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DIRECTORATE FOR SCIENCE, TECHNOLOGY AND INDUSTRY

OECD Special Meeting at High-Level on Steel Issues

INDUSTRY PROSPECTS

Statement by Mr. Roeland Baan, Mittal Steel Company

The Outlook for Steel Conference, organised by the OECD in co-operation with the IISI on 12-13 January 2005 at the OECD Headquarters in Paris.

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Good morning ladies and gentlemen, contrary to my colleagues represented here, I am a relative new comer to the steel industry, having joined 5 months ago from the oil and gas sector. This has enabled me definitely to understand much better the emotions of Alice, when she was dropped into Wonderland.

Looking at this industry with the eyes of a stranger does make it feel like a different world from time to time. A world that, for a long time, has been rather insular and internally focused, operating according to its own rules. A business environment where serving markets and market segments has been a secondary consideration to technological pride and operational imperatives. In other words, an industry that has had its assets as the point of departure rather than the requirements of customers.

On top of that, or maybe as a result, it has been an industry that has not been able to produce sustainable profitability and hence excite capital markets. Highly volatile profitability and lack of profit predictability have made investors weary of our industry, resulting in stocks trading at relatively low multiples and increasing the cost of capital.

Needless to say, the latter effect is not particularly desirable in a capital intensive industry.

As an industry, we have been extremely unsuccessful at balancing supply and demand. Traditionally this has lead to behaviour of maximising profitability in the good times and hoping to survive the bad times between the peaks.

Again, this is not an issue that is particular to the steel industry; all process industries face certain cyclicity, it is just that steel been lagging behind in learning how to manage this.

Even today, during this meeting, it has been mentioned that the biggest downward risk for prices would be a slow down in the growth of the demand, whereas in an industry that is responsive to market circumstances, the obvious impact should be on volume, not price!

However, a number of fundamental changes have occurred over the last decade, that indicates a departure from history, and the pace of change seems to be still accelerating.

What are these changes?

Firstly, governments have been actively divesting from their involvement in the steel industry. In order to realise the value of state owned assets and reduce the burden of running inefficient and often loss making entities many governments have turned to privatisation.

As a general rule, government owned businesses are not amongst the most efficient, do not respond to market economies and as a result often take the role of market spoilers. In process industries it is the marginal ton that determines the pricing of the total market, and it is very likely that this marginal ton comes from a subsidised government entity and not from a bottom line oriented, entrepreneurial outfit.

In this process, not only have assets been transferred to private business, but at the same time some significant, obsolete capacity has been closed down, leaving a far more healthy structure in its wake.

Mittal Steel has successfully completed 15 privatisations, starting in 1989 with the acquisition of Caribbean Ispat, then ISCOTT. We have witnessed first hand over the past fifteen years the progress that can be made in a relatively short period of time when a private enterprise takes over a previously state-run operation. In nearly every privatised asset that we had acquired, the company has been loss-making prior to our involvement – in some instances losing up to US\$1 million per day. And in each situation, we have managed to turn the situation around, often in the first year after acquisition.

Second, and partially connected to the previous point, is the consolidation trend. Whereas other industries like the oil sector, the chemicals industry and the cement industry are highly consolidated, the steel industry is still relatively fragmented. The top ten steel producers will in 2005 represent only 28% of global steel output, whereas the comparable figure for the earlier mentioned industries would be more in the order of over 50%. Still, in spite of the waves of consolidation in steel in the last ten years, this figure is only slightly up from 20% then!

It is obvious that consolidation will, and will have to, continue.

The first reason for this is the consolidation and globalisation taking place at the steel consuming industries. The top ten car manufacturers for instance, represent 73% of world wide car and truck output. This type of customer is increasingly looking for fewer suppliers that can reliably cater to their needs at all the facilities where they manufacture.

This means that the global supplier will have to be able to guarantee quality, delivery performance, develop products with the customer and provide adequate supply chain support. Differently said, this consolidation drive will move steel from the commodity arena into the Branded, value added product world.

Also, further consolidation, especially of the global type, will bring price stability and a far greater ability to balance supply and demand than is the case today. As stated before, it is the marginal ton of supply that determines the market price.

In a process industry, serving a growing market, as is the case in steel, there will almost always be an over capacity. The reason is simple: capacity can only be added in discrete steps.

