Challenging Conventional Wisdom in Steel

A new approach for an old industry

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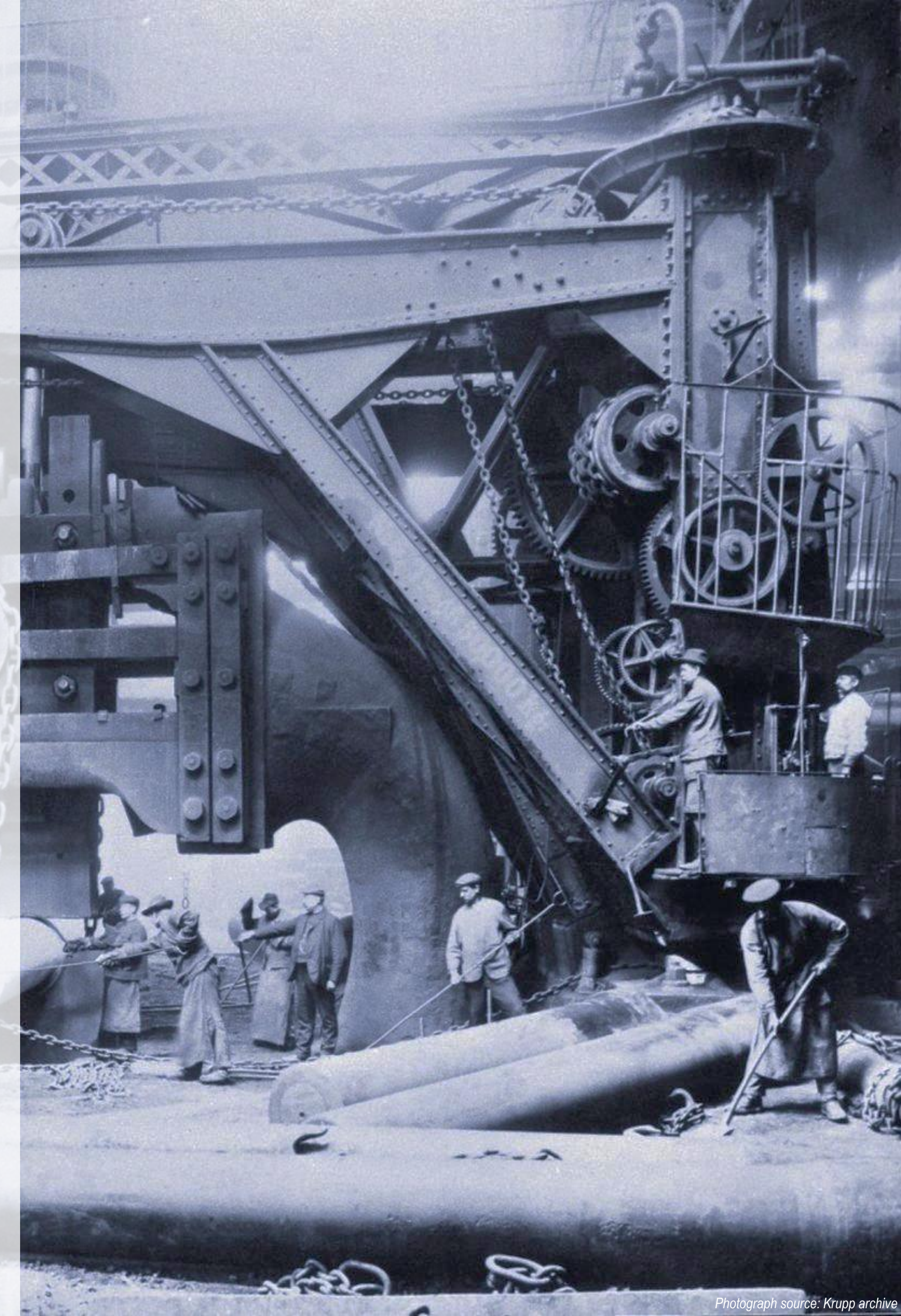


