Infrastructure Push for Growth in Metal Consumption

- Metalworld Research Team

The economy worry in China resulting into a massive sell off in its equity market has prompted Indian government to respond positively to cash in on its own economic growth. Despite closely linked with global economies, Indian government has forecast its gross domestic product (GDP) to grow by 7 per cent in the current financial year. Although, revised marginally downwards from 7.5 per cent earlier, India would be perhaps the only country in the world to witness such an emphatic economic growth at a time when developed countries have posted a negative growth.

A big push to Infrastructure

In a bold decision, the government gave a big push for infrastructure sector with a hefty 70,000 crore increase in investment to pump the economy even though it means postponing by a year to 2017-18 achieving the stiff fiscal deficit target of 3 per cent. There is a pressing need to increase public investment, India's finance minister Arun Jaitley said while announcing fresh investment in this sector. Listing infrastructure among the five major challenges he has to reckon with, Jaitley said with private investment in infrastructure via the public private partnership (PPP) model still weak, public investment needs to step in to catalyze investment. He also stressed on the need to revitalise the PPP mode of infrastructure development. The minister said investment in infrastructure will go up by 70,000 crore a year 2015-16 over year 2014-15 from the Centre's funds and resources of Central public sector enterprises. The government has increased outlays on both the roads and the gross budgetary support to the Railways by Rs 14,031 crore and Rs 10,050 crore, respectively. The capital expenditure of the public sector units is expected to be Rs 3,17,889 crore, an increase of approximately Rs 80,844 crore over 2014-15. The government also plans to establish a National Investment

and Infrastructure Fund (NIIF), and find money to ensure an annual flow of 20,000 crore to it. This, he said, will enable the trust to raise debt and invest in equity of infrastructure finance companies such as the IRFC and NHB and the companies in turn can then leverage this extra equity manifold. To augment the power generation capacity in the country, Jaitley announced five new ultra mega power projects each of 4,000 MW in the plug-and-play mode. The minister stated that all clearances and linkages will be in place before each project is awarded through a transparent auction system. This will unlock investments to the tune of 1 lakh crore. The government would also consider this plug-and-play mode for other infrastructure projects as roads, ports, railway lines and airports. To augment power sector, he said, India will set up 5 more ultra mega power projects, entailing investments of around 1 lakh crore.

Impact on Base Metals

With big infrastructure spending proposed by the government, metal consumption is likely to rise being nearly two-third of its production goes only in housing and construction sectors. The disinflationary cycle pervading commodity cost structures and reluctant supply cuts against weaker demand outlook have led analysts to put through aggressive downgrades across base metals. Meanwhile, global investment banking Macquarie Research has cut aluminium price forecasts by 6-18% FY16-18E to $1420/t until 2020. While global aluminium producers are witnessing cost deflation from falling coal and alumina prices, Indian aluminium industry is losing its competitiveness having bid aggressively in recent coal block auctions. Aluminium production has become uneconomical at current aluminium prices with negative returns on expenditure at a time when Hindalco as doubled its capacity to 1.3mnt and Vedanta is waiting to ramp up its 1.25mnt capacity. The only hope industry has is possible government intervention to increase import duty from 5% to 10%. Current valuation optically appears attractive as most of the companies are trading below book and lower than historic averages however, historic average are now losing relevance as aluminium business in India has become structurally unattractive and loss making.

In fact, aluminium would remain as the structural underperformer among the base metals, even from current levels suffering from overcapacity and a steadily falling cost structure. With thermal coal prices falling, grid based power costs have moved steadily lower in China. For this cycle to reverse, it would take either strong growth in mining cost inflation or a thermal coal price recovery. Moreover, new supply in Western China continues to come to market with breakeven costs nearer to $1,200/t. Further, the rate of capacity addition in China is still well in advance of domestic consumption, particularly with scrap set to play a more important role in supply. Chinese exports are set to the rest of the world (through semi-finished products) to remain elevated over the coming years. Given the base case aluminium surplus, supply will have to be idled and kept offline for the foreseeable future to keep the market in balance. The question raises of course is where these supply cuts will be and China does remain the most likely source of supply cuts (or any positive market news) over H1 2016. With this bleak outlook, LME aluminum price forecast is cut by 6-18% to below $1,400/t until 2020.

Focus on Individual Companies

The aluminium market has a whole host of problems, but at the core are overcapacity and a steadily falling cost structure. Unfortunately, as of yet the market has not seen enough action to address the former while the latter is only accelerating. Aluminium remains the structural underperformer among the base metals, even from current levels. The biggest change in view over recent times has been around the Chinese cost structure. With thermal coal prices falling, grid based power costs have moved steadily lower. As a result, the price setting tonne has taken a big leg down over 2015, helped by the dramatic fall in the alumina price. For this cycle to reverse, it would take either strong growth in mining cost inflation or a thermal coal price recovery. At the present time, it is unlikely as yet. Moreover, new supply in Western China continues to come to market with breakeven costs nearer to $1,200/t.

The fundamental story in aluminium remains around Chinese production. China has added over 16mt of capacity since 2010, and about 14mt of production. For the global market, the good news is that this rate is slowing – China will only add half this volume over the coming 5 years. The challenge is that this rate is still well in advance of domestic consumption, particularly with scrap set to play a more important role in supply.

