

Unbeatable! Why China's wholesale steel markets won't go away*

"It is an amazing situation unlike the rest of the world. But it will be gone in a few years." This is the common reaction during the first visit to a Chinese wholesale steel market. The assumption is that consolidated sales channels such as distributors will replace steel markets. Yet since we first heard predictions of their passing, steel markets have only grown in size and importance. Their resilience explains much about China's distribution of steel and what the future may hold for the industry.

A snapshot

A wholesale steel market is a sight to behold – a motley assortment of traders, retailers, distributors and processors all thrown onto a small plot of land. A typical market is composed mainly of small shops ("mom & pops") anchored by a few large distributors. Goods are often stored in the centre of the market, creating what looks like a giant community pile of steel. Any

steel product can be found inside these modern day bazaars. The China Iron and Steel Association estimates there are more than one thousand wholesale steel markets across the country. Most of them consist of around fifty small shops with large groups of workers. Some, such as the Lecong Steel Market near Guangzhou, are enormous: there are more than 600 stores and several regional distributors which make up a

steel flowthrough of 4.5 million tonnes – roughly 1% of China's total steel production.

Cost structures

One important reason for the existence of steel markets is low cost: a tenant in Kunming's busiest market pays RMB20,000 rent per year for a 60 square meter shop. He doesn't use electricity except when operating his saw. When it comes to other typical business necessities, let us say that they are light on overhead.

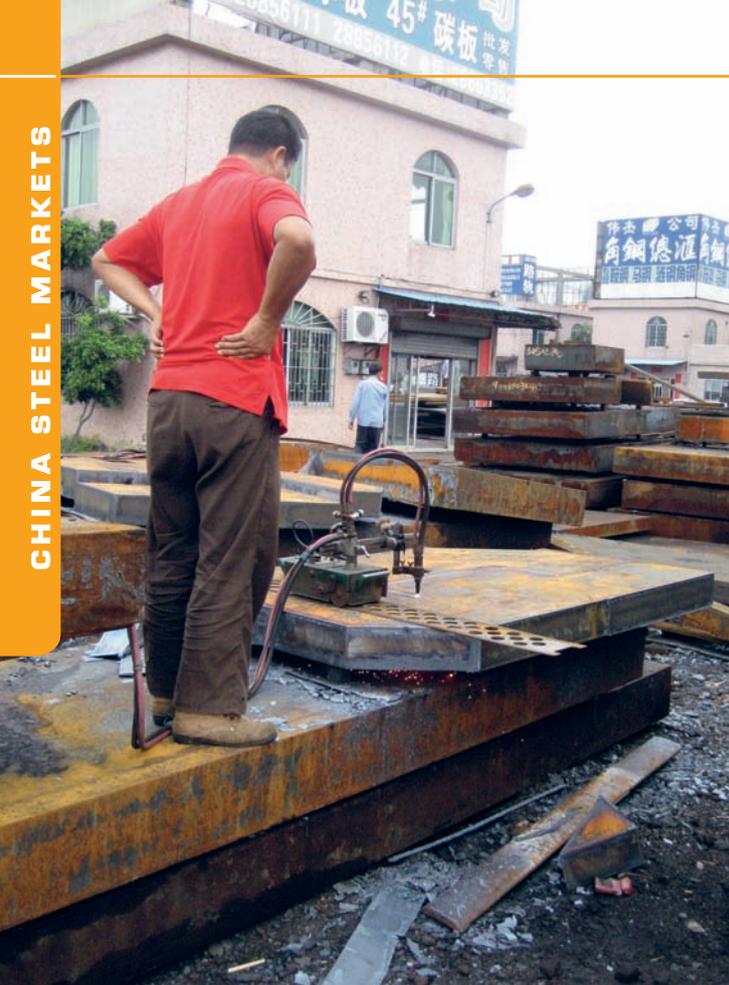
To mom & pop shops, minimising risk is paramount, so they keep low inventory levels. They may sell only one thousand tonnes per year, yet the amount of inventory on hand is a small fraction of this amount – often just a few tonnes.

