

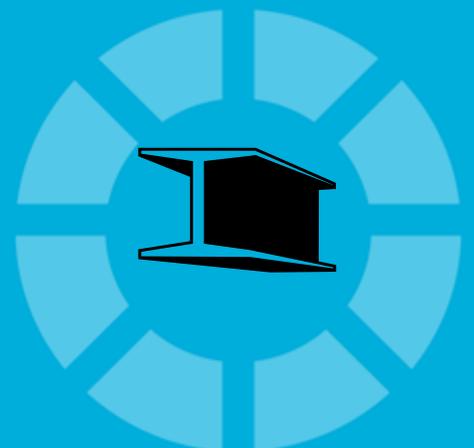
**Q2 2014**

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# **IRAN**

## **METALS REPORT**

INCLUDES 5-YEAR FORECASTS TO 2018





# Iran Metals Report Q2 2014

INCLUDES 5-YEAR FORECASTS TO 2018

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## Part of BMI's Industry Report & Forecasts Series

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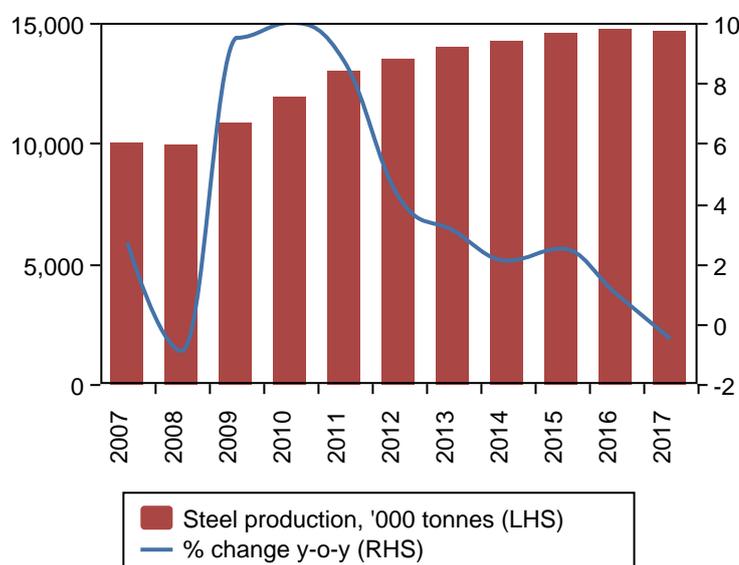
## BMI Industry View

The outlook for Iran's steel sector remains poor; however, there are a few signs of light given the election of Hassan Rouhani and possible moderation in tone towards the West which could result in a reduction in sanctions on the metals sector. On the whole, however, we are far from sanguine given our bearish outlook for steel prices and the fact that any rapprochement with the West, if indeed it happens, will be drawn out and not have a significant impact in the near term. We note with scepticism, Iran's plans to increase its steel capacity from 20mn tonnes per annum (mntpa) to 55mntpa by 2025, as well as a tripling of aluminium smelter capacity to 1.5mntpa.

While a cut in external trade has impacted negatively on the steel industry, isolation has ensured that imports have also been restricted. However, domestic industrial deficiencies in certain market segments mean that Iran will struggle to meet its own needs in spite of declining consumption. Crude steel output rose 11.1% year-on-year (y-o-y) to 13.27mn tonnes in the first 11 months of 2013, representing one of the strongest growth rates in the world, rivalling Turkey's.

### Growth To Slow

Iran - Steel Output



Source: BMI, WSA

Nevertheless, due to infrastructural problems and a lack of billet and rebar capacity, the country is still dependent on imports to serve the market, mostly from Turkey. Meanwhile, growth in the manufacturing of steel products has slowed markedly, with existing crude steel capacities unable to sufficiently supply to downstream industries and therefore exacerbating the dependence on imported supplies. Weak points remain, with flats demand coming under pressure as automotive output suffers from declining domestic demand. Over the medium term Iran will be reliant on exports at a time when it is becoming harder to sell on external markets.

Iranian trade has been affected by international sanctions, with the country having to manoeuvre strategically to meet domestic demand and maintain the robust production growth seen a few years ago. Iranian steel production grew by 10.0% and 8.7% in 2010 and 2011, and **BMI** forecasts that growth will remain robust in Iranian steel production; however, this will begin to slow down from 2014 until the end of our forecast period in 2017.

The country's political situation has affected many of its trade dynamics and the negative impact on imports and exports of steel has meant that the domestic industry has had to find a way to ensure that demand is met by ramping up production and clearing stockpiles to make room for imported steel.

Prior to the intensifying international sanctions imposed on Iran, the nation would rely on a significant amount of exports to other Arabian countries in the Gulf region; however, companies in the Arabian Gulf have simultaneously been expanding their capacities rampantly off the back of sustained demand in the region. This has meant that steel prices in Iran have been heading downwards as companies seek to offload their steel stockpiles by selling at a lower price.

Outlooks for metals-intensive sectors - specifically construction, infrastructure and automotives - are all in negative growth territory, meaning further obstacles for growth in the Iranian metals industry.

# SWOT

## Iran Metals Industry SWOT

### Strengths

- Self-sufficiency strategies forced by tight trading rules following intensifying international sanctions have allowed continued functioning.
- Significant iron ore mining industry offers a degree of vertical integration in the steel sector.
- The election of Hassan Rouhani could precede a more moderate line to foreign investors which would benefit the steel industry.

### Weaknesses

- Exports severely weakened and have little prospect for recovery, owing to sanctions.
- Sanctions discouraging outside business investment or partnerships with foreign companies that might improve capacity and efficiency.

### Opportunities

- Observer status on World Trade Organization gives the opportunity for Iran to implement strategies learned from member countries.
- Political rapprochement by Turkey can deepen ties with one of the fastest-growing economies in the world.
- We expect a slight reduction in sanctions over the coming months with the metals sector well placed to benefit.

### Threats

- Export growth hampered by capacity expansion and investments in Gulf metals industries.
- Capital flight is likely to continue owing to high inflation and currency depreciation.
- We remain bearish on the outlook for steel prices and do not expect a recovery in the near term.

## Industry Forecast

### Steel: Modest Growth Despite Sanctions

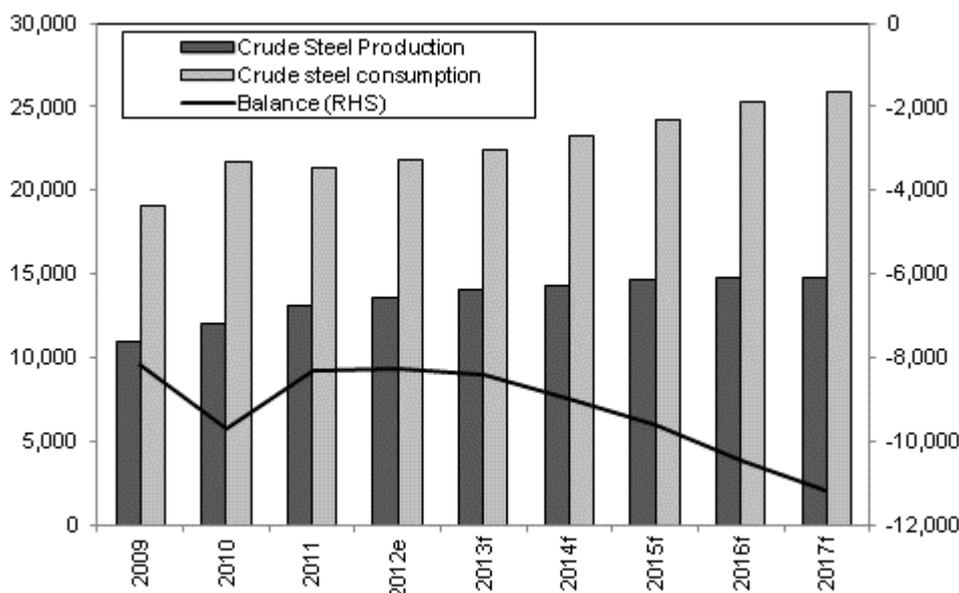
***BMI View:** The Iranian steel industry has proven to be remarkably resilient in the face of attempts by Western powers to isolate it from external trade. While a cut in external trade has impacted negatively on the steel industry, isolation has ensured that imports have also been restricted. Domestic industrial deficiencies in certain market segments mean that Iran will struggle to meet all its own needs in spite of declining consumption. Given our expectations for a slight easing in sanctions, we believe the country's metal sector will see modest growth over the coming years.*

We expect to see a slower but still strong steel production growth rate for Iran over the next five years. However, we forecast growth to begin dwindling from 2014 and will continue to do so until the end of our forecast period in 2018.

We see a relatively stable Iranian steel industry as the country moves to battle the effects of international sanctions and become self-sufficient. Progress has been made in trade liberalisation efforts, with bans on the import of certain products removed, tariffs lowered and all import quotas on cars eliminated. Iran currently has observer status at the WTO and has a stated policy goal of gaining access, which it hopes to achieve within five to six years. However, such a timetable is optimistic, as Iran is facing stiff opposition from the US and other key bilateral partners in light of the continuing concerns over its nuclear programme. In effect, WTO talks have been halted for political reasons. Iran has 13 import tariff bands with tariff rates ranging from 4% to 174%. A gradual reduction of tariffs has brought the simple average tariff rate down to 22.6%, from 27% in 2003-2004.

