Research

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Steel makers stare at rising ore cost

Non-integrated players on course for 300-400 bps decline in Ebitda margins through next fiscal

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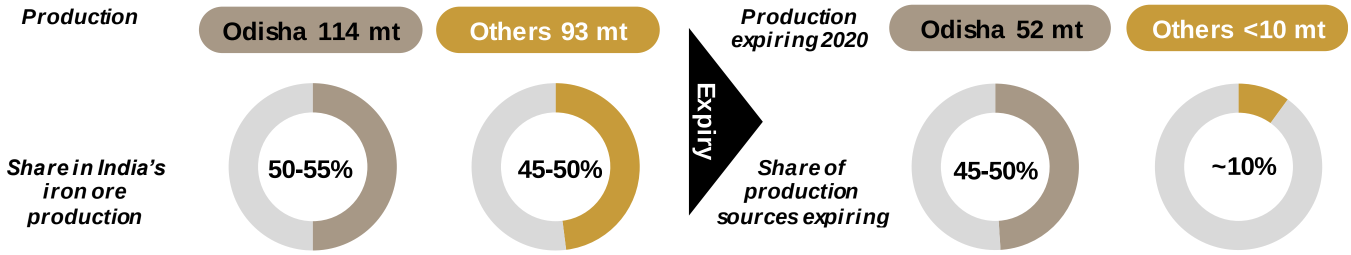
Iron ore mining leases accounting for 30% of India's and half of Odisha's production will expire in 2020

In fiscal 2019, India is estimated to have produced 207 million tonne of iron ore, 65-70% of which was by merchant miners and the rest by captive steelmakers. Odisha alone is estimated to have produced 114 million tonne, or more than half of India's iron ore production. Of this, 70% was produced by merchant miners and the rest by captive steelmakers.

In March 2020, leases on over 30 iron ore mining leases which account for 50-55% of Odisha's and 10% of other states' production, is expiring. That could lead to a 30% reduction in iron ore output. Importantly, all these leases are held by merchant miners.

Profile of iron ore mining auctions



Source: Indian Bureau of Mines, Government documents, Industry

Note: Estimated numbers; mt = million tonne

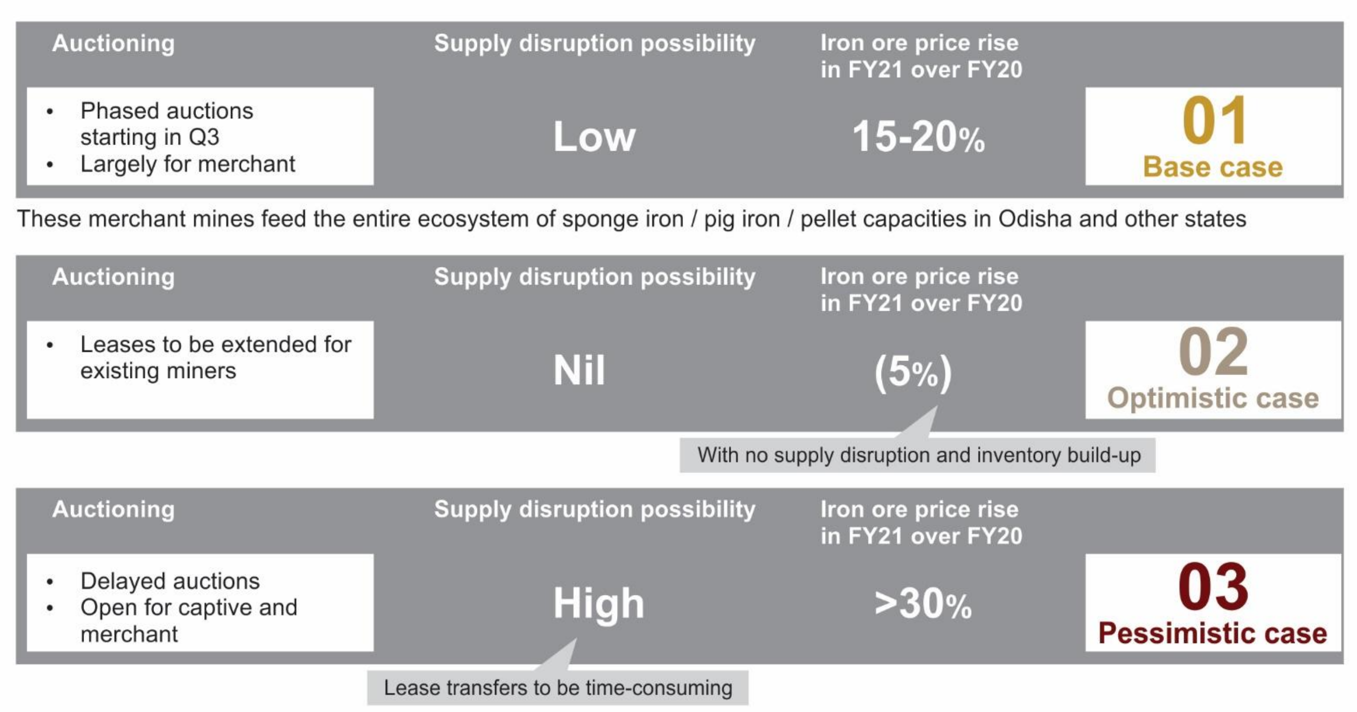
3 scenarios for Odisha auctions, 15% rise in ore prices inevitable next fiscal

