with subdued steel prices, high input costs and the strong Australian dollar.

Table: Apparent steel use (ASU)

Short range outlook for apparent steel use, finished steel products (2010-2012)

Regions	ASU, mmt			Growth Rates, %		
	2010	2011 (f)	2012 (f)	2010	2011 (f)	2012 (f)
European Union (27)	144.9	155.0	158.9	21.1	7.0	2.5
Other Europe	29.6	33.0	34.8	24.0	11.3	5.7
CIS	48.6	55.6	59.8	34.5	14.4	7.5
NAFTA	110.9	120.9	126.8	32.8	9.0	4.9
Central & South America	45.6	47.8	52.4	35.2	4.7	9.8
Africa	24.5	21.4	23.8	-8.9	-12.7	11.0
Middle East	47.6	50.0	53.9	14.6	5.0	7.9
Asia & Oceania	860.6	914.0	963.1	11.1	6.2	5.4
World	1 312.4	1 397.5	1 473.6	15.1	6.5	5.4
Developed Economies	372.7	392.9	403.0	24.4	5.4	2.6
Emerging & Developing Economies	939.6	1004.6	1 070.6	11.8	6.9	6.6
China	598.1	643.2	681.6	8.5	7.5	6.0
BRIC	725.0	777.4	827.1	11.1	7.2	6.4
MENA	61.5	61.0	66.3	5.5	-0.9	8.7
World excl. China	714.3	754.3	792.0	21.3	5.6	5.0

Source: World Steel Association

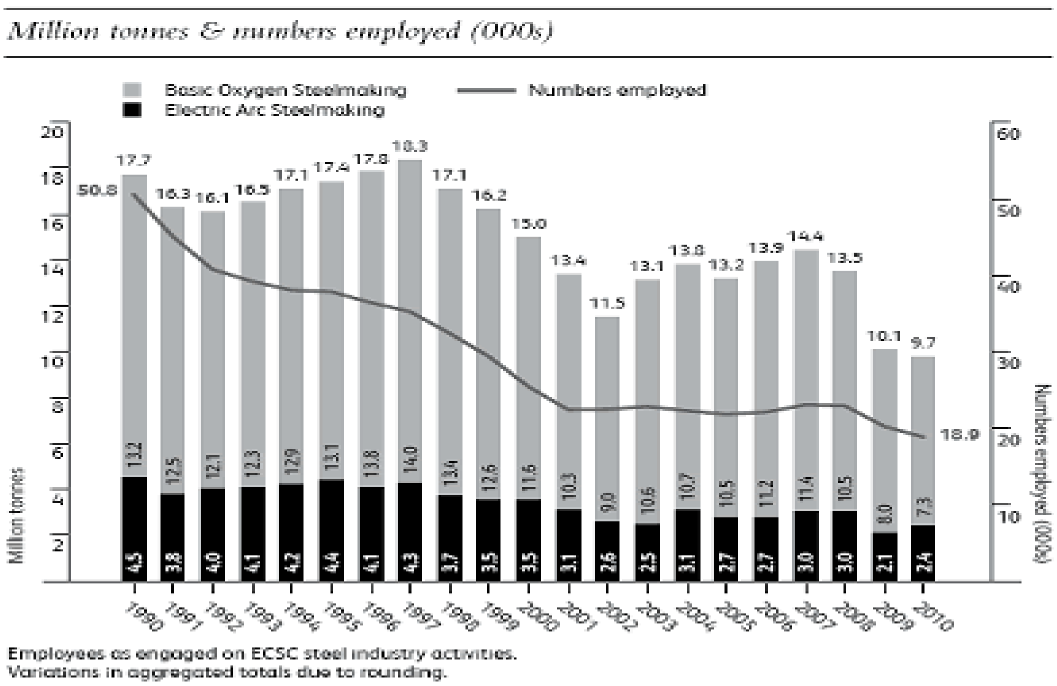
On the following pages, we indicate the general outlook for each sector featured using these 'weather' symbols:

Excellent Good Fair Gloomy Bleak

United Kingdom: steel/metals

A difficult second half of 2011

In general, the British steel sector performed better than expected in the first half of 2011, showing a year-on-year increase in production: averaging 193,000 tonnes per week in Q2 (2.3% higher than in Q1). The recovery in global steel demand that began in 2010 sustained its momentum in the first half of 2011, despite a series of anticipated and unexpected negative developments: the ongoing Eurozone debt crisis, the tsunami in Japan, the political/social unrest in the Middle East and Northern Africa leading to a surge in oil prices, and the tightening of monetary policies in many emerging economies.