## Steel Going Strong Despite Sanctions

Iran - Steel Production, Consumption & Balance (kt)



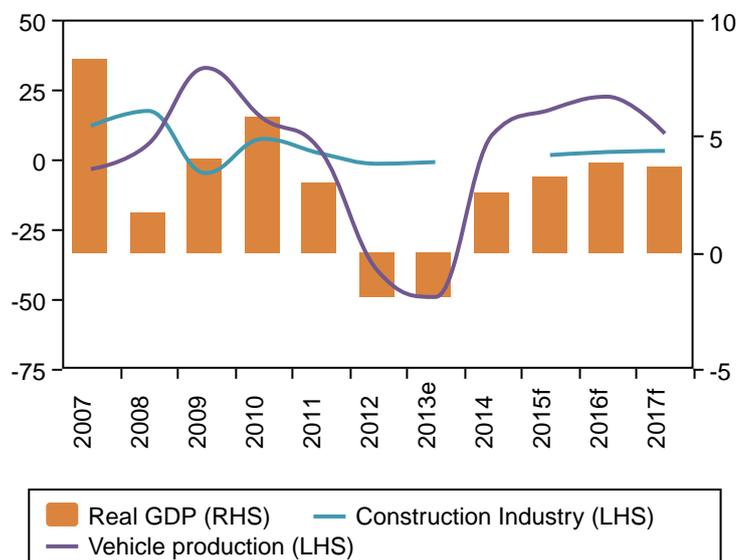
Source: BMI, WSA

The government has implemented reforms in its foreign trade regime, lifting the ban on automobiles. An *ad valorem* commercial benefit tax applies to most imports, ranging from 5% to 375%. Customs duties for chemicals, metals and medical equipment are set at 10%; food, minerals, leather, paper and machinery at 15%; and electronic machinery at 25%.

Export growth is being undermined by strong growth in Middle Eastern capacities, as well as the ongoing economic sanctions regime. Operating rates can only be raised through market diversification, a process that has been severely curtailed by the sanctions regime imposed by the US and the UN. Market growth is particularly limited in the metals-intensive automotives and construction segments where investment has been restricted. Even with strong export growth, the moderation in domestic consumption means that metal processing plants are operating well below nameplate capacity. However, in the latter part of 2013 Iranian carmaker **Iran Khodro Industrial Group** (IKCO) announced that it plans to increase its daily production to 2,800 cars in 2014 and plans to produce 1.2mn cars by the end of 2016, of which 50% will be exported to international markets.

## Growth To Pick Up

Iran - Real Growth y-o-y Across Sectors



Source: BMI, UN, IVMA

The Iranian government was to finalise its Comprehensive Steel Plan in 2013, which is due to point the way towards self-sufficiency in steel products and increase exports. The focus will be on private sector investment, particularly in the mining sector in order to improve iron ore availability. The objective is to raise Iran's steelmaking capacity from 20 million tonnes per annum (mntpa) in 2012 to 55mntpa by 2025, with an interim objective of 48mntpa by 2015.

Iran's medium-term self-sufficiency in billet depends on securing financing for 10-12 meltshops currently under construction that have a combined capacity of 4-5mntpa. At least four of these are being spearheaded by the private sector. With financing and hard currency in short supply as a direct result of international sanctions, **BMI** expresses grave doubts about Iran's ability to meet these targets.

The sanctions regime will affect Iran's ability to export and attract investment, which will be crucial to realising the government's long-term goals for steelmaking. We forecast steel output to be increasingly devoted to the domestic market with external trade, both in terms of exports and imports, likely to dwindle under a prolonged sanctions regime. If planned capacity increases come into effect, we anticipate

diminishing capacity utilisation as exports decline and the domestic market fails to absorb output growth. Low capacity utilisation will undermine the profitability of the Iranian steel industry, as well as potential market instability. Moreover, the domestic industry is unable to satisfy the country's needs due in part to the technological problems caused by lack of investment and expertise that would come with the involvement of global majors.

Nevertheless, there is still promise from projects being agreed and planned for the future, such as that agreed between China and Iran, and will help sustain **BMI**'s forecast for sustained steel production growth over our medium-term outlook (2013-2018).

The Chinese government has made an offer to build a new freight rail line in Iran, according to Engineering News-Record. The freight line is aimed at allowing continuous rail transport of goods from China, through the Middle East, to Europe. The project is expected to cost US\$2.0bn, starting in Tehran and running to Khosravi on the Iraqi border.

The line will also offer a passenger service. Iran's minister responsible for transport is reported to have invited bids to construct the line. That said, we saw some setbacks within the China-Iran relationship when the Asian giant pulled out of the development of phase 11 of the US\$4.7bn South Pars gas field.

**Table: Iran - Steel Production Forecasts ('000 tonnes, unless stated otherwise)**

	2010	2011	2012e	2013f	2014f	2015f	2016f	2017f	2018f
Crude Steel Production	11,995	13,040	13,588	14,009	14,303	14,661	14,807	14,733	14,659
- % Change y-o-y	10	8.7	4.2	3.1	2.1	2.5	1	-0.5	-0.5
Apparent crude steel use	21,720	21,379	21,849	22,417	23,269	24,247	25,289	25,896	26,503
- % Change y-o-y	13.7	-1.6	2.2	2.6	3.8	4.2	4.3	2.4	2.4

*e/f = estimate/forecast. Source: BMI, WSA*

**Table: Iran - Steel Production Historic Data ('000 tonnes, unless stated)**

	2004	2005	2006	2007	2008	2009	2010	2011	2012
Crude Steel Production	8,682	9,404	9,789	10,051	9,964	10,908	11,995	13,040	14,463
Hot rolled products	8,009	9,252	9,205	9,309	8,835	9,905	15,425	16,842	17,292
Heavy sections	1,628	1,645	1,620	1,910	1,704	1,846	2,230	2,223	2,087
Light sections	41.0	43.0	27.0	17.0	21.0	19.7	18.4	17.1	17.4
Concrete reinforcing bars	2,507	3,000	2,817	3,256	3,269	3,259	5,610	6,044	5,834
Tube and tube fittings	35.0	44.0	26.0	24.0	26.0	22.5	21.6	25.8	30.7
Exports	1,400	1,500	2,000	582	450	131	297	253	127
Imports	7,913	8,431	7,566	12,246	7,914	8,035	9,238	8,449	2,535
Imports of scrap	310	104	42.0	42.0	85.0	6.0	3.0	2.1	1.7

Source: BMI, WSA

## Regulatory Development

Iran's metals sector will remain highly challenging to new investment as sanctions and an uptick in political risk take hold. Whilst there has been some reform of the tax regime, corruption remains a key issue and it is likely that little will be done to tackle this impediment to investment.

### Corruption

Iran scored a dismal 28.0 in Transparency International's Corruption Perceptions Index 2012, ranking 133rd out of 176 countries measured. After falling every year from 2002 to 2009, when it was 1.8, Iran's score in the index edged up slightly in 2010. With newspapers and news agencies tightly controlled and censored, there is little information available from inside the country on the level of corruption; independent estimates, such as Transparency International's index, remain the best indicators.

### Tax Regime

The tax regime has undergone substantial reform, with a flat corporate tax rate as opposed to the old, progressive corporate tax system. Resident companies enjoy a corporate tax rate of 10% on taxable income, with the remainder taxed according to a progressive scale ranging from 12% to 54% according to their income. The authorities are planning to curb tax exemptions.

The flat corporate tax rate is 25%, down from a previous cap of 54%. According to the tax code, the taxable income of companies or non-resident persons operating in sectors including construction, technical installations, transport, preparation of construction and installation drawings, surveying, supervising and technical calculations is limited to just 12%.

**Table: Iran - Political Overview**

	Islamic Republic based on the 1979 Constitution
	Supreme Leader - life-term (elected by Assembly of Experts)
System of Government	President - four-year terms, eligible for a second term and third non-consecutive term
	Parliament (Majlis) - 290 members elected for four-year terms
	Assembly of Experts - 86 clerics elected by direct public vote to eight-year terms
Head of State	Supreme Leader Ayatollah Ali Khamenei
Head of Government	President Hassan Rouhani
	Parliamentary - March 2 2012
Last Election	Presidential - June 12 2009
	Parliamentary - 2017
Next Election	Presidential - June 2013
	Mohammad Bagher Ghalibaf (Mayor of Tehran)
	Ali Larijani (speaker of parliament)
Key Figures	Ayatollah Mohammad Reza Mahdavi Kani (Chairman of the Assembly of Experts)
Main Political Coalitions	Ultra-conservatives: Generally Pro-Khamenei. This faction is led by Ayatollah Mesbah Yazdi, an ultra-conservative displaying a staunch anti-Western rhetoric.
	Moderate conservatives: Anti-Ahmadinejad coalition, important members include Ali Larijani, Mohammad Bagher Ghalibaf and Mohsen Rezai, support moderate economic and political reforms but still favour current policy formation.
	Reformists: Made up of a number of factions with varying views, largely anti-government, favour political freedoms and more open policy formation.
Current Parliamentary Make-Up	Conservatives - 143 seats (53.5%), Reformists - 59 seats (26.2%), Independents - 9 seats (4%), Minority Religions - 14 seats (6.2%)
Ongoing Disputes	US and EU (economic sanctions), UN (four resolutions against nuclear enrichment), Israel, UAE (Lesser and Greater Tunb), Azerbaijan and Turkmenistan (Caspian Sea borders)
Key Relations/Treaties	WTO, Organisation of the Islamic Conference, increasing economic and political relations with Iraq, limited relations with GCC and member countries, strong alliances with Syria. Increasing relations with China.
BMI Short-Term Political Risk Rating	41.7
BMI Structural Political Risk Rating	50.2

