

Metals & Mining Practice

Consolidating European steel: Strategic responses to industry challenges

In light of the many structural and crisis-related challenges Europe's steel manufacturers face, pursuing M&A strategies will open up new opportunities.

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The European steel industry entered 2020 as it had departed 2019: facing the significant challenges caused by stagnating business profitability. The onset of the COVID-19 pandemic in early 2020 made conditions even more challenging. To successfully navigate the path ahead, European steel producers might consider rethinking their M&A strategies and priorities.

about 19 percent below the average demand during the period from 2004 to 2008—mainly the result of the decreasing amount of steel used in automotive production and declining investments in the oil and gas industry as societies transition to cleaner energy. Moreover, international trade disruptions of tariffs (such as the United States' introduction¹) increased steel imports to and decreased exports from Europe.

Challenges for Europe's steel industry

Existing and new crises, slowing down market demand, too much capacity and too little utilization, as well as increasing pressure to reduce carbon emissions, are the industry's primary issues in Europe.

No demand recovery before 2030

The European steel industry has made little headway on its efforts to recover from the global financial crisis of 2008–09. The structural demand for steel dropped from the 2011–19 average by

The COVID-19 crisis triggered a significant drop on top of that decline in demand, and demand for European steel may not recover and return to a precrisis level until 2030. If so, the industry's structural loss is likely to be about 5 to 10 percent below the average demand level from 2011 to 2019 (Exhibit 1), given the following factors:

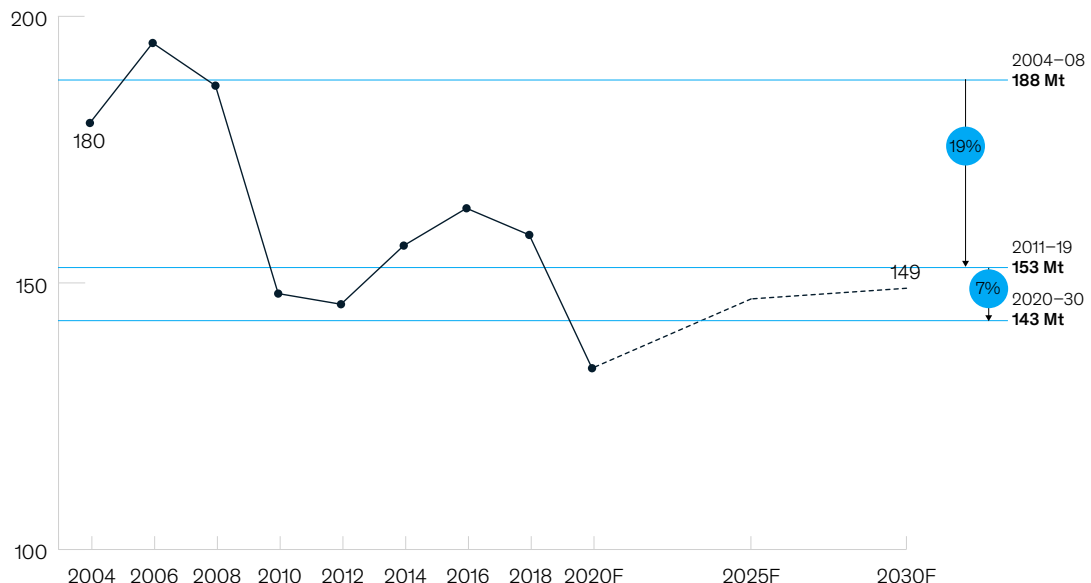
- lower demand for cars in Europe, accompanied by a decline in automotive exports due to localization initiatives by importing countries

¹ Section 232 of the US Trade Expansion Act of 1962 allows for the imposition of trade tariffs.

Exhibit 1

A structural demand loss of 5 to 10 percent is to be expected in postcrisis Europe.

