

UBS Investment Research

North America Steel Market Update

Destocking Nearly Over – Then What?

■ Long-awaited end of destocking approaching

Industry sources suggest US steel inventories may finish a sharp destocking cycle in 1-2 mos. While mills have run at mid 40% utilization ytd, the end of destocking should see distributors start buying in line with underlying demand. The obvious next query is – “How bad is underlying demand? Service center shipments suggest down 25-30% y/y, but worsening non-res construction could yield downside.

■ Steel veteran John Packard expresses concern over demand

In a call with industry veteran John Packard on Friday, we discussed inventory and demand, among other topics. He said destocking would continue for at least 30-60 days, and anticipated flat m/m January inventories. His contacts indicate very weak buying sentiment and little conviction of demand improvement in most end mkts.

■ Skepticism over contained supply

Packard said supply can come on quickly as mini-mills can take advantage of any improved order activity nearly immediately, but the true test will be for integrated mills to either add capacity or lose market share. In addition, he said OEMs were starting to look at foreign tons, and anticipated a potential import recovery in H2 as costs retreat with contract iron ore/coal and overseas mills cut prices aggressively.

■ Selective opportunities in challenging market

Sidelined global supply, ready to serve any hike in demand, can keep prices capped, in our view. We are particularly worried about low-cost Russia/Brazil supply. Mini-mills can restart quickly and take share, and we prefer variable-cost mills CMC and STLD, while remaining wary on higher fixed-cost U.S. Steel.

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We hosted a conference call on February 13 with steel industry veteran John Packard, founder of newsletter *Steel Market Update*, to share his views of the N. American steel market with investors. He painted a bleak pressure at least near term, and sees potential downside to prices below the current ~\$500/t for hot-rolled coil (HRC). Prices fell in recent weeks ~\$20-\$30/t for HRC, he said.

To listen to a replay of the call, please dial either **+1-888-203-1112** or **+1-719-457-0820**, code: **5437617**.

Key takeaways were as follows:

Domestic supply is disciplined, but poised to run. Packard said domestic producer discipline remains impressive, remaining below 50% year-to-date, and likely prevented a sharper drop in steel prices. In fact, given current utilization levels, he said it was remarkable that HRC was prices weren't near recent lows of \$260/t. Nonetheless, he thinks that much capacity, particularly at mini-mills, is positioned to ramp quickly to fill any uptick in orders and suppress any potential price increases at least near term. He said that mini-mills could resume 80-90% production rates nearly instantaneously to satisfy any potential inventory restocking-driven demand, and that integrated furnaces could likely resume full production levels within two to six weeks.

Buyer sentiment is poor, and re-stocking is not close. Packard said that steel buyer sentiment, both among end users and service centers, is poor according to a recent survey he conducted. He does not expect any inventory restocking at least within the next 30-60 days. He sees service center shipments rising from December levels, but inventory/shipment ratios remaining in balance near 3x for January. Inventory data is scheduled for release Tuesday or Wednesday. His contacts suggest metals buildings demand is down 30-50%, U.S. auto production should be 10-11M units (vs 12.9M in '08), and commercial construction falls 5-10%.

Imports could become a threat in H209. Packard said import offers into the U.S. were as low as \$430/t, although most exporters including Brazil and Russia are focusing on the higher priced Chinese market. With prices in China now falling (down approximately \$20/t in February), he expects China to eventually resume exporting again, and Brazil and Russia to shift export efforts to other markets including the U.S. In addition, he noted that foreign steel mills will become more price competitive when iron ore and coal price contracts settle at lower prices in JFY09 (UBS forecasts iron ore prices fall 40% and coal 72%), adding to downward pressure on prices.

■ **Statement of Risk**

The potential risks in the metals sector, including NUE, X, AKS, STLD, RS, GNA, CMC, SCHN, ATI, and Sims may include, but are not limited to: the volatile nature of raw materials and finished product prices; trade flows of raw materials and finished products; and operational difficulties, including weather and other uncontrollable logistics glitches. In addition, U.S. Steel, AK Steel, GNA, ATI, and Reliance employ a unionized workforce and could consequently be subject to work stoppages. U.S. Steel's pension and healthcare underfunded liability position approximated \$2 billion as of the latest filing.