Source: BMI

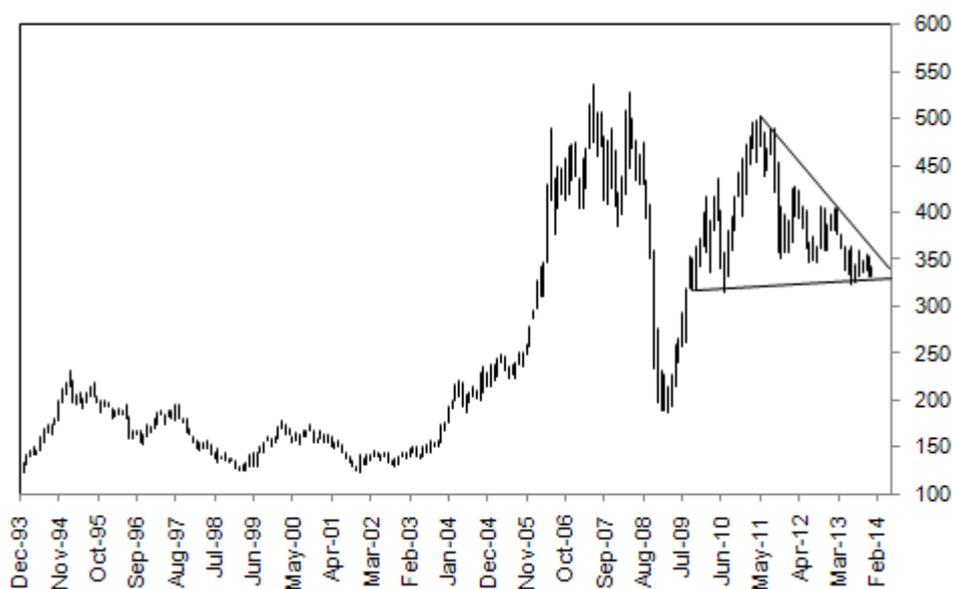
# Commodities Forecast

## Commodity Strategy

- The resilience of LME metal prices in December underlines currently robust Chinese demand, which we expect to continue into early 2014.
- Although we have raised our 2014 China real GDP growth forecast (to 7.1% from 6.7%), we remain below consensus. Combined with positive supply outlooks, this underpins our bearish price view on key metals such as copper and iron ore over a multi-quarter horizon.
- We expect continued iron ore price resilience in the next few months as leading indicators suggest Chinese import demand remains strong. Nonetheless, we expect renewed steel sector weakness combined with stronger iron ore supply to eventually drag iron ore prices considerably lower in 2014.
- Tin and lead prices will outperform other metals over the coming quarters due to supply disruption and resilient demand. In contrast, improving supply (copper, iron ore) or elevated stockpiles (aluminium, zinc, nickel) in other markets will undermine price performance.

## Boom Years Behind Us

S&P GSCI Industrial Metals Index (monthly chart)



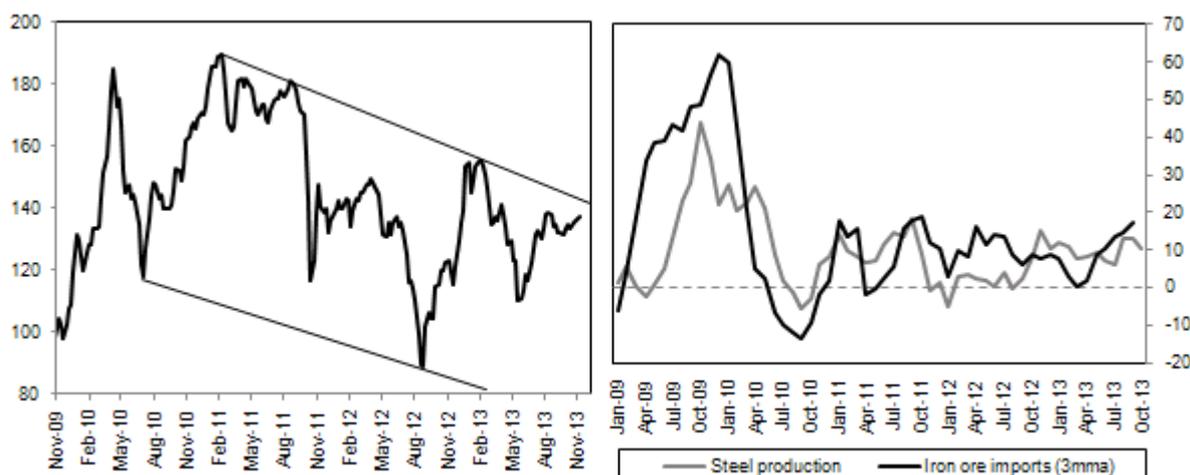
Source: BMI, Bloomberg

### Iron Ore: Headwinds In H114

We expect the impressive bounce in iron ore prices since mid-year to surrender to structural headwinds in H114 as the economic slowdown of in China comes back into focus and supply continues to improve. Import demand from Chinese steel mills has been particularly strong in recent months, up 20.2% year-on-year (y-o-y) in October, on the back of record run rates in the country's steel sector.

### Rallying...But Not For Long

China - Iron Ore Import Price (US\$/tonne, LHS) & Steel Production and Iron Ore Imports (% chg y-o-y, RHS)



Note: China iron ore import price, 62% grade (US\$/dry metric tonne, CFR). Source: BMI, Bloomberg, China Customs General Administration

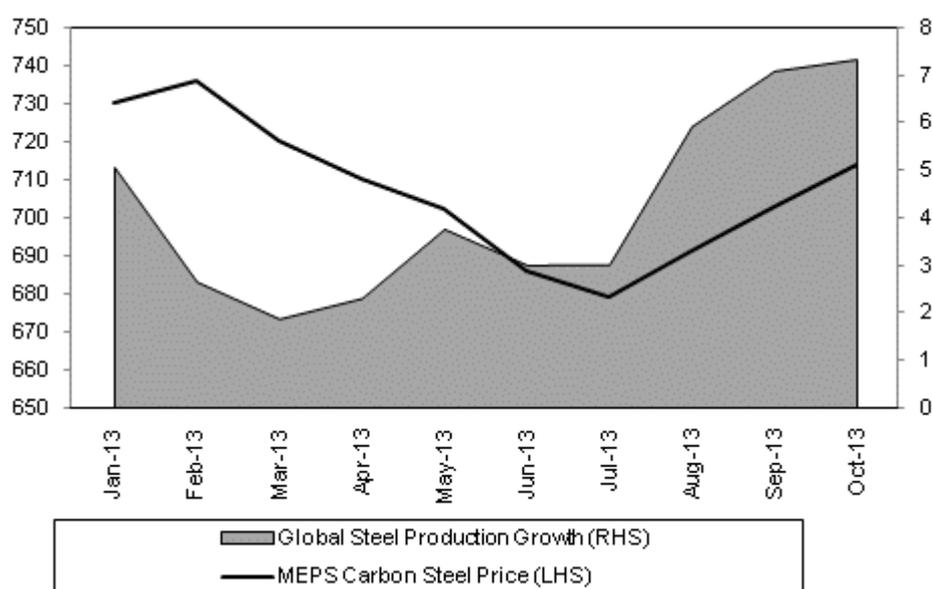
However, iron ore prices are likely to encounter stiff resistance around US\$140/tonne. Anecdotal evidence suggests that a further rally in iron ore prices would prompt a growing number of price-sensitive consumers in China to switch to local supply. Furthermore, the diminishing efficacy of economic stimulus measures coupled with the ramp up in seaborne supply, should eventually take their toll on prices over the coming quarters (see *'Iron Ore: Limited Respite'*, November 28).

## Steel: Locked In Secular Downtrend

Despite steel prices ticking higher and steel-producers enjoying a reprieve since mid-year, we expect the difficult dynamics of the steel market to come back into focus as we move into Q114. Over the period July to October, global steel production grew on average 5.9% y-o-y while steel prices moved from US\$679/tonne to US\$714/tonne, thus indicating stronger than anticipated demand for the metal. Nonetheless, we emphasise that this uptick is likely to prove fleeting, as the global steel industry continues to battle with weak margins and persistent overcapacity. Already, we have seen steel prices begin to unwind, with the MEPS Carbon Steel Index averaging US\$710/tonne in November. We forecast steel prices to average US\$695/tonne and US\$690/tonne in 2014 and 2015, respectively.