European¹ apparent finished-steel demand, million metric tons (Mt) — Average



¹Western and Eastern Europe.
Source: Eurofer; Worldsteel; McKinsey analysis

- a reduction in or localization of corporate investment by importing countries in the engineering sector
- a prolonged period of low oil prices that led to a significant decrease in oil and gas exploration and exploitation
- declining construction investments and changes in the construction mix (fewer new business buildings) in the medium term

Structural overcapacity and underutilization

As a result of these demand drops, structural production overcapacities and underutilized assets have been recognized since the aftermath of the financial crisis (Exhibit 2). Since 2009, the crude steel capacity of the European Union and United Kingdom (EU-28) has been unable to reach utilization levels above 80 percent.

After 2019, when steel manufacturers' hopes for a cautious post-2009 recovery in demand had not materialized, even more pressure was added by further drops in utilization in the following year

(driven by the COVID-19 crisis). After the initial action in 2019, when European flat-steel players temporarily idled or closed 20 million to 30 million metric tons of annual blast-furnace capacity (Exhibit 3), the continuation of a late-2019 slowdown in incoming orders, exacerbated by the pandemic, resulted in a further adjustment of approximately 30 million to 40 million metric tons in crude steel capacity in 2020. With this reaction, the room for steelmakers to maneuver became even smaller.

Consequently, even if a partial recovery were to occur in 2021 or 2022, structural overcapacity with utilization below 75 percent is anticipated. To attain and sustain utilization of about 85 percent, surplus capacity of 25 million to 35 million metric tons would need to be reduced.

Growing pressure from CO₂ regulations

Alongside challenges from drops in demand and the resulting overcapacities, regulators of carbon-dioxide (CO₂) emissions are increasing pressure on the European steel industry's cost position. Increasing the share of steel production based on electric arc furnace (EAF), and thus

Exhibit 2

Decreasing demand and increasing imports lead to a structural underutilization of European steel production.

EU-28 crude steel (long and flat) capacity utilization, %

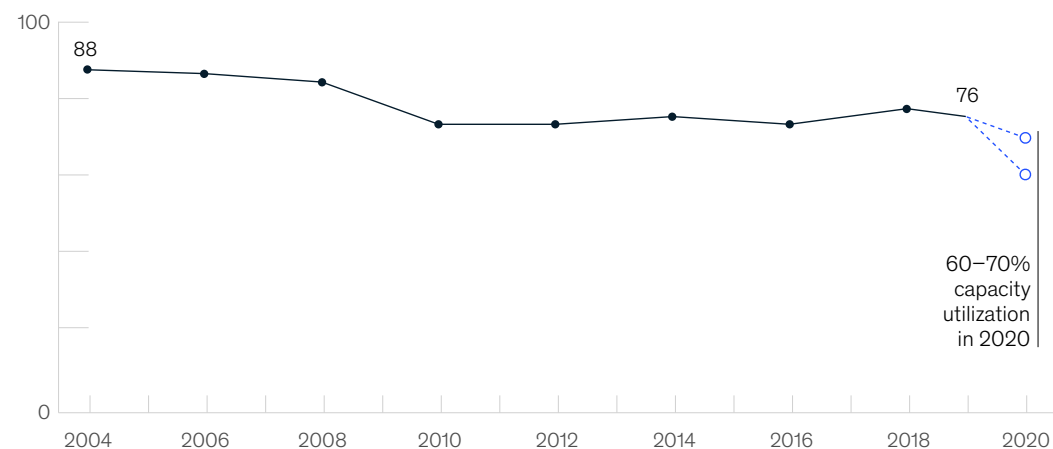
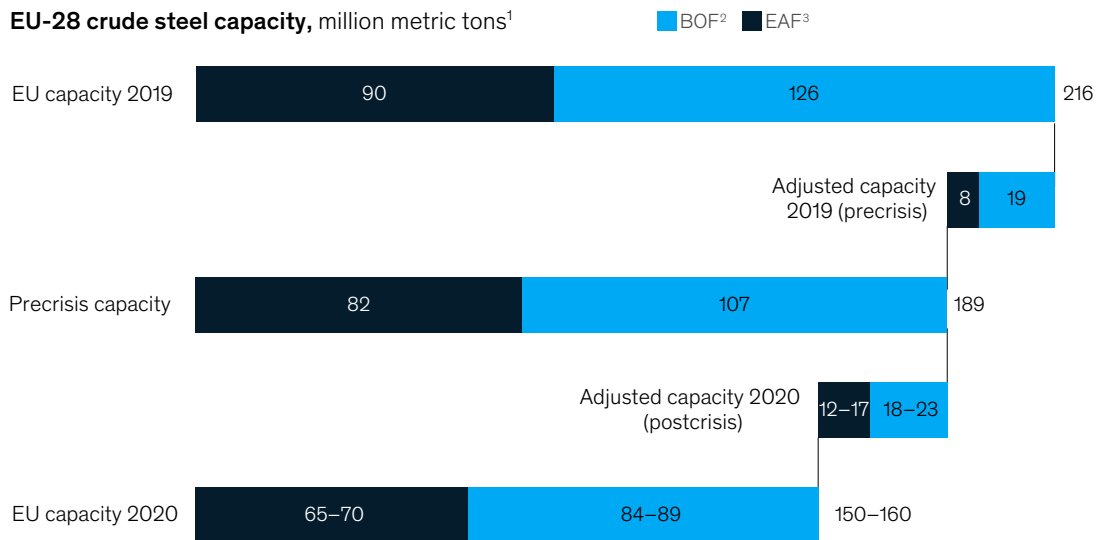


