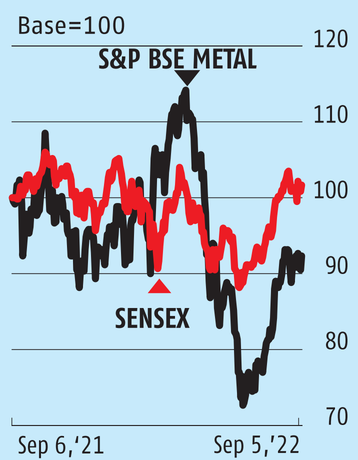
Metal sector: Investors should brace for a difficult Q2; H2 could be better



Compiled by BS Research Bureau

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The global industrial metals scenario has been extremely confused since the Russia-Ukraine war. We have seen both cuts in supply and also falling demand. The new equations are not yet clear.

On the one hand, supplies from Ukraine and Russian have been disrupted. On the other hand, China lockdowns have led to both cuts in production as well as a drop in demand - weak GDP numbers and a real estate slowdown means demand is more affected.

Since Europe has been hit by energy shortages and soaring energy prices, many European Union (EU) smelters have shut. One silver lining is that raw material prices (meaning ores and coking coal) have dipped, leading to cuts in costs. However, global metal prices have seen steep corrections so there is still margin pressure for metal producers.

Metal spreads may not yet have bottomed out with guidances indicating that the second quarter for the 2022-23 financial year (Q2FY23) may see lower profitability. Drops in raw material prices - coking coal and NMDC ore prices have averaged 47 per cent and 36 per cent lower respectively - are still being offset by Hot Rolled Coil and Rebar price declines of 16 per cent in July-August 2022. High inventories of raw material bought at high costs and held by end of Q1FY23 will lead to more margin pressures.

The domestic industry is hoping for several possible paths to relief. One is simply stronger demand in the second half of FY23 (H2FY23), both domestic and global, especially in China. Another hope is that the export duties imposed on steel will be removed, now that global prices are down.

Of course, domestic metal producers will also have to reckon with cheaper imports but they can compete in the global market. Market leaders like Tata Steel (which has the best domestic spreads, as well as Corus exposure, which could benefit if there's an European rebound) and Hindalco (a big player in aluminium, also in copper, and in value-added aluminium products via Novelis) could be the biggest gainers. In industrial metals, if there's an improvement in the sector's dynamics and supply-demand equations, every major producer will see some gains.

Domestic steel production dropped 5.5 per cent quarter-on-quarter (QoQ) in Q1 versus Q4, 2021-22. Consumption declined 6 per cent QoQ. Export volumes dropped 31 per cent QoQ. Domestic consumption and production improved in July over June (MoM) but exports continued to nosedive. Iron ore prices from NMDC have dipped by 36 per cent QoQ in July-August while coking coal has declined 47 per cent as global demand has eased.

In aluminium, which is highly energy intensive, European and Chinese production has been drastically reduced. Hindalco has strong guidance from Novelis and likely demand surplus over supply in European winter. Novelis delivered strong performance in the first quarter and guided for 5 per cent rise in earnings before interest, tax, depreciation and amortisation (ebitda) per tonne for the full fiscal. Hindalco is hoping to source more coal through supply agreements from the third quarter onwards, to reduce its raw material costs.

There has been a recovery in share prices in the last month. JSW is up 4.4 per cent while Hindalco is up 3.5 per cent. Hindustan Copper is up 11.8 per cent. SAIL is up 5.4 per cent. Tata Steel, which suffered 92 per cent loss in the last year due to the EU exposure, was down 0.2 per cent. Investors will have to endure what's looking like a difficult Q2 and hope for a pickup in Q3, and Q4 followed by a better FY24.