### Respite To Prove Fleeting

Global Steel Production % Growth y-o-y & MEPS Carbon Steel Index (US\$/tonne)



Source: BMI, Bloomberg

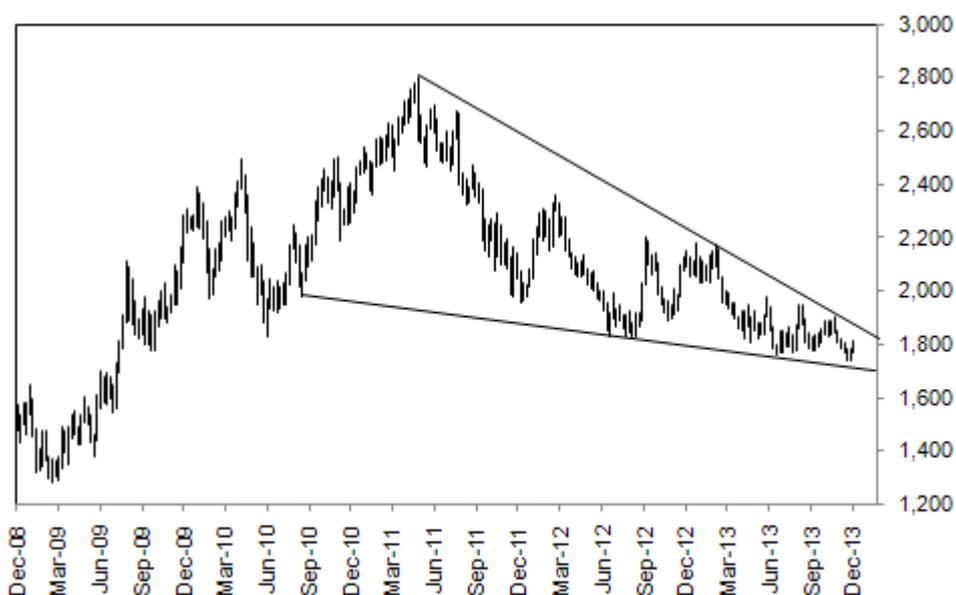
## Aluminium: US\$1,800/tonne To Provide Strong Support

We expect aluminium to remain above US\$1,800/tonne after falling below that level in recent weeks. We note that below that level, production becomes unprofitable for various producers, highlighting the need for further production cuts. The metal's movement is in line with our previous forecast highlighting continued sideways trading through Q413. Thus, we expect that prices will maintain a base around the US\$1,800/

tonne mark and maintain our forecast that prices will average US\$1,900/tonne in 2014. Capacity cuts in the coming quarters should provide minimum support for prices, though we recently highlighted key downside risks that will play out in H114 (see 'Aluminium: Fork In The Road With Risks To The Downside,' December 10 2013). These include LME reforms, which could bring more aluminium onto an already oversupplied market, and the potential for China to become a significant net exporter as it builds up greater production capacity. Both could contribute to lower prices and lead us to revise our already below-consensus forecasts downward.

## Back Up To Safety

Three-Month LME Aluminium (US\$/tonne, weekly chart)



Source: BMI, Bloomberg

## Copper: Bearish View In Place Despite Some Recovery

We do not believe the current rally in copper will persist and lead to prices breaking out of their current range, but rather maintain our bearish position on copper prices. We maintain our view that copper prices will continue to weaken in Q114 and average US\$6,800/tonne in 2014, though note short-term strength through the end of Q413. We believe this strength will subside as market tightness peaks this quarter and then gives way to slower Chinese demand growth in 2014. Recent declines in copper ore exports from Chile and Peru may have boosted prices in the short term, though continued mine supply growth will lead to

ample supply in the coming quarters. We note the recent decline in global stocks of copper reflects solid physical demand, but do not expect destocking to persist at its current rate.

## Retracing From Losses

Three-Month LME Copper (US\$/tonne, weekly chart)



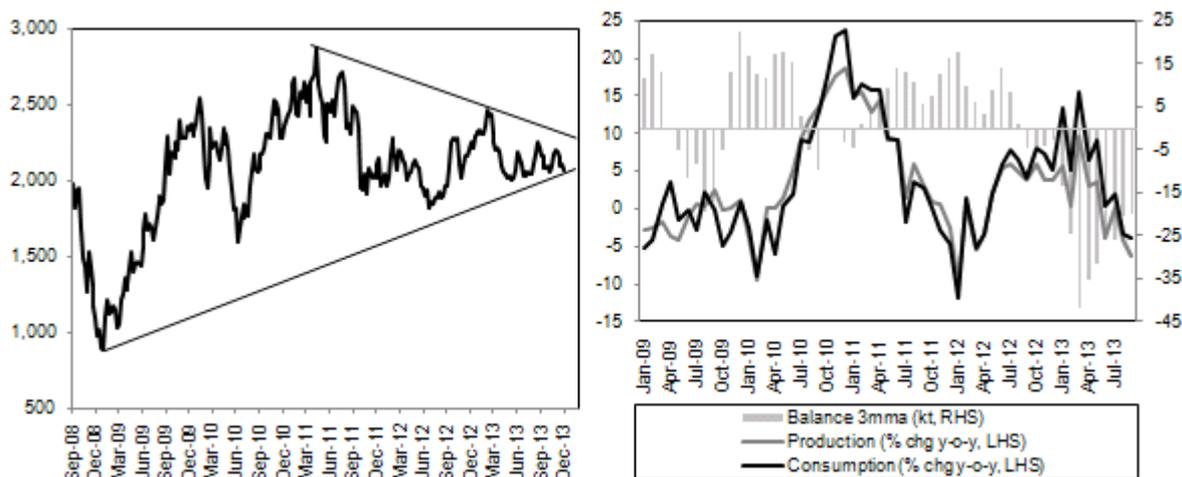
Source: BMI, Bloomberg

## Lead: Respite Ahead

Currently resting on long-term support at US\$2,070/tonne, we expect three-month lead to head higher over the coming months. In contrast to our bearish projections for industrial metals such as iron ore and nickel, several fundamentals point to continued support for lead prices. In particular, we expect rising demand for refined lead to amplify the supply crunch in the market and push prices higher over our forecast period out to 2017 (see *'Lead: Upside On The Cards'*, December 09).

## Modest Gains Ahead As Supply Crunch Persists

Lead - Three-Month LME Lead (US\$/tonne, LHS) & Global Refined Lead Balance (RHS)



Source: BMI, Bloomberg

Our constructive outlook on lead consumption will take place against the backdrop of slowing production growth in the lead market. We forecast the global stocks-to-use ratio for refined lead to decrease from an estimated 6.4% in 2013 to 0.2% in 2017. On a 3 month-moving average (mma) basis, the global production balance of refined lead has remained negative since September 2012. According to the latest data from WBMS, the refined lead market hit a structural deficit of 19.9 thousand tonnes (kt) in September 2013, due largely to a collapse in output growth from China.

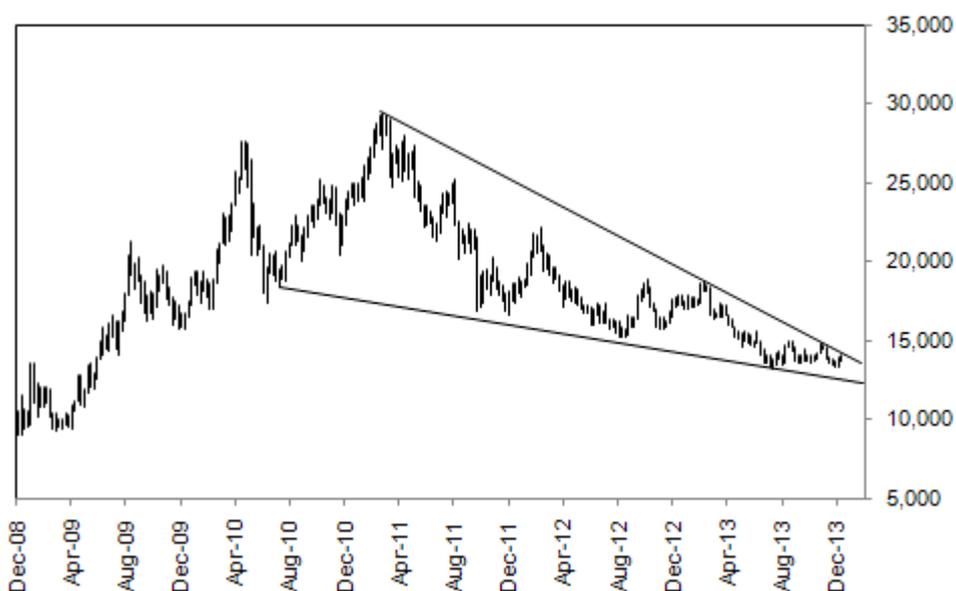
## Nickel: Despite Recent Gains, Downside Risks Dominate

Nickel prices have bounced back upward and are pushing against trend resistance, though we forecast the metal will continue to underperform across the base metals complex through the end of Q4. Persistent oversupply and rising LME inventories will limit gains for the metal. Indeed, production of refined nickel exceeded consumption by 146kt in the first three quarters of 2013. Increasing Chinese nickel pig iron production capacity and persistent global steel capacity utilization rates below 80% have also weighed on prices and have contributed to the metal's long-term decline. However, continued uncertainty regarding Indonesia's ore export ban, set to go into effect in early January, is likely pushing prices upward despite current supply fundamentals. Though we do not expect an outright ban to stay in place, we believe uncertainty regarding future ore supply is likely behind recent price movement. Furthermore, relatively

subdued current prices will likely lead to further production cuts. Our forecast remains for nickel to average US\$15,000/tonne in 2014, and despite the aforementioned factors supporting prices, we note that medium term risks are to the downside.

