The Economist

Feeling the heat

Europe's steel companies are among the biggest and best in the world. That is little help to them in a fiercely competitive and overcrowded industry

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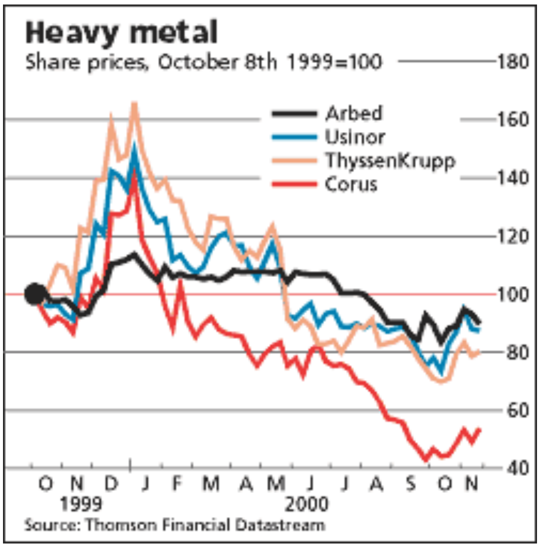
JUST outside Dunkirk, on France's northern coast, sprawled across a 450-hectare (1,125 acre) site, is Sollac, one of Europe's biggest and most efficient steel plants. Owned by Usinor, France's biggest steel company, Sollac has its own port, railway and a 55km (35 miles) road network. In one continuous process, it takes raw iron ore and coal from all over the world and turns them into top-quality rolls of steel. Visitors to Sollac cannot fail to be impressed by its scale. Its output this year will be 6m metric tonnes. Inside its cavernous buildings, giant furnaces belch flames and steam as the elements meet, while huge rollers squeeze fat steel slabs into elegant gleaming rolls.



Europe has six of the world's ten biggest steel companies. But Sollac and other steel mills like it operate in a desperately bleak environment. Even by their own standards, European steel companies have rarely been so out of favour with investors. This year, share prices have collapsed, dropping to levels last seen almost a decade ago. Usinor's shares have fallen by more than 40% since January; an index of European steel companies has fallen by more than 55% (the S&P index of American steel companies has also plummeted, and is now around its level in 1990). Shares in well-known companies such as Corus, a British-Dutch combination, and Arbed, a Luxembourg-based producer, are trading at discounts to book value of more than 60%. Shocked by falling share values, Germany's ThyssenKrupp pulled the flotation of its steel arm in August, causing a further fall in its shares and triggering a rethink of its entire strategy.

The price collapses have produced some remarkable anomalies. Peter Dupont, an analyst with Commerzbank, points out that Arbed has a market capitalisation of only *euro*850m ($725m), despite being expected to have *euro*14 billion of sales this year. It also has a 35% stake in Aceralia of Spain, worth around *euro*400m; so the rest of its assets are valued at little more than *euro*450m. Corus, which should have more than £10 billion ($14 billion) of sales this year, is judged by the stockmarket to be worth a mere £1.9 billion.

Cynics might point out that these are simply examples of the old economy-new economy divide. Although their share prices have fallen of late, plenty of Internet companies have achieved huge valuations based on tiny staff, minuscule sales and no profits, the inverse of the steel industry's experience. Steel companies have only a limited ability to exploit the Internet via, say, B2B exchanges. Yet today's low valuations would be less shocking if all the companies concerned were losing money.

Most of them, however, are profitable, some healthily so. The exception is Corus, which will struggle to return to profit next year despite an aggressive cost-cutting effort. But Mr Dupont reckons the best European steel companies are comfortably covering their cost of capital. He expects returns on equity to be between 12% and 15% this year, not bad for an industry with a long history of low returns. Arbed, ThyssenKrupp and Usinor should all report operating profits of around *euro*1 billion this year.

