SECTOR PROFILE

STEEL SECTOR

Small and Medium Enterprises Development Authority

Ministry of Industries & Production

Government of Pakistan

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2 INTRODUCTION TO SMEDA

The Small and Medium Enterprises Development Authority (SMEDA) was established in October 1998 with an objective to provide fresh impetus to the economy through development of Small and Medium Enterprises (SMEs).

With a mission "to assist in employment generation and value addition to the national income, through development of the SME sector, by helping increase the number, scale and competitiveness of SMEs", SMEDA has carried out ‘sectoral research’ to identify policy, access to finance, business development services, strategic initiatives and institutional collaboration and networking initiatives.

Preparation and dissemination of prefeasibility studies in key areas of investment has been a successful hallmark of SME facilitation by SMEDA.

Concurrent to the prefeasibility studies, a broad spectrum of business development services is also offered to the SMEs by SMEDA. These services include identification of experts and consultants and delivery of need based capacity building programs of different types in addition to business guidance through help desk services.

3 PURPOSE OF THE DOCUMENT

This document is a demonstrative guide for new / start-up and existing entrepreneurs particularly businesses categorized as Small & Medium Enterprises (SMEs). The guide aims at highlighting areas of caution for SME’s about commonly observed pitfalls for new start-ups and small businesses. Although it is inevitable that every new business will face challenges and problems but through this document we hope that businesses can be better prepared to tackle hurdles faced during the start-up phase.

4 INDUSTRY STRUCTURE

4.1 PRODUCTS

Long Steel Products comprise bars, structural sections, and wire products. The scrap from ship breaking and automotive is melted to form billets which are then rolled on stands to form bars. Bars are generally divided into merchant bars and reinforcing bars (rebars). Application of merchant bars is in the fabrication of furniture, whereas rebars are used in strengthening concrete in bridges, highways, and buildings.

4.2 DEMAND DYNAMICS

Demand for long products has grown at a healthy CAGR of 14% over the last three years. As per estimates, Pakistan's per capital finished steel consumption at around 45kg/capita is well below World average of 208kg/capita indicating significant potential for growth. CPEC related projects, higher Public Sector Development Programme (PSDP) allocation in FY18 (increased by 40% to Rs. 1trillion) and increased construction of housing schemes bodes well for the demand outlook for sector. Healthy demand for long steel products is evident from most top-tier players having two month order pipeline. A major demand driver is the planned construction of hydropower dams; as per industry estimates 8,000-10,000 MT per month of demand for the next 8 years due to construction of Dasu dam while Suki Kinari is expected to result in incremental demand of 5,000 MT per month for the next 4 years. Given the importance of timely availability and quality, most of these orders are expected to be catered to by top-tier players[1].

4.3 IMPORTS

Given the excess capacities in China and low availability of quality long steel products, imports have witnessed a rising trend over the last few years. According to Pakistan Bureau of Statistics, finished steel imports continue to outpace finished local production. Finished steel imports have grown at a 3 year (FY13-FY16) CAGR of 16% while local finished steel production has grown at a 3 year (FY13-FY16) CAGR of 10%. Post increase in regulatory duty, month on month imports have witnessed a decline post January'2017 after having spiked during the October'2017 to January'2017. While top-tier local players have an advantage of catering to customer requirements as per desired quality (customers can get the product changed if it is not as per the required quality) and in a timely manner, imports still continue to be available at a slightly lower price vis-à-vis locally produced steel.

4.4 DUTY STRUCTURE

To shield the local players from dumping, National Tariff Commission (NTC) has imposed regulatory and anti-dumping duty on imports of rebars and billets. Local players enjoy 24% and 30% duty protection on imported billets and rebars, respectively. Imposition of duty on imported billets in June'2017 is expected to reduce competitiveness of non-integrated players (who do not have melting furnace or there is a mismatch between melting and rolling capacity). Amongst top-tier players, Agha Steel

[1] Pakistan British Business Council

Industries (ASI) and Amreli Steels (ASTL) are expected to benefit the most. Imposition of anti-dumping duty on imported re-bars (under review) will further enhance competitive advantage from imports.