## Touching Resistance

Three-Month LME Nickel (US\$/tonne, weekly chart)



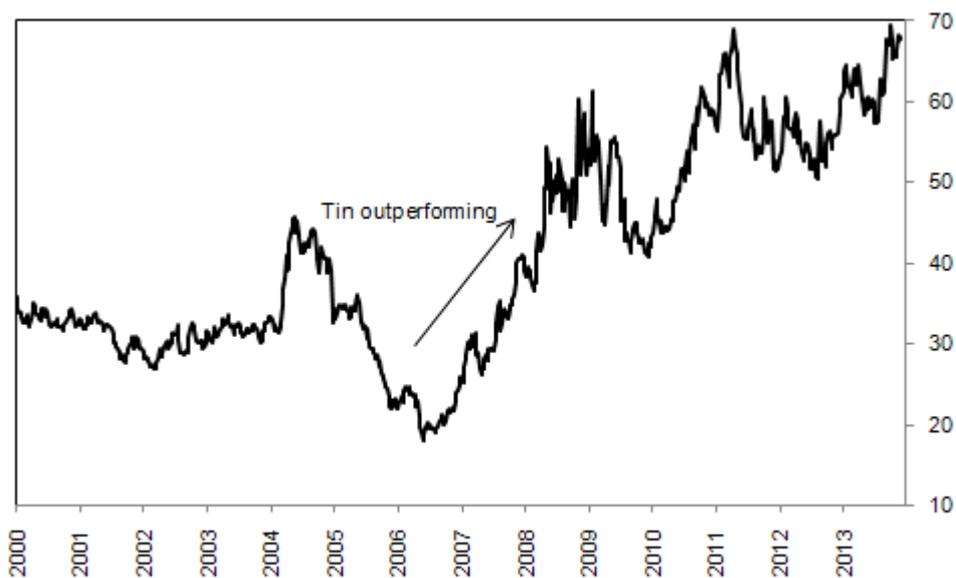
Source: BMI, Bloomberg

## Tin: Outperformance To Continue

We expect tin to outperform the industrial metals complex over the coming quarters, and expect the uptrend in the ratio between tin and the S&P GSCI Industrial Metals Index to stay intact. Tin prices will remain supported by restrictive export policies in Indonesia, as well as resilient demand from the electronics sector. Demand for consumer electronics should continue to improve as private consumption becomes a key driver of China's economy over the coming years. Overall, we forecast tin prices to continue a secular uptrend, from an estimated US\$22,300/tonne in 2013 to US\$25,000/tonne in 2017.

## Outperforming A Weak Field

Price Ratio: Tin / S&P GSCI Industrial Metals Index



Source: BMI, Bloomberg

## Zinc: Channelling Support

Recent zinc price movements are in line with our forecast that zinc will continue to trade sideways within its current channel and remain above support. After recent declines mirroring other base metals, zinc prices continue to climb and the metal remains the best performer among the base metals traded on the LME over the past month. Prices have edged up after initially falling towards long-term support in late-November. Consumption in the first three quarters of 2013 outpaced production, supporting prices. Indeed, current LME zinc inventories remain at their lowest level since September 2012. Still, we maintain our forecast that zinc prices will average US\$1,950/tonne in 2014, rather than see significant growth, due to steady mine supply and persistent overcapacity in global steel production. Given zinc's use in the galvanization of steel, the latter will continue to weigh on prices.

## Support To Hold

Three-Month LME Zinc (US\$/tonne, weekly chart)



Source: BMI, Bloomberg

Table: Select Commodities - Performance &amp; BMI forecasts

Commodity	Unit	Spot Price	YTD (%) Chg)	1 Year (%) Chg)	2012 (ave)	YTD (ave)	2014 (BMI ave)	2015 (BMI ave)
Aluminium	US\$/tonne	1,811	-12.6	-15.4	2,052	1,892	1,900	2,000
Copper	US\$/tonne	7,215	-9.0	-11.3	7,953	7,352	6,800	6,750
Gold	US\$/oz	1,246	-25.7	-27.4	1,669	1,418	1,250	1,150
Iron Ore	US\$/tonne	139	-4.0	11.4	128	135	110	100
Lead	US\$/tonne	2,149	-7.8	-7.5	2,074	2,153	2,250	2,300
Nickel	US\$/tonne	14,123	-17.2	-20.2	17,591	15,123	15,000	15,500
Palladium	US\$/oz	738	4.9	6.2	645	727	na	na
Platinum	US\$/oz	1,379	-10.4	-16.3	1,553	1,493	na	na
Silver	US\$/oz	19.88	-34.1	-41.0	31.15	23.96	na	na
Steel (MEPS Carbon Steel)	US\$/tonne	710	-1.5	-0.1	755	707	695	690
Tin	US\$/tonne	22,571	-3.5	-2.4	21,100	22,276	22,500	23,000

## Select Commodities - Performance &amp; BMI forecasts - Continued

Commodity	Unit	Spot Price	YTD (% Chg)	1 Year (% Chg)	2012 (ave)	YTD (ave)	2014 (BMI ave)	2015 (BMI ave)
Zinc	US\$/tonne	1,961	-5.7	-6.4	1,965	1,935	1,950	2,050

Source: BMI, Bloomberg

## Table: BMI Commodities Strategy

	Entry Date	Entry Level	Gain/(Loss)	Rationale
<b>AGRICULTURE</b>				
-	-	-	-	-
<b>ENERGY</b>				
-	-	-	-	-
<b>METALS</b>				
Bearish three-month LME copper	27-Nov-13	7,100	-1.62%	Global market tightness to peak in Q413. Chinese demand to wane in 2014, supply to improve
Bearish spot silver	13-Nov-13	20.85	4.15%	Continued US economic recovery to erode demand for gold & silver in the West

Note: Returns do not take into account roll yield, unless stated otherwise. Source: BMI, Bloomberg

## Commodities Forecast

Table: BMI Steel Forecast

	Spot	Short-term	2013	2014	2015	2016	2017
US\$/tonne, average	703	-	710	695	690	685	690

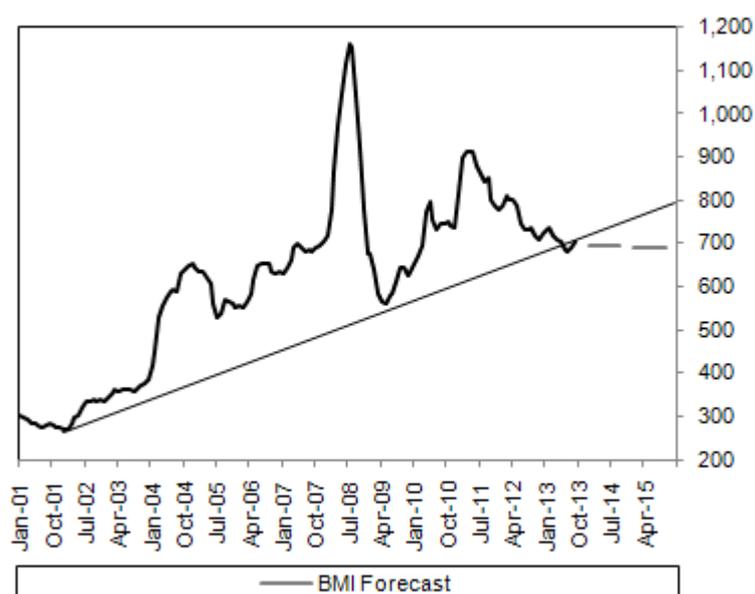
Source: BMI, Bloomberg, October 21 2013

## Short-Term Outlook

We expect steel prices to head modestly higher in coming months as demand improves in several key markets. The eurozone economy will gradually emerge from recession, while a temporary resolution to the US fiscal impasse means no derailment of the US recovery. Stimulus measures in China will improve downstream demand, albeit with diminishing efficacy, and lend support to prices over the near term.

## More Pain Ahead

MEPS Carbon Steel Product Composite Price, January 2001-April 2015 (US\$/tonne)



Source: BMI, Bloomberg

### **Core View**

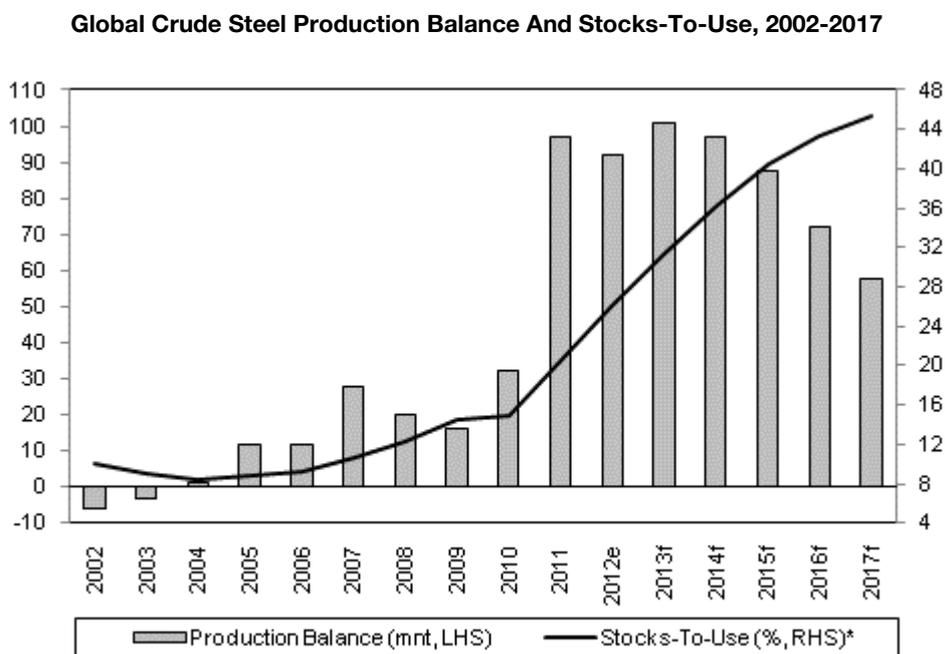
We remain bearish on steel over the medium term and forecast prices to average US\$695/tonne in 2014, compared with our previous projection of US\$700/tonne. The outlook in the global steel market remains depressed, with little prospect of brightening in the coming quarters. Crucially, resilient production in China will exacerbate the overcapacity problem gripping the steel industry over the coming quarters. Significant overcapacity and weak margins are unlikely to abate anytime soon and Western steelmakers, in particular, will struggle to emerge from the doldrums. Cheap steel exports from China will continue to pressure marginal producers around the world and undermine steel prices on the international stage.