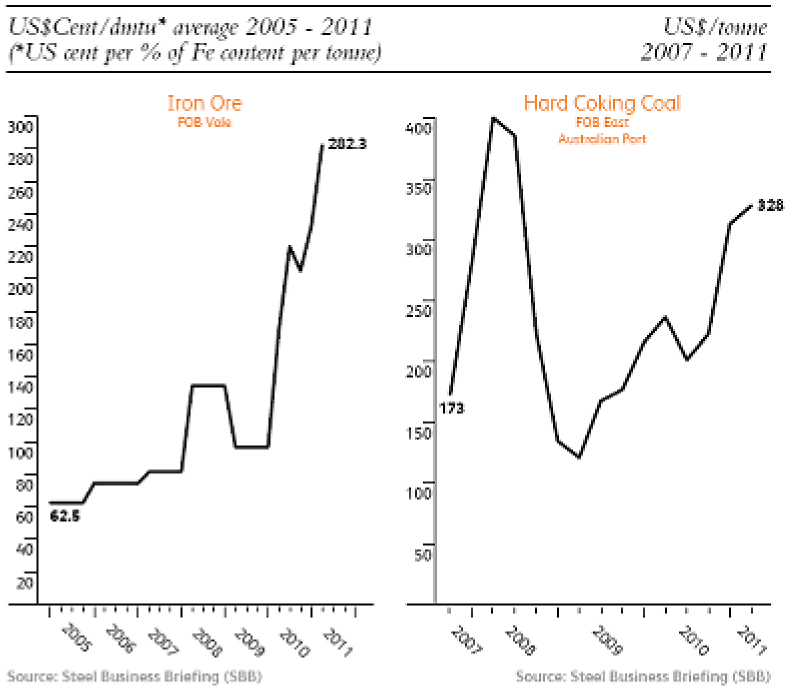
Source: Steel Business Briefing

However, output in the third quarter was quite flat, with steel production in the UK still around one third below pre-recession levels - and this before the traditionally slow fourth quarter. Demand from the automotive, energy and aerospace industries is still strong, but demand from other sectors - in particular construction - remains weak in the wake of the banking crisis and, more recently, in response to cuts in infrastructure projects and public spending in Britain and across the EU. Steel orders held up well - and in fact exceeded expectations - in the early part of the year. However, in the second half, with the economic situation increasingly uncertain, orders are levelling off or even decreasing. While higher steel prices helped to improve profit margins in the first half of the year, the growing economic uncertainty and flattening demand will increasingly affect prices and consequently margins.

The main driver of change in steel prices in the past couple of years has been the rising cost of its two main raw materials - coking coal and iron ore (see chart overleaf), coupled with the switch to negotiating iron ore prices from an annual to a quarterly basis. Passing these additional costs on in the face of lower demand has been a challenge.

United Kingdom: steel/metals

Raw material prices – iron ore and coking coal



In the metals industry, a key driver of growth remains robust demand from overseas markets, and, overall, manufacturers remain optimistic about output and order books in the short term. However, many uncertainties remain, as the overall economic situation, fluctuations in prices, access to credit and real demand will impact the sector's performance in the future.

On average, payments in the British steel/metals industry take 90 days, and we have not seen any increase in payment delays in the last couple of months. However, there may be some increase in payment delays towards the end of the year, as traditionally Q4 activity in the steel sector is low. On insolvencies, while there has been a steady increase across all sectors, we have not yet seen any real upsurge in the past six months. The economic difficulties of 2008/2009 led to an increase in insolvencies in the sector and have thus already taken out some weaker players. The future insolvency picture in the steel/metals sector will depend on the financial health of the buying sectors. For instance, UK construction continues to struggle, and we would therefore expect an increase in insolvencies of steel/metal companies focusing mainly on this area.

Main UK markets for UK steel mill deliveries, 2008-2010

Main UK markets for UK steel mill deliveries: 2008 - 2010			
	Thousand tons		
	2008	2009	2010
Stockholders	3,204	2,004	2,459
Construction	1,214	814	829
Engineering	312	200	344
Metal goods	488	376	316
Wire drawing	279	244	217
Automotive	204	142	185
Other consumers	463	391	417
Total UK deliveries	6,164	4,171	4,767

Source: ISSB

Outlook: (too) many uncertainties

Weakening demand for steel - by volume the world's biggest selling industrial commodity, used in sectors from construction to automotive - is expected to lead to subdued production increases during the rest of 2011. Underlining the difficulties for the sector, the composite share price of the world's listed steel makers has underperformed global stock markets by 30% in 2011.

There are worries about the build up of government debt in the US and Europe, coupled with the sense that the Eurozone crisis could be about to worsen in the wake of a default by Greece. The current uncertain UK economic outlook, decreasing growth in the Eurozone, flattening of real demand and financial market volatility will all have an influence on the UK's steel/metals sector. The expected drop in steel prices threatens the profits of some of the biggest steelmakers in 2012.

The current forecast for 2012 assumes that developing economies will continue to drive global growth. China has been instrumental in driving the expansion of the global steel industry, and has helped support and sustain the sector, particularly when demand in more mature markets was flattening out. However, there are now concerns about Chinese demand, as inflationary pressures have forced Beijing to cut back on the supply of credit, slowing the growth of China's steel consumption.

United Kingdom: steel/metals

Cautious underwriting stance due to weak market conditions

In the UK, the market is currently weak. Producers reacted to a lack of orders by slashing prices, week on week, throughout August, although the situation may have now settled. Customers who took advantage of price cut opportunities now have sufficient stock for most of Q4. The tough business conditions reported by distributors are a reflection of the general economic situation. The uncertain outlook is affecting the buying habits of steel users, with few wishing to hold large stocks of steel in these conditions and resale values under considerable pressure.

Our extensive knowledge of this sector means that we can readily identify the characteristics of those businesses that can survive and even thrive in difficult times. In view of the current economic climate, our underwriting stance towards the sector is cautious. Generally, during and since the last economic downturn, steel/metals businesses have been successful in cutting costs and preserving cash. However, with the current outlook we may again see pressures on prices and margins.

When underwriting a business in this sector, we look for up to date financial information and seek to understand the strengths and weaknesses of the business, and its ability to manage those factors that influence performance. We are particularly cautious when assessing risk on a business whose sole focus is on construction, while those that diversify across sectors and markets will be better able to cope than those reliant on a single market/business.

British steel/metals sector

Strengths	Weaknesses
• Well established companies who know their customers and markets • Companies who have seen and dealt with recessions in the past and know what actions to take to safeguard their business	• Continued flat performance in the construction industry will cause problems • Exposure to the Eurozone and the current uncertainty in those markets

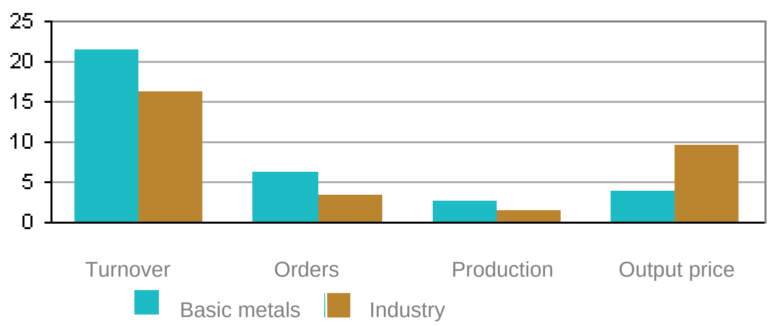
A short-lived recovery in 2011?

