Kimura Dremvisor Newsletter Summary 26th if June

When an industrial sector restructuring occurs profit margins improve...

There is scope for large steel maker's stock prices to go up.

It looks like Mittal/arcelor merger (or Mittal's offer for arcelor) has succeeded. After the next general shareholder's meeting this agreement will give birth to world's number one steel maker capable of producing 1 billion tons of steel this figure is above the Japanese total domestic output and boost a global market share of more than 10 %.
Compared to such production capacity Nippon Steel's output is 32 million tons, Korea's POSCO 21 million tons, JFE Steel 30 million tons. Arcelor current market capitalization (calculated on the basis of Mittal Steel offer) is 4 trillion Yen, which compare to 2 Trillion 840 billion Yen for Nippon Steel , JFE is 2 trillion 690 billion Yen.
The history of Mittal goes back to only 30 years behind. Current Mittal's chairman who is the father of Lakshmir Mittal started with producing in Indonesia but then outlined an aggressive external growth strategy in newly developed countries and Eastern Europe markets. Not doubt that Mittal strongly benefited from the worldwide equipment investment boom but the fact he could build a business the class of Nippon Steel in such a small amount of time must be highly regarded. In an industrial sector known for its low growth rate he powered ahead growth at the same rate that Intel in the past...
This has been said and repeated numerous times but each Japanese large steelmaker has been involved in the industrial sector restructuring and M&A related matters. Recently Nippon Steel launched a poison pill strategy with three other companies. It is difficult to imagine Mittal looking to Japanese large steel makers whatever aggressive the group external growth strategy is. However after 1 to 2 years of operations and the first scale merit of the merger becoming clear such scenario is not totally impossible.
Considering the steel industrial sector restructuring please don't quote me saying 'well the profitability of the whole steel sector is now increasing therefore let's buy the steels which look cheap....'
When I was at university I studied Industrial restructuring theory, the core logic was simple. Profitability is low for industrial sectors with a lot of new entrants, the top quartile only show acceptable profitability, for industries where the entrant's number stays small profitability is higher. At that time I wondered what kind of value such

knowledge would bring; now I know thanks to my then professor.
Finally large companies competing between themselves cannot increase profitability. However in a low profitability industrial sector when enough mergers and bankruptcies materialize necessarily profitability increase. Prices which felt much lower than necessary under unbridled competition started to recover. End users may protest but that does not matter price hikes are passed to end users, Oil, paper, steels and cement sectors are good examples of such logic.

Reasons behind the low per of steel sector.

If world number one and number two would merge it is obvious that competition would decrease. Overhead cost decrease and competitive position improves therefore profitability naturally goes up.

If worldwide steel sector Per is low this is due to the fact that market has discounted the risk of a market crash as China has strongly expanded production capacity which would lead to supply/demand unbalance . From 2000 China increased production by 30 million tons per year , something really big. In 1950 Chinese steel production was near zero. China output was 20 million tones in 1970, 1.5 billion tons in 2000, and last year 300 million tons. A large part of such output is energy consuming low quality steelworks. It looks difficult to trust an industry which did not experience any downturn nor merchandise carry back hence the risk of oversupply.
The reasons lying behind the explosion of steel demand is the high speed of China infrastructures development. In China there is no Japan style demo against land industrial development. Usually for peasants who live in the development areas a government order is enough to expel them. Those peasants then take the small compensation offered by the Chinese government and go to newly developed suburban areas. Such Chinese specific situation led to the steel huge demand, mainly for construction. That also mean that steel is melted in concrete and one cannot check the product quality. Until energy price rose the cost was not even an issue. But with oil price having tripled by now the chance that this low grade products remain on the market is near zero I believe. Said in other words it is nearly impossible such products come on the international market considering the high standards requested by industries such as auto, special steel or others..

One could say that if Japan represents 100 million people, 100 million tons production then China with 1.3 billion people and 300 million tons has still place to grow but this is flawed logic. The Chinese sheer production numbers seem enormous but lack the technical specifications to compete in worldwide markets. This is a different market and Chinese steel won't be used in Lexus type car bodies. By revising the competitiveness the right level of per should revised, I feel.