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UBS 12-Month Rating	Rating Category	Coverage ¹	IB Services ²
Buy	Buy	53%	36%
Neutral	Hold/Neutral	36%	34%
Sell	Sell	10%	20%
UBS Short-Term Rating	Rating Category	Coverage ³	IB Services ⁴
Buy	Buy	less than 1%	43%
Sell	Sell	less than 1%	22%

1:Percentage of companies under coverage globally within the 12-month rating category.

2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.

3:Percentage of companies under coverage globally within the Short-Term rating category.

4:Percentage of companies within the Short-Term rating category for which investment banking (IB) services were provided within the past 12 months.

Source: UBS. Rating allocations are as of 31 December 2008.

UBS Investment Research: Global Equity Rating Definitions

UBS 12-Month Rating	Definition
Buy	FSR is > 6% above the MRA.
Neutral	FSR is between -6% and 6% of the MRA.
Sell	FSR is > 6% below the MRA.
UBS Short-Term Rating	Definition
Buy	Buy: Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.
Sell	Sell: Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.

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Forecast Stock Return (FSR) is defined as expected percentage price appreciation plus gross dividend yield over the next 12 months.

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Buy: Positive on factors such as structure, management, performance record, discount; Neutral: Neutral on factors such as structure, management, performance record, discount; Sell: Negative on factors such as structure, management, performance record, discount.

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UBS Securities LLC: Timna Tanners; PT Luther.

Company Disclosures

Company Name	Reuters	12-mo rating	Short-term rating	Price	Price date
Commercial Metals Company ^{16, 20}	CMC.N	Buy (CBE)	N/A	US\$12.81	13 Feb 2009
Steel Dynamics Inc. ^{6, 7, 16, 20}	STLD.O	Buy (CBE)	N/A	US\$12.73	13 Feb 2009
United States Steel Corp ^{2, 16, 20}	X.N	Sell (CBE)	N/A	US\$30.61	13 Feb 2009

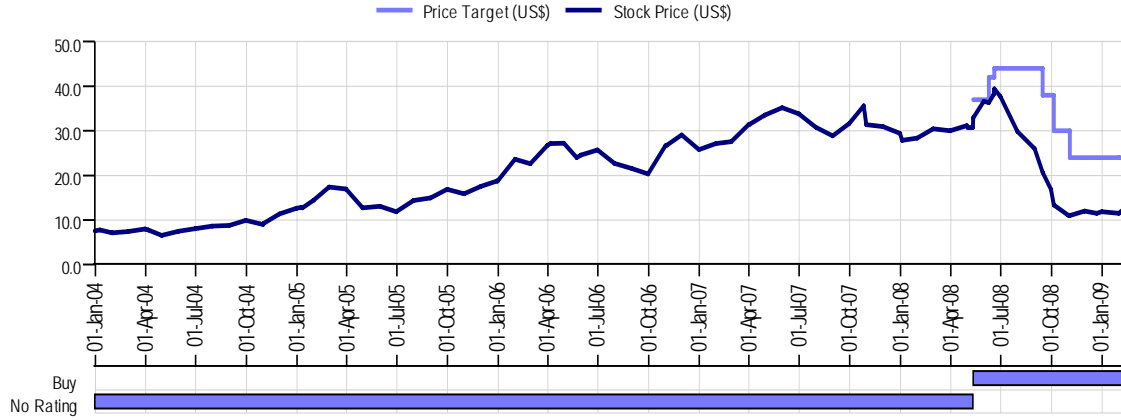
Source: UBS. All prices as of local market close.

Ratings in this table are the most current published ratings prior to this report. They may be more recent than the stock pricing date

