Iron Ore Overshoots to the Upside

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Summary

Iron ore prices surged over the past several weeks and now sit at nearly double the early September 2012 trough levels. The price increase stems from an up-tick in Chinese infrastructure spending which boosts steel production. This effect is compounded by steel mill restocking of iron ore and a cold winter limiting Chinese domestic iron ore supply. We think current prices far outstrip levels suggested by underlying supply and demand.

Expect prices to decline as these temporary effects abate. We continue to forecast iron ore at an average US$130 per tonne this year, essentially in line with 2012 levels, but far below the near US$160 per tonne currently in the spot market. Longer term, we see iron ore falling to US$90 by 2015, which will place higher cost producers under threat. Low cost iron ore miners, of which Australia is lucky enough to have two of the world's three best in Rio Tinto and BHP Billiton, are likely to continue to generate attractive profits at our long term forecast. Some of the higher risk, no moat iron ore miners have enjoyed significant share price improvement.

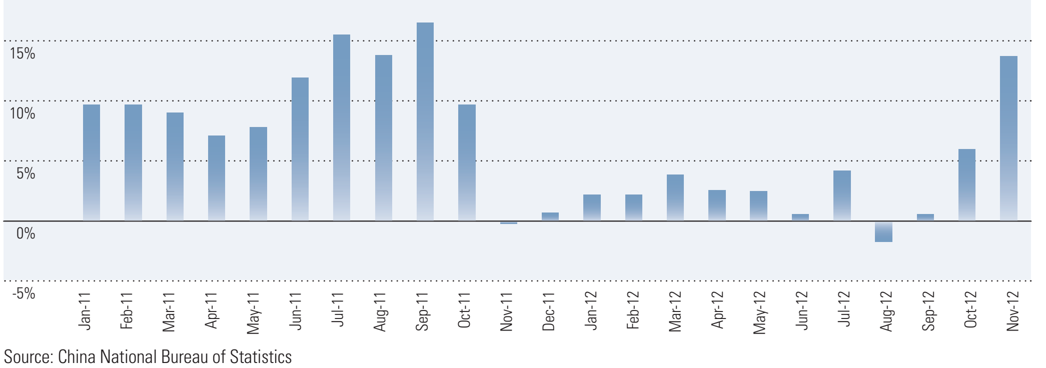
Price at more than one year highs

The iron ore price reached levels not seen in well over a year, hitting US$158 per tonne, 62% iron content, delivered to China basis on January 8. This is a continuation of iron ore's spectacular run iron since early December as prices breached the US$115–120 per tonne level it had been bound by since October. Last week, the price dropped marginally to US$154 per tonne but remains at levels not seen since October 2011.

Figure 1: Daily benchmark iron ore fines price, 62% iron delivered to China

Source: TSI/Platts

Figure 2: Chinese monthly crude steel production growth – % change year on year



Source: China National Bureau of Statistics

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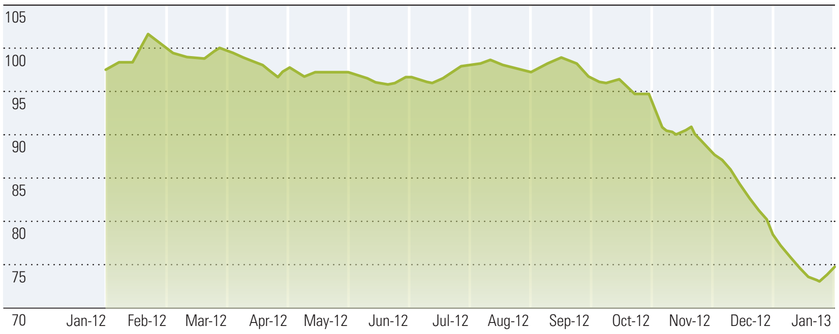
Chinese infrastructure spending assists prices
China consumes roughly two thirds of all seaborne traded iron ore and is the primary driver of iron ore demand. Infrastructure projects boosted steel production in recent months, improving demand for iron ore. Domestic crude steel production expanded at a rather tepid 2.1% rate year to date through October but bounced to 13.7% year on year in November. Expect a similarly strong gain when China releases December data in the coming days.