4.5 CAPACITY UTILIZATION

Most large players are operating at high capacity utilization levels indicating healthy demand for rebars. Capacity utilization of three large players Mughal (MUGHAL), ASTL and ASI stood at 75% (FY16), 88% (FY17) and 91% (FY17), respectively.

ASTL	
In MT	FY17
Capacity	
Billets	200,000
Bars	180,000
Production	
Billets	163,778
Bars	158,206
Capacity Utilization	
Billets	82%
Bars	88%

MUGHAL	
In MT	FY16
Capacity	
Billets	155,719
Bars	326,563
Production	
Billets	99,657
Bars	245,675
Capacity Utilization	
Billets	64%
Bars	75%

ASI	
In MT	FY17
Capacity	
Billets	216,000
Bars	135,000
Production	
Billets	127,656
Bars	122,656
Capacity Utilization	
Billets	59%
Bars	91%

4.6 EXPANSION

Given the robust demand outlook and most players operating at high capacity utilization levels, most of the top-tier players are undergoing expansion to enhance both melting and rolling capacity. Over the next two years, additional capacity (only of top-tier players) coming online of billets and bars is estimated at around 1million and 2million MT, respectively. A number of new players (Liberty & Naveena Steel) are also considering expansion but the plans have not been finalized as yet.

In MT	Current	After Expansion
AMRELI STEELS		
Billets	200,000	600,000
Bars	180,000	750,000
AGHA STEEL INDUSTRIES		
Billets	250,000	450,000
Bars	150,000	750,000
MUGHAL IRON AND STEEL		
Billets	155,719	546,000
Bars	326,563	1,000,000
DOST STEEL		
Bars	350,000	NA

With expanding construction activities, volumetric sales of two of the three major players have doubled over the last three years with the third player also witnessing healthy increase in sales. Given that most players are undergoing BMR/capacity expansion and in the backdrop of healthy demand outlook, sales of top-tier players are expected to grow.

Margins for top-tier industry players have shown a varying trend with the same ranging between 10%-29%. Sector specialists believes that variation in margins is a function of differences in composition of production plant (integrated vs non-integrated) and power consumption. Margins of ASI benefits from efficient plant (lowest power consumption vis-à-vis competition, and in-house gas production) with melting and rolling facility in the same place resulting in limited transportation charges. Mughal Steel margins are the lowest amongst top-tier players due to power constraints and high utilization of imported billets. Margins of Mughal Steel have declined in the ongoing year due to rising billet prices and increase in duty on imported billets. ASTL margins compare favorably to Mughal but higher transportation charges due to shipping of billets from SITE to Dhabeji for rolling result in lower margins vis-à-vis ASI.

5 BUSINESS RISK FACTORS

5.1 HEALTHY DEMAND OUTLOOK SUPPORTS BUSINESS RISK PROFILE OF LONG STEEL PLAYERS

Significant infrastructure development planned to be undertaken under CPEC, high PSDP spending and construction of mega housing schemes is expected to keep demand outlook healthy over the medium term. However, any significant delay in planned projects due to political uncertainty pre-elections and cut in PSDP spending post elections in order to curtail deficits may impact sales.

With repayment of debt and retained profits, gearing levels have witnessed a noticeable decline for most players. Gearing levels for ASI is on the higher side vis-à-vis other players. Going forward, gearing level of ASI may depend on timing and quantum of cash inflows from proposed Initial Public Offering (IPO). Gearing levels for ASTL and Mughal are expected to remain within manageable levels. Given the improvement in profitability, cash flows have grown and now provide healthy buffer against upcoming debt payments for most players.

5.2 PRICING POWER

Higher demand and imposition of RD & ADD has improved pricing power of industry players. This has allowed companies to pass on impact of higher steel scrap prices which have increased by 28.5% in calendar year 2017. As per industry players room for further increase in prices remains; although same is not planned to be undertaken in order to capture market share in view of existing capacities coming online. However, any change in duty structure or demand outlook may impact pricing power and margins.

