Forging a new path
Opportunities for Latin American metals and mining companies to consider in the Asia-Pacific region

Introduction

The recovering global economy and return of demand are translating into new opportunities for companies in the metals and mining sector as inventories are restocked. This is particularly true in Latin America, where national economies generally fared better than others during the downturn, and companies in the industry are emerging in a strong position.

Demand from infrastructure and industry in the large, growing economies of the Far East (including China, India, and the Middle East) is once again boosting the prices of raw materials. In particular, countries in the Middle East, hoping to take advantage of high oil profits to diversify their economies beyond petroleum, are entering the industry and increasing production. As such, there are opportunities for globally-oriented mining and metals companies, suppliers, and downstream partners. The overall outlook is positive, but navigating the landscape can be challenging.

This document provides a broad overview of the metals and mining industry in the Far East. It aims to put recent developments in context for those Latin American companies that are considering the best way to approach these markets and to capitalize on potential opportunities.

Demand for steel renews the scramble for raw materials

Several forces currently in play have led to the strong recovery of the metals and mining industry. First is the return of demand for steel. Global finished-steel demand is expected to grow robustly from 2009 to 2011, exceeding 10 percent.[1] At the same time, global crude-steel capacity is expected to grow by much less. Naturally, this is having an inflationary effect on the price of ore. Spot prices of iron ore and coking coal have strengthened in 2010, and the long-term contract price for 2010 is significantly higher than in 2009. Over the last year, the spot price of iron ore has nearly doubled, while coking coal prices have also risen significantly.[2]

This is why so many companies are actively searching for new sources of raw materials. Mining companies have been aggressively searching for new sources of ore, such as in Africa, where large deposits are believed to lie in the western equatorial countries. Activity is also high in Australia and Brazil, among other regions.

[1] Nomura, "The Korean way: auto steel, integration," 8 April 2010.

[2] KSL Sector Update, "Metals & Mining – On the Expressway to Growth," 8 February 2010.

A second factor in changing supply and demand dynamics is the reality that some economies – notably China and India – are attempting to develop value-added industries and are promoting vertical integration among mining companies. India, for example, has shown reluctance to export its rich ore, preferring to see it converted to finished products by Indian companies. China is actively trying to advance the development of end-use products derived from steel. Automobiles are one example. China expects to increase car production between 25 percent and 30 percent or 17 million vehicles in 2010. It is anticipated sales will exceed 30 million vehicles in 2015.[3]