With the expiry of iron ore mining leases nearing, there is quite some uncertainty about the completion and scheduling of auctions for G2 exploration licenses. Further, based on our interactions with market participants, two sets of arguments posed by merchant and captive steelmakers in the supply chain bring us to three possible scenarios: (1) base case; (2) optimistic scenario; and (3) pessimistic scenario.

The base case assumes that the auctions would be conducted in a phased manner from the third quarter of fiscal 2020, with leases being opened largely for merchant miners. This case stems from two facts. First, the vintage factor given that these mines have been previously owned by merchant miners since more than a decade and two that the entire ecosystem of secondary steel making in the eastern region feeds from these mines. Around 40-45% of Odisha's merchant iron ore production is consumed within the state and the rest is outbound to other states.

In this scenario, the supply disruption shall be limited, as the auction process will be phased. While the rise in iron ore prices will depend largely on the auction premium, under the base case, we believe the premium will be more rational, keeping the long-term landed prices in mind. This shall translate into a price hike of 15-20% in fiscal 2021 over the current fiscal. Domestic iron ore prices were half of the landed prices in last year, giving enough comfort to merchant miners. Further, the healthy profitability of merchant miners at 30-35% lends room for a 15-20% hike in prices.

Three scenarios



Source: Industry, CRISIL Research

The optimistic scenario assumes lease extension of 2-3 years for existing mines, leading to no domestic supply disruption. Further, prices would correct given the high inventory build-up and expectations for global iron ore prices subsiding from current highs. However, market participants believe auctions are likely to begin in the third quarter of this fiscal making this scenario unlikely.

Under the pessimistic scenario, a delay in the auction process is assumed, with the auction open for both captive and merchant steelmakers. In such an event, larger steel players shall bid higher premiums to ensure long term supply because of better financial muscle, translating into a greater rise in iron ore prices for them. The entire 50-60 million tonne of supply will halt until new clearances are received, leading to iron ore imports at higher prices.

However, captive players that intend to use the mines only in the long term are allowed to participate in the auction, given that a mining plan is submitted before the auction and adhered to post-auction. In addition, 0.5% of the value of the estimated resource has to be paid upfront for the mining lease, with an additional 0.5% as a performance security to the state government.