### **Production: Glut To Persist, Despite China Slowdown**

Our downbeat macro view on China will have an outsized impact on the steel industry, given China's position as the world's largest steel producer and consumer, at 46% of global consumption in 2012. We expect China's real GDP growth to average 6.1% a year over our 10-year forecast period, compared with 10.4% in the previous decade.

While Chinese steel production growth is set to contract sharply over the coming years, the global steel sector will remain under pressure from the supply glut in China. We forecast persistent surplus in the steel market, with the global production surplus gradually declining from 100mn tonnes (mnt) in 2013 to 57.4mnt by 2017. The stocks-to-use ratio will increase from 31.3% to 45.4% over the same period.

## Sustained Glut To Limit Gains



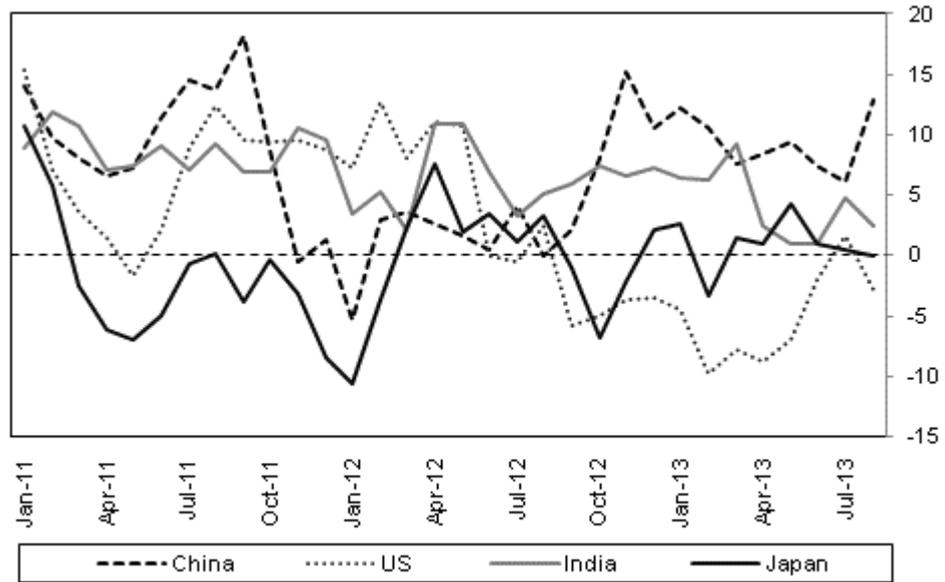
*NB Stocks calculated using 2000 as base year; e/f = BMI estimate/forecast. Source: BMI, World Steel Association (WSA)*

Despite the collapse in margins over recent quarters, efforts to rationalise production in China's steel sector will be hindered by concerns over maintaining employment. This situation is similar to, albeit more extreme than in many steel sectors in Europe and North America, where government intervention is circumventing the natural process of consolidation in an oversupplied industry.

Chinese steel mills are expanding production at record rates and defying the broad slowdown in the country's economy. Crude steel output surged 12.9% year-on-year (y-o-y) in August 2013, the fastest pace since November 2012.

## China Charging Ahead

China, US, India And Japan - Crude Steel Production, January 2011-July 2013 (% change y-o-y)

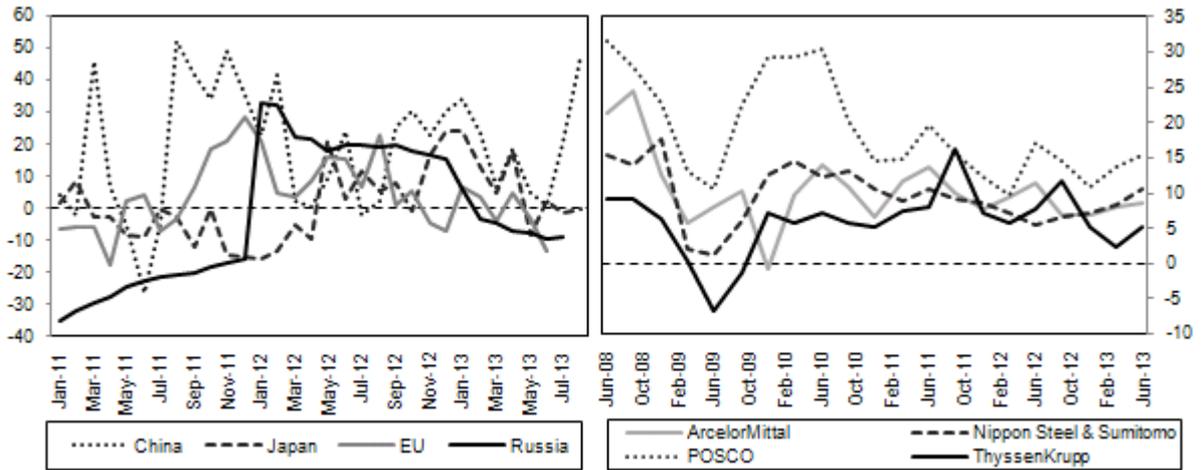


Source: BMI, Bloomberg

Surplus Chinese supply will continue to bleed into global markets, as highlighted by European, Asian and North American markets turning the screw on China over its alleged dumping of cheap steel products abroad. On a cumulative basis, Chinese steel exports jumped 17.0% y-o-y between January and August 2013. According to data from Bloomberg, a growing percentage of domestic output has been diverted to the international market, from 7.9% in March to 9.3% in August.

## Feeling The Heat From Chinese Exports

Steel Exports By Country (% change y-o-y, LHS) And EBITDA By Steelmaker (% , RHS)

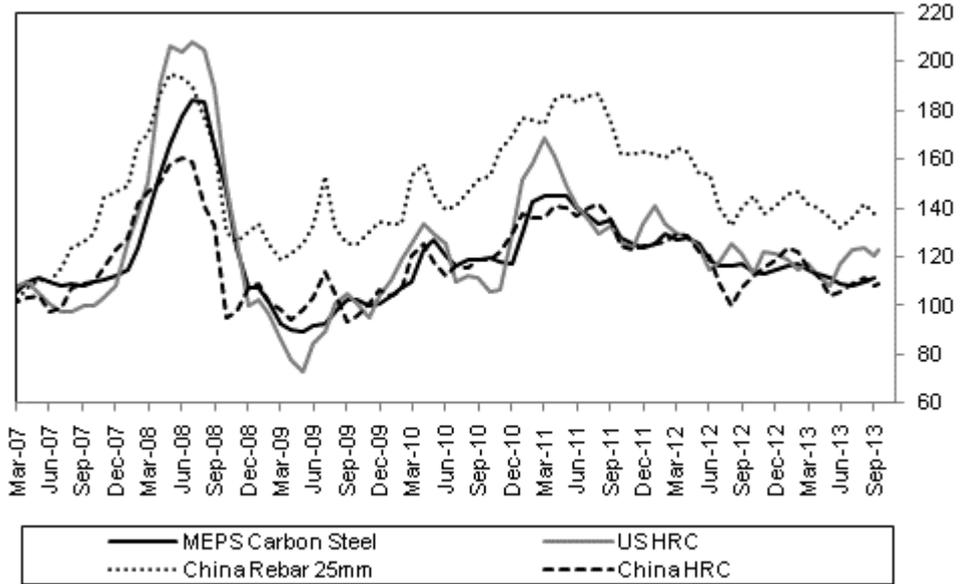


Source: BMI, Bloomberg

Outside China, we expect modest output growth in dominant steel producers such as Japan and the US over our forecast period. Steelmakers in these countries will continue to feel the heat of rising exports from China, and the pick-up in steel demand from an improving economic outlook will fail to provide much respite for the steel industry. Although India is on track to become a steel powerhouse over the long term, steelmakers there are struggling with a raft of challenges, including a rising import bill and a shortage of iron ore supply.

## Steel Struggling

Select Steel Contracts, March 2007-September 2013 (US\$/tonnes, rebased)

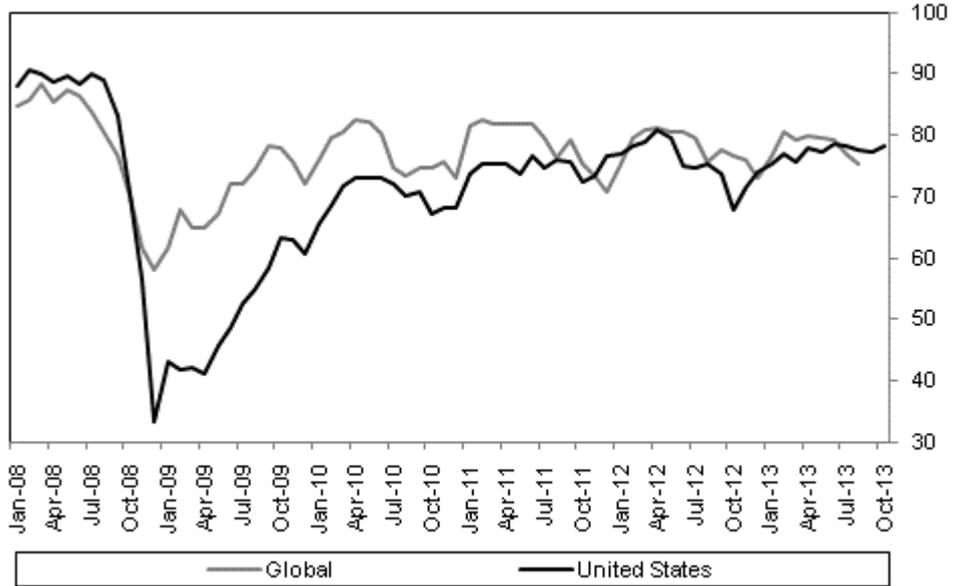


NB January 2007 = 100. Source: BMI, Bloomberg

The improvement in smelter margins as a result of falling iron ore prices in coming years will be insufficient to combat the overall weakness in the steel industry. According to Bloomberg, the global steel sector remains locked in significant slack, with the capacity utilisation rate reaching 75% in August 2013.