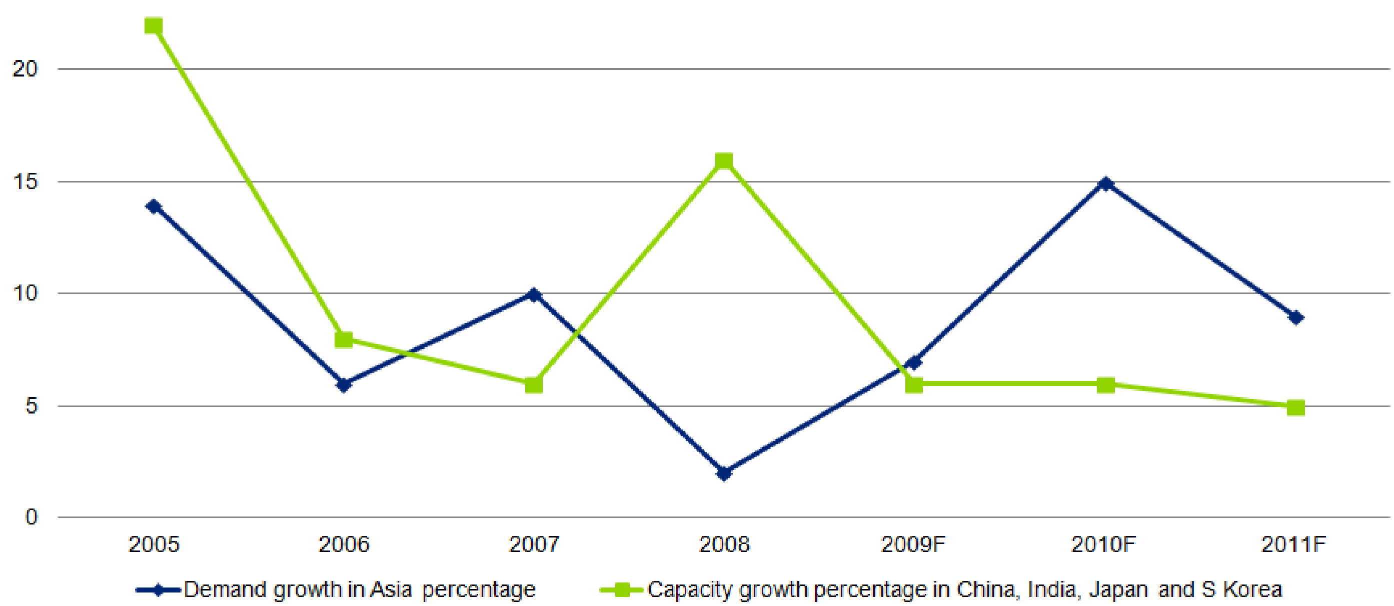
The cost of participating in this growth is high. The plants and equipment required to add capacity to steel-making are extremely capital intensive and required a strong commitment of both cash and time. As a result, companies should strategically evaluate expansion plans to ensure that any executed deals align with overall business strategies as well as consider China's development goals.

Consumers and industry are spurring demand for steel in Asia

Consumer goods – whether large or small – are leading the recovery of the metals and mining industry in Asia, and demand for high-grade steel to make these products is especially strong. In China and India, investment in construction and demand for steel used in household appliances remains robust. In Japan and Korea, demand is primarily coming from automotive and electronics manufacturers. Korean construction companies are also clamouring for steel products partially due to government initiatives to stimulate consumer demand and generate employment,[4] in contrast to Japan, where demand from the construction industry is weak (see Figure 1).

[3] Automotive News, "China carmakers' plans raise overcapacity concerns," 18 October 2010.
[4] Report Linker, "The Future of Construction in South Korea to 2014," October 2010.

Figure 1: Steel: Demand growth versus capacity growth in Asia



Source: Nomura, "The Korean way: auto steel, integration," 8 April 2010.

India: Vertical integration is characterizing the industry's development

India is fortunate to have large deposits of high-quality iron ore, meaning that many steel companies in India benefit from ore self-sufficiency. As a result, while rising raw material prices are a concern for steelmakers in most other countries, the higher prices work to the advantage of Indian steelmakers. Moreover, the country's economy continues to grow rapidly. Consumption of steel in India rose 8 percent in the year ended March 2010[5] (as compared to the same period the previous year), because of improved demand from the automotive, infrastructure, and housing sectors.

Industry observers suggest that markets for steel in India will likely offer good prospects in the long term. Large-scale infrastructure projects throughout the country will also play an important role in keeping steel demand high.

Foreign companies are watching India with great interest, but the risk of establishing large greenfield projects is considerable. Land acquisition, statutory clearances, and securing long-term domestic raw material supply agreements all present challenges to international participation in the Indian market.

[5] Economic Times, "Arcelor's India plans gain fresh ground," 8 September 2009.

China: Reducing capacity, increasing clout

China's most significant challenge to keeping pace with demand is access to high-quality, easily extractable raw material. Although China possesses large iron ore reserves, China does not have high-quality domestic ore. The deposits are widely dispersed, have low iron content (on average only 33 percent), and are contaminated by chemical impurities like phosphorus.[6] As a result, Chinese companies have been active in searching for ore in Africa and are partnering with companies in other countries to ensure their supply. As the largest producer of steel, China is also the world's largest importer of ore.[7] Between 2000 and 2007, the country was responsible for 90 percent of the net increase in internationally traded iron ore, pushing ore prices and shipping rates to record highs.[8]

China's global strategy has demonstrated certain patterns. Looking for more export markets, the country has moved into emerging markets as a first step to global expansion. It has taken a raw material–focused, backward integration strategy to strengthen its upstream and downstream clout. The Chinese government export incentives provide local opportunities, but present challenges for a global level playing field.