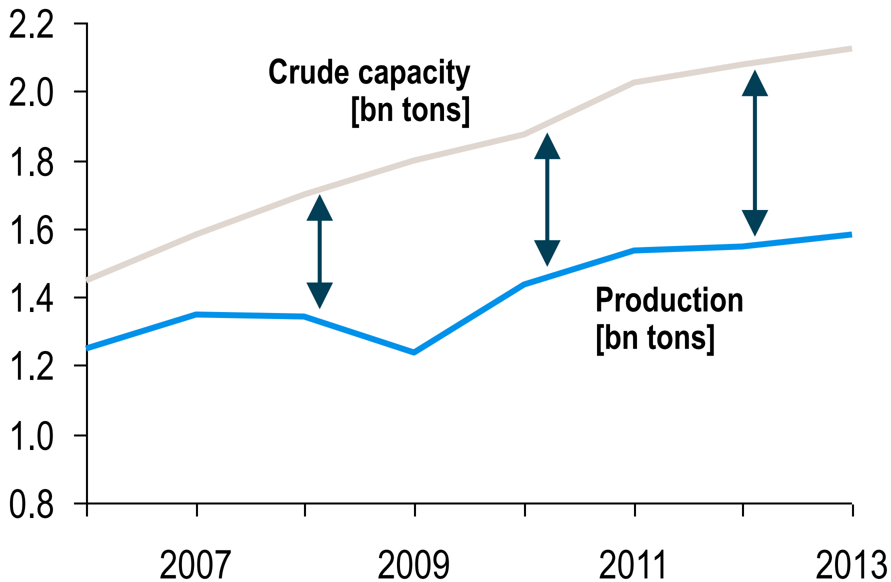
Photograph source: Krupp archive

Executive summary

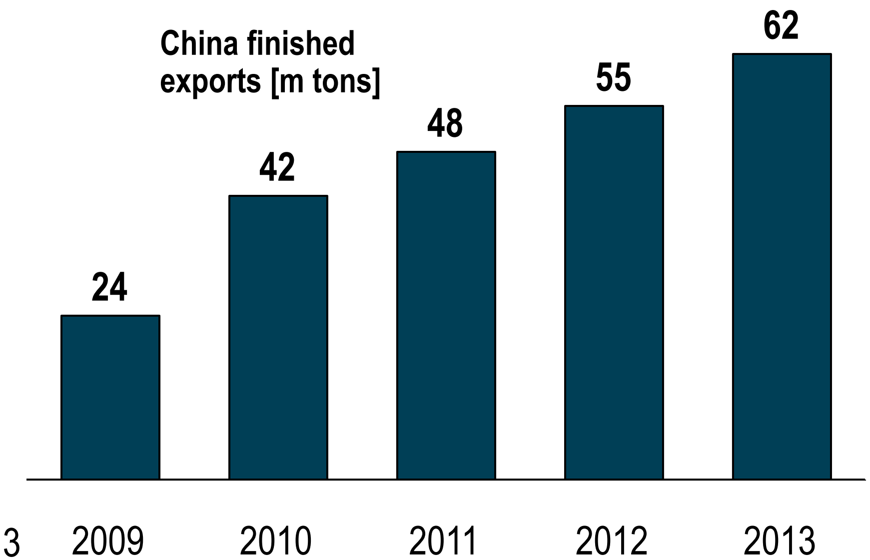
- **Overcapacity** and **import** pressure will **continue** to plague domestic steelmakers
- In the wake of **flagging profitability**, steelmakers focus once again on cost reductions while overlooking one crucial fact: They are **leaving money on the table**
- The **flawed conventional wisdom** of the industry is **trapping** steel companies in a **vicious cycle** of unprofitable sales decisions
- To break this cycle, steel companies need to **rethink** the role of the **P&L**, capacity **utilization** and **commoditization**
- Decisions are often made based on **obsolete financial information** instead of true **economic value**
- Many companies try to 'fill the mill,' but more volume is not always better since it comes with a tradeoff in pricing
- **Competing on price** with imports is **futile**, so domestic steelmakers need to **leverage** their inherent advantages in offering **additional services**
- It is time for domestic mills to **challenge conventional wisdom** and take a fresh look at their commercial decision-making

Experts and analysts routinely blame the struggles of the domestic steel industry on overcapacity and import pressure

Global overcapacity



Threat of imports



An inferno of unprofitability

The world's overcapacity in steelmaking is getting worse, and profits are evaporating

– Economist (July 6, 2013)

Steel Imports Into U.S. Surge

Buyers Embrace Cheaper Overseas Prices Amid Global Oversupply

– Wall Street Journal (June 2, 2014)

Tata Steel

Net profits drop 70% as imports hit European division

– Financial Times (August 13, 2014)

Source: World Steel Association, China Customs, Economist, Wall Street Journal, Financial Times,

Yet global overcapacity is not going away – As China begins to curb, India plans to expand capacity in the coming decade

The cat-and-mouse game of capacity and demand

The **economic slowdown** is finally pressuring **China** to take the first **small steps** toward **curbing** its rampant **excess capacity**

Meanwhile…

Major **investment** plans in **India** will result in **capacity increases** over the next **decade**

> POSCO's USD 12 bn Odisha project proceeding
> Tata Steel's 6 MT Odisha plant opening in 2015
> RINL doubling to 12 MT capacity by 2020
> JSPL tripling to 10 MT by 2020
> JSW nearly tripling to 40 MT capacity by 2025
> SAIL tripling with 50 MT capacity by 2025

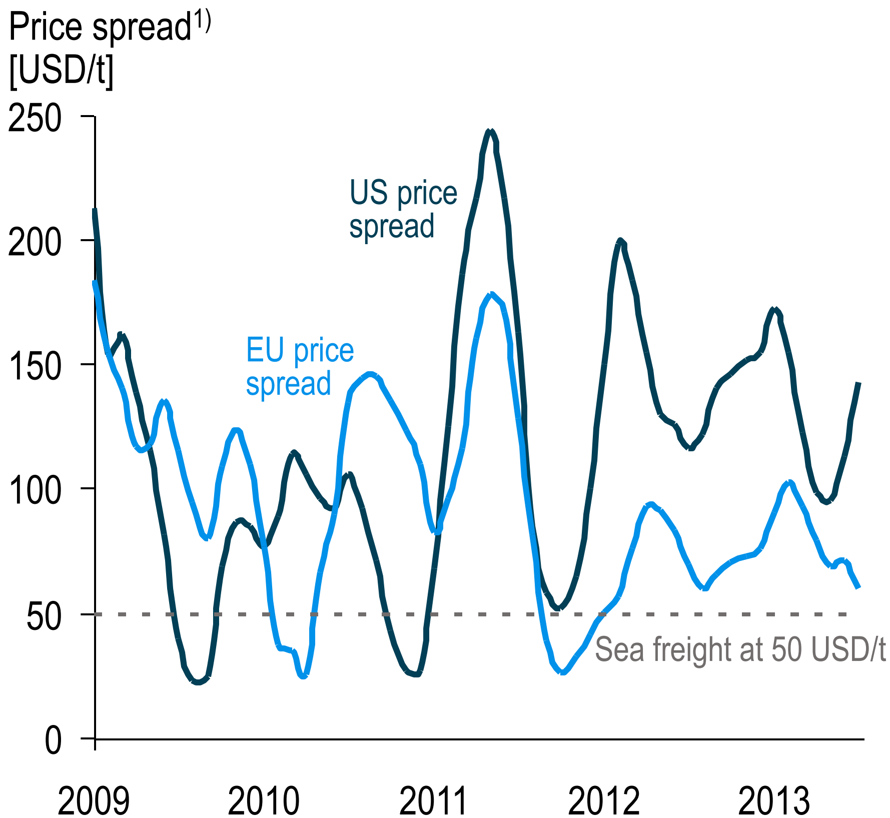
The pattern of behavior:

> Steelmakers rush to build out capacity in fast-growing regions in order to gain key advantages from localization
> When local demand later subsides, the region is left with excess capacity that lingers, leaving little choice but to export
> As one market slows, another one rises to take its place, as seen with China and India

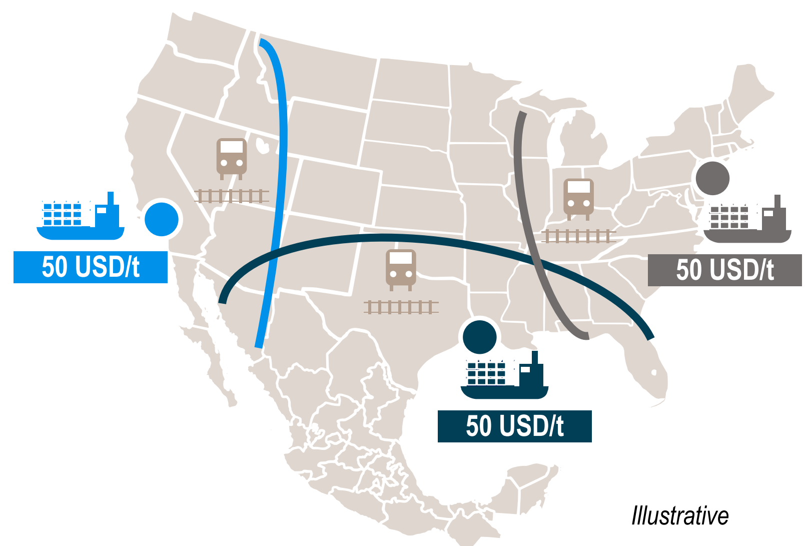
Source: Economic Times, Reuters, The Times of India, The Wall Street Journal, company press releases