5.3 SIZEABLE EXPANSION BY MAJOR PLAYERS TO INCREASE COMPETITION

Three of the major existing players are increasing their capacity by over 3(x). This along with addition of capacities by second tier players and planned entry of new players is expected to intensify competition. Specialists believes that integrated players with higher plant efficiency (lower power consumption in terms of KWH/Ton) would be well positioned vis-à-vis competitors. Industry players believe that growth in demand and reduction in imports is expected to cater to additional capacities coming online.

5.4 EXPANSION TO PROVIDE COMPETITIVE EDGE TO TOP-TIER PLAYERS

Expansion is expected to provide competitive edge to top-tier players who will be able to compete with low quality producers even in terms of prices due to efficiency benefits from new plants. The new plants will have lower power consumption (around 30% power cost savings) and continuous process of making rebars from billets (no heating of billets will be required which will result in saving of labour and heating cost of around 2,500/ton). Moreover, conversion yield of billets to rebars is also expected to improve post expansion.

5.5 INCREASE IN RAW MATERIAL AND POWER COST

Increase in raw material (scrap) and power cost, which are the two major cost components for long steel players, may negatively impact margins. Moreover, rupee depreciation which besides increasing raw material cost will also increase working capital requirements for industry players. In a healthy demand outlook scenario, expects all increase in costs to be passed on to consumers.

6 OPPORTUNITIES

- Iron and steel industry has gained importance due to China-Pakistan Economic Corridor (CPEC) project and increased construction activities in the country.
- Iron and steel industry remains small and fragmented in spite of surging demand due to infrastructure development and private construction activity.
- All the sectors of this industry including Pakistan Steel Melters representing around 400 units want a policy and resolution of tax-related issues.
- Chinese firms were buying steel from the local market and avoiding importing it, which will boost local industry, provide jobs and revenue
- There is a need for giving a clear as well as long-term policy for protecting investments and take steps to make the industry competitive
- In another positive development for the local steel industry, the National Tariff Commission (NTC) has notified a 19.15% definitive five-year anti-

dumping duty (ADD) on deformed concrete reinforcing steel bars (re-bar) imported from China. This is in addition to a 30% regulatory duty on imported re-bars already imposed.

- Soon after the imposition of anti-dumping duty on Chinese and Ukrainian flat steel products in early 2017 similar duties are expected on long steel products (mainly re-bars that are used in construction of buildings, bridges etc.) that have now been notified. This measure will further cement protection for the domestic long steel industry and provide them a level playing field.
- The imposition of new duties will help Aisha Steel Mills Limited, Dost Steels Limited, Mughal Steel – companies that make re-bars and are currently expanding their production capacity. Domestic steel industry is upbeat after the reactivation of NTC in recent years as it is now acting on its complaints of steel dumping (mainly from China) in Pakistan, causing material damages to local producers.
- Anti-dumping duty on rebar has been imposed to rationalize the duty structure between raw material and finished imports. Billet earlier had 24.04% anti-dumping duty and 15% duty (which goes to 39.04% in total) while re-bar, which previously had only 30% regulatory duty, now has 19.15% anti-dumping duty on top (which goes up to 49.15% in total).
- Construction cost is set to go higher as the steel industry announced its plan to increase prices by Rs2,500-3,000 per ton from July 1, 2017, citing measures the government has taken in Budget 2017-18.the industry has no choice but to increase steel prices. Steel companies will not be able to bear the burden for more than one or two weeks.
- The industry can easily pass this burden to the consumers due to strong demand of steel. Steel industry is witnessing rising demand due to the increase in Public Sector Development Program (PSDP), China-Pakistan Economic Corridor (CPEC) projects and higher conduction activities in the last few years.
- Steel industry in Pakistan has remained in the limelight on the Pakistan Stock Exchange in recent years. Moreover, a number of steel companies have also expanded, raising money through Initial Public Offerings (IPO).
- Local steel plate prices remain firm across the board and even though the currency in Pakistan suffered a surprising and worrying depreciation of about 5% this week, demand has continually improved of late, even after the brief fourth-quarter blip in sentiment / pricing.
- Pakistan needs to strengthen safety and environmental standards for its ship-breaking industry on the face of new guidelines being prepared by the European Commission for Asian ship-breaking industry to ensure compliance with its criterion by 2019.