## Running Below Capacity

Steel Capacity Utilisation, January 2008-October 2013 (%)



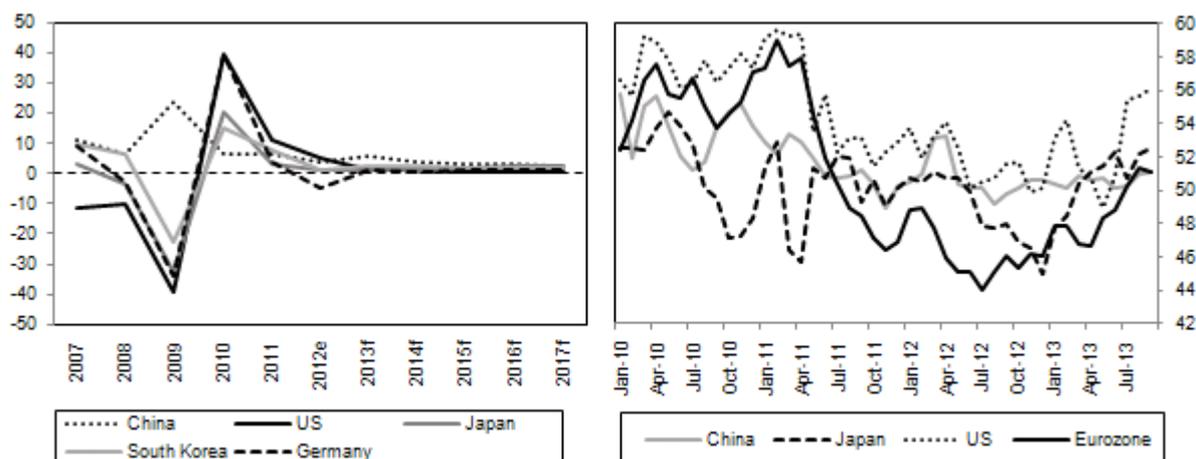
Source: BMI, Bloomberg

### Consumption: No Return To Boom

We expect weak demand to be the key driver of overcapacity and low prices in coming quarters. The sharp slowdown in Chinese fixed-asset investment will be a heavy burden on the steel industry, as excess production from Chinese steel mills becomes increasingly hard to absorb. Indeed, the trend of rising steel exports from China is not sustainable. The proliferation of protectionist threats and anti-dumping investigations by countries from the US to Indonesia in recent months should eventually stem the surge in Chinese steel exports.

## Demand Growth In Structural Decline, Despite Manufacturing Pick-Up

Select Countries - Crude Steel Consumption (% chaeng y-o-y, LHS) And Manufacturing PMI (RHS)



elf = BMI estimate/forecast. Source: BMI, WSA, Bloomberg

Aside from China, other countries in Asia and the EU will also suffer from lacklustre demand growth for steel products. In Japan, automakers have been shifting their production overseas, while domestic shipbuilders are reducing capacity in light of shrinking orders and rising competition from Chinese and Korean shipyards. Similarly, many European markets will see negligible growth in steel demand due to low GDP growth and declining investment in infrastructure. In our view, the structural drivers of steel demand are entering a protracted period of decline in many countries and the recent pick-up in manufacturing activity in the US, Japan and eurozone is not cause for much optimism.

### Risks To Price Outlook

The risks to our price outlook are fairly even. In terms of downside risk, the economic recovery in the eurozone is fragile and these countries could slip back into recession over our forecast period. This would further pull down demand for steel products and amplify the glut in the steel industry.

On the upside, demand from China's property sector may prove more resilient than we expect and stem the decline in steel prices. The Chinese government could also decide against providing more liquidity to embattled steelmakers in the near future. This would allow a painful unravelling of the steel sector and considerably reduce the amount of steel overhang plaguing the market.

**Table: Steel Data And Forecasts, 2009-2017**

	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013e</b>	<b>2014f</b>	<b>2015f</b>	<b>2016f</b>	<b>2017f</b>
Price, average	612	733	854	757	710	695	690	685	690
Production, mnt	1,236	1,432	1,582	1,621	1,694	1,741	1,780	1,814	1,849
Consumption, mnt	1,220	1,400	1,485	1,529	1,593	1,644	1,692	1,742	1,792
Inventories, mnt	177	209	306	398	499	596	684	756	813
Stocks to use, %	14.5	14.9	20.6	26.1	31.3	36.3	40.4	43.4	45.4
Stocks to use, weeks	7.6	7.8	10.7	13.6	16.3	18.9	21.0	22.6	23.6

*e/f = BMI estimate/forecast. Source: BMI, WSA*

## Competitive Landscape

Iran's relatively low level of per capita steel production demonstrates its great potential. It is also the only country in the Gulf region with the resources to become self-sufficient in steel production and is the only country in the Middle East that is not heavily dependent on iron ore imports, with domestic reserves estimated at 4.5bn tonnes, located in five main deposits. The country also has large coal reserves, which can be utilised by the steel industry, as well as the third-largest gas reserves after Russia and Qatar, representing an important source of energy for electricity generation. The downside is that steel has to compete with other industrial sectors - such as water desalination, petrochemicals and aluminium - for electricity supplies. Furthermore, sanctions on the country, which we do not expect to be lifted for the foreseeable future, will deter investment.

Iran has seen a high level of import growth since 1994, when domestic supply first outstripped demand. The government is attempting to boost production, largely in crude steel, but its target for 2012 of 15mnt tonnes (mnt) was missed by nearly 2mnt, and the industry typically operates at just 50-60% of capacity.

**Mobarakeh Steel Company** represents around 47% of the market, followed by **Khuzestan Steel Company** (23%), **Esfahan Steel Company** (20%) and the **Iranian National Steel Industries Group** (10%). Mobarakeh Steel dominates exports and is heavily exposed to external markets, while **Esfahan Steel** and **National Iranian** are oriented towards domestic markets. Mobarakeh Steel was aiming to reach 10 million tonnes per annum (mntpa) of capacity by end-2012 and is planning a 700,000tpa continuous strip processing plant, with facilities including an EAF, a thin slab caster and a hot rolling line at the Saba steel plant. The crude steel production capacities of Mobarakeh Steel, Saba, as well as the Hormozgan plants were expected to rise by 7.5mnt, 1.5mnt and 1.5mnt respectively by end-2012.

**Table: Production & Sales By Producer (2012)**

Producer	% crude output	% semi-finished and finished output	% domestic sales by tonnage	% domestic sales by value	% exports by tonnage	% exports by value
Mobarakeh Steel	47	47	37	41	54	57
Khuzestan Steel	23	na	18	14	42	38
Esfahan Steel	20	25	23	27	3	4
National Iranian Steel	10	28	23	18	1	1

na = not available/applicable. Source: BMI estimates

While long steel output growth is lagging behind flat steel, there are dynamic segments within the Iranian steel industry. In 2011, **Isfahan Steel** completed the IRR300bn (US\$28.0mn) renovation of its first blast furnace, which has a production capacity of 800,000tpa; its two other furnaces each have a capacity of 1.4mntpa. However, it had no effect on Iran's overall steel output figure, and Isfahan Steel reported that its semi-finished steel output was down 3% year-on-year (y-o-y) in the first eleven months of the current Iranian year (to July 21 2013). The **Bardsir Steel** plant in Kerman province, a project owned by a holding company belonging to Iran's **Bank Pasargad**, is expected to come into operation in early 2013, comprising a 1mntpa DRI unit and a 1mntpa melt shop; although progress is reportedly slow, it looks likely to meet its deadline. Nevertheless, growth in capacity without corresponding growth in domestic demand and exports will simply lead to higher levels of surplus capacity.

By 2016, aluminium and copper production capacities are set to rise by 400,000tpa each, according to the government. This will push aluminium capacity to over 900,000tpa and copper capacity to over 600,000tpa. **BMI** believes the industry will fall well short of its targets, however, owing in large part to the effects of sanctions. Even in the absence of new sanctions, the financing, expertise and infrastructure would not be sufficient to achieve the aspirations of the steel industry, with some projects set to see lengthy delays. Individual steelmakers are, nevertheless, retaining overly optimistic forecasts.

Renewed efforts to privatise Iranian metal producers have only been partly successful. In 2011, IMIDRO announced plans to sell four new steelworks under construction to the private sector. Each of the steelworks, which consists of a DRI module, as well as a steel meltshop and billet caster, has a capacity of about 1mntpa of crude steel. The facilities, which will all be sold by tender, include **Bafgh Steel** in Yazd and in Kerman, **Sabzevaer Steel** in Khorasan and **Shadegan Steel** in Khuzestan.