With sea freight so inexpensive, domestic mills are unable to compete on cost against imports from developing countries

Price spreads relative to BRIC countries typically exceed the cost of sea freight…



… enabling imports to penetrate major regions



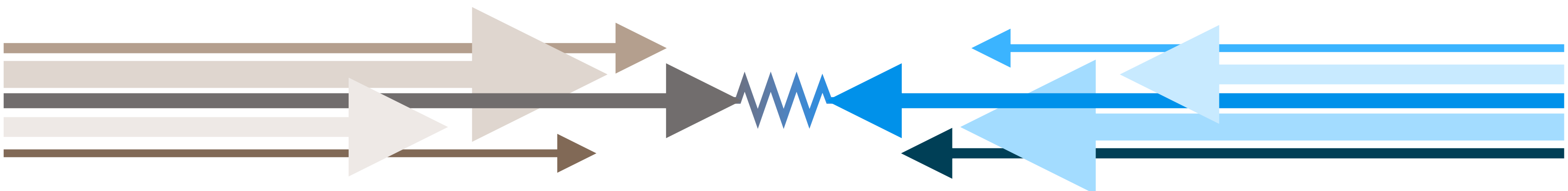
1) Comparison of trailing 3-month average prices; data shown pertain to hot roll coil, but results hold across other products

Source: CRU, CME Group

However, mills and industry experts focus on restructuring and cost reduction while their sales methods remain unchanged

Cost

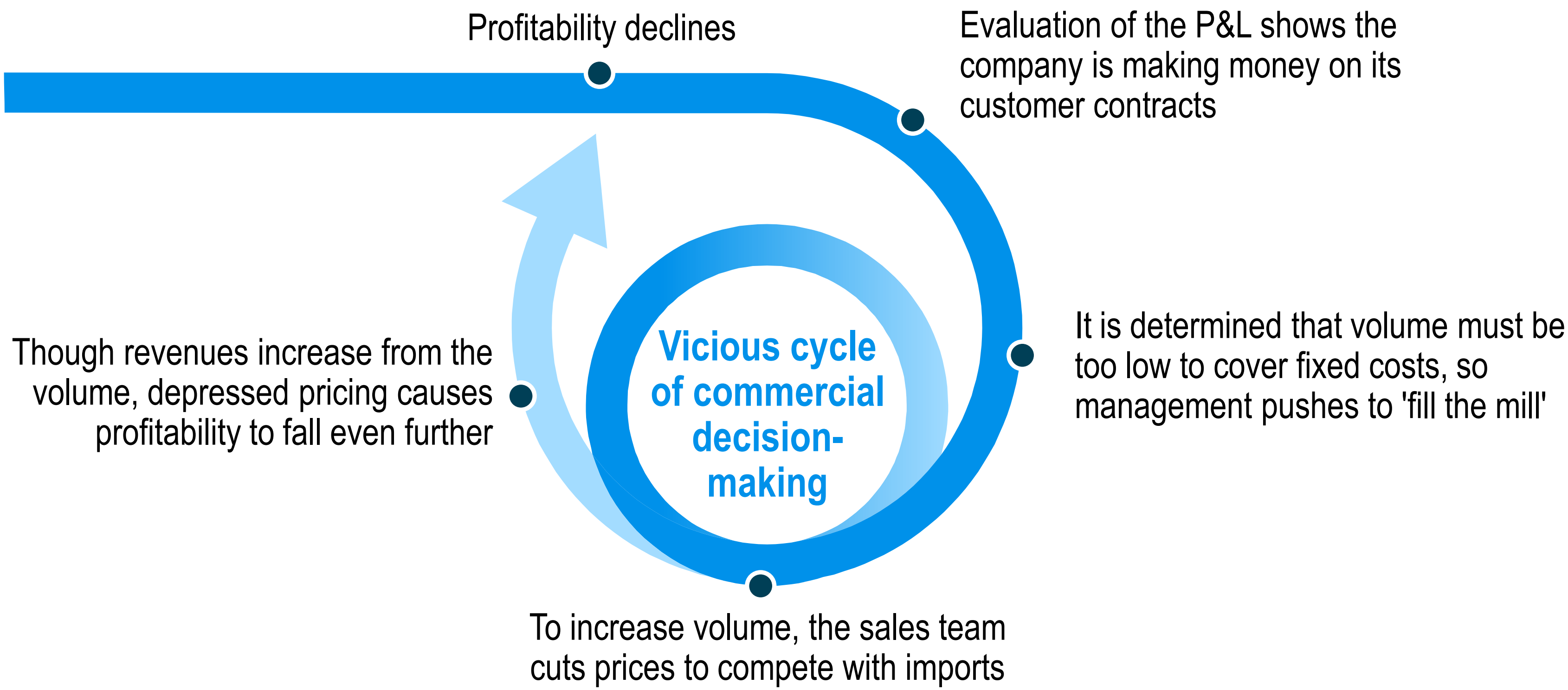
Revenue



> Raw material cost savings
> Pension cuts
> Labor reductions
> Technological innovation (e.g. minimills)
> Stricter expense policies
> Asset disposal
> Financial restructuring
> etc.