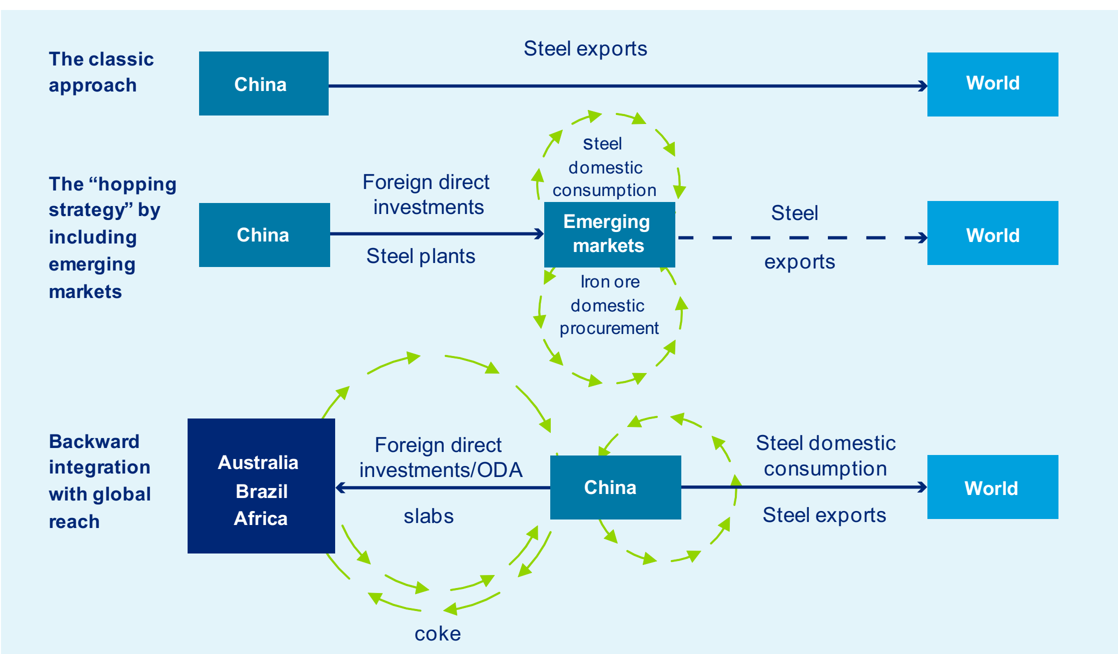
China is not alone in the quest for ore. Companies in Latin America that cannot count on an adequate supply of raw material are also looking to secure long-term sources of ore. However, Chinese companies have important advantages in the form of a high savings-to-gross domestic product ratio and the government's surplus of American dollars, coupled with the desire to convert this cash into hard assets. This ready supply of hard currency is a significant source of clout for Chinese companies in the quest for iron ore supply.

[6] BusinessForum China, "Drivers and Patterns of Chinese Overseas Investments in Steel Mills and Iron Ore Mines," May 2008.

[7] ibid.

[8] ibid.

Figure 2: New expansion strategies for Chinese companies in international markets



Source: BusinessForum China, "Drivers and Patterns of Chinese Overseas Investments in Steel Mills and Iron Ore Mines," May 2008.

At home, the Chinese government has announced plans to concentrate capacity. By 2015, it is expected that 60 percent of Chinese steel will be made by the top 10 mills, up from 44 percent in 2009.[9] This drive to consolidate what is currently a fragmented steel sector will create a handful of global giants and lend leverage to relations with raw materials suppliers.[10]

The new giants will likely also wield more power in setting global steel prices for the auto and construction sectors. Construction alone, much of it for home building, already accounts for about half of China's demand (see Figure 2).

