Evolution and Innovation in Steel Company Business Models

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I would like to start with a few comments regarding where the industry finds itself today and where it is headed over the next few years, before turning to the topic of "evolution and innovation in steel company business models."

The good news is that market growth is slowly resuming in many, though not all, regions.

The not-so-good news is that the forecast growth is misaligned geographically and insufficient in aggregate to absorb the 250—400 mt of excess capacity. While reasonably strong growth in the US means that NAFTA is on track to return to its pre-crisis peak by 2016, this goal will elude the EU and Japan for several more years, and perhaps permanently. The Middle East continues to grow at almost twice the world average, and there are high hopes for India, though it is uncertain how long it will take for economic reforms to translate into a return to robust steel market growth. On the other hand, Brazil continues to disappoint and the CIS remains at risk, highlighting steel’s ongoing vulnerability to geopolitical disruptions.

The most dramatic development of course is the sharp slowing of Chinese market growth, from double digits down to 3 percent or less this year. For only the third time since the turn of the century, this year’s growth rate for the rest of the world is likely to exceed that of China. While China’s impact on global steel and raw materials markets will remain paramount, the prospect for more balanced global growth is a positive development—particularly based on the view to which we subscribe, that the Chinese market will stop growing altogether by the end of the decade.

One forecast that can be made with a high degree of confidence is that the market outlook for trade lawyers is extremely positive, with a record number of cases already filed and more to come.

At the same time, the noose around non-competitive Chinese excess capacity is being tightened from two directions: externally, by the trade cases as noted, and domestically, by stricter enforcement of environmental regulations and financial reforms resulting in tighter credit: not just producers, but for the entire ferrous value chain.

With respect to industry consolidation: after limited progress since before the financial crisis, consolidation is once again advancing, at least on the regional level. Shifts in corporate and portfolio strategies, responses to continued local market declines and an increase in distress situations are all contributing to increased buying opportunities for producers looking to grow and/or protect their franchises. Examples include: Nippon Steel & Sumitomo Metal Corporation (NSSMC), SSAB Swedish Steel AB and Ruukki, and the potential involvement of POSCO in the restructuring of Dongbu Group and ArcelorMittal S.A. in the resolution of the Ilva situation.

While these combinations (except NSSMC) barely move the needle on global industry concentration, they are nonetheless significant, especially as cross-regional blockbuster combinations remain a remote possibility due to limited synergy potential, cultural barriers and economic nationalism.

China’s slow growth rate, combined with increasing global supply of raw materials, will cause the latter’s pricing to remain weak for an extended period. At the same time, there is an iron ore price floor in effect, at around $90—$100/ton, based on the marginal cost of the approximately 100 mt of Chinese capacity that sits in the middle of the industry cost curve. These mines stop producing when prices fall to this level, thus tightening supply which then prevents further price declines.

We expect much of this capacity to permanently exit the market in the coming years, gradually raising the floor by the end of the decade, though not to the level of $250 as recently forecast, no doubt hyperbolically, by a noted commentator. Supporting the trend toward increasing ore prices is the shift in the proportion of Chinese steel being produced at coastal plants, as closures will occur primarily in the less competitive inland locations. On the other hand, factors that will limit the speed and terminal value of the iron ore price recovery include the reduction in Chinese hot metal ratios as scrap becomes more readily available, and the shift in the locus of global steel production growth to iron-rich countries, particularly India.

The combination of improving steel demand and soft raw material prices has resulted in an increasing spread that in Q2 of this year is higher in Europe than it has been since 2011 and since before 2009 in the US. Moreover, the differential between steel prices in the US and the rest of the world, particularly China, is also at an historical high.

It is difficult to see how this is sustainable. Chinese excess capacity will continue to depress domestic utilization levels and steel prices, with increased exports as the inevitable corollary. And while trade actions may be successful in limiting Chinese imports on a case-by-case basis, the impact of 60—70 mt of Chinese steel sloshing around the globe will eventually be felt in all markets, either directly or indirectly through deflected imports from other countries.