There might be periods of tightness, but on average the addition of capacity will always overshoot the immediate requirement of the market. A small producer, in trying to react to market circumstances, can only choose to run his mill, or shut it down, dropping output significantly more than the market change he is reacting to.

Obviously, he will choose to 'fill the mill' and dump the product on the spot market. The result of this behaviour is obvious and unfortunately well known in our industry.

Large consolidated players have much more flexibility in reacting to market circumstances and act as a type of 'swing producer'.

Additionally, these globally consolidated players have no interest in dumping product onto the export market, as this will affect the market of an overseas subsidiary. I can assure you that maintaining price discipline within our group of companies is one of the most rigorous processes of all!

Obviously, the balancing of supply and demand and the resulting price stability is of crucial importance for not only the steel industry, but the steel consuming industries as well! A profitable industry will be able to invest in R&D, product development and environmental initiatives, ultimately benefiting the end consumer.

It is with this in mind that Mittal Steel, and before that Ispat International and LNM Holdings, have pursued an aggressive acquisition strategy. We have always believed in the benefits consolidation will bring to the sector and as such have sought out opportunities on a global basis. Today, Mittal Steel is the most global steel producer with operations in fourteen countries, on four continents.

However this is still not enough. Despite now being the largest in our sector, we still only account for 6% of total global production. As such we continue to look for opportunities on a global basis.

It has been interesting to see that since we announced the merger between Ispat International and LNM Holdings and the subsequent merger with ISG that many external steel commentators have started to predict other global acquisitions, mergers and link-ups. This is very positive and we will be watching the future with interest.

The third fundamental change is not new, but is growing in its impact. I am talking of the continuing strong development in the Asian economies, with China in a leading role. As far as the latter is concerned, China has been producing double digit GDP growth figures for almost every single year during the last 20! Coming from a low base, the beginning of this curve hardly made a dent into the global economy. By now however, this growth rate means that China adds an economy the size of Brazil, the world's 14th largest economy, every three years!

The billion dollar question is: will this continue?

Definitely, short term, there is no reason to expect any significant change in this. The rather favourable environment the steel industry has enjoyed during 2004 looks set to continue for the year 2005.

Global growth rate predictions are robust, even with a, for China terms, moderate growth scenario for the Chinese economy. Looking beyond this, developing nations will remain to have an imperative for rapid economic growth in order to sustain their large populations and eradicate poverty. The rising living standards that go with this will immediately translate into an increased demand for commodities, underpinning a medium term upward trend in prices.

This will surely not be a linear curve, and fluctuations on the way will happen, but the prices of commodities like iron ore, coal, scrap and energy will stay firm. This relative tightness of base materials for the steel industry in itself will already put a floor into the pricing of steel and steel products, making the occurrence of deep troughs more unlikely.

The China factor merits a separate place in this analysis. Not only does China now represent roughly a quarter of the world's steel consumption, the rapid increase of steel making capacity could change the global balance as well. There are a number of factors that make a case for continuing strong growth in demand for steel.

Firstly, continuing urbanisation at a very high rate fuel large housing and infra structure projects in the major cities. Currently an estimated 2 million people are migrating from the countryside into the cities. An added effect is that, once these migrants settle in their new dwellings, they will spend on durables, many of which have big steel content.

Secondly, China attracts still big sums of Foreign Direct Investment. A large part of these investments are concentrated in steel consuming industries like car manufacturing. The third factor I want to mention here, is the continuing heavy investment in infra structure projects, which carry a high steel consumption.

Even if this demand increase would be satisfied with increased local capacity, this still does not spell disaster for global steel pricing. As mentioned before, the increased demand for raw materials will put a floor in the market. Moreover, the Chinese government has announced that they favour investment into higher added value production over investment in further steel making capacity, making it very likely that China will remain a net steel importer for the foreseeable future.

In summary, the fundamental changes that have been occurring during the past decade have still quite some way to run and in fact are still on the rise. Steel's future looks bright and potentially very different from the past. In order to fully live up to the potential presented by these changes, the industry does however need to embrace the new mindset, using current profits for debt pay down and growth through acquisition, rather than ploughing it into new capacity. And last but not least, as part of this new mindset, the industry has taken its cue from the markets, rather than from the existence of the hardware.