No fundamental change in the way that steel is sold

Flawed conventional wisdom of the industry is trapping steel companies in a vicious cycle of unprofitable sales decisions



To break this cycle, steel companies need to rethink the role of the P&L, capacity utilization and commoditization

I Rethink P&L

Eliminate the noise when judging performance

Profitability declines

Measure contracts by their true economic value

Evaluation of the P&L shows the company is making money on its customer contracts

II Rethink Utilization

Properly manage the trade-off between utilization and price

It is determined that volume must be too low to cover fixed costs, so management pushes to 'fill the mill'

III Rethink Commodity

Fight imports with levers other than price

To increase volume, the sales team cuts prices to compete with imports

Though revenues increase from the volume, depressed pricing causes profitability to fall even further

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The P&L is often used to diagnose profitability issues, with an assessment of customer contracts based on contribution margin

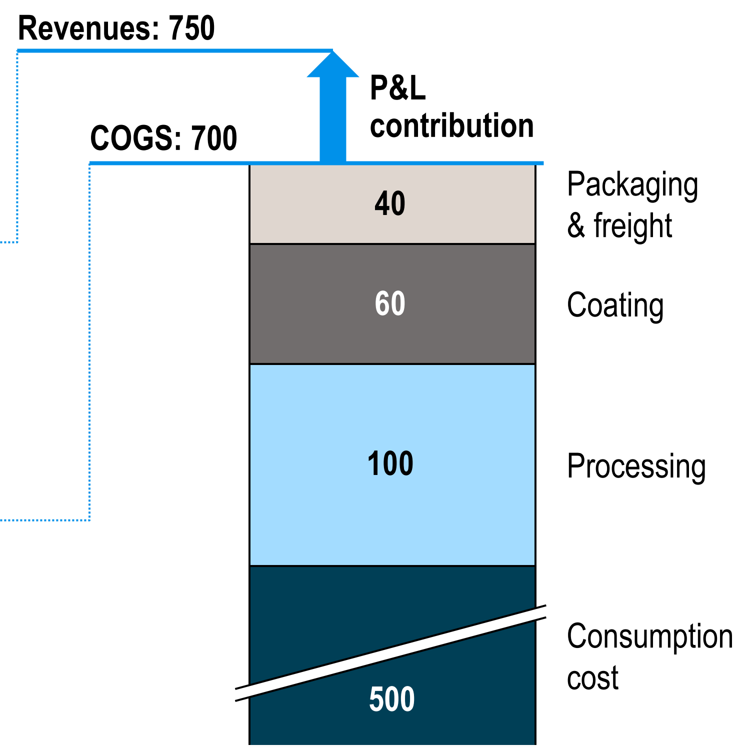
Revenues and COGS aggregate results from all shipments to customers

INCOME STATEMENT
For the period ended September 30, 2014

	Q3 2014
Revenues	…
Shipment A	
Shipment B	
Shipment C	
…	
Cost of Goods Sold	…
Shipment A	
Shipment B	
Shipment C	
…	

For example, this calculation shows a positive margin for Shipment A

Shipment A contribution [USD/t]



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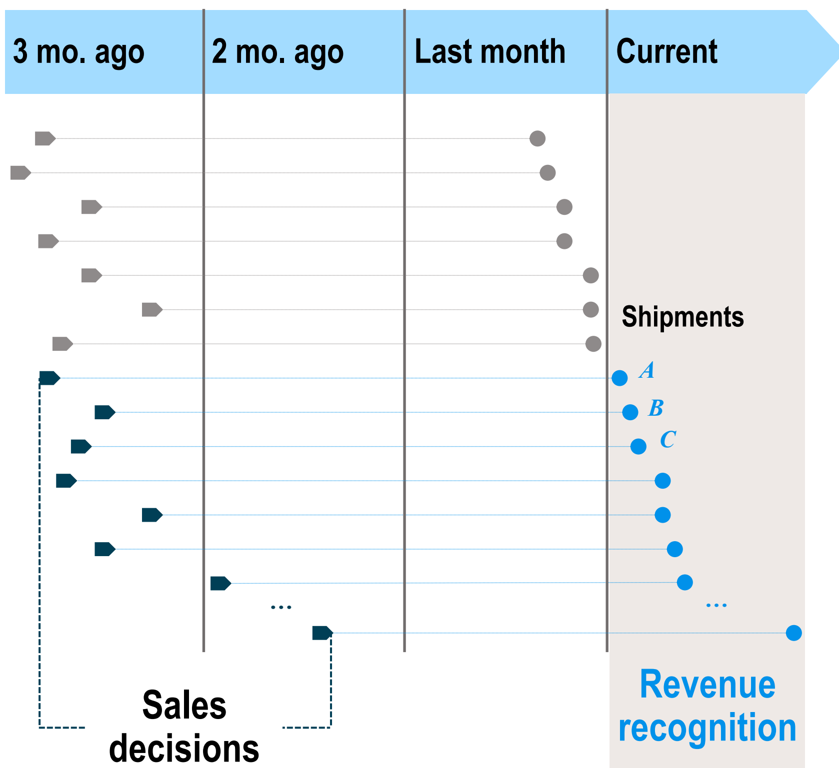
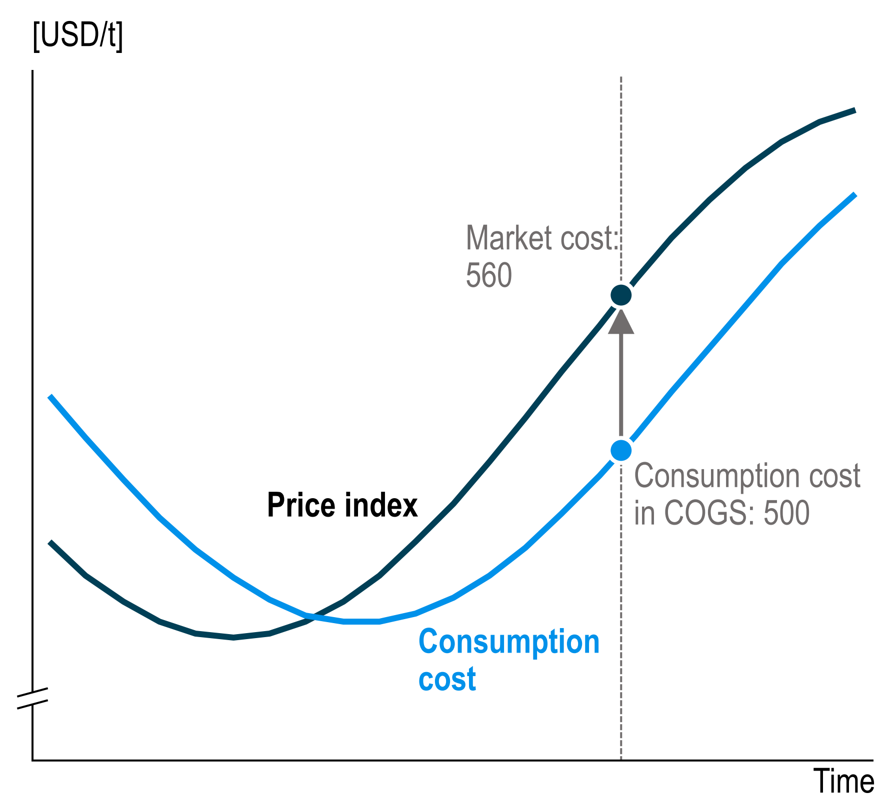
However, this determination is based on the wrong information as the P&L provides a distorted view of performance