2. UBS AG, its affiliates or subsidiaries has acted as manager/co-manager in the underwriting or placement of securities of this company/entity or one of its affiliates within the past three years.
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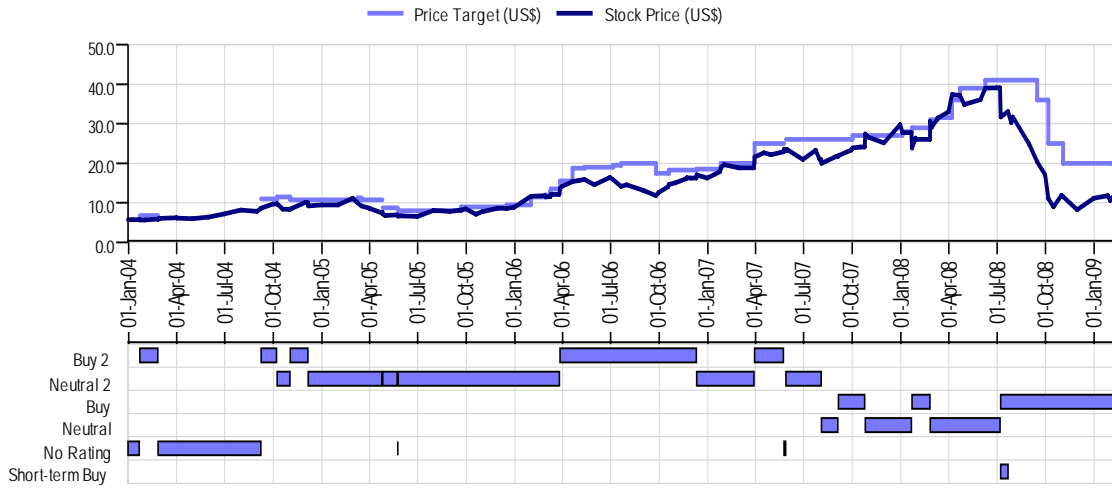
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Commercial Metals Company (US\$)



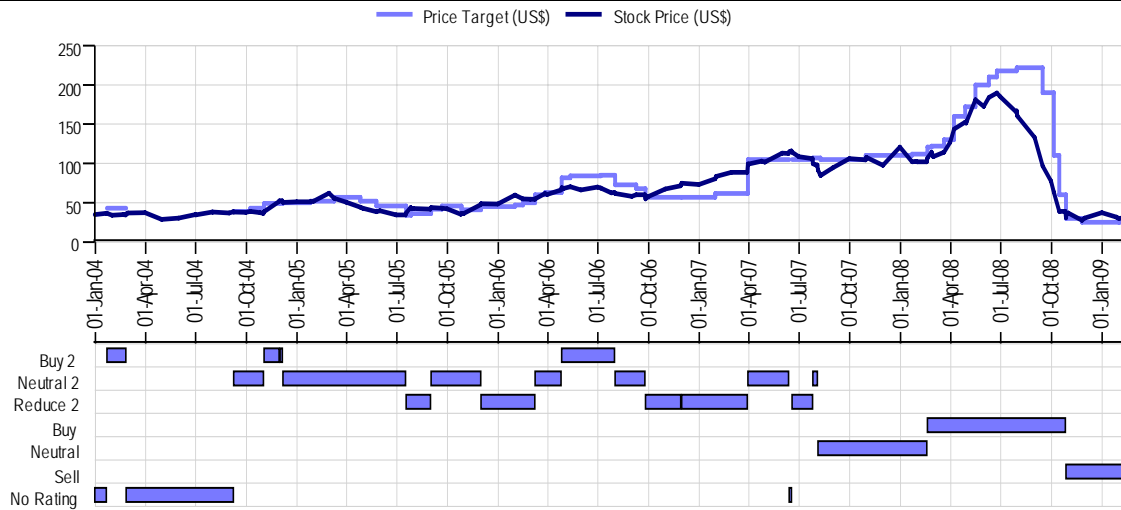
Source: UBS; as of 13 Feb 2009

Steel Dynamics Inc. (US\$)



Source: UBS; as of 13 Feb 2009

United States Steel Corp (US\$)



Source: UBS; as of 13 Feb 2009

Note: On August 4, 2007 UBS revised its rating system. (See 'UBS Investment Research: Global Equity Rating Definitions' table for details). From September 9, 2006 through August 3, 2007 the UBS ratings and their definitions were: Buy 1 = FSR is > 6% above the MRA, higher degree of predictability; Buy 2 = FSR is > 6% above the MRA, lower degree of predictability; Neutral 1 = FSR is between -6% and 6% of the MRA, higher degree of predictability; Neutral 2 = FSR is between -6% and 6% of the MRA, lower degree of predictability; Reduce 1 = FSR is > 6% below the MRA, higher degree of predictability; Reduce 2 = FSR is > 6% below the MRA, lower degree of predictability. The predictability level indicates an analyst's conviction in the FSR. A predictability level of '1' means that the analyst's estimate of FSR is in the middle of a narrower, or smaller, range of possibilities. A predictability level of '2' means that the analyst's estimate of FSR is in the middle of a broader, or larger, range of possibilities. From October 13, 2003 through September 8, 2006 the percentage band criteria used in the rating system was 10%.

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