- With financial incentives to get ship-owners chose EU-approved yards, the European Commission has decided to update a worldwide list of shipyards that meet European social and environmental standards — by this fall — and oblige owners of commercial vessels flying an EU country flag to use EU-compliant facilities for recycling by 2019.
- Asian yards also have an advantage over their European rivals because they are closer to local steel industries. “The reason why the yards in Asia are interested in recycling the ships is because they use the scrap. There is a live steel scrap industry – which is not there in Europe. It does not make economic sense to do it in Europe.

7 THREATS

- Due to almost zero production at PSM, the domestic industry is relying on imported hot rolled, cold rolled and galvanized steel and huge foreign exchange is being spent for this purpose.
- Domestic steel production capacity has been estimated to be around 6 million tons compared to the global capacity of 1.65 billion tons.
- Domestic steel consumption remains low as 23 kilograms per capita compared to the Asian average of 261 kg and the global average of 217 kg, which indicate the potential for new investments.
- With government subsidies, Chinese steel companies grew phenomenally in last few decades to meet the country’s extraordinary infrastructure requirements. However, due to economic slowdown in recent years, these companies started dumping their stocks in different countries that ultimately prompted governments to slap anti-dumping duties on Chinese steel firms. China has an installed capacity of over 800 million tons of steel per annum and is, by far, the largest steel producer in the world. Its nearest competitor Japan produces a little over 100 million tons of steel a year.
- The government has decided to increase sales tax rates for the steel industry from the current Rs9 per unit to Rs10.5 per unit. The government collects General Sales Tax (GST) from the steel industry through electricity bills.
- The industry must invest in technology as local producers have not been able to take full advantage of the surge in demand as almost one-third of the domestic demand is met through imports.
- The demand for iron and steel would continue to increase but the local manufacturers would not be able to benefit from it or invest more unless the government gives a clear as well as long-term policy for protecting investments or take steps to make the industry competitive that include cutting the cost of doing business

- Pakistan only placed 10% to 19% anti-dumping duty on Chinese CRC producers, which was still very low compared to many other countries that slapped up to 100% duties on Chinese companies to save their domestic players from collapse.
- Mis-declaration in secondary steel (a notch below the best quality steel) must have been going on because people tend to import primary steel (top quality steel) under the garb of secondary to save on import duties. This (mis-declaration) not only hurt the interests of local industry, but also dent government's income in taxes.
- Unlike long steel products and cement, our products are not directly going to consume in mega infrastructure project that are undergoing under the CPEC. CPEC is going to help us indirectly because we do not produce finished consumer items.
- On top of that some producers fear that the Chinese firms involved in the CPEC projects will prefer to import steel from their country rather than buying it from the local market unless the government takes actions to ensure that imports are allowed for CPEC projects only when the local industry is not able to meet demand.
- Falling international prices of iron, steel and allied products over the last few years made it feasible for the domestic sector to import huge quantities; the industry would not be able to sustain this level of imports if prices revert.

8 FUTURE OUTLOOK

The steel demand is rising and it will continue to remain strong in the next year. The local manufacturers will be able to get the benefit by investing more in the modernizing the industry. Apart from PSM, the outlook for downstream steel mills remains positive in the backdrop of high construction activity.

In view of the significance of steel for other sectors of the economy, Pakistan needs a clear and consistent policy. Such a policy should identify segments in the steel chain that need protection at the initial stage; define and enforce quality and performance standards; and ensure fair competition in the market. This policy should also consider the level of protection available to steel manufacturers in Pakistan's competitors, especially China and India. Here it is important to recall that due to ongoing public developmental spending, and the initiation of infrastructure projects under CPEC, steel consumption is likely to remain strong in coming years. If investment and domestic production in the country fails to keep pace, the additional demand for steel will have to be met by imports, putting additional burden on the country's balance of payments.