At the heart of the Chinese steel industry's global expansion strategy, however, is the desire to secure access to the world's iron ore deposits. This places China in competition with many Latin American companies that do not control sources of ore and must purchase resources on the open market.

Middle East: The emerging steel region

Economies in the Middle East are taking advantage of the income provided by oil to invest in the steel industry, not only as a means to supply the domestic infrastructure and construction demands, but also as a way to diversify national economies and make them less dependent on oil. Large investments are being made to increase domestic steel production, and major regional customers have responded by increasingly sourcing material from domestic producers rather than importing it from outside the region. Producers in the region are planning to expand capacity to meet growing demand, especially in the production of long products such as reinforcing steel.

The longer-term outlook for the Middle East steel market is equally promising as high oil prices are expected to continue to fuel economic growth and capital investment. Demand for steel is forecast to grow due to government-backed infrastructure and housing projects. To meet demand, a number of Middle Eastern countries are investing in multimillion-dollar state-financed projects, which are set to come on-stream over the next couple of years.

As capacity from these and other projects continues to rise, it is possible that Gulf Council countries will be oversupplied with steel, and over the long term, the Middle East will emerge as a net exporter.[11] Already, in places such as Dubai, slowing activity in the construction industry is creating supply surpluses. However, infrastructure development is still an important theme in the region, and coupled with the potential for growth, this is attracting global players to the Middle East.

The impact on mergers and acquisition activity

The risks and challenges in mature economies of organic growth in the mining and metals industry often lead companies with the resources for expansion to grow through merger and acquisition (M&A) activity. As the price for ore remains high and improvements in the overall economy boost demand for steel products, M&A activity is showing signs of recovery.

Though deal activity was depressed in 2009, there were a number of acquisitions by Asian companies in the Central Asia/Asia-Pacific, Americas, Europe, Middle East, and Africa regions, as companies in China and India looked to secure resource supplies. However, the majority of deals made among Asian companies in 2009 were domestic. And, in 2009, Asian companies focused more on domestic acquisitions than on cross-border purchases.[12]

Looking forward, the rationale for M&A activity remains strongest among steel and ore companies outside the largest global players, driven by the need among smaller ore companies to consolidate, and the pressure on steel producers to mitigate raw material risks.

Currently, differences in the economic growth rates across the regions mean that emerging economies are likely to be most motivated to engage in new deals and are more likely to consider M&A activity as an avenue for growth.

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[9] Chinamining.org, "China sets consolidation target for top steel mills," 18 June 2010.

[10] JP Morgan, "China Steel – Release from the Iron Maiden," 10 August 2010.

[11] Steel Business Briefing, "GCC seen becoming net exporter if capacity gro-wth continues," 21 June 2010.

[12] Mergermarket data, deals taken for 2009–2010.

A strategic approach for growth

The end of the global recession and development needs of the Far East are presenting myriad opportunities for global steel companies to pursue in the Far East on a number of levels. In China, ready cash for capital investment may lead to rapid expansion of the industry. India is also seeking to build capacity and counts on strong supplies of raw material to support development. The Middle East, while not as strong a player, should not be forgotten. Its need to diversify away from oil may present new opportunities in the region. More developed economies like Japan and Korea, with lower savings rates, may find it difficult to keep pace with the emerging economies.

However, the Far East is a dynamic landscape, and companies must be strategic when entering the region. The price of building capacity is very high. Risks are plentiful, from financial to regulatory to environmental. Being close to the customer is key, but getting there can be complicated. Apart from seeking growth opportunities, a priority for steelmakers is attaining or securing supplies of iron ore. Self-sufficiency can make the difference not just in profitability, but in whether the steelmaker ultimately survives.

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