Further, most shops within steel markets are cash businesses which can yield hidden benefits. Few tenants pay VAT on their steel sales and invoices are difficult to get. Though the value-add of these stores is low, in a sector with extremely thin margins, the ability to bypass VAT is a major advantage against large distributors.



A sea of steel at the Lecong Steel Market

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A man uses his portable flame cutter to cut thick steel plates

Trader mentalities

Tenants in steel markets must strike a difficult balance. Successful mom & pops work with neighbours to achieve sales, but are not held back by cumbersome allegiances. Our observations of the flow of goods make the interdependence of these players clear. For instance, one of the more successful mom & pops at a Tianjin market credited half of his success to his good relations with neighbours, with the other half based on his changing neighbours whenever his current ones outlived their use. This peculiar mindset is what gives the market such vitality. And it is this type of continually adapting environment that helps make steel markets so resilient.

For the uninitiated, here is an example of typical steel market purchasing behaviour. If a mom & pop shop receives a large order, say one hundred tonnes, there is little chance the store can fill it on their own. Yet instead of turning it down, they will accept, in effect selling material they don't yet own. The seller will then work with their neighbours to find these goods. Often this process is done in front of the customer so it is possible to see two deals struck at roughly the same time.

In this environment, market knowledge and strong relationships are the best assets. It is not just individual stores that adapt quickly though: an entire market can transform as most companies have very little stock. This year tightened loan requirements have slowed property development, so that steel markets changed their stock since they cater heavily to construction businesses. Mom & pops within the steel markets were among the first to adapt, clearing out their already limited inventory of construction steel quickly; large distributors with large inventories were less fortunate.

A race to the bottom?

To the flood of Chinese wanting to start their own business, however small, a shop in a steel market still represents a good opportunity. Few businesses require so little investment, and steel remains a high-growth industry - so it is not difficult to understand why markets are full of tenants. This, however, is a key reason for the persistent problems facing the industry. Tenants with little experience or

few qualifications in evaluating steel quality play an important role in the development of China's skylines and infrastructure. Many steel markets lack official oversight (other than security guards). Theft isn't a problem, but unscrupulous dealing in low quality steel is. According to a Shanghai Daily article from March, "half the steel material sold at wholesale markets and now being used in construction has failed quality tests." It continues, "The Shanghai Industrial and Commercial Administrative Bureau inspected fifty-two batches of steel material at three markets and fifteen construction sites and officials said twenty-seven batches had quality problems." As long as mills are able to sell their lowest quality materials to steel markets, this issue will be difficult to resolve. And after visits to over twenty steel markets near Tianjin, Beijing, Shanghai, Kunming and Guangzhou, it is clear that quality issues are not an isolated problem. According to one interviewee, "if you want quality assurance here, you're going to have to bring your own inspectors."

Looking ahead

Taken individually, the shops that make up steel markets are not of much concern to large distributors. Yet as a whole, they are formidable competition. These shops have low entry barriers and operating expenses; they are quick to adapt and have minimal oversight; and finally, they work directly with end customers - the most profit-



An assortment of steel tubes



Steel longs on display for potential buyers

able part of the distribution system. There is no doubt that these markets provide an efficient and cost-effective service to China's many small construction companies and SMEs. However, these markets also challenge

traditional distribution channels and are willing traders of some of the lowest quality steel. Short of major market events or changes in government policy, these markets will remain a central part of steel distribution. ■

Profile of Fiducia Management Consultants

Fiducia Management Consultants (www.fiducia-china.com) is a professional service provider focusing on Greater China. With four offices strategically located in Beijing, Hong Kong, Shanghai and Shenzhen, and a multinational team of experienced and dedicated full-time professionals, Fiducia provides China solutions combining international expertise and local know-how.

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