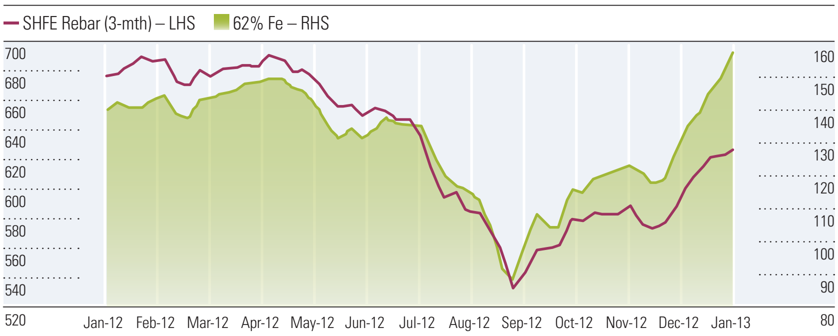
Part of the reason November crude steel production looks so strong is the very weak comparable. Chinese steel production growth in November and December 2011 was unusually soft, at negative 0.2% and plus 0.7% respectively, following what was a mostly strong year +11.1% in the year-to-date to October. For the first 11 months of 2012, Chinese steel output has grown just 2.9%, versus annual growth of 9.0% in 2011, 9.3% in 2010 and 14.7% in 2009. This is in line with our expectation that Chinese steel production and consumption growth will moderate in the long term. Coupled with a relatively healthy outlook for supply growth, this will lead to lower long term prices.

Figure 3: Iron ore stocks at major ports – million metric tons



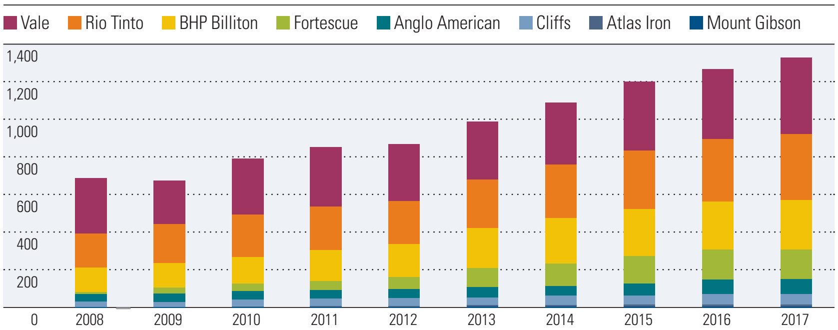
Source: Mysteel, TSI/Platts

Figure 4: Chinese steel versus seaborne iron ore price



Source: TSI/Platts, Shanghai Futures Exchange

Figure 5: Forecast production for companies under Morningstar global coverage (Mt)



Source: Company filings, Morningstar forecasts

Steel mill inventories causing price volatility
Much of the recent iron ore price strength is due to restocking by Chinese steel mills. This is similar to the period of iron ore price weakness around September when steel mills destocked. While prices were declining, there was little incentive for steel mills to order new ore. But as soon as the price finds a natural bottom and starts to rise, expectations of further increases can lead to panic buying as mills rush to beat the price rise.

In an ideal world, steel mills would permanently run with low inventories to minimise the amount of capital tied up in the business. The capital required to pay for those stockpiles – either equity or debt – comes with a cost in the form of a required rate of return on equity or an interest cost on debt. But when the iron ore price is rising by several dollars a day, the cost of financing stockpiles quickly pales into insignificance compared to paying a higher price for ore purchases. This kind of herding behaviour also reflects the relatively fragmented nature of the steel industry. The higher short term demand generates a temporarily higher market price as in the short run iron ore production is relatively fixed. In the long run, demand troughs and spikes based on inventory will even out and significant supply can be added.

We suspect demand is not the only culprit for higher iron ore prices as the cold Chinese winter has hampered domestic iron ore output. The southern hemisphere summer is also the prime period for weather related disruptions in Australia and Brazil, the world's dominant seaborne iron ore suppliers. Iron ore stocks at major Chinese ports have declined 25% inside six months and the ratio of stocks/imports has fallen to multiyear lows.

Our forecast remains US$130 per tonne this year
Once mill inventories are rebuilt and temporary supply constraints abate, expect prices to fall from prevailing US$150 per tonne plus levels. Short-term prices around US$130 per tonne are justified based on the near term cost of supply and a continuation of more sedate, low single-digit Chinese steel production growth.

Longer term, expect the marginal cost of supply to fall as low cost global producers like Rio Tinto, BHP Billiton and Vale expand. For those miners, re-investment at prices around US$90 per tonne is still attractive and makes sense. This feature differentiates the low cost, narrow moat iron ore miners from their higher cost producer peers.

The relationship between iron ore and Chinese steel suggests the iron ore price is ahead of itself. Prevailing Chinese steel prices have historically been associated with an iron ore price around US$120–130 per tonne. Recent meaningful declines in the coking coal price provides room for iron ore to take a greater share of steel making raw materials costs but there is no guarantee this dynamic will persist.