During 2010 and the first half of 2011, the Dutch steel/metals industry benefited from export growth, compensating for the lesser domestic demand in recent years due to stagnation of construction output and lower demand from machinery and consumer products industries. In 2010, domestic sales dropped 4.4%, while exports rose 4%. In 2011 export will again lead, taking particular advantage of the rebound in Germany, with an expected revenue increase of 4%.

In 2010, the metal processing industry suffered in the face of robust and steady increasing metal prices. Particularly affected were those companies that restructured insufficiently during and after the 2008/2009 crisis, and those with a weaker bargaining position than their metal suppliers and customers. In addition, metal businesses have been able to pass on price increases only modestly during 2011. However, in August 2011, the turnover of businesses in the basic metals and metal products industry increased 20% year-on-year, as an increase in working days and higher prices had a positive effect on sales. In the same period, in the basic metal subsector, sales increased 16% and, in the fabricated metals subsector, a noteworthy 25%. The value of orders received in the basic metals and metal products industry increased 6%. Foreign demand continued to increase faster than domestic orders.

Turnover, orders, production and output price (August 2011)

Year on year % change

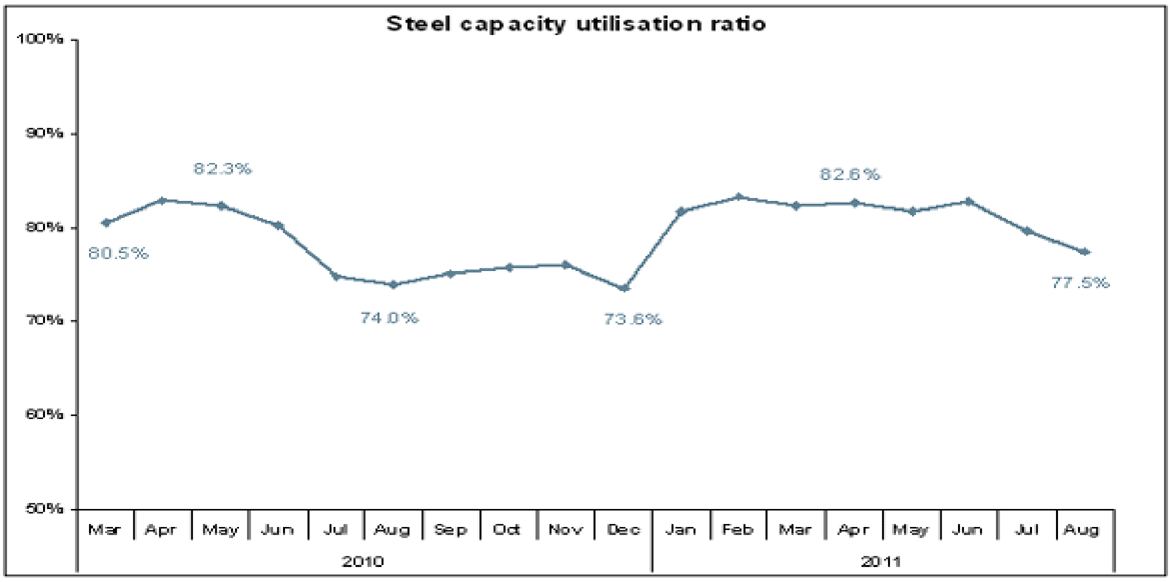


Source: Statistics Netherlands (CBS)

Last year, Dutch finished steel consumption grew 30.6% - to 3.47 million tons - although this was not enough to return the market to pre-recession levels. The aluminum industry reported stagnant growth, and the uncertainties facing the automotive sector will continue to affect aluminum producers, although the sector appears to be over the worst.

The steel/metals industry capacity utilisation rate shows a roughly similar development pattern as revenues. After its low point in mid-2009, the rate increased in the last quarter of 2010 to 78%. However, this is still below the average of 81% achieved in the period 1989 to 2010. Overall, the global steel utilisation ratio has shown a decreasing trend in recent months (see chart overleaf).

The Netherlands: steel/metals



Source: World Steel Organisation

While most companies in the steel and metal processing industry saw their equity strength decline at the end of 2010, those in steel and metal trading remained on an equal level. As for solvency and liquidity, steel/metals companies, while still in the process of cost reduction, have had to invest for growth in production and sales volumes. However, as growth will slow down again, tensions are resurfacing, and, in general, solvency and liquidity are insufficient to support business growth.

More payment delays and insolvencies to come

On average, payments in the steel/metals industry take between 45 and 60 days, and we have seen a slight increase in payment delays, so we are unlikely to see payment terms tightened to improve the cash position. This year, the steel and metal processing industries have needed more working capital to meet increasing production and sales volumes, while at the same time commodity prices have again risen. However, restrictive bank lending has hampered the whole sector, which was unable to finance new orders. Additionally, buyer industries such as construction and infrastructure have been unable to obtain sufficient project financing. Construction plays a pivotal role in the domestic market for the steel and metal processing industry.

Against this backdrop, the pressure to provide working capital is an increasing burden on steel and metals suppliers, as buyers demand extended payment terms. We expect a further increase in payment delays in the coming months, as the economy slows and the outlook for 2012 remains uncertain.

