The Construction Industry Dilemma – Price Fluctuations of Cement and Steel

By: Gary Wong

Introduction

The recent price hike on petrol in Malaysia and its subsequent backlash is indicative of the alarming rate of inflation in recent times. Admittedly, the Malaysian government has, for many years, eased the rising cost of oil by subsidising our petrol usage, until recent cost of per-barrel oil has spiralled to unsustainable limits.

The move to reduce consumer subsidy was not entirely unexpected, but citizens are weighing the rising cost of petrol as signs of the times. The cascade effect from rising oil prices on the construction sector is devastating Oil prices have significant impact on construction operating costs, logistic and transportation costs, production and manufacturing costs and many others.

Most recently, crude oil prices have surpassed the USD$70 (approximately RM 264)[1] per barrel for Malaysia. According to CIBC World Markets forecast analysts[2], this spells an impending escalation in prices for the next two years, perhaps even exceeding USD$100 by 2007.

Nowhere to go but up

In local cement and steel manufacturing industry, rising oil prices are not the only factors that forecasts trying times for the construction sector.

Earlier this year, the cement industry's largest manufacturers (comprising the top 4 cement producers in Malaysia; namely Lafarge Malayan Cement Bhd, YTL Cement Bhd, Cement Industries of Malaysia Bhd and Tasek Corp Bhd) was involved in a furious price war on cement. Some speculate that the impetus for the price war stems from the ongoing company acquisition and expansion by YTL Cement Berhad, including the high profile purchases of Pahang Cement Sdn Bhd (50% stake) and Perak-Hanjoong Simen Sdn Bhd (64.84% holding stake) last year. Market share impact was enormous, increasing YTL Cement's share from around 10% to 24%.

In an effort to combat the perceived threat of a consolidating cement player, which is gathering momentum in the industry, LaFarge Malayan Cement Berhad entered into a rebate and discount one-upsmanship with YTL Cement. Other smaller players followed suit.

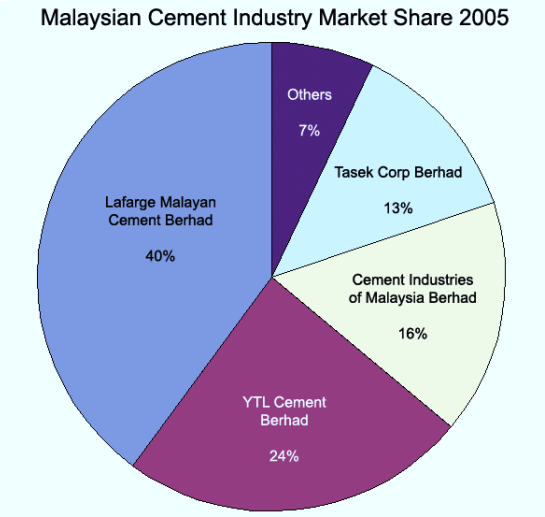

Figure 2: The market share of major cement manufacturers in Malaysia after a major upheaval at the beginning of the year

2004 was already earmarked as the first time that the key economic indicator for the construction industry has fallen despite consecutive years of increase. Another factor for price discounts and rebates was the overproduction and surplus of cement from 2004's construction downturn.

Although cement has been government controlled since 1995 (prices cannot exceed RM 198 per tonne within Kuala Lumpur, with distance from major towns being a factor for price increase above the ceiling), cement manufacturers have been giving scintillating rebates after rebates earlier this year. Prices were as low as RM 117 per tonne in April/May this year. Many cement buyers were ecstatic with the price rebates, but the good news would not last long.

Industry pundits were lamenting the price war as being unhealthy for the construction sector, as price-

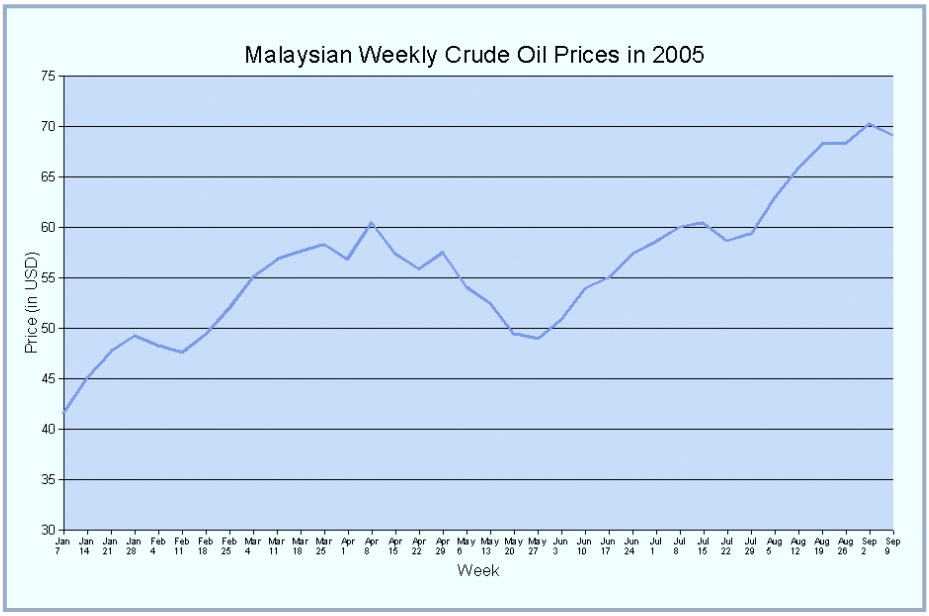

Figure 1: A crucial indicator of the times, the spike of oil prices in August 2005. Source: The Energy Information Administration (EIA), U.S. Department of Energy.