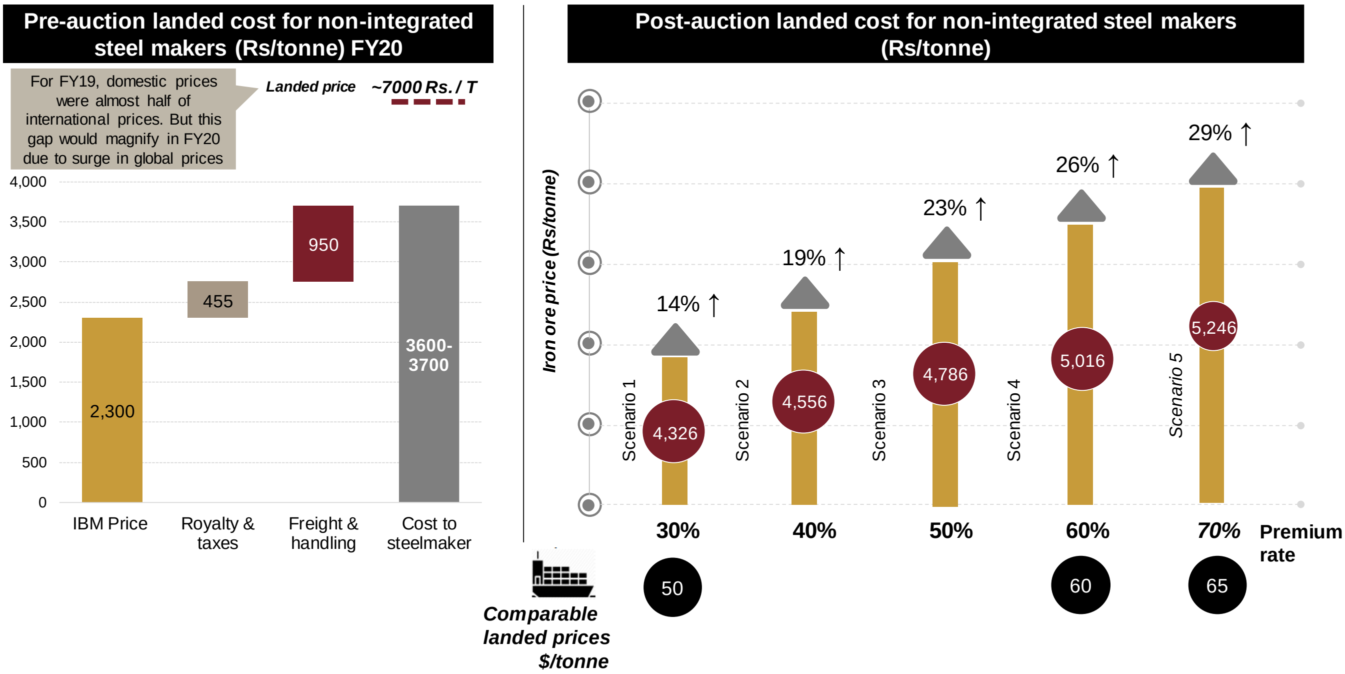
Iron ore prices set to rise for non-integrated steelmakers

Non-integrated players contributed to nearly three-fourth of total production as of fiscal 2019. In the current fiscal, we expect the landed price for a non-integrated steelmaker on the eastern coast to be around Rs 3,600-Rs 3,700 per tonne (including royalty, other charges, and freight).

Iron ore prices are expected to rise depending on the bid premiums quoted in the auction. The below graph illustrates the potential rise in iron ore prices for non-integrated steel makers dependent on the possible bid premiums.

We expect the auctioning to be rational (keeping in mind the long-term landed iron ore prices), translating into a 15-20% rise in domestic prices in fiscal 2021 over the current fiscal.

Post-auction landed cost based on different auction bid premiums



Note: Freight refers to Odisha to Vizag, IBM Price for Fe 62% fines projected for FY20