Insolvencies are currently at a lower level than in 2010, but are likely to increase. In steel/metals production and processing the current overcapacity and pressure on margins will hit the weakest companies, as the economy slows and manufacturing production volumes are about to decrease. Moreover, many companies are still addressing the consequences of the 2008/2009 crisis through cost cutting and reorganisation, while struggling to obtain external finance. Steel and metal processing directly related to the construction market is most highly exposed.

A rather bleak outlook

The steel and metal processing sectors are mostly suppliers of semi-fabricated products and the expected slowdown of Dutch economic growth will have a negative effect on sales volumes. According to the latest Consensus Economics October 2011 forecast the economy will grow only 1% year-on-year in 2012, while manufacturing increases 0.9%, after 3.5% in 2011 (in August 2011, estimations for GDP and manufacturing growth were still 1.6% and 1.9% respectively).

The problems in the Dutch construction market will continue throughout 2012 and those steel processing businesses dependent on construction will also face a lack of support by banks, an end to their options for cost-cutting, and fewer opportunities through public investment. Although other sectors, such as transport machinery, processing industry and food, have provided some impetus to steel/metals sales and production volumes, these are not robust and steady enough to sustain the sector.

While exports have so far compensated for the lack of domestic demand, the outlook for sales to the Eurozone and the US is increasingly uncertain.

A lack of orders is not helping the current overcapacity in steel construction and margins remain under pressure. Larger steel businesses in the steel processing industry compete with smaller companies for orders and the outlook is for tighter liquidity and extended payment terms.

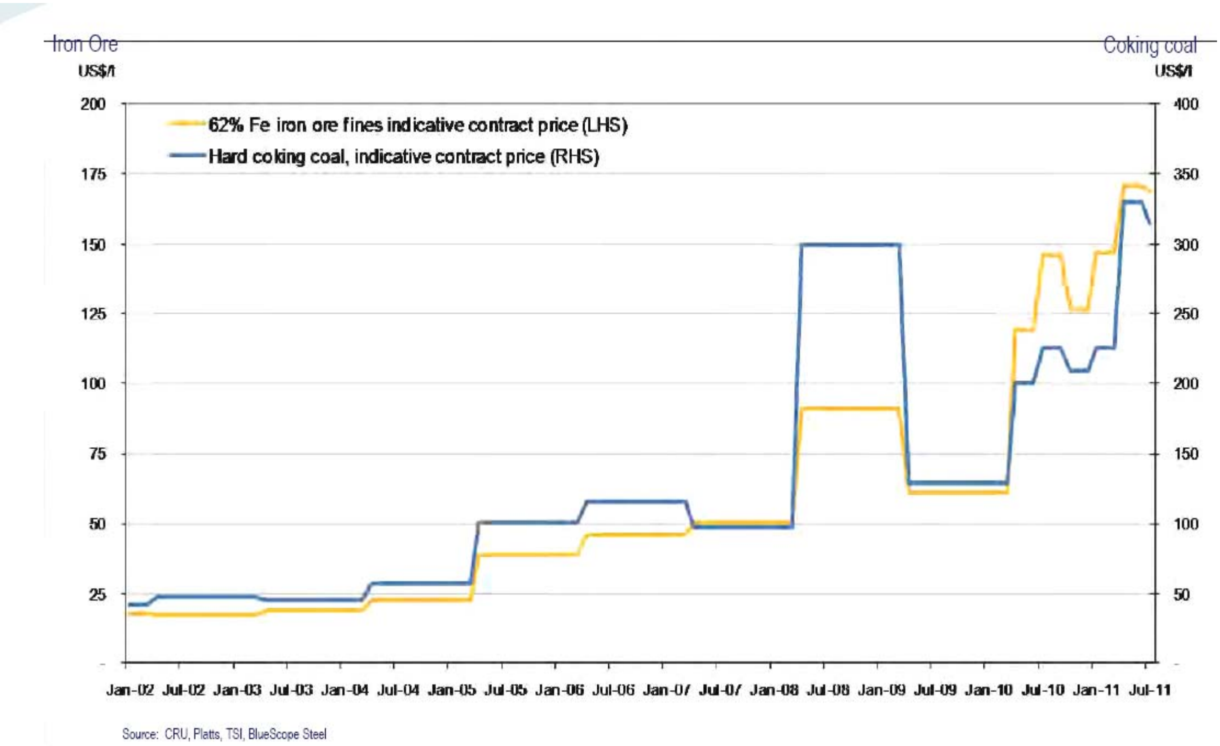
In view of all this, our underwriting approach to the steel/metals sector remains cautious. In the recent past, while established companies have been subject to takeovers, news of those changes in ownership has often been late in surfacing. Constant checking of Chamber of Commerce information is essential, as in many cases management buy-outs have been financed far too optimistically – based on forecasts made before 2009. We therefore have to remain alert to the possibility of the new owners defaulting on their finance repayments.

Dutch steel/metals sector

Strengths	Weaknesses
• Good export performance so far	• More payment delays • Squeeze on margins • Restrictive bank loans

Pressure from higher input costs

Australian steel producers have experienced shrinking profit margins this year, as a result of high input costs: particularly iron ore and coking coal (see chart below). At the same time, they are finding it hard to remain competitive on the international stage because of the strong Australian dollar.



Despite these difficulties, the two main steel producers in Australia - BlueScope Steel and OneSteel - maintain their strong equity, good liquidity and reasonable solvency.

There has been no change in the payment behaviour of Australian steel companies over the last couple of months, and we expect this to continue in the short-term. However, we did see a number of insolvencies in the steel wholesaler subsector during 2010.

More cautious about wholesalers

With the growing uncertainties over global economic development, subdued steel prices, high input costs and the strong Australian dollar, we expect 2012 to be a challenging year for Australia's steel sector. BlueScope, as the largest steel producer in Australia, is currently undertaking a major restructuring - including employee cutbacks. OneSteel´s steel section has had a difficult 2011, but overall the company has performed well, thanks to their other assets such as iron ore mines which have benefited from higher commodity prices.

