WILSONS

Iron Ore Prices Come Back to Earth

Our weekly view on Australian equities.

19 August 2021

Why Speed not Direction is the Key Debate

Iron ore prices have fallen 35% since they peaked in May 2021 (at an all-time high), providing a headwind for share prices of the major miners - Fortescue Metals (FMG.AX), Rio Tino (RIO.AX) and Vale (VALE3.SA). On a relative basis to the broader market, the Australian iron ore pure-plays are down ~12% over the past 3 months.

In contrast, BHP Group (BHP.AX) - a Wilsons Australian Equity Focus List Member with a more diverse commodity suite - has set all-time highs over recent weeks.

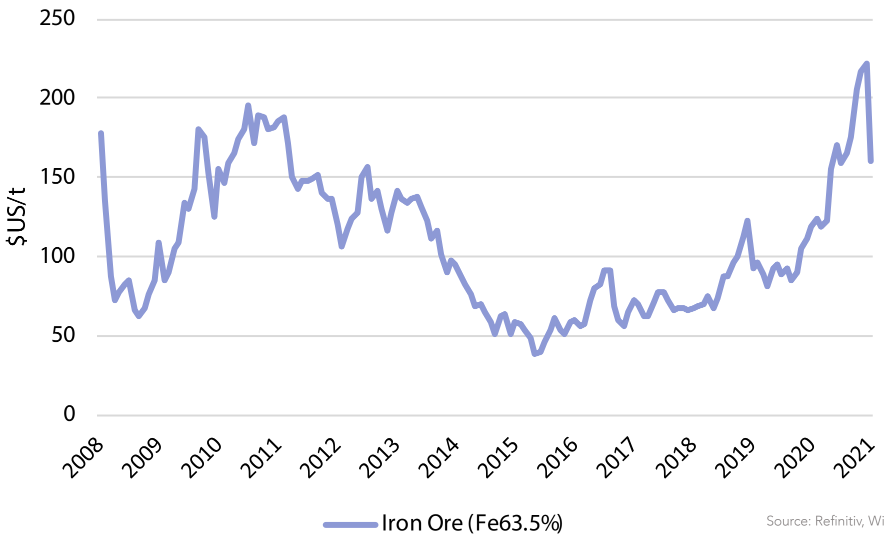
Subtle changes in Chinese policy around capping steel production in 2021 appear to have triggered the sell-off in iron ore.

In the short-term, the direction of the iron ore price is likely to dictate where the share prices of the iron ore majors head. While iron ore prices were not expected to remain at +$US220/t forever, there is likely to be significant hesitancy among investors in an environment where the iron ore price is falling.

The key debate for investors should not be around the direction of the iron price but the speed of mean reversion to the long-term price. Our base case remains that iron ore prices are likely to remain well above the market's long-term estimates of $US65-75/t into 2022, settling in the $US100-120/t range.

The four big iron ore majors BHP, FMG, RIO and Vale control +90% of the seaborne iron ore market. We see little evidence that the major miners are looking to materially grow volume, ex-Vale recovery over the next few years. Global demand should also continue to remain elevated, given prospects for a global growth recovery.

Exhibit 1: Iron Ore Price has fallen 30% since its recent peak in May 2021



Source: Refinitiv, Wilsons.

Why Iron Ore Prices Have Fallen

1. **China reminds steel producers of zero output growth for 2021**

At the start of 2021, China called for no annual growth in crude steel production in 2021 vs 2020 levels. In the first 6 months of 2021, output grew at just shy of +12% YoY. The Chinese Administration in early July 2021 flagged a refocusing of compliance efforts on production growth, sighting greater compliance with environmental orders.

We estimate that to reach the stated goal of flat output growth for 2021, steel production will need to fall by 60Mt to 500Mt between July and December 2021. That presents a potential ~90Mt iron ore headwind (1.4t of iron ore per tonne of steel) in the 2H21 for iron markets.

The narrative of increased compliance for environmental reasons, particularly as we move into the autumn and winter months (Winter Olympics in Feb 2022), masks what is likely to be simply a desire by the Chinese administration to get iron ore prices much lower. This would provide significant relief to Chinese steel mills, which have seen profit margins collapse. It would also help ease elevated PPI inflation, which is running at +9% YoY in China.