Iron ore to fall to US$90 per tonne by 2015

Our unchanged long-term outlook rests on a relatively sedate demand outlook compared to the buoyant last, China fuelled, decade. Demand hinges on the sustainability of China's investment-led growth model. The investment boom of the past decade has transformed China into the world's largest consumer of every major industrial metal but especially steel – the bones for China's investment – and the iron ore needed to make it. China's share of global iron ore demand now stands at a staggering 65% compared with a 40% for base metals like aluminium and copper. After a blistering decade, we expect China to grow markedly slower. This will see lower growth in steel demand and for steel making materials like iron ore, albeit off a much higher base.

On the supply side we are relatively optimistic and see significant expansion in train, primarily from the low cost producers. Expect prices to come under pressure in this more tepid demand growth environment, as major supply additions displace high-cost, predominantly Chinese, iron ore production. Our long term iron ore fines forecast remains US$90 per tonne from 2015 (2013 dollars, inflated at 2.5% per annum) from US$130 per tonne in 2012. Profit margins for the big players like Rio Tinto, BHP Billiton and Brazil's Vale will be lower but still relatively handsome. But for higher cost producers, particularly those leveraged with debt, the earnings environment will be significantly harsher. The last five to seven years have been extraordinarily kind to emerging iron ore miners but we think it is a mistake to expect a repeat.

Best value remains at the high quality end

Since the iron ore price bottomed in September 2012, it has risen just over 70%. The leveraged miners have tended to benefit most but, by the same token, suffered the most during the iron ore price decline in September 2012. We would largely expect similar behaviour in a falling iron ore price environment where the leveraged plays suffer the most. Interesting to note that none of the share prices have risen more than the iron ore price. This suggests the market is somewhat sceptical of the longevity of the recent bounce. Share prices are generally well below August 2011 levels, the last time the iron ore price was north of US$150 per tonne.

We include the key Morningstar data for iron ore companies under our Australian coverage. The narrow moats for both BHP Billiton and Rio Tinto reflect their cost advantage over other iron ore producers.
We expect this cost advantage to sustain for at least a decade, if not longer. While a lower iron ore price is likely to reduce returns from elevated levels for those narrow moat miners, we expect returns to remain attractive longer term. BHP Billiton and Rio Tinto also have the advantage of a considerable portion of its infrastructure being built over a decade ago when capital costs were one-fifth or less of current rates. That capital cost advantage is impossible to replicate. We think the market underestimates the long term value of BHP Billiton's and Rio Tinto's long life and low cost expansion options versus peers.

Iron Ore Price Moves

	7/09/2012	14/01/2013	% Change
Iron Ore (USD per tonne)	90	154	+71.1
Fortescue Metals	3.31	4.73	+42.9
Aquila Resources	2.25	3.16	+40.4
Mineral Resources	7.20	10.10	+40.3
Rio Tinto	52.38	65.99	+26.0
Atlas Iron	1.36	1.68	+23.5
BHP Billiton	31.98	36.57	+14.4
Gindalbie Metals	0.30	0.32	+6.7
Mount Gibson	0.82	0.80	-2.4

Key Morningstar Data

	Moat	Fair Value Uncertainty	Fair Value	Price/Fair Value	Recommendation
BHP Billiton	Narrow	Medium	50.00	0.73	Accumulate
Rio Tinto	Narrow	Medium	90.00	0.73	Accumulate
Atlas Iron	None	High	2.00	0.84	Hold
Mount Gibson	None	High	0.95	0.84	Hold
Mineral Resources	None	High	6.40	1.58	Sell
Fortescue Metals	None	Very High	2.20	2.15	Sell
Gindalbie Metals	None	Very High	n/a	n/a	Avoid
Aquila Resources	None	Speculative	n/a	n/a	Avoid

Atlas Iron, Mount Gibson and Mineral Resources, though considerably higher cost miners than BHP Billiton and Rio Tinto, do enjoy relatively strong balance sheets. This is a key risk differentiator from Gindalbie Metals and Fortescue Metals where the balance sheet gearing, coupled with significantly lower margins than our two narrow moat miners, make for potentially excessive leverage should the iron ore price retreat as we expect. Atlas Iron, Mount Gibson and Mineral Resources – at least at this stage – have balance sheets which provide some defence should the iron ore price become unfavourable. Aquila Resources has a strong balance sheet with significant net cash post asset disposals. The Speculative tag reflects its pre-production status and unfavourable capital costs. It will be expensive and risky for Aquila to get into production. That balance sheet strength is almost certain to be destroyed if the company proceeds with its ambitious, 50% owned, US$7.4 billion West Pilbara Iron Ore Project.