### **International Sanctions**

The UN approved a fourth round of sanctions on Iran in 2010, including restrictions on financial transactions, a tighter arms embargo and the authority to seize cargo suspected of being used for Iranian nuclear or missile programmes. These were followed by yet more sanctions approved by the US Congress, which will force 'banks, insurers, energy firms and others to choose: trade with Iran and you will be barred from business with the United States.' Tougher sanctions mean trade finance is even harder to obtain when dealing with Iran, forcing the country to seek more difficult and innovative ways to bypass the sanctions or demand cash upfront. As trade comes to a halt, Iran will have less money to fund growth in its metals industry. Moreover, given that a significant amount of new metals output was to be exported, the sanctions will cut into output growth and limit production activity.

Iran's trade with Asia in semi-finished and finished products is unlikely to be immediately affected by the tougher UN sanctions regime relating to the country's nuclear programme and further sanctions by the US and EU, although it is likely to be affected by overcapacity in China. However, increased political risk associated with sanctions will dampen future capacity growth in the sector, since Iran will find it more difficult to secure partners and financial backing for any project. Even without the sanctions regime, the investment climate is challenging owing in large part to the regulatory processes and restrictions.

Increased international isolation exacerbates the problem, with sanctions making payment and shipping processes for Iranian cargoes more complex, although some banks and shipping companies had been excluded from the list of restricted firms. For example, the **Bank of China** has stopped accepting letters of credit for Iranian cargoes, though Iranian suppliers can still get letters of credit through other Chinese banks. However, Iranian cargoes traded by Japanese and Korean trading houses are likely to be affected as these countries seek to adjust to the new sanctions and protect their US and EU markets. Given that they handle a significant bulk of Iranian exports to China, this development will restrict trade movements.

### **Developments**

The government is aiming to establish plants across the country, with a focus on generating jobs in underdeveloped provinces. As with most large-scale industrial projects in Iran, the objectives are political in that they are aimed at securing support among the poor, while sidelining more practical issues regarding infrastructure and access to markets and raw materials. Due to poor transport links in the country, it often remains more profitable to import steel products than to transport them internally from main production areas to more economically advanced provinces in the north of the country.

Crude steelmaking capacity continues to be ramped up at other new projects. Construction of the Oghlid Steel plant formally started in 2011. The plant is expected to have capacities of 1.1mntpa of pellets, 800,000tpa of sponge iron and 1.5mntpa of steel billet. The project is expected to be completed by 2014 at a cost of about IRR8.3trn (US\$700mn). **Sirjin Steel** is building a IRR3.5trn (US\$330mn) second phase in Kerman province with a DRI capacity of 1mntpa, which was due to be completed by end-2013. Kerman is also the location chosen for a possible new steel plant, with capacity of 1.5mntpa of billets and slabs. Part state-owned **Zarand Steel** has a contract with a consortium of contractors, including Iran-based **Ghaem Reza** and China's **Sino Steel**, for the construction of a EUR513mn blast furnace plant, which is due for completion by 2013. Most output will be consumed domestically.

**Table: Largest Listed Metal Producers In Middle East**

Company	Country	Market Cap (USDmn)	Revenue (USDmn)	Net Income (USDmn)	Profit Margin (%)	PE Ratio	PB Ratio
Saudi Arabian Mining	SAUDI ARABIA	7,251	1,487	291	19.6	27.3	1.5
Aluminium Bahrain BSC	BAHRAIN	2,002	1,972	256	13.0	6.5	0.9
EL Ezz Aldekhela Steel Alexandria	EGYPT	936	2,413	101	4.2	9.5	2.1
Ezz Steel	EGYPT	785	3,262	1.4	0.0	645.2	1.2
Egyptian Iron & Steel	EGYPT	651	307	-67	-21.8	na	na
United Wire Factories	SAUDI ARABIA	420	268	31	11.5	13.7	3.8
Saudi Steel Pipe	SAUDI ARABIA	370	194	14	7.4	23.6	1.7
National Metal Manufacturing & Casting	SAUDI ARABIA	266	107	1.6	1.5	166.6	2.8
Egypt Aluminium	EGYPT	255	751	19	2.6	na	0.5
Arabian Pipes	SAUDI ARABIA	230	181	-6.8	-3.7	na	1.3
Kuwait Foundry	KUWAIT	217	7.8	3.9	49.9	197.4	1.2

na = not available/applicable. Source: BMI, Bloomberg

## Company Profile

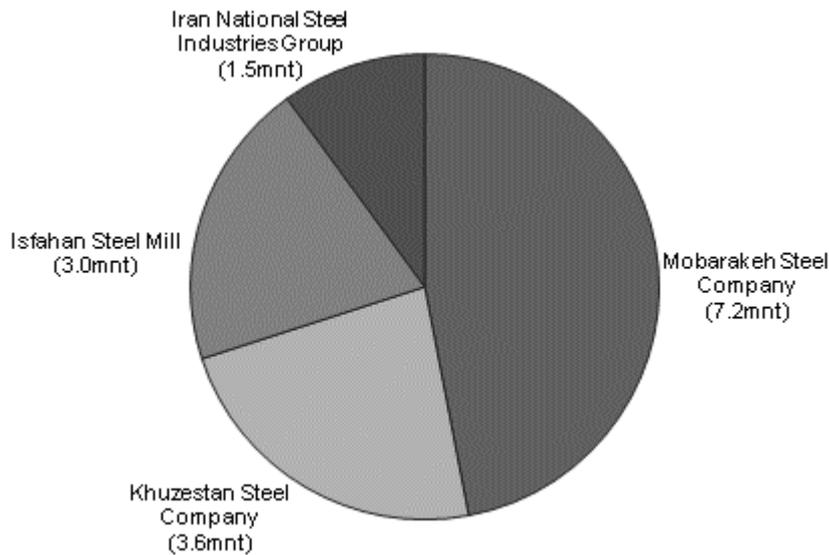
### Mobarakeh Steel Company

- Strengths**
- Mobarakeh is Iran's largest steel producer and should benefit from the Iranian government's ambitions infrastructure plans.
  - The company benefits from subsidised energy costs which help keep output expenses relatively low.
- Weaknesses**
- Sanctions will remain in place for sometime which will restrict the company's ability to export.
  - We hold a bearish outlook on the country and do not expect the economy to pick up significantly anytime soon.
- Opportunities**
- Any significant rapprochement between the US and Iran would bode very well for the company's outlook as long as there is a material reduction in restrictions on the metal sector.
- Threats**
- Political risks in Iran will remain high for the foreseeable future.
  - We expect inflation to remain elevated in Iran over 2014 and 2015.
- 

**Company Overview** Mobarakeh Steel Company is located 65km south west of Esfahan, near the city of Mobarakeh. It is Iran's largest steelmaker, having begun operations in 1993. The company produces 7.2mntpa, with an additional four ladle furnaces coming on-stream. The complex's steelmaking and continuous casting plant has eight electric arc furnaces, which use scrap for 15% of feedstock. The plant also has four ladle furnaces. It has four continuous slab casting machines, with slab production capacity currently at 5.4mntpa. The complex also produces HRC and CRC, pickled coils, narrow strip coil, tinplate sheet, galvanised coil, pre-painted coil and slab.

## Little Change Ahead

### Iran - Largest Steel Producers, 2012



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Source: BMI, Ministry of Mines Iran

Mobarakeh Steel is aiming to reach 10mntpa of capacity by the end of 2014. The company receives its iron ore from mines in Golgohar and Chadermaloo (Kerman and Yazd provinces) which is converted to pellets in the pelletizing plant (diameters: 8-10 mm). In 2009, it began an expansion project to add an extra 1.2mntpa of crude steel capacity and take its overall capacity to 5.4mntpa within a year of commissioning. It is also constructing three DRI modules with a total capacity of 4.5mntpa, while its Shahid Kharazi steelmaking project will create an extra 2.2mntpa of crude steel capacity. It is also constructing another compact strip processing plant that will have a capacity of 700,000tpa.

## Methodology

BMI's industry forecasts are generated using the best-practice techniques of multiple regression analysis, using a combination of industry indicators, as well as country-specific, regional and global macroeconomic variables that have statistically significant explanatory power in explaining past movements in industry-specific indicators. The indicators used vary from industry to industry, and from country to country within each industry, depending on the structure of supply and demand

When forecasting for some of our industry sub-component variables, however, using a variable's own history is often the most desirable method of analysis. Such single-variable analysis is called univariate modelling. We use the most common and versatile form of univariate models: the autoregressive moving average model (ARMA).

In some cases, ARMA techniques are inappropriate because there is insufficient historic data or data quality is poor. In such cases, we use either traditional decomposition methods or smoothing methods as a basis for analysis and forecasting.

Human intervention plays a necessary and desirable part of all our industry forecasting techniques. Intimate knowledge of the data and industry ensures we spot structural breaks, anomalous data, turning points and seasonal features where a purely mechanical forecasting process would not.

## Cross Checks

Whenever possible, we compare government and/or third-party agency projections with the reported spending and capacity expansion plans of the companies operating in each individual country. Where there are discrepancies, we use company-specific data, as physical spending patterns ultimately determine capacity and supply capability. Similarly, we compare capacity expansion plans and demand projections to check the chemicals balance of each country. Where the data suggest imports or exports, we check that necessary capacity exists or that the required investment in infrastructure is taking place.

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