Moreover, European production is close to record levels, thanks to strong demand and good productivity levels at mills such as Sollac. According to the International Iron and Steel Institute, an industry forecasting group, world demand will be 752m metric tonnes this year, almost 6% higher than last year. So what is causing the industry's slump in investors' eyes?

Their disdain can be explained by looking both backwards and forwards. Europe's big steel groups are relatively recent products of mergers between once state-owned companies. Privatised during the early 1990s, they faced particularly tough markets because of low-cost new entrants in Asia, and because the break-up of the Soviet Union, which had not previously exported steel to the West, added 40m metric tonnes of capacity to an already stretched industry. They responded by merging into bigger, tougher cross-border entities, and by expanding into new markets overseas, in particular Latin America.

They have also tried to become more efficient. In 1970, the combined European industry employed 725,000 workers, but by the end of 1996, employment had dwindled to a mere 220,000. Numbers have continued to fall, despite buoyant output. In the past year Corus, for example, has shed 4,500 workers in Britain alone. Usinor's Sollac plant, although massive, employs a modest 4,500 people, thanks in part to ruthless outsourcing. A few years ago it had twice as many workers.

The result of all this cost-cutting is that Europe's steel companies remain competitive when measured against such global rivals as Nippon Steel of Japan and Posco of South Korea. But such is the industry's overcapacity that the impact on financial performance has been muted. A recent study by McKinsey found that average annual operating returns on assets have been 4% over the past decade, half the level achieved by aluminium and paper companies. That has tried investors' patience.

Taking a bashing

It is when they look forwards, however, that investors really dislike what they see. The fear is that the world economy is slowing down. Demand for steel is strongly influenced by the construction and car industries, which tend to lead big economic cycles. In Europe, demand from these customers is slipping. Construction orders, for example, fell by 8% in September, with Germany showing a particularly sharp decline this year. Steel prices have been falling in response, by 7% on average since August. Inventories have begun to swell.

The impact on steel makers will be nasty. On November 21st, Morgan Stanley Dean Witter slashed its forecasts for next year's profits by one-fifth. Announced cuts in production have come too late and are too little to make much difference, at least until well into next year.

Worryingly, steel firms have neither obvious nor easy responses to their difficulties. One problem is that both suppliers and customers have been faster to merge than they have. A mere three competitors dominate the world's iron-ore business, for instance, while the number of big car makers has shrunk to six, with control of 70% of the world market between them.

By contrast, the ten biggest steel companies account for less than one-fifth of the global market. This limits their room for manoeuvre. Raw-material costs have been rising, thanks to high oil prices, which push up the costs of running coking plants and the oligopoly power of the iron-ore companies. One response to falling steel prices might be to pass the impact to the ore producers. But individual steel makers lack the muscle to force down ore and coal prices. If anything, prices are rising.

An alternative response would be for Europe's steel companies to merge into even bigger entities and use their sheer scale to try to swing the cycle in their favour. Many observers think there are attractive combinations to be made between the likes of Usinor, ThyssenKrupp and Arbed. Usinor has held talks with ThyssenKrupp, to no avail, although there may be scope for further talks now that the German company has separated out its steel-making arm.

But the merger route is also fraught with dangers. Within Europe, there would almost certainly be antitrust objections to any proposed deals. Earlier this year a three-way aluminium merger was blocked, despite evidence that the companies concerned are struggling to compete with giants such as Alcoa of America. That might discourage the steel companies from trying similarly radical steps, even though the threat to competition would arguably be limited to a few niches.

That leaves the industry facing at best a long, hard grind. Companies' best option might be to invest more in ways to turn steel into a higher-margin product. A forthcoming survey of the European steel industry by McKinsey finds that it has been poorer at product innovation than other heavy industries. For example, a mere 12% of average steel revenues comes from products that are less than five years old. The comparable figure for the construction industry is 25%. Yet a few innovative steel makers, such as SSAB of Sweden, seem able to make the sort of steady returns that keep investors happy. More firms should follow its lead. Until they do, Europe's steel companies will continue to feel an uncomfortable degree of heat.

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