Revenues reflect sales decisions made months earlier



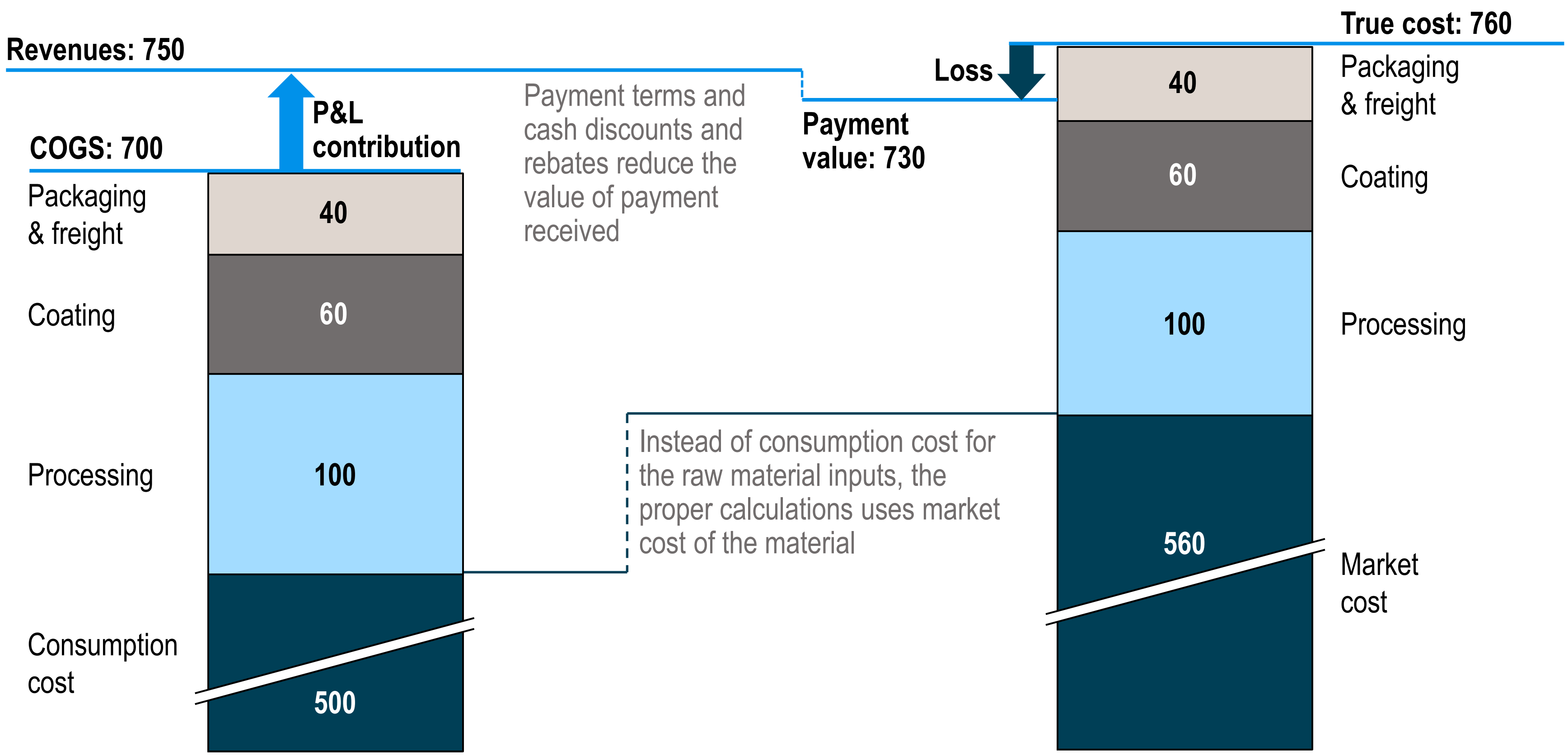
COGS also represent a delayed version of the market but do not match revenues