Quite simply, the base case aluminium surplus, the supply demand balance simply cannot happen. The market will not be able to sustain inventory build of this level, even with strategic stockpiling. The result is that supply will have to be idled and kept offline for the foreseeable future to keep the market in balance. Indeed, given the high level of inventory the market would need to be in deficit to draw this down before there is any reason to get excited on price. The question this raises of course is where these supply cuts will be and China does remain the most likely source of supply cuts (or any positive market news) over H1 2016.

With end of the $5bn capex program, Hindalco's domestic business is set to witness 50% increase in aluminium volume during FY15-18E with ramp up of 1.5mnt Utkal alumina refinery and 0.36kt Mahan & Aditya aluminium smelter. However, given the flattish aluminium price outlook, global investment banking Macquarie forecasts, aluminium smelting margin to remain sub $100/t in the foreseeable future. Further, with gradual ramp up of 900kt new capacity, Novelis aims to increase share of high margin auto sheet from 11% in FY15 to 25% by FY20 and increase share of recycled content to 80% by FY20. Therefore, silver lining in the company is its end of capex cycle which will generate strong free cash flow and help deleverage the balance sheet.

Nalco, with 0.46mnt smelting capacity and 2.3mnt refinery capacity is a pure play on

aluminium prices. With bleak outlook on aluminium, earnings are forecast to remain weak in medium term. Further, Nalco is awaiting mining lease approval for 3mnt Pottangi bauxite mine for start capex on its 1mnt alumina refinery at Damanjodi. The company proposed $900mn capex for 3-4 years is nearing completion.

Zinc is forecast to trade at $1833/t in CY2016 steadily rising to above $2,800/t in 2019, before softening concentrates balance sparks a small retracement. In 2016, however, zinc price may trade at $1833/t in CY2016 steadily rising to above $2,800/t in 2019, before softening concentrates balance sparks a small retracement. Zinc has also been the subject of a heavy demand downgrade similar to other base metals and global growth is seen at 1.5% and 1.6% in 2015, 16E, within which China is seen at 1.9%, 2.0%. From 2017 growth is seen at 2.1%- 2.5%, with a return to positive China construction growth and global transport strength key. This downgrade has softened the balance, but the aggressive cutbacks by Glencore on top of a number of smaller mines leaving the market and the exhaustion of Century and Lisheen means that zinc actually still looks pretty tight for the next few years. The concentrate balance is seen at a 430kt deficit next year, which will eat into the stocks in China and Europe and force cutbacks amongst smelters. With smelter output constrained by feed shortages and price-driven cutbacks, however, a major stock draw seems to is inevitable, and tightness in metal to slowly begin to emerge from 2Q 2016.

Zinc has also been the subject of a heavy demand downgrade similar to other base metals with an exception from vehicle sales, ~25% of end-use, witnessing strong demand. Global growth is seen at 1.5% and 1.6% in 2015, 16E, within which China is seen at 1.9%, 2.0%. From 2017 growth is seen at 2.1%-2.5%, with a return to positive China construction growth and global transport strength key. This downgrade has softened the balance, but the aggressive cutbacks by Glencore on top of a number of smaller mines leaving the market and the exhaustion of Century and Lisheen means that zinc actually still looks pretty tight for the next few years.

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The metal is set to remain in deficits resulting into relentless upward price pressure directing a strong upward move in zinc prices. With impressive progress on SK mine, Kayad mine and Rampura Agucha open pit deepening project, Hindustan Zinc Ltd. (HZL) is on track to expand is mine metal production from 1mnt to 1.2mnt by FY18-19E. In the next 3-4 years, HZL would transform from 80% open cast mining to 100% underground mining company and has been managing costs pressures as per guidance and better than expectations.

Actions on the Ground

As a consequence of falling prices, however, the government is considering in-principle approval for allocation of Potangi mines to Nalco. This is critical for expansion of Damanjori Unit capacity by 1 million tonne, at an investment of around Rs 6000 crore. Also, in-principle approval accorded for giving primary lease for Thakurani mines block-A to SAIL and resolution of Bolani mines and Barsua mines issue. The government is also considering a concrete action on the following in a month or two:

● Expediting setting up of District Mineral Foundations in different districts, in addition to the 12 districts where DMF has been set up already. Efforts will be made to set up DMF in remaining districts and amending the DMF rules, within this month.

● Extending full support of MECL in facilitating G-2 level exploration of mine blocks.

● Consideration of making royalty of iron ore lumps and fines different in line with the practice in other states for revival of steel and mining sector. At present lumps and fines are being charged same royalty rates in Odisha.

* Expediting renewal of mineral lease of mines, which are pending owing to different reasons. Only 80 out of 400 major mineral mines in Odisha are operational at present.

Meanwhile the government of Odisha sought support from the government on approval for grant of mineral concessions for 3000 hectares Karlapet Bauxite deposit in Kalahandi district. State government had reserved the deposit for Odisha Mining Corporation on this site. Also, the proposal was sought to grant mineral lease for 1848 hectares and PL for 1157 hectares and setting up of Aluminium Park by Nalco in Odisha. All these would give a big fillip to the metal sector in India.