China Basic Materials Sector

More on "supply side reform": Risk of overshooting

- We see emerging risk of overshooting in supply cut in 2017E for China basic materials, driven by more aggressive steps taken by NDRC/MIIT, Ministry of Environment Protection (MEP), and local government. The efforts, mostly uncoordinated and some likely irrational in our view, would lead to strong support to commodity pricing, potentially overshooting beyond mid-cycle recovery.

- Specifically, we expect an early execution of planned capacity closures in 2017E. In the political context, the supply reform may lead to additional disruptions, with MEP likely a major surprise driver. We estimate the proposed policy by MEP on air pollution control for the BJ-TJ-HB region to boost capacity utilisation by 4% for steel, 2% for aluminium, 6% for aluminium, albeit reversible.

- Our view on steel and alumina profit outlook is incrementally more positive, yet remains mostly unchanged for aluminium. We continue to like cement, and expect self-initiated supply discipline by producers to lead to positive surprises in pricing and earnings.

- We raise earnings for Angang, Maanshan, Conch, CR cement and Chalco. Our top picks are Baosteel, Angang and Conch. We least prefer Chalco and Shenhua.

Figure 1: Sector summary—China basic materials

Figure 2: Potential affected cities (26+2) and provinces by the proposed policy MEP air pollution control

Figure 3: Potential impact of MEP policy supply control during winter

Pricing and earnings outlook revisited

Our view on steel remains positive, with higher visibility on sustainable mid-cycle recovery, where ROEs of most steel names are likely to reach 10% or above. While the recent restocking has reverted to the normal pattern, further supply cut will still lead the pricing pattern to outperform the past, given the current stretched effective BF utilisation. We raise Angang’s earnings by 15% for 2017E and revise up TP to HK$7.50 (from HK$6), Maanshan by 26% and revise up TP to HK$3.50 (from HK$2.70).

We are incrementally more positive on alumina due to the potential meaningful supply disruption by MEP, yet remain cautious on aluminium. We revise up Chalco’s 2017E NP from Rmb1.2 bn to Rmb3.9 bn, to reflect the higher-and-longer alumina prices. Valuation remains expensive, in our view, under strong pricing assumption. Maintain UNDERPERFORM with a revised TP of HK$3.20/sh (from HK$2.20).

We see cement producers’ supply discipline to lead to lower inventory than the past, thus better protected margins and likely more price hikes in the peak season. We raise Conch’s and CRC’s earnings by 6-20% and maintain OUTPERFORM with a revised target price of HK$34/sh (from HK$30) for Conch, and HK$5.00 (from HK$4.60) for CRC.

Source: Company data, Credit Suisse estimates

MEP proposed supply cut for air pollution control

In order to improve the air quality in the BJ-TJ-HB region, MEP has proposed more aggressive steps in expanded supply controls in steps, affected regions around Beijing, including 26+2 cities located in 4 provinces (Hebei, Henan, Shanxi, Shandong). The region represents 20-78% of the major basic materials supply, per our estimates, including 43% of steel, 78% of alumina (or 36% if based on the cities) and 35% of aluminium (or 24% if based on cities). Specifically, during the 4 months in the winter heating season, the proposed policy required a 50% cut in steel production for the 4 cities that breached the AQI limit in 2016, 30% cut in aluminium, 50% in alumina for the region, and rotative cut in cement and steel for the regions. Other sectors affected are carbon and pesticides, based on the proposal. Coal consumption in the region accounts for nearly one-third of the national coal demand, and the potential replacement of coal used in winter heating and boilers may lead to 3-4% reduction in coal consumption, partly offset by higher thermal power.

Figure 2: Potential affected cities (26+2) and provinces by the proposed policy MEP air pollution control

The national coal demand, and the potential replacement of coal used in winter heating and boilers may lead to 3-4% reduction in coal consumption, partly offset by higher thermal power.
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