Australia: steel

When underwriting the steel sector, we currently monitor the wholesale subsector particularly closely. It is a subsector that we have underwritten for many years and so we are familiar with the main players. Because of our concerns, we remain cautious and generally seek the latest financial statements in confidence from the buyer to support any application for cover.

Australian steel sector

Strengths	Weaknesses
• Local mills are located close to their markets • Locally known brand names.	• Strong Australian dollar • Competing against cheaper imports

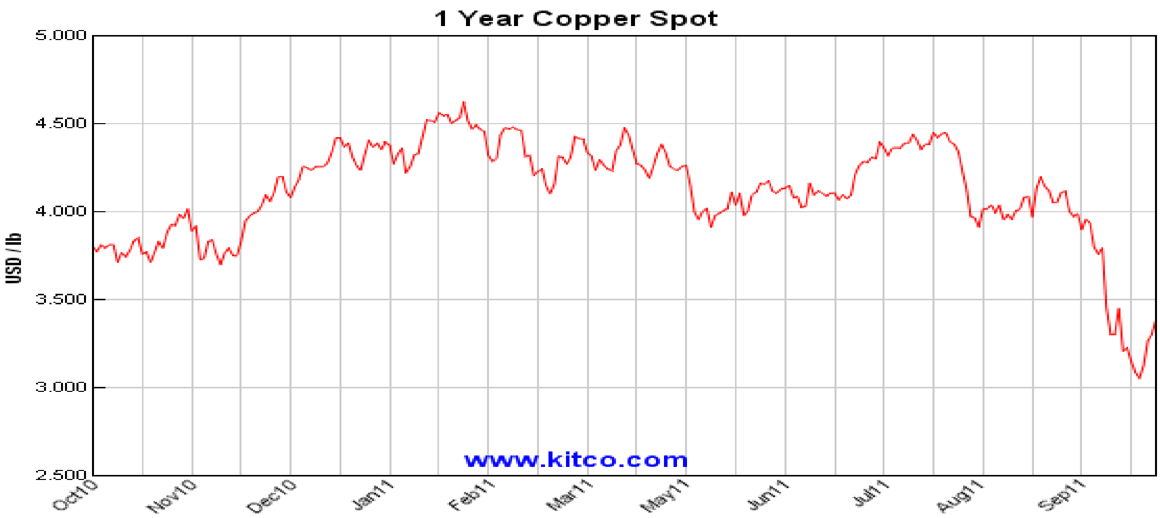
Outlook remains positive

Overall, higher metal prices over the last 18 months (due mainly to high demand from China) have boosted the profit margins of many Australian metal miners. In general, their equity strength is solid and solvency/liquidity reasonable. However, there has been a recent drop in prices due to the growing uncertainty over the world economy. Currently, the outlook remains positive but, if metal prices continue to fall, this will have an impact on 2012 results.

Copper

According to the Bureau of Resources and Energy Economics, world copper consumption is forecast to increase 4% year-on-year in 2011. Consumption growth in the first half of the year has come largely from OECD countries demand while, in the second half, China is forecast to account for most of the growth in world copper consumption. Australian copper mine production will increase 16% in 2011: to 949,000 tonnes.

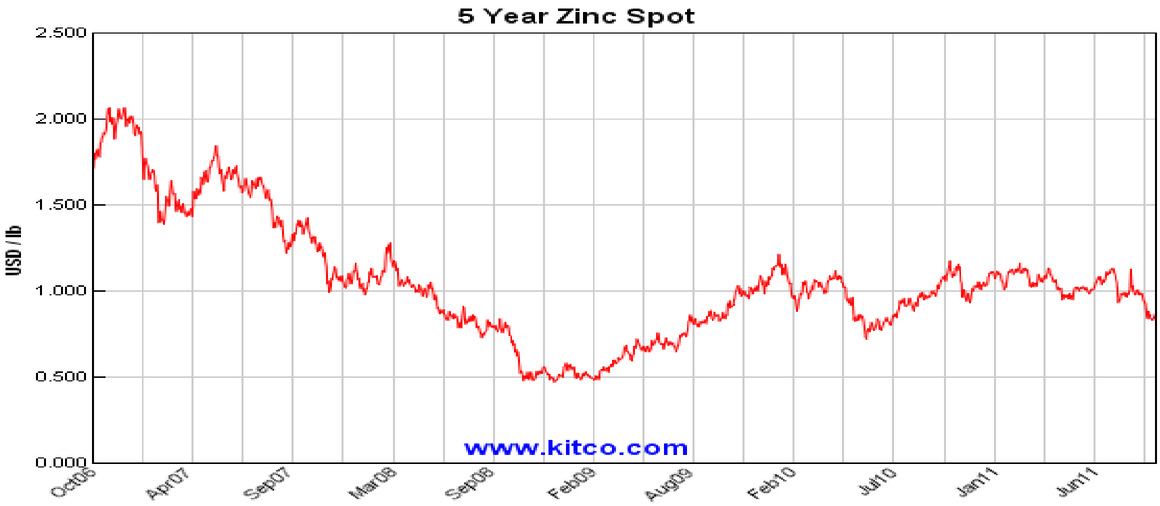
Copper prices increased 32% in the first half of 2011, to an average of US$9,400 a ton, as a result of strong growth in global consumption compared to weak supply growth in a number of regions. However, in Q2 and Q3 copper prices decreased (see chart below), reflecting mounting concerns over growth prospects in the United States and Europe and the tightening of China's monetary policy in order to avoid economic overheating. Nevertheless, currently copper prices are still forecast to increase by 5% year-on-year in 2012, as world copper consumption continues to rise.