Ex-Australia, the traditional regions of incremental seaborne iron ore supply - India, South Africa, South America and Canada - are supply constrained due to a combination of COVID-19, domestic consumption/hoarding and operational mining issues limiting supply.

2. China producers begin cutting output

Large China steel producers have responded by cutting steel production. Baowu, the largest China producer, with 115Mt annual production (greater than India's total steel output!), flagged production cuts last week.

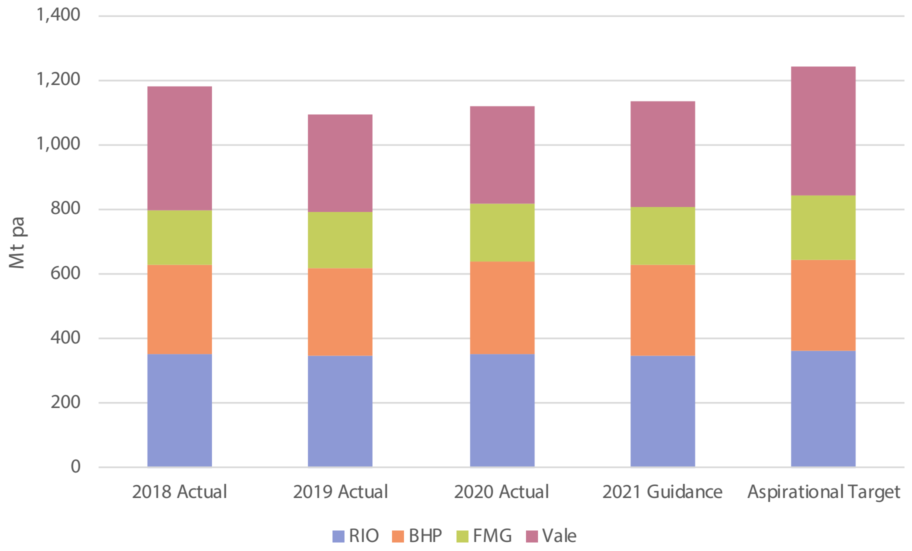
Data from China Industry and Steel Association, the China steel industry body whose members produce +1bn pa tonnes of steel or +60% of global supply, shows that steel production peaked in June, whilst data through July and August 2021 is running at 4-5% below 1H21 levels.

The impact through the supply chain is being felt across the steel sector. Steel mills are destocking (reducing inventory) and reducing iron ore intake. Port inventories have risen. As a consequence, with falling steel output, iron ore prices have fallen 35% since May 2021. It remains to be seen how compliant the steel mills will be through the remainder of 2021 – but history suggests it is not wise to bet against the China Administration.

We would note more broadly, Chinese Industrial Production (IP) surveys have softened materially this year. This week's IP growth for July 2021 slumped to +6.4% YoY, down from 9.8% YoY in April 2021 (China NBS). Some of this slow-down is normalisation post the very strong COVID recovery in 1Q21, but also impacts of new COVID restrictions and large-scale flooding events across China.

Nevertheless, at the big picture level, falling IP growth rates are not consistent with iron prices at almost 2-3 times the market's estimate of the long-term price of iron ore.

Exhibit 2: Major miners iron ore production rates. Aspirational production is <10% higher vs 2021



Source: Company Data, Wilsons. Aspiration Target taken from miners' commentary around future volume levels.

3. Iron ore supply growth in 2H221

Shipment volumes from the four major players have not yet changed in response to output cuts. The market is acutely aware that supply could lift by ~60Mt in 2H21 vs 1H21 on planned mining rates that miners have guided too.

To be sure, much of this planned volume growth is due to expectations of better weather and fewer supply chain issues rather than an influx of new mine volume.

Looking out into the middle part of this decade, the aspirational volume targets for four major miners imply a further 100Mt pa of supply or just 10% from 2021 levels.

Much of this growth is expected to come from Vale. Despite the mining issues in recent years, Vale aims to lift annual production from 325Mt to 400Mt. Given more challenging mining geology, geography, and inferior operational performance historically, the market currently discounts Vale's ability to reach that throughput.

The Outlook for Iron Ore Prices

Forecasting iron ore prices in our experience is about as difficult as forecasting the gold price. Specialist commodity forecasters within investment banks have dwindled over the years – with the market increasingly using a combination of spot and long-term estimates – of $US65-75/t.

It must be remembered that extraction costs or C1 costs across the four majors sit at around $US15-25/t, so the spot iron price is often viewed as an incentive price for marginal low-grade, high-cost producers to add to global supply.