As a result, the P&L does not reflect the true value of customer contracts

While Shipment A appeared profitable based on the P&L…

… proper analysis reveals that it is actually loss-making



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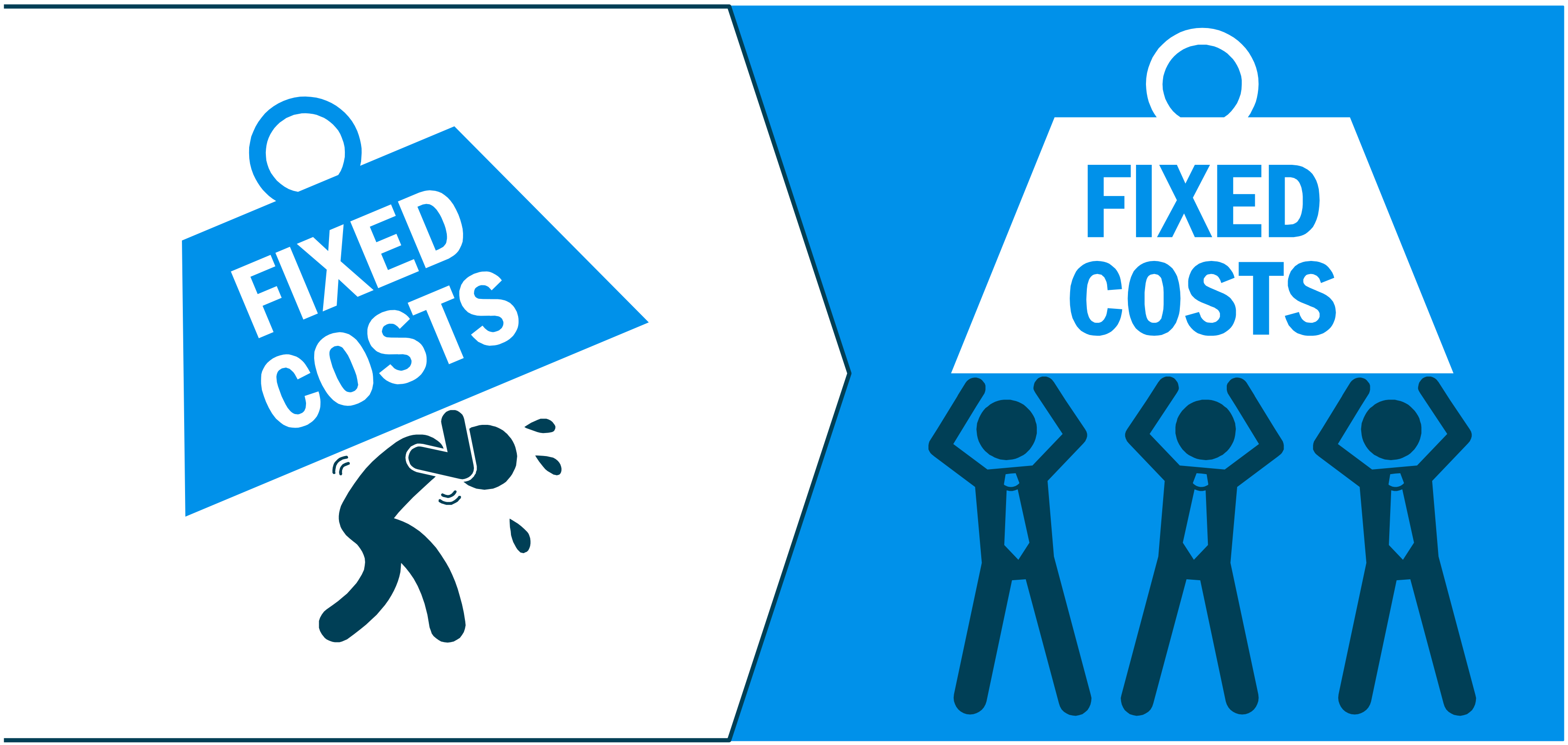
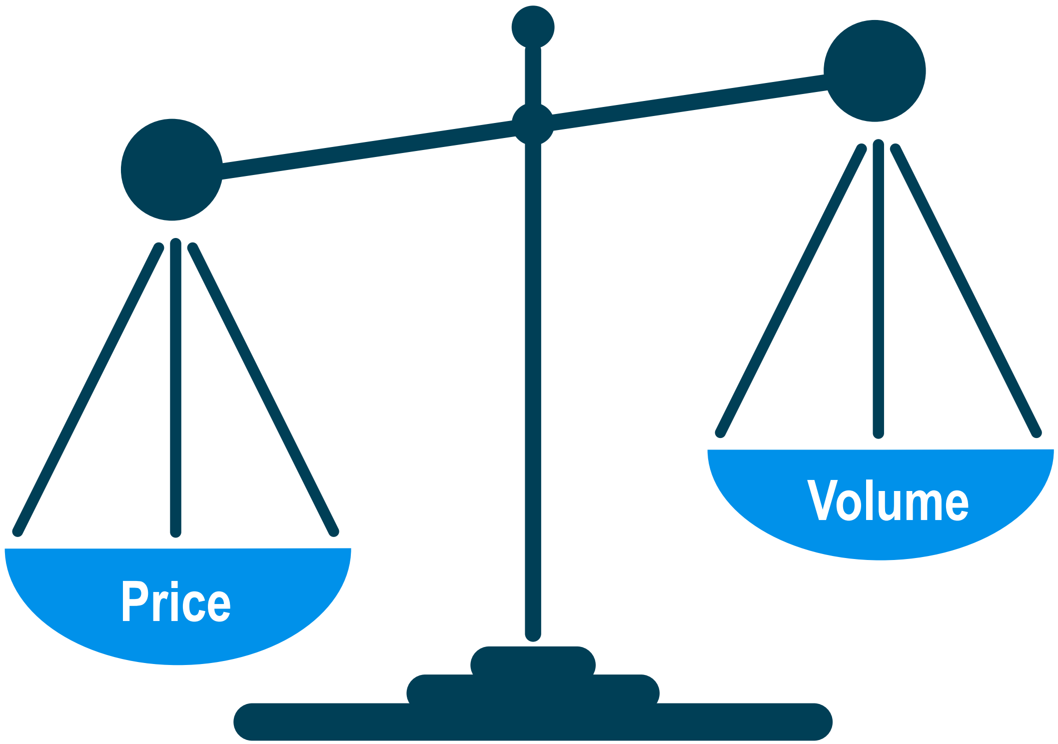
When profitability falls, the natural reaction is to 'fill the mill'



Spreading the burden of fixed costs

But the logic behind 'fill the mill' oversimplifies the relationship between price and volume



Setting the record straight

> The effect of spreading fixed costs is actually quite limited because the cost structure of a mill is largely variable

> There is no single break-even utilization level, as profitability depends on the combination of volume, price, and cost