Source: Kitcometals

Zinc

The Bureau of Resources and Energy Economics has forecast world zinc prices to increase 8% year-on-year in 2011 and another 6% in 2012, thanks to relatively strong growth in world zinc consumption: particularly in China and other emerging economies. In 2012, Japan is expected to substantially increase its zinc consumption as a result of rebuilding after the March 2011 tsunami. However, in 2011/12, Australian export earnings from zinc are forecast to decrease in Australian dollar terms, and the volume of exports to remain at similar levels to 2010/11.



Source: Kitcometals

Gold

For the remainder of 2011 and 2012, gold prices are forecast to remain high, underpinned by strong investment and retail demand associated with the uncertain economic outlook for the United States and European Union economies. According to the Bureau of Resources and Energy Economics, in 2011/12 Australia's gold production will increase 4% compared to 2010/11- to a total of 277 tonnes - while gold export values are forecast to increase by 47% compared to 2010/11 - to US$ 19.2 billion.

While we cover other metals buyers such as smelters, in Australia our main exposure in this sector is through the cover we provide on metal miners. During the last 12 to18 months, our underwriting approach towards these miners has been relaxed, due to price increases and the return of bank and stock exchange funding to miners. However, this sector is cyclical and was a source of large claims following the 2008 financial crisis. The recent drop in copper and zinc prices is something we monitor closely, as our experience in 2008 showed that rapidly falling metal prices can result in the failure of miners. Therefore, we remain vigilant to movements in metal prices, so that we can pre-empt future failures. For example, when assessing a buyer, we compare the 'cash cost' of mining a metal to its current spot price to determine if they are viable at current prices.

Australian metals mining sector

Strengths	Weaknesses
• Well developed metals mining sector • Stable political environment, which provides comfort to investors of long-term projects.	• High labour costs • Slow approval process for metal mining projects

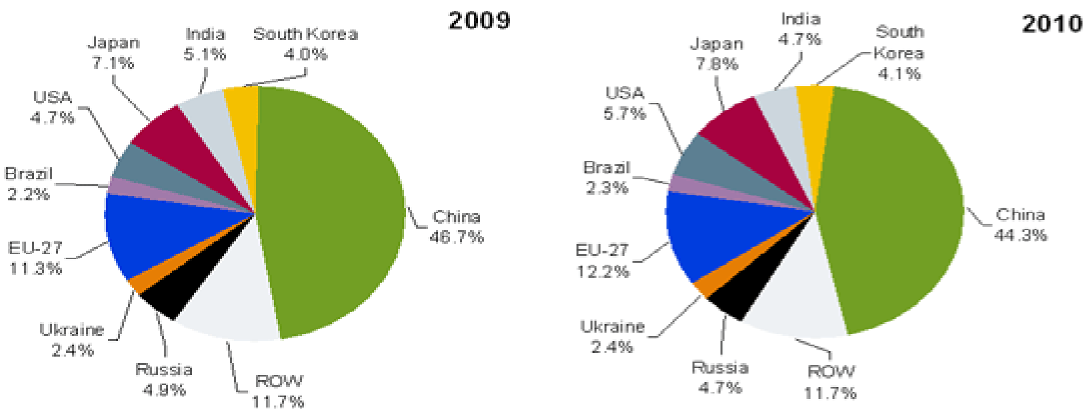
Post-earthquake reconstruction provides opportunities

Japan's steel market is quite concentrated and, because of the high quality of Japanese steel production, manufacturing demand accounts for more than 65% of Japan's domestic steel consumption. The automotive sector is the largest buying industry, accounting for around 22% of that demand. Construction, electrical appliance manufacturers, shipbuilders and machinery manufacturers are also major consumers of Japan's steel products.

March's tsunami and earthquake battered a key manufacturing region and stifled steel demand, not least because of the power shortages caused by the disaster at the Fukushima nuclear plant. With the disruption to manufacturing plants in north-east Japan, major automobile and electrical home appliance makers had to halt some of their operations due to uncertain parts supply. Consequently, domestic steel demand reduced sharply, badly denting the industry's profits. In terms of direct impact on the metals sector, the disruption halted production at several copper and aluminium refineries.

According to a recent World Steel Organisation estimate, Japan's steel use is expected to decline 2.7% year-on-year in 2011. However, business disruption is expected to last only 6 to 12 months maximum and many of the large players in the industry, including the large car makers, are quickly recovering to their pre-disaster capacity. Demand and supply of steel and metals are expected to pick up as reconstruction efforts begin, providing opportunities for local steel makers to boost their sales. Steel and aluminium are the two sectors most likely to benefit from this activity, and the World Steel Organisation expects Japan's steel use to increase 0.8% in 2012.

Share of world crude steel production 2009, 2010



Source: World Steel Association

A major merger in response to global competition

While the earthquake's impact on manufacturing has largely passed, on the supply side global competition in the steel industry has intensified in recent years. The moderation of growth in the Chinese steel market is a major concern, as overproduction by Chinese firms had led to increased exports to other Asian markets, affecting the price of steel and posing problems for the Japanese steel industry. At the same time Japanese automakers, electronics producers and other steel users have sought to expand production overseas in search of growth, stronger consumer demand and as a hedge against foreign exchange risks, and this too has had a negative impact on domestic demand for steel. Steelmakers in Japan therefore need to seek more export growth in the face of falling domestic demand in the long-term.

Nippon Steel and Sumitomo Metals industries, Japan's biggest and third-largest steelmakers, hold a 44% share of the domestic market, but just a 3% global share of steel output. The recent announcement of the JPY 1.7 trillion merger of these two large steelmakers is indicative of the challenges facing the local steel industry. The new entity, which plans to start trading on 1 October 2012, will create a global steel giant: second only to India's ArcelorMittal. The merger is aimed at cutting costs by gaining more leverage over raw material suppliers and to increase presence and production in Asia and other regions, in competition with rivals such as China's Baosteel Group and South Korea's Posco.