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In China, the central government appears to have traded industry browbeating for stricter regulatory enforcement and market forces as the primary levers to drive steel industry consolidation. This is a welcome development, though it is likely to drive elimination of non-competitive excess capacity more quickly than it will industry consolidation due to the continued sway of regional and local governmental interests.

The possibility, now being mooted, that China will end the prohibition on foreign control of domestic steel companies would seem to be a game changer for global consolidation. At this point, it is not clear when and how this might be implemented, if at all. However, the outlook for chronically low steel prices combined with the likelihood that the higher-performing companies will remain unavailable suggests that acquiring steel a Chinese steel company anytime soon would be a highly risky and unattractive move for most foreign companies.

Against this backdrop of slow global growth and changing industry landscape, I would like to comment on evolution and innovation in steel company business models.

In its 100 or so years of history, the modern steel company business model has evolved and cycled through various incarnations. “In the beginning,” separate businesses were brought together to form large-scale enterprises based on a model of services self-sufficiency and total vertical integration—both upstream and downstream. This model survived through the Second World War and the boom/rebuilding years that followed. Starting soon after, western steel companies in particular pared back to “core” steel operations by closing or shedding most of their upstream, downstream and ancillary operations. In most cases, this was a matter of financial survival as companies lacked the capital, cost structures, agility and management capabilities to be competitive in all steps of the value chain and in all disparate corners of their enterprises.

In response to the rapid rise in raw material prices in the middle of the last decade, steel companies with financial scale and/or fortuitous locations began to re-integrate upstream. Setting aside the question of the returns on these investments in an era of soft prices, this is an important first step. More fundamentally, steel companies need to rethink and innovate their basic business models to contend with slow growth, intensified global competition and resulting margin pressures. While there are different directions and shapes this can take, it is principally in the areas of more sophisticated services and more complete solutions that steel companies need to focus.

Certainly, the idea of steel companies emphasizing service and solutions is not new. There are good examples of companies in this room that are doing this today across different markets and geographies. However, there are three key developments that are significant enablers of a faster and more ambitious adoption of this strategy:

- **Evolution of more sophisticated operating models.** This refers to the organization structure, business processes and performance management systems that define management accountability. Steel producers have become more adept at the proper allocation of decision making between corporate, regional and local executives, and have started to implement more robust and balanced performance management systems that drive optimization at the enterprise level without sacrificing local accountability. This is a precondition for driving a higher proportion of business into advanced services & solutions.

- **Technology advancements in the areas of digital, mobility and analytics provide steel producers with step change capabilities to reduce costs, improve asset reliability and throughput, and also transform customer experience.** Two examples: From the operations perspective, producers can for example create remote centers of expertise, leveraging scarce technical talent, which monitor and in some cases direct maintenance and operations across multiple locations, something not possible within traditional plant-centric operating models. On the customer side, the near-instantaneous availability of analytics-powered insight literally in the hands of the sales force or even customers can enable both more sophisticated services and solutions.

- **Increased opportunities to engage business partners that can bring leading technologies and business processes and can also assume operational responsibility for non-core and even some core parts of the business.** At the risk of appearing self-serving, I would point out that outsourcing and particularly business process outsourcing, is gaining traction in the metals industry in such areas as procurement, finance, sales support, and even planning & scheduling.

I would like to end by raising the possibility—probably heretical in this room—that the time has come for a multi-materials solutions company. This also is not a new concept. There have been, and still are, companies that produce both steel and aluminum, though their performance does not compel emulation. Managing competing materials with different raw material and value structures under the same corporate roof is difficult; deriving real synergies is even more so. Nor does this concept work as a strategy to hedge one’s bets on customer material choices: shareholders would do better building their own portfolio of steel and aluminum stocks.

Yet, the logic of becoming a customer solution provider, and not just a steel provider, drives one to consider this option, particularly as customers are increasingly looking for more technologically advanced, complete solutions for their design and engineering requirements. Beyond this, I would suggest that some aluminum companies have strong expertise in managing extended value chains from which steel companies can learn. And finally, with the advancement in operating models noted earlier, steel companies now have the perspective and tools with which to manage more complex multi-material organizations to generate increased shareholder value.

Thank you.
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