> More volume is not always better since it comes with a tradeoff in pricing

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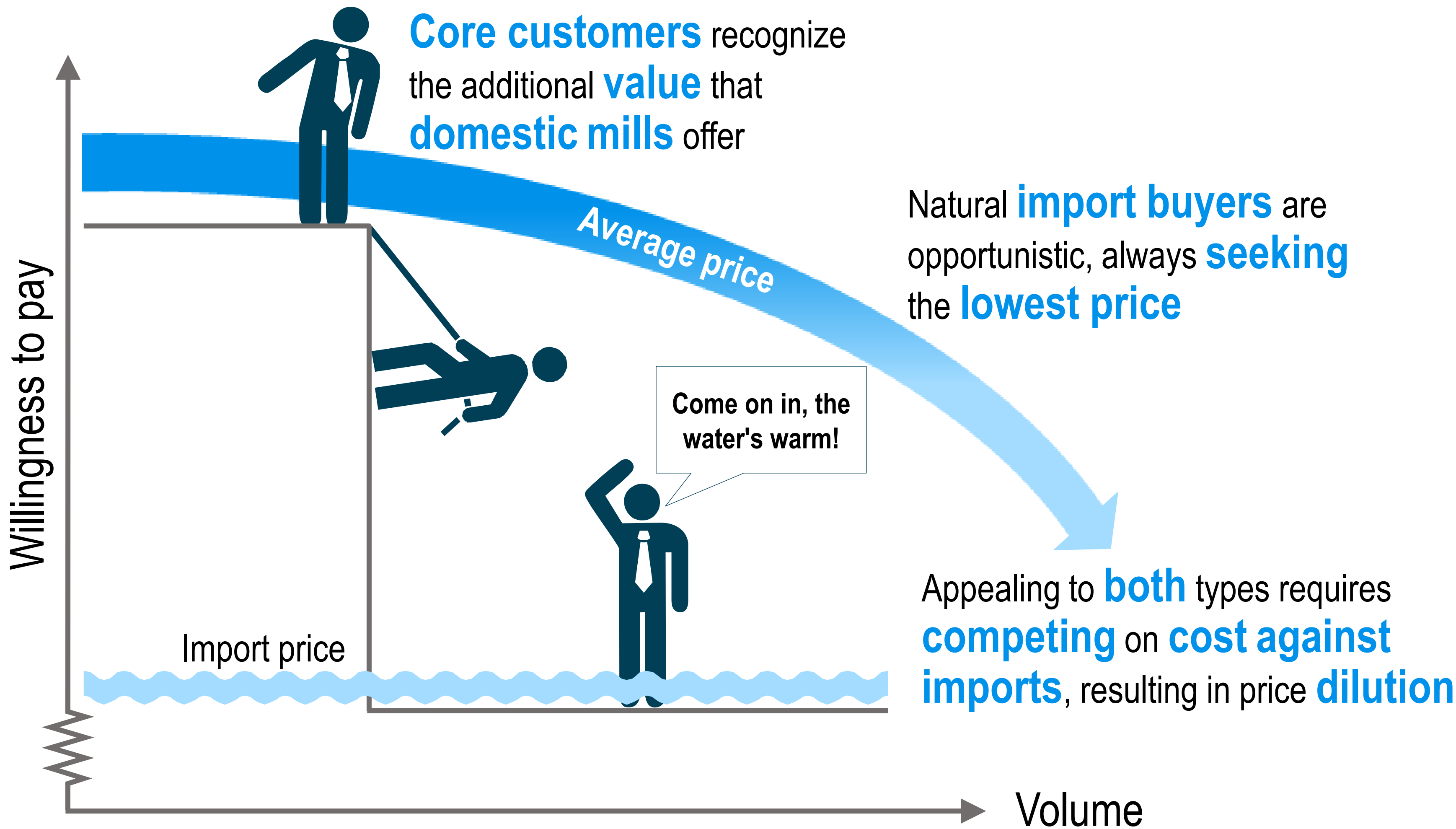
Obtaining additional volume requires appealing to non-core customers, which results in price dilution



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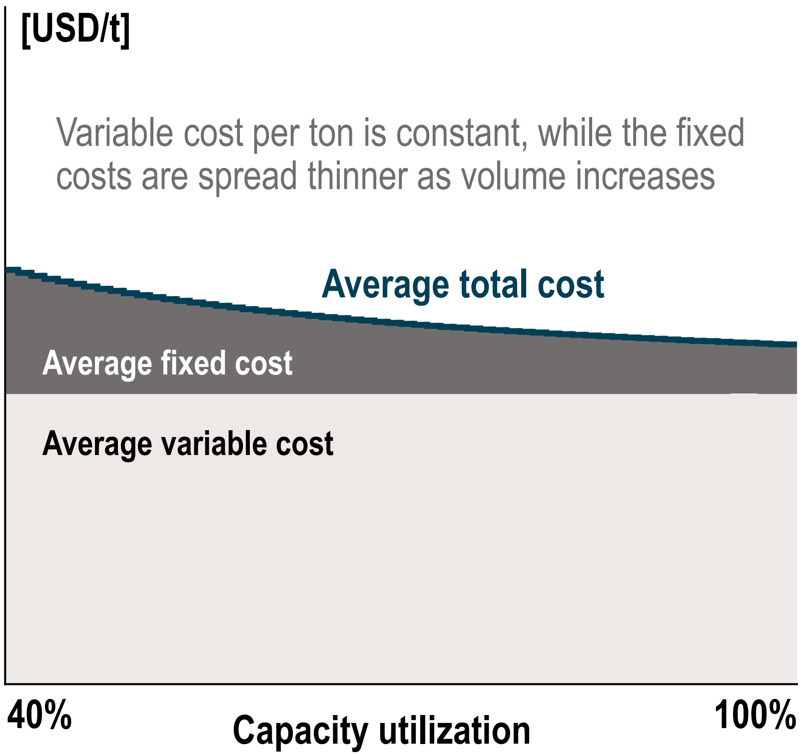
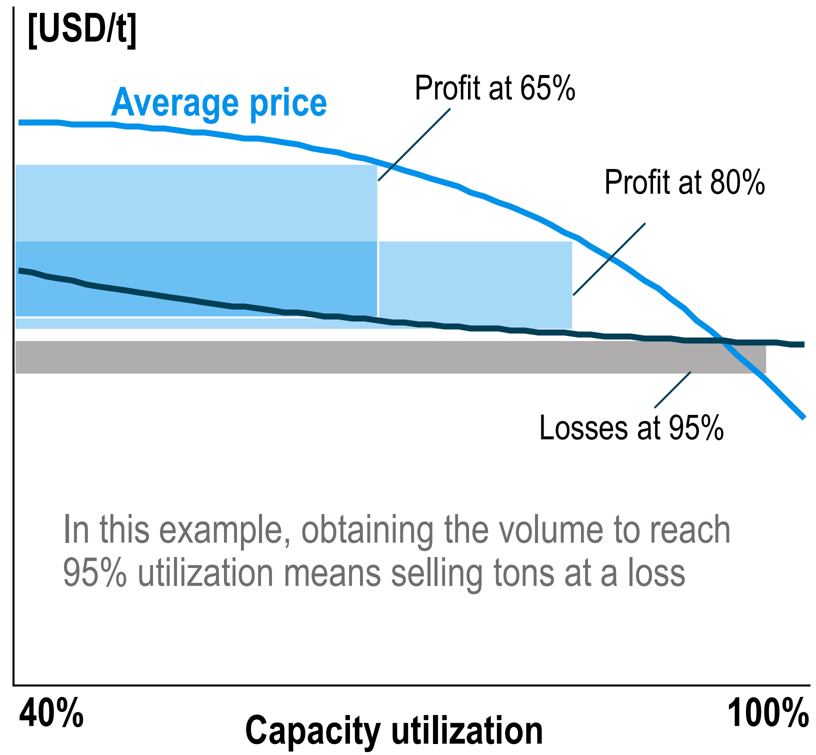
Think twice before filling the mill: Higher utilization may not fix the problems and can actually harm profitability as prices fall