We have not received any notifications of non-payment relating to Japanese steel producers in the last couple of months and do not expect any change to this in the short-term. All the larger players' balance sheets appear relatively robust, although gearing (as with many Japanese firms) is elevated because of the capital intensive nature of the industry and the ready availability of cheap Japanese Bank loans. We rarely see bankruptcy in this sector, and in the first quarter of 2011 the number of business failures in the steel and metals sector manufacturing industry was very low. This sector has only a very small portion of total business bankruptcies, and shows a general decreasing trend.

Financial Year 2010, ending March 2011, showed a steady increase in sales and profits for most of the large steel producers. Despite the fact that most of the companies did not release their forecast for FY 2011, our view is that the outlook for Japanese steel and metals makers is positive. We therefore have a relaxed underwriting approach to this sector, with no special criteria set for underwriting steel/metals companies. However, global headwinds are expected to continue to impact the industry and the strengthening yen will limit export competitiveness.

Japanese steel/metals sector

Strengths	Weaknesses
• Increase in domestic demand as a result of reconstruction of East Tohoku region following the March 11 disaster • Merger of the two biggest steel producers in Japan to create the world's 2nd largest steel producer. This will increase Japanese steel producers' competitiveness in global market • Increase in global steel prices and demand	• Persistent competition from Chinese and South Korean steel producers • Exposure to possibility of future natural disasters • Uncertain outlook for the global economy

The world's second-largest steel producer by 2015?

India is currently the fifth largest crude steel producer in the world and the largest producer of sponge iron (direct-reduced iron), and is projected to become the world's second largest steel producer by 2015/16. India's national steel policy, drawn up in 2005, forecast consumption to grow at 7% - based on GDP growth of 7.0-7.5% and an annual production volume of 110 million tonnes - by 2019/20. However, these estimates have already been exceeded and the most likely scenario is that crude steel production capacity will reach almost 110 million tons by 2012.

The following table shows the trend of production for sale, import, export and consumption of total finished steel (alloy + non alloy) in India.

Year	Production for sale ('000 tons)	Import ('000 tons)	Export ('000 tons)	Consumption ('000 tons)
2005-06	46566	4305	4801	41433
2006-07	52529	4927	5242	46783
2007-08	56075	7029	5077	52125
2008-09	57164	5841	4437	52351
2009-10	60892	7296	3235	57675
Apr- Dec 2010-11	47296	5359	2462	44275

Source: Ministry of Steel, Government of India.

Demand for use in construction and infrastructure constituted 61% of total finished steel consumption in 2009/10. Of late, higher interest rates have impacted demand, resulting in a slowdown in end-user industries such as automotive and consumer durables. Higher financing costs and high raw material prices have also been a major challenge for steel companies. Although the high cost of coking coal has eased in the last few weeks, giving some breathing space to steel makers, consumption has reduced and growth has failed to pick up as expected, as a result of which some producers have cut production. The recent order by the Supreme Court, banning mining activities in several parts of Karnataka, has also had a considerable impact on some players in this sector (Karnataka accounts for 30% of India's steel output and about 25% of India's annual iron ore exports).

However, current projects in hand and the Government's commitment to infrastructure projects mean that we will continue to see robust demand in the immediate future. Investment in construction and infrastructure is expected to be 9% of GDP at the end of India's Eleventh Plan (2011/12) with proposed investment of US$ 514 billion for the core infrastructure sector (power, road, highways etc). In recent months, steel prices have moderated and are expected to stabilise in the near future.

In view of the weakening global economic environment, the World Steel Association has reduced its growth forecast for Indian steel use from 14.3% (April 2011) to a still robust 7.9% (October 2011). While the recovery of steel demand in the developed world will be slow, most of the emerging and developing world is expected to continue to enjoy comparatively better growth in demand. In the medium to long term, growth momentum in Indian steel supply and demand is expected to remain upbeat, with an improvement in consumer demand coupled with capacity expansion. India's domestic demand for steel is expected to rise at an annual rate of around 10% until 2014: mainly from the infrastructure, construction, and automotive sectors.

Financially strong players

The major players in the Indian steel industry are all financially strong, and most are listed on Indian stock exchanges. The largest players generally maintain a healthy liquidity position and reasonable profit margins, as demand is strong, but there are times when margins come under pressure from increasing input costs and imports (e.g. from China).

Steel companies are currently looking to improve production capacity and are also entering into alliances with foreign producers to meet growing domestic demand: for example, Tata Steel has linked with Nippon Steel of Japan, and JSW Steel with Japan's JFE. India's steel exports to China are only around 2 million tons a year, accounting for 5% of its total steel production. Therefore any slowdown in the Chinese economy does not represent a major concern for India.

In the medium to long term, further consolidation is expected in this sector through mergers and acquisitions. Key strategies for success would involve greater integration between mining and the production of finished products, leading to economies of scale, cuts in logistics and raw materials costs, and increased value added products. Much will also depend on producers' ability to pass on expected raw material price increases to consumers.

In a recent noteworthy development, India has been awarded the right to hold the World Steel Conference in October next year: an indication of India's emerging importance in this sector.

Metals sector continues to grow

Aluminium

India's aluminium production grew to 1.73 million tons in 2010, boosted by 12% growth in domestic demand. India is the world's fifth largest aluminium producer with one of the world's lowest per capita consumption rates: just 1.3 kilogram. The largest user markets for aluminium are the power, construction, automotive and consumer durables sectors. Domestic consumption is expected to be around 1.6 million tons in 2011 and to double over the next five years, with growth in domestic manufacturing expected to increase aluminium consumption.

The country has one third of the world's Bauxite reserves, with over 1.4 billion tons in Orissa and 650 million tons in Andhra Pradesh: the two states with the largest reserves.