Exhibit 3

In 2019 and 2020, crude steel capacities are taken out of the system to react to structural demand loss and COVID-19.



¹Preliminary estimates; figures may not sum, because of rounding.

²Basic oxygen furnace.

³Electric arc furnace.

shifting the balance toward the greater use of scrap, remains the most realistic short-term option to address the pressure to decarbonize. Securing raw materials of the required quality and mobilizing capital expenditure to push technology upgrades are additional challenges to be faced in the medium term.

Strategic priorities for steel players

The European steel industry's recovery from the 2008–09 financial crisis began as market demand started increasing in 2013 (Exhibit 4). However, the deteriorating earnings before interest, taxes, depreciation, and amortization (EBITDA) margins and significant underutilization that were already evident in 2019 left European steel players with little room to maneuver in reaction to the worsening market conditions—which the COVID-19 crisis made far more acute in 2020. Structural demand drop, coupled with a structurally manifested

upstream underutilization, have made the need for consolidation more urgent.

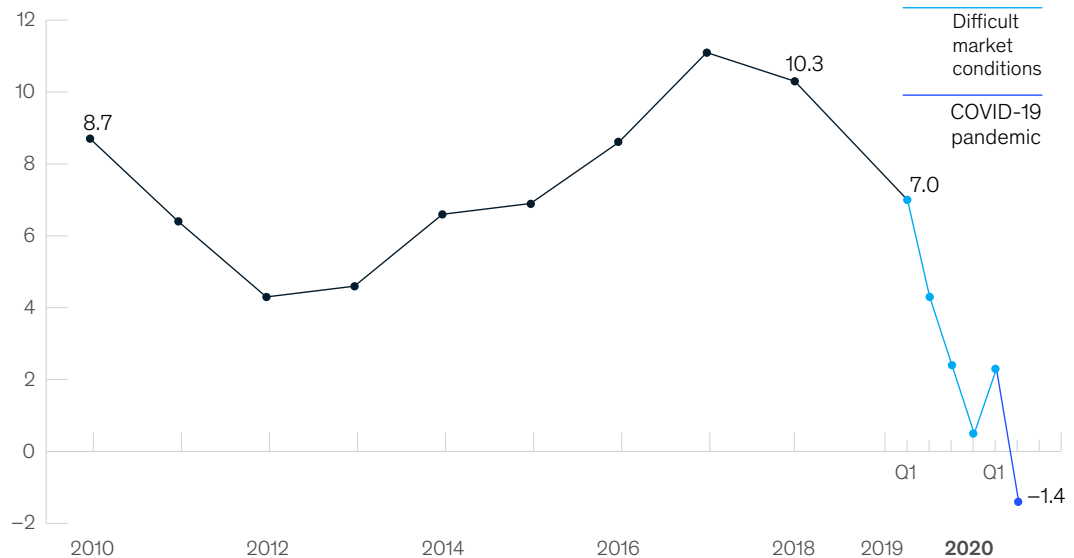
Given this situation, steel-company leaders should consider pursuing three strategic priorities in addition to acting in response to the immediate crisis:

1. **Optimize capacities**, in reaction to forecasted demand and in order to strengthen the health of the company's portfolio, by focusing on upstream steelmaking and commodity products to reduce overcapacities and optimize the size of the company footprint.
2. **Accelerate large-scale digitization and automation programs**, which is likely to capture additional opportunities in operational efficiency and production flexibility and improve the company's cost position on the global market.
3. **Prepare for the CO₂ challenge in an economically sustainable way**, including

Exhibit 4

The deterioration of European steel producers' margins was accelerated by COVID-19.

EBITDA¹ margin of European steel companies² (mainly flat steel), %



¹Earnings before interest, taxes, depreciation, and amortization.

²ArcelorMittal Europe, SSAB Europe, TATA Steel Europe, Thyssen Krupp Steel Europe, Voestalpine Steel division, Salzgitter strip steel business, USS Europe.

increasing the share of direct reduced iron (DRI) or scrap in steel production and embracing technological innovation (within the bounds of possibility dictated by the crisis). Reducing upstream capacities and importing semifinished steel could also be considered.

overall cost position of two steel players at scale by combining their production volumes and optimizing their joint network. This cost-leadership play aims at achieving, at differing intensities depending on the partnership's overall strategic direction, these four goals:

M&A strategies to transition to the 'next normal'

To tackle these strategic priorities, we believe that steel companies shall consider incorporating M&A into their strategies for the next normal. To address the strategic priorities, we have identified the following three M&A themes.

1. Cost leadership through horizontal consolidation

The objective of using horizontal consolidation to become a cost leader is to significantly reduce the

1. upstream optimization of assets to reduce overcapacities within the production network by closing cost-intensive sites and concentrating production on assets with a more competitive cost position (Exhibit 5)
2. realization of significant synergies from scaling effects in selling, general, and administrative expenses and support functions as the main nonproduction-related cost drivers, but scaling effects in procurement and supply as well (for example, using the same supply routes)

3. taking advantage of having a critical mass that allows the rolling out and scaling up of digital solutions in production and also in support functions
4. joint exploitation and buildup of green technologies (for example, EAF technology and hydrogen-based steel production); moreover, pursuing strategic M&A instead of independent testing of low-CO₂ technologies could help bundle investments

For this play to be successful, company leaders should consider taking the following actions:

- Apply an integration approach that minimizes complexity, facilitated complementary sales portfolio.
- Develop a clear perspective on the synergy potential from scale and network optimization,