Our aggregation of iron ore forecasts has iron ore gliding from current levels down to $US75/t or the long-term estimate by 2024. The forecasts match closely to the Chinese iron ore futures strip, which implies $US120/t by the end of June FY22. In our experience, commodity prices never just glide in a smooth linear fashion.

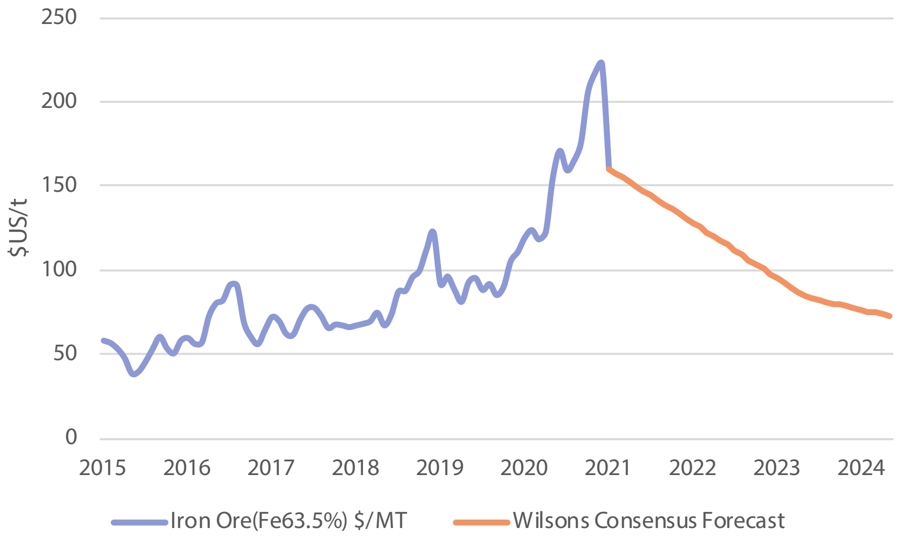
While we do not formally forecast the iron price, we are increasingly worried that our prior view of prices would remain higher for longer is at risk.

Read Australian Equities - Major Miners

We think the Chinese Administration's policy change is a big deal and should not be underestimated. A combination of 90Mt of unwanted iron ore and 60Mt tonnes of increased mine supply could see the iron ore market in balance in 2H21. That would represent a significant risk for the iron ore price.

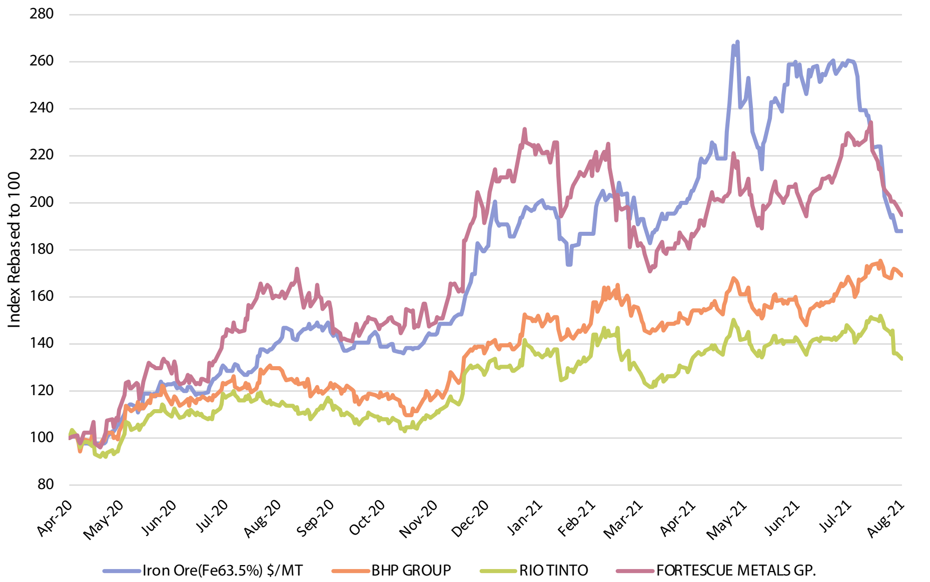
Australian and Brazilian port volumes are yet to show any reaction to a change in Chinese policy. We think that could be the 'shoe that drops', causing an investor re-assessment of equity prices. We are watching port data very closely at present.