The major players are Hindalco, NALCO, BALCO and MALCO, all with strong financials, good liquidity and all cash rich with huge treasury investments. The Indian aluminium market is well balanced with strong domestic growth and export opportunities (subject to capacity expansions). Hence the companies are expected to continue to do well in the future. The current challenges for the industry are hindrances to expansion because of the difficulty in obtaining environmental clearances and the activities of Naxalite-Maoist guerrillas near mining and production facilities.

Lead

India accounts for around 1.8% of global refined lead production and 2.2% of global consumption. While India's refined lead output grew 20.1% to 167,000 tons in 2010, it remains dependent on imports, with consumption up 12% to 202,500 tons. The primary use in India is for battery manufacture and demand is largely driven by the automotive sector. By 2012, Indian lead smelting is expected to reach the limit of its capacity, forcing the market to depend more on imports.

Zinc

India's refined zinc output grew 23% to 752,711 tons in 2010, leading to an exportable surplus of almost 176,700 tonnes. Domestic demand rose by 10% to just over 576,000 tonnes and is set to reach 985,000 tonnes by 2015. This output growth is due to stronger demand from China and the domestic market - particularly the automotive sector. In India, 70% of zinc consumption is for the manufacture of galvanized steel used in vehicle manufacture.

Hindustan Zinc Limited (HZL) and Binani Zinc are among the major players, with HZL having nearly 90% of the market. HZL reserves are expected to last for 25-30 years and the company is looking at mining expansion abroad. Capacity utilisation at India's zinc refineries is around 84.7% and demand is rapidly outpacing output. With the increased pressure on production and zinc refining there is little likelihood of a price drop or of oversupply.

Copper

India is a significant copper producer and net exporter, accounting for 3-4% of global output: mostly for construction and telecommunication. However, India's refined copper output shrank by 10.2% to 647,500 tons in 2010 amid a 22% decline in consumption to 430,300 tons.

The major players in the copper industry are Vedanta-owned Sterlite Industries, Hindalco, and state-owned Hindustan Copper Limited (HCL), with Sterlite contributing 84% of national refining capacity and the other two each contributing 8%. Domestic demand aside, exports are expected to be substantial once capacities are enhanced. These companies are each divisions of larger private listed groups (HCL is government owned), all with strong financial standing and liquidity.

India: steel/metals

A relaxed underwriting stance

The political situation in India may hinder capacity expansion because of issues relating to land acquisition for green-field capacities and delays in environmental clearance for mining and logistics support. Indeed, these issues confront all metal producers and miners in India.

On average, payments in the Indian steel/metals industry take 60 to 90 days. We have received very few credit insurance claims in the last 2 years and, based on our experience, do not expect any future change. Therefore, our underwriting policy is relaxed, with no significant difference between the various subsectors. When assessing buyer risk, we look mainly at the current financial performance, performance analysis in relation to peer group, positive trading experience and customer relationships.

Indian steel/metals sector

Strengths	Weaknesses
• Abundant and high quality iron ore - states such as Orissa, Jharkhand and Chhattisgarh are rich in iron ore reserves • Relatively low capital costs due to low land and construction cost • Cheap labour costs • 100% foreign investment allowed through automatic route in mining sector	• Cheaper imports from China, Russia, Ukraine, Kazakhstan and Romania • Heavily dependent on imports of metallurgical coal and coke • Costs of power and high funding costs impacting projects • Infrastructure constraints in roads, railways, ports etc. • Restrictive labour laws • Land acquisitions issues hindering capacity additions, delays in getting environmental clearances

Recovery thanks to state support

In 2010 Russia was the world's fifth largest steel producer (see chart below). While the sector was severely affected by the 2008/2009 global crisis, the Russian government took major initiatives in order to support steel-using industries such as automotive, machinery and the energy sector. As a result, the steel/metals sector has recovered significantly since then, and production is expected to reach or even surpass pre-crisis levels in 2011.

Top steel-producing countries

	2010		2009	
1.	China	626.7 mmt*	China	573.6 mmt
2.	Japan	109.6 mmt	Japan	87.5 mmt
3.	United States	80.5 mmt	India	63.5 mmt
4.	India	68.3 mmt	Russia	60.0 mmt
5.	Russia	66.9 mmt	United States	58.2 mmt

*million metric tons

Source: World Steel Organisation

According to the Russian statistics office production of metals and related products increased 3% (in volume terms) and comprised 50.9 million tons in the first 9 months of 2011. At the same time production of pipes and tubes increased 18.4% to 7.7 million tons.

The market continues to be driven by domestic demand (e.g. construction, infrastructure, transport, and machinery), while exports (mainly to China and other Asian countries and to Western Europe) are also important. However, external demand has become more volatile over the last 10 months as growth in Western Europe has been slowing down and there are emerging signs that China's high growth rates are about to decrease in the coming months.

Share prices of major Russian listed steel/metals companies decreased substantially over the last 12 months, mainly due to increased volatility in financial markets and capital outflow from Russia. That said, the general solvency and liquidity position of Russia's major steel/metals producers remains strong, and equity situation as well as profitability show a positive trend. On average (compared to other Russian industries) the steel/metal sector's default/ insolvency rate is good, and we do not expect any increase in the short- or medium term. As steel/metals is seen as a key sector by the Russian Federation, it is expected that the government will help again should there be another downturn.

Russia: steel/metals

Despite lower exports domestic demand will drive further growth

Despite the fact that export demand is about to decrease the outlook for the Russian steel/metals sector is generally positive, as strong domestic demand will continue to drive production and state support is almost certain in case of troubles. Therefore our underwriting approach to the Russian steel/metals sector generally remains relaxed. According to the World Steel Organisation apparent steel use in the Commonwealth of Independent States (CIS), of which Russia is by far the largest economy, is forecast to grow 14.4% in 2011 and 7.5% in 2012.

Russian steel/metals sector

Strengths	Weaknesses
• Strategic sector for the Russian government • Local access to raw materials	• More investment needed in order to improve machines and equipment