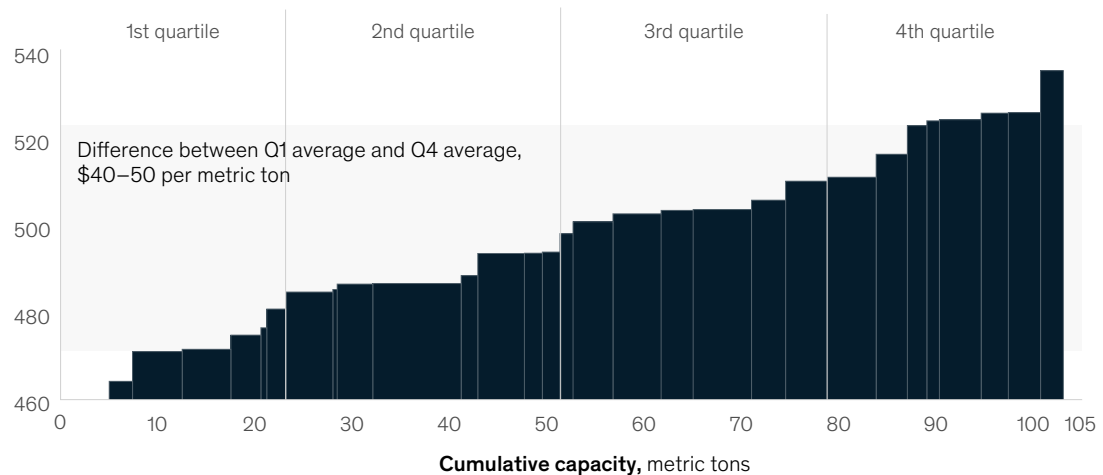
including restructuring need, timing, and geographical location of assets.

- Identify and prioritize the need for innovation, based on a clear strategy for scaling of digital and green solutions.
- Consider partners with sufficient size, capital resources, and complementary strategies.
- Start M&A consideration immediately to prevent mistaken investments in plants and technologies, given that all steel players are starting to invest in digitization and green technology now.
- Consider and identify potential regulatory concerns and customer-attribution risks.
- Discuss with leadership and ensure support for workers' participation.

Exhibit 5

Production-network optimization could improve European steel players' operating expenditure by up to \$50 per metric ton.

EU-28 HRC¹ operating expenditure² (90% standard utilization rate = 2019), \$ per metric ton



¹Hot rolled coil.

²Excluding capital charges, depreciation, and selling, general, and administrative cost.

2. Reduction of portfolio complexity

The logic of reducing the complexity of a company's portfolio is to reassess the product and customer portfolio in an environment of collapsing profitability. Through the targeted divestiture of unprofitable or low-profit products and noncore assets or businesses, steel companies gain opportunities to reduce complexity in a fragmented market. They refocus their production, sales, and investments while increasing overall profitability. Current discussions with European steel players show that, without collaboration across companies, sufficient portfolio streamlining cannot be realized.

For this play to be successful, company leaders should consider taking the following actions:

- Take a fresh view of their portfolio strategies based on 2019, the COVID-19 pandemic impact, and the outlook—not based on legacy.
- Thoroughly understand their own product portfolios, including core and noncore assets.
- Focus asset optimization on nonintegrated sites first, shifting production volumes to integrated plants as needed.

3. Globalization

M&A activities are not limited to Europe, especially taking recent European steel-demand forecasts into account. Using strategic partnerships or acquisitions to expand a steel company's global footprint is another option to cope with the challenges of recent times. By increasing their global footprint, European steel players can diversify into new, more promising markets outside

Europe. They gain regional access to new markets and end customers as a result but may also realize economies of scale in raw-materials sourcing. Furthermore, in times of supply-chain instability (from trade disruption and potential pandemic-driven logistical problems) and medium-term localization of end customers, global partnerships may act as risk-mitigating factors.

For this play to be successful, company leaders should consider taking the following actions:

- Thoroughly determine the potential for synergy, given the company's global network and economies of scale.
- Understand the limitations to and framework conditions for access to new markets of end users.
- Consider the possibility of challenges coming from cultural differences and regulatory and investment barriers.

The strategic plays outlined in this article set out various opportunities for company leaders to consider in light of the European steel industry's need for consolidation and other strategic challenges. The pandemic has left the companies, which were already facing a volatile future, with few options. Thus we see strategic M&A as the primary means for European steel players to tap into new potential and broaden their range of solutions, thereby accelerating the pace of their recovery as they head into an uncertain future.

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