Exhibit 3: Wilsons consensus sees prices falling to $US75/t by 2023



Source: Refinitiv, Wilsons. Average of 5 major investment bank commodity forecasts.

Exhibit 4: The iron ore prices rose more than the share prices of iron ore equities on the way up



Source: Refinitiv, Wilsons.

What Share Prices Imply

Share prices of the miners typically discount extreme moves in iron ore price – on the basis that price typically mean-revert over the long-term. Over the last two quarters, we have seen that despite rising iron prices, share prices of iron ore stocks remained relatively flat (in some cases underperforming the broader equity market).

Not even FMG, the iron ore pure-play, could outperform the iron ore price as prices rose, despite the operating leverage within a miner. To be sure, if we include dividends, the total returns would be very similar.

Another way of looking at iron ore price is to solve the current share price for what iron ore price assumption you would need to get an equity DCF valuation of a company to equal the current share price.

Yes, there are lots of assumptions that go into DCF valuation, and we are yet to discover a perfect DCF model (hint: it does not exist), but if we did solve for implied iron ore price, we find that spot iron ore prices are 25-40% ahead of what stock prices are assuming.

That implies that as iron ore prices fall, the share prices of major iron ore players should not move on a 1:1 basis. Iron ore equities should be more defensive than the iron ore price.

Is There Historical Evidence to Support this View?

We have reviewed eight episodes since 2008 where iron ore prices have fallen by 20% or greater. In no period has BHP or RIO fallen as far as the iron price. FMG has for around half the observations, typically when FMG was financially over-geared almost 10 years ago.

If the current period of iron ore weakness persists, we again suspect that iron price will fall much further than the share prices of major iron ore players due to just how elevated prices were (further to fall for iron ore).

The fact that all three Australian producers are essentially net cash and can distribute sizable dividends/capital management as we have seen with RIO and BHP this week.

Exhibit 5: Iron ore price falls vs share price falls – equities typically do not fall as far then the cycle turns

Time	Trough Price	Iron Ore Price Declines	BHP Price Change	RIO Price Change	FMG Price Change
Mar 2008 - Nov 2008	$72	-63%	-32%	-45%	-76%
Apr 2010 - Sep 2010	$147	-18%	-11%	-5%	-9%
Sep 2011 - Dec 2011	$143	-24%	-8%	-13%	-24%
Apr 2012 - Sep 2012	$112	-26%	-3%	-14%	-41%
Feb 2013 - Jun 2013	$117	-27%	-15%	-24%	-36%
Feb 2017 - Jun 2017	$57	-38%	-14%	-11%	-32%
Jul 2019 - Nov 2019	$83	-31%	-9%	-8%	5%
Jul 2021 - TBC	$160	-28%	-1%	-11%	-16%
Average		**-32%**	**-12%**	**-16%**	**-29%**

Source: Refinitiv, Wilsons.

Iron Ore and the Wilsons Focus List

The Focus List remains overweight the resources sector 22% vs market at 18% - primarily through a large overweight in energy. Within materials, we are underweight iron ore exposed names at 8% vs market at 11%. We lowered our exposure to iron ore by reducing BHP from 10% to 8% at the end of April.

With further downside potential likely in the iron price, BHP - with its more diversified asset base - should continue to outperform RIO and FMG in our view. Diversification falls post-de-merger of the petroleum assets. We estimate iron ore will move from 65% to 70% of BHP's earnings base.

If the iron price were to average $US130/t across FY22E – If the iron price were to average $US130/t across FY22E, we estimate BHP earnings would be see upgrades of ~20-30% vs current market estimates.

BHP's Free Cash Flow (FCF) yield at spot price equates to 15-17%, falling to 12-13% $US120/t, which we think provides an indicative guide to total return over the coming 12 months before any additional stock-specific attributes feature. In dividend yield terms that equates to 6-7% at $US120/t for FY22E.

Outside of iron ore prices, BHP continues to offer the strongest catalyst profile – primarily by its restructuring;

1. Petroleum demerger (potential for higher earnings multiple given less ESG risk)
2. Jansen potash development (a new angle on volume growth)
3. Potential collapse of the Dual Listed Company (DLC) structure which could see earnings multiple increases for BHP.AX given BHP.LN generally traded at a discount to Australian listing

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Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

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