Rising cost of construction could leave many contractors in a lurch

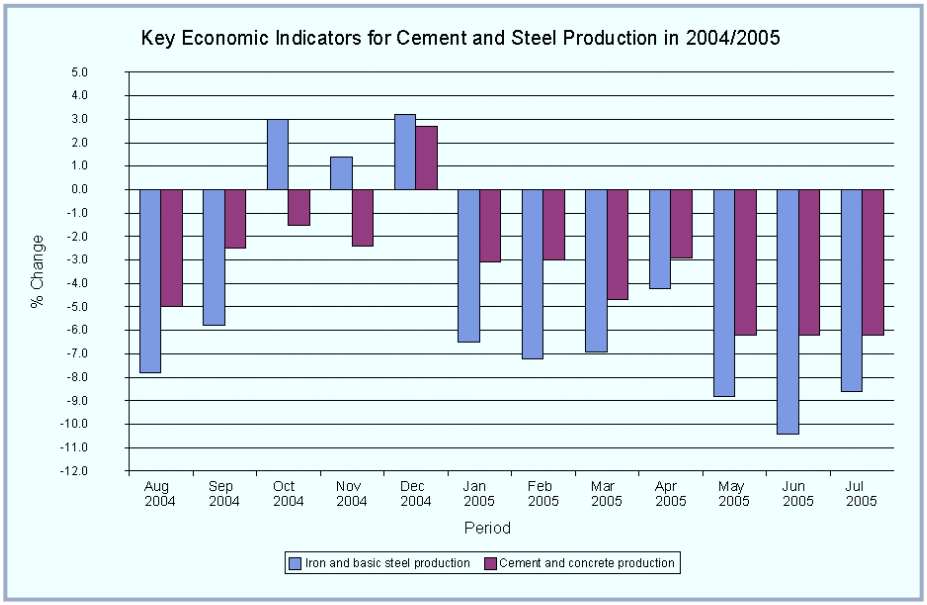

Figure 3: While cement production is experiencing a slight downturn, steel and iron production has plummeted in 2005. Source: Bank Negara Malaysia

undercutting destabilises the overall market. The major players in the cement industry could also feel the pinch of the price war, as Lafarge, CIMA and Tasek all recorded net losses and falling revenues in the second quarter of the year. Only YTL managed to stay buoyed with increased revenues and reduced net profit, particularly due to their high-profile acquisitions.

Despite the price war, cement prices would not remain at a discount for long. At the end of June 2005, cement prices shot up to around RM 180 almost overnight, hovering close the the government's price ceiling. Cement buyers were up in arms over the abrupt price fluctuation.

The major cement manufacturers were believed to be in agreement to taper off cement price rebates, in order to stabilise market prices, but this factor wasn't the only impetus for the price increase.

The impact of increasing oil prices and second quarter cement shortage only compound the price increase. While public construction works have provisions for rising fuel prices, the private sector construction industry have no such luxury and many projects feel the added burden of increasing fuel prices.

Steel got the blues

Steel manufacturing, on the other hand, already went through similar price fluctuations last year. Availability of raw materials were fluctuating wildly, resulting in volatile prices. However, at around the same time that cement prices started escalating, the price of steel has already settled somewhat. Currently, in the third quarter of 2005, the price of steel is on a rebound from a low of RM 700 per tonne early this year for local scrap to around RM 800. Steel bar prices are also government controlled, with a cap of RM 1,242 per tonne.

The main problem that plagues the steel industry is that of supply and low profit margins. Since early this year, steel production and output has been scarce, recording a monthly reduction of around 8% on average. The latest figures peg the output of iron and steel bars and rods in Malaysia for the period of January to July 2005 at 1,568,674 metric tonnes[3], less than half of last year's overall steel production.

Conclusion

Even though the price of steel is still low comparatively, scarce supply means that contractors are still unable to offset increasing construction costs, with the added pressures of cement prices within touching distance of the price ceiling and further increasing fuel prices. Many contractors are increasingly burdened with a lack of preparation for these market fluctuations, with private projects wildly under-budgeted and under anticipated.

It is not all a bed of thorns for the construction industry. Many optimists are predicting stronger demand and pricing stabilisation towards the end of the year.

The construction industry malaise is anemic and it requires strong support from the government. The upcoming 2006 Budget is hoped to be able to provide solutions for local contractors and sub-contractors to cope with market price fluctuations. Re-invigorating the construction sector will require provisions for bailing out construction projects currently in limbo due to these factors. ■

REFERENCES

[1] http://www.eia.doe.gov/pub/oil_gas/petroleum/data_publications/weekly_petroleum_status_report/current/pdf/table13.pdf

[2] "*CIBC World Markets Predicts $100 per barrel Oil within Years*" PR Newswire, Source: www.forbes.com/prnewswire/feeds/prnewswire/2005/09/08/prnewswire200509080948PR_NEWS_B_GBL_HS_TO062.html

[3] '*Production of Selected Materials*', Monthly Statistical Bulletin August 2005, Bank Negara Malaysia