

Mill Consolidation and a Buyers Perspective

The intent of this article is to discuss three major changes occurring in the global steel industry; consolidation of producers, higher rates of demand growth, and the impact on regional pricing trends.

First some background on the author. Pat McCormick recently joined World Steel Dynamics (WSD), a world-renowned steel information and consulting company. He comes to WSD with 30 years of global steel buying experience with a fortune 500 company. Pat is excited about his new role as managing partner with WSD because he sees the opportunity to add focus to the buyer-seller interface.

It is from the above vantage point that the author will explore and comment on the buyer's perspectives of steel industry consolidation.

M&A activity sure to continue at a high rate

The rejuvenated financial positions and soaring EBITDAs of many steel companies are fueling an unprecedented wave of consolidation. EBITDAs for non-Chinese steel companies increased from \$28 billion in 2002 to \$118 billion in 2006 and Chinese steel companies increased from \$7 billion to \$15 billion over the same period. The steel mills' huge cash flows have giving them the wherewithal to acquire others; however, if they are not careful, they may be acquired themselves. Steel company investors and investment bankers are feeding the frenzy; they are pressing management to be bold when it comes to mergers and acquisitions. In Europe, we have recently seen the large merger of Arcelor/Mittal and Tata's intention to acquire Corus.

Overall, M&A activity seems sure to continue at a high rate no matter what the industry circumstance: WSD's expectation is that, by 2010 there will be five to ten companies with a capacity range of 50-125 million tonnes.

Steel mill consolidation not unnoticed by the steel buying community

A positive buyer perspective on global steel industry consolidation is the appealing attributes of uniform product quality, service and supply relationship being available from a single steel company in multiple regions of the world. Automotive and appliance companies are good examples of companies that need these attributes because of their global manufacturing presence and their need for high quality steel products.

A negative buyer perspective is the concern about steel pricing and availability. Buyers are also apprehensive about their potential loss of steel buying clout as the steel producers become larger entities. A simple example is a steel buyer of 1 million tonnes per year can only be 1% of Arcelor/Mittal's supplying portfolio assuming the buyer places all of its business with this company.

Mill consolidation concern to steel buyers is real

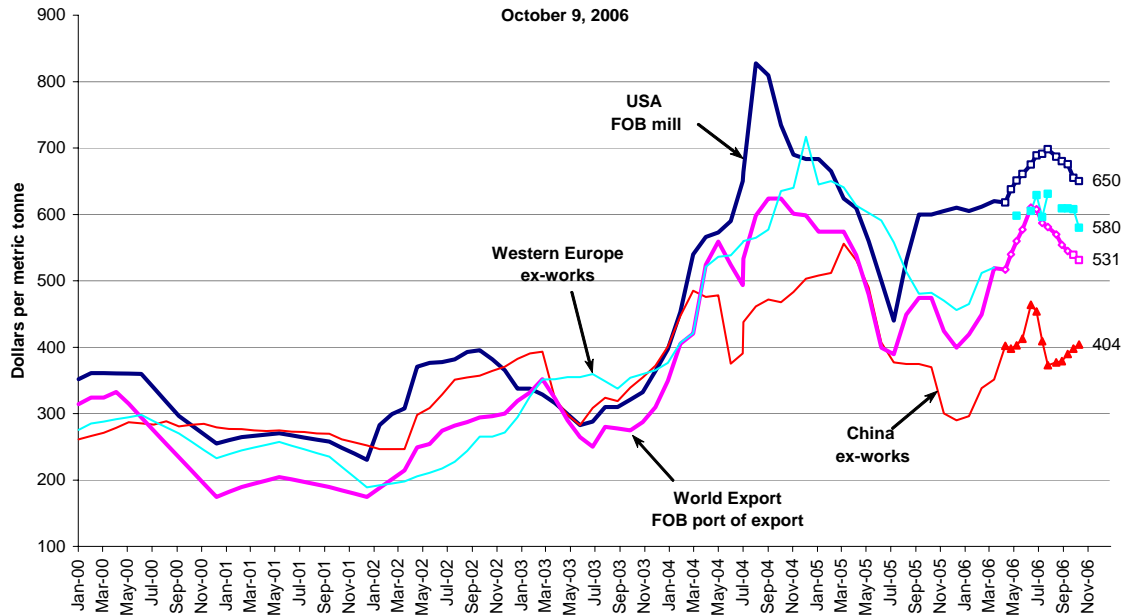
If we analyze recent World Steel Dynamics *Steelbenchmarker* price information, which is a composite of price observations from many steel market participants, we can see that a change has occurred in the pricing tendencies within and between regional markets.