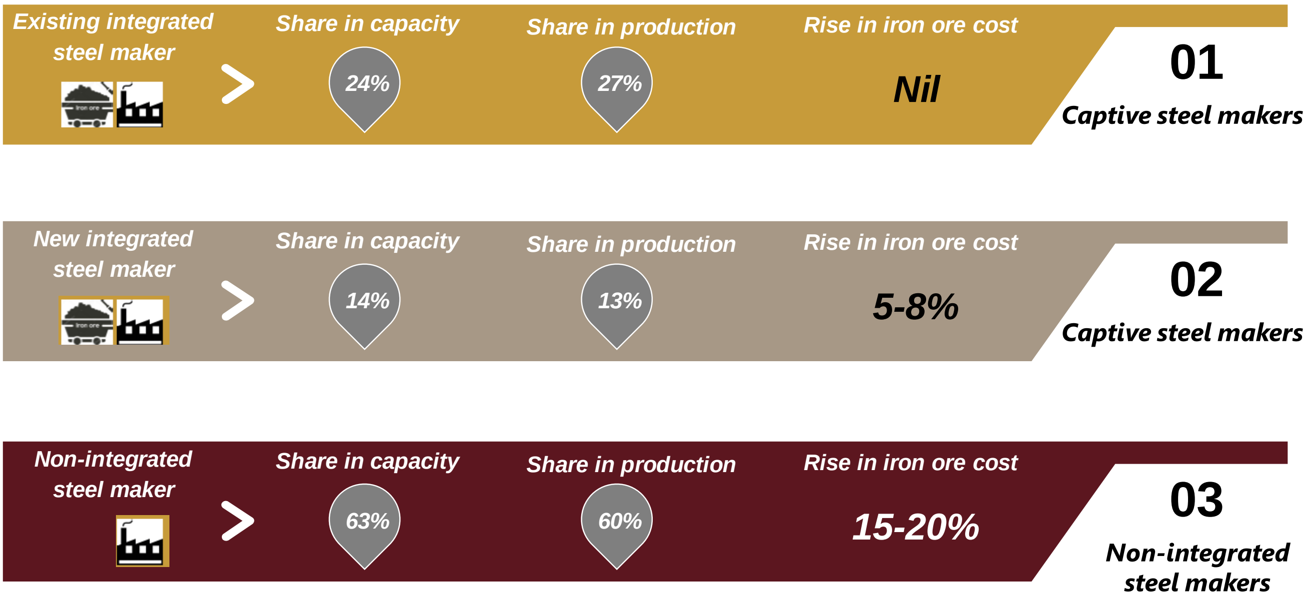
Source: Industry, CRISIL Research

Cost structures to recalibrate post-auction

After the auction, the difference in iron ore cost to various categories of steelmakers is expected to magnify further.

- Existing captive steelmakers will continue to enjoy lower iron ore cost as before
- New captive / integrated steelmakers, which have won new iron ore leases at high bid premiums in the past two fiscals, would witness a 5-8% rise in their iron ore costs versus the earlier merchant-procurement price. Bid premiums were quoted high to ensure long-term supply for iron ore and lower dependence on merchant procurement.
- Non-integrated players are expected to cough up 15-20% more in fiscal 2021 (base case). This shall be 2.6 times the cost of an integrated player.

Difference in iron ore costs for steel makers

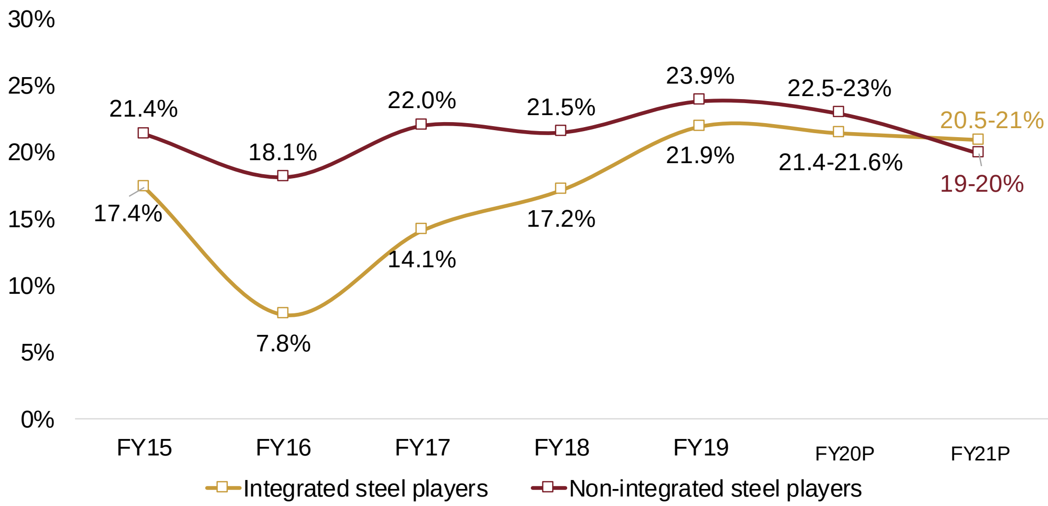


Source: Industry, CRISIL Research

Ebitda margin to fall 300-400 bps for non-integrated players

Revenue growth for larger players shall be under pressure in the current and next fiscal, because of an expected decline in domestic flat and long-steel prices following the global cues. Further, iron ore prices – which contribute to 11-15% of the total operating cost for non-integrated steelmakers – are expected to rise ahead of the upcoming auctions and elevated global prices. As a result, Ebitda spread for non-integrated steel players, which account for 3/4th of production, should narrow 300-400 bps over the next two fiscals. In contrast, for integrated players the narrowing in the Ebitda spread is expected to be restricted to 100 bps because of lower realisation.

Operating margin for large steel players



Source: Industry, CRISIL Research

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