Average cost per ton declines as utilization approaches 100%



However, at some point average price falls faster than average cost



Average fixed cost | Average variable cost | Average total cost | Average price

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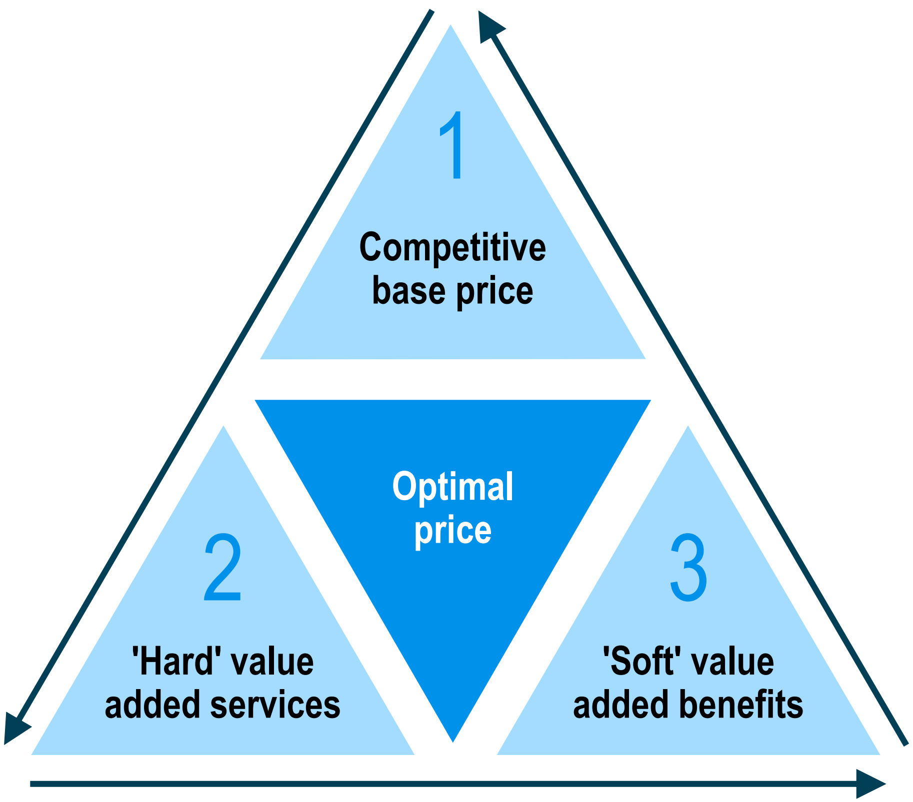
Recognizing factors through which domestic mills can add value that imports cannot is essential to the go-to-market strategy

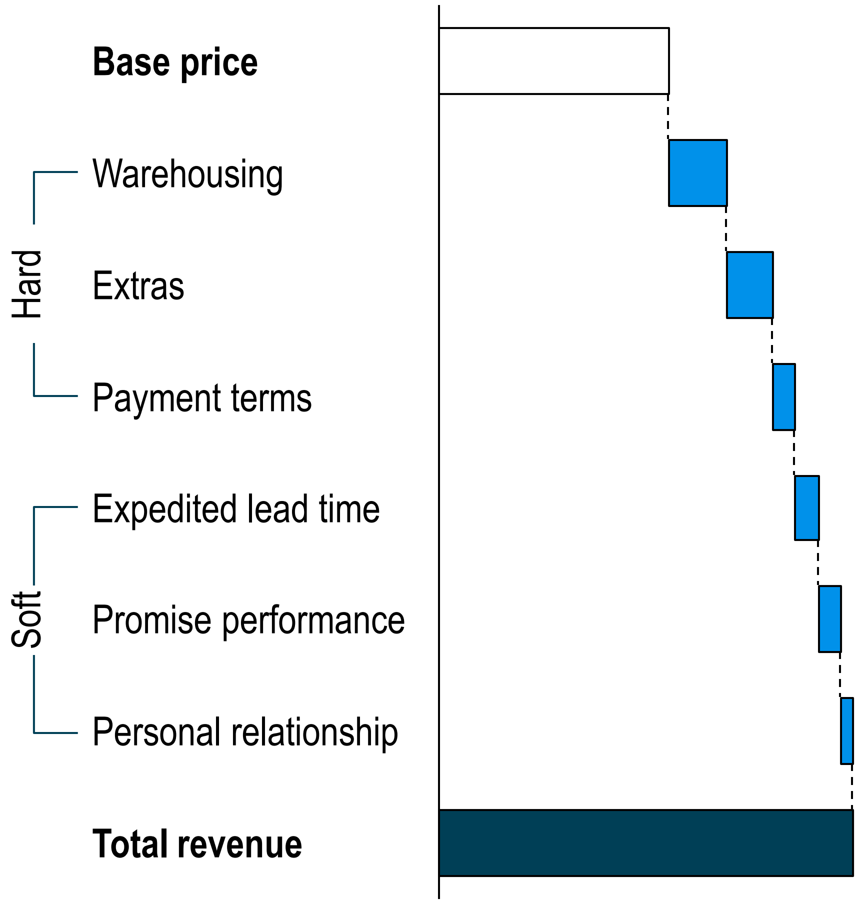


A holistic approach to pricing

1. Ensure competitiveness of base price relative to other comparable peers
2. Analyze tangible value added services provided to customers that warrant price premiums
3. Assess the soft value added benefits such as the day-to-day flexibility, level of communication, and overall ease of doing business

Do not underestimate these factors – Providing them has a substantial cost that must be incorporated into pricing

Economic value [USD/t]



Example value levers:

- > **Warehousing:** Stock certain high frequency items for customers and allow them the flexibility to ship finished inventory after the promised date
- > **Extras:** Determine appropriate prices for extras based on a detailed analysis of production costs, and competitive capabilities and offering
- > **Payment terms:** Evaluate the customer's financial position to offer appropriate payment terms
- > **Expedited lead time:** Opportunistically leverage line time and actively manage inventory to offer core customers 'rush' delivery
- > **Promise performance:** Agree to a level of promise performance to command a price premium which reflects the benefits to the customer's operations
- > **Personal relationship:** Demonstrate a willingness to work with the customer to jointly create value through better coordination and cooperation

think:act to be in the business of making money, not just in the business of making steel

CEO agenda to stop leaving money on the table

1 Get a clear picture of what is really going on inside your sales organization – Measure real performance

2 Be ready to accept an unfilled mill – Volume can be beneficial, but not at any price

3 Create an effective go-to-market strategy for the current market dynamics – Don't fight imports on cost

4 Change the mindset of your organization towards a 'new approach' for the industry


Creative
strategies
that work!
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