Price volatility has increased and the price spread between regional markets has also increased since June 2004.

*SteelBenchmarker*TM HRB Price

USA, China, Western Europe and World Export

(WSD's PriceTrack data, Jan. 2000 - March 2006; SteelBenchmarker data begins April 2006)



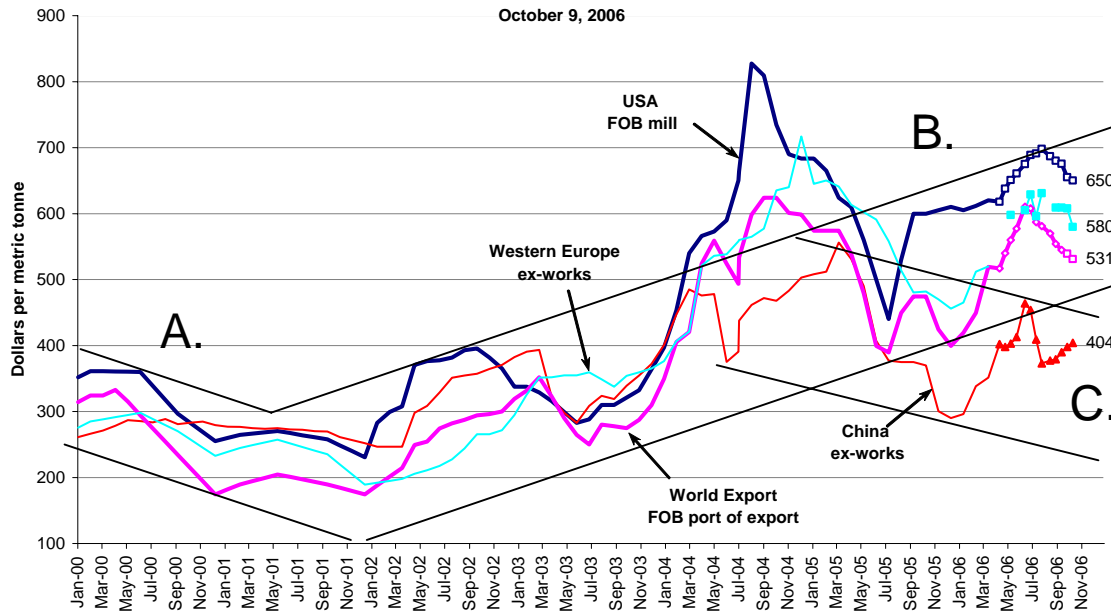
The World Steel Dynamics *Steelbenchmarker* is a web-based steel price tracking system which has two big advantages over other market price tracking services. The advantages are the frequency of price observations and the large number of market participants who contribute price observations. The frequency is twice a month versus once a month for other services and the number of registered price providers is 250 representing steel users, traders, and mills. The *Steelbenchmarker* reports are available to all market participants via the internet. The sign up process is easy and can be accessed at: www.steelbenchmarker.com

What has contributed to the rise in price volatility and the increase in price spread between regions? I have added trend lines to the next *Steelbenchmarker* global pricing chart and offer the following explanations.

SteelBenchmarker™ HRB Price

USA, China, Western Europe and World Export

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1. There was a negative slope (labeled A) in the global steel pricing trend prior to 2002. A positive slope (labeled B) has occurred in the global steel price trend since the beginning of 2002. The author attributes the change in slope direction to the change in the global demand growth rate for steel. Developing country growth (i.e. China especially) and their appetite for steel has more than doubled the global steel demand growth rate in trend B versus trend A.
2. The price volatility has also increased when comparing the width of trend B to the width of trend A. Again, the author attributes the price volatility change to the change in the global steel demand growth rate. The increase in price volatility results from the time lag which occurs between increases in global demand growth and increases in global steel production. The steel demand growth increase initially strains existing global steel capacity and trade patterns until new regional production comes on line. A significant consequence of this timing lag can be observed in the pricing pattern of net importing regions like the United States where steel production is not growing much and the region needs to compete in the global market to attract imports.
3. A pricing breakout from trend B occurred in 2004. This is an example of how a net importing region like the United States went into buyer panic mode. Pricing “shot the moon” due to the time lag and pricing incentive required to attract sufficient imports from other regions. The huge price premium that occurred in the United States cascaded into the European market and eventually the Asian market as exports to the United States and then Europe became more profitable than domestic prices for steel producers.

4. The recent Chinese market price trend C appears to be moving in the opposite direction of the other regional markets in price trend B. The downward Chinese trend is being driven by the massive additions of steel capacity and production in China. Steel production in 2006 has increased faster than steel demand and has transitioned China from a large net importer to a large net exporter. As China increases its exports you can observe a decrease in prices in the other regions and observe an increase in prices in China.
5. The price spread between regions remains very large. This observation feeds the buyer concern about mill consolidation adversely impacting pricing and availability. While we know that the overall level of global mill consolidation is still limited in that the top 15 steel producers make up only one-third of world steel production, steel consolidation in the United States and Western Europe is much more advanced. The consolidating mills have adopted a “production management” approach to support pricing in their regional markets. China is quite different in that the steel producers are highly fragmented and their “production management” approach is if we will build capacity, we will operate it. In January 2006, the pricing in China fell below the cash cost of many producers and in-turn made exporting to other regional markets very attractive.
6. My conclusion is that steel consolidation is directly impacting steel pricing in the Western markets and indirectly in the Asian market. The consolidators’ quick action to cut production output during times of weaker orders is supporting prices at higher levels in these regions. Their production cuts also impact availability when increased steel orders return. These impacts eventually attract more imports which provide export opportunities to more fragmented markets such as China.
7. Buyer behavior compounds the steel pricing and availability effect from mill consolidation and will be discussed next. Markets that have a considerable consolidation and are net importing regions have the most price and availability risk.

Let me describe how buyers’ behavior can compound the pricing and availability impacts from mill consolidation. The setting is in the United States’ market where the flat-rolled steel producers are heavily consolidated and imports are required to balance market demand.

It starts with a decrease of orders from customers. Spot market prices start to reflect the lower order rates. Some customers compound the reduction in mill orders further as they decrease their inventory levels as they speculate on the depth and duration of the price decline. Concurrently, buyers will also decrease their reliance on imports since they are fearful imports will become a pricing liability in the forward market.

Mills are quick to turn down production in response to the decrease in steel orders. Since three mills have 70% share of the domestic flat rolled market, their production cuts have significant market impact. Smaller mills may be showing a rising prosperity to follow the production cuts.

The table is now set for availability issues to occur in the market. Mills have reduced their production output, buyers have reduced their reliance on imports, and some buyers have reduced their inventories. As soon as increases in orders occur, domestic mill lead times extend and spot market prices firm. As market prices revert, the benefit of reduced inventories also reverses and results in additional increases in orders. The deluge of orders results in a further extension of mill lead times and increases the occurrence of late deliveries and in some cases can lead to shortages of supply. The duration of supply concerns last until the domestic mills have increased their production output, customers have replenished their inventories, and customers have increased the flow of imports to rebalance the market.

Price speculation behavior of some buyers adds to market pricing volatility and availability risk. This is especially true in consolidated markets where mills have adopted a “production management” approach to support price and in markets where imports are required to balance demand.

In closing, the global steel market is as dynamic as I have ever seen it my 30 years of experience. The mill consolidation frenzy is still in its early stages. Steel buyers must consider how market price volatility, large pricing spreads between regions, and availability swings take an economic toll on their company and industry.

I encourage all industry participants to reassess their buying and selling approaches to achieve more stability in the steel markets. Please remember that WSD is available to be part of your team.

Very truly yours,

Pat McCormick

Managing Partner

World Steel Dynamics