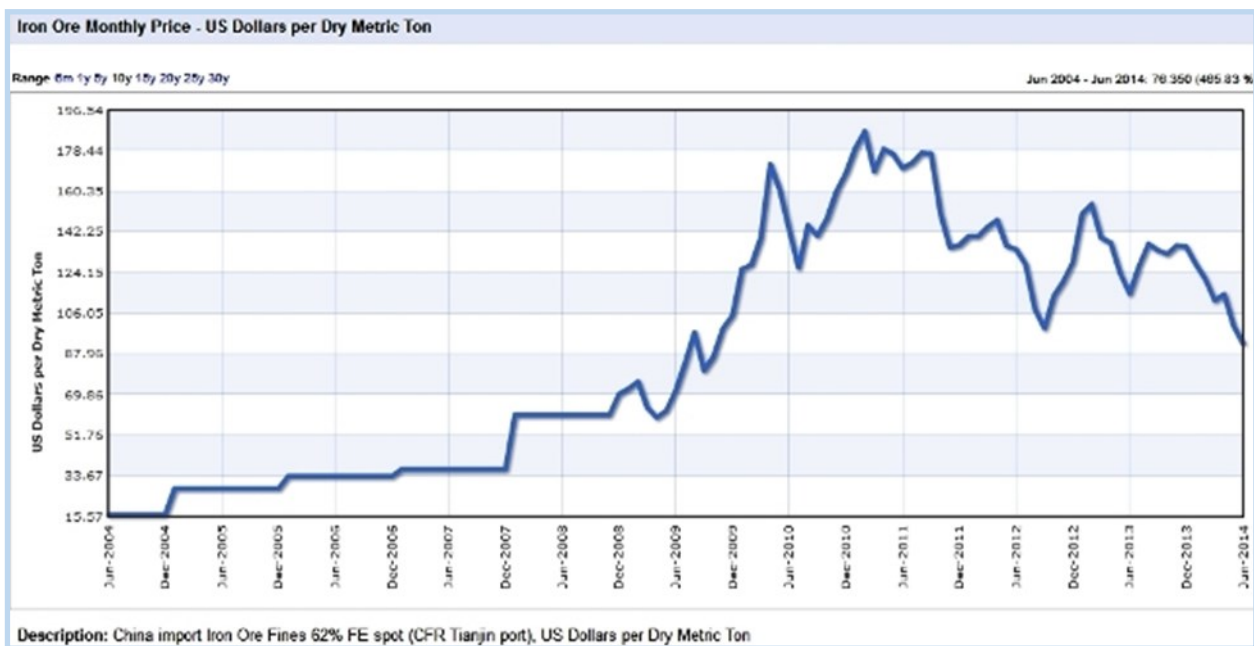


# Iron Ore

## keeping things in perspective

Iron ore continues to be in the news in a major way. There are arguments and counter-arguments with respect to the near- to medium-term price outlook, with varying degrees of optimism and skepticism. If you read some of the reports about in the financial press you could be forgiven for thinking that the iron ore industry is in the midst of a catastrophic crisis.

The reality however, once one looks past the dramatic headlines, is vastly different. The chart below puts everything into perspective. Whilst the iron ore price has retreated from its pre-GFC peak, it is still trading at a price that's around five times higher than the \$20/t price that it averaged for more than two decades between 1980 and 2004.



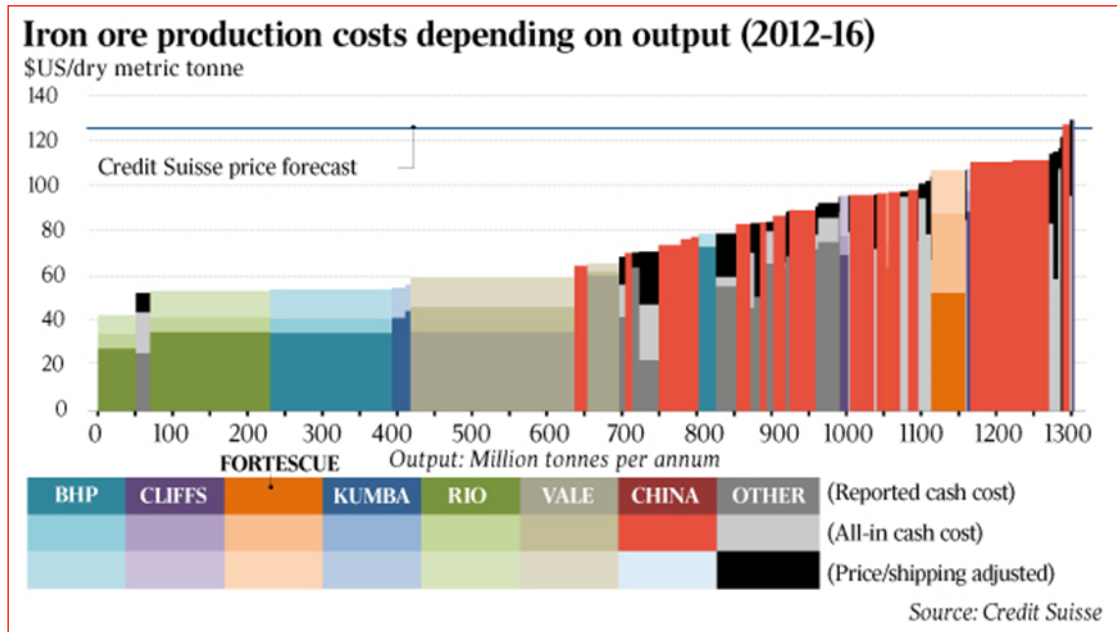
This still provides a robust margin for low-cost iron ore players such as the big three – Vale, Rio Tinto and BHP Billiton, particularly in terms of the context of the sorts of operating margins that the industry had become accustomed to during the course of the preceding decades.

From a local perspective, Rio Tinto, BHP Billiton and Fortescue Metals Group - the world's second, third and fourth biggest iron ore miners behind Brazil's Vale - plan to add a combined 235 million tonnes of new mine capacity by 2015, almost equal to Rio's total output in 2012.

In terms of the outlook for demand, Rio Tinto forecasts steel demand will grow by about 3% a year for the next decade, which is well down on 10% growth rates during 2009–2011; but in reality a more realistic and sustainable demand scenario.

## Digger Commodity Review

Rio Tinto, which derives more than two-thirds of its revenue from iron ore, is counting on its premium ore and low operating costs to provide hefty profit margins despite any cyclical downturn in the market. Rio's economies-of-scale allow it to mine iron ore at a lower production cost than anyone else in the iron ore business, as the chart below demonstrates. What's also significant is how much iron ore production would be wiped out at an iron ore price of \$80/t or lower – much of it Chinese.



The iron ore business has typically been dominated for decades by the major players - Rio, BHP and Vale - which together have accounted for as much as 80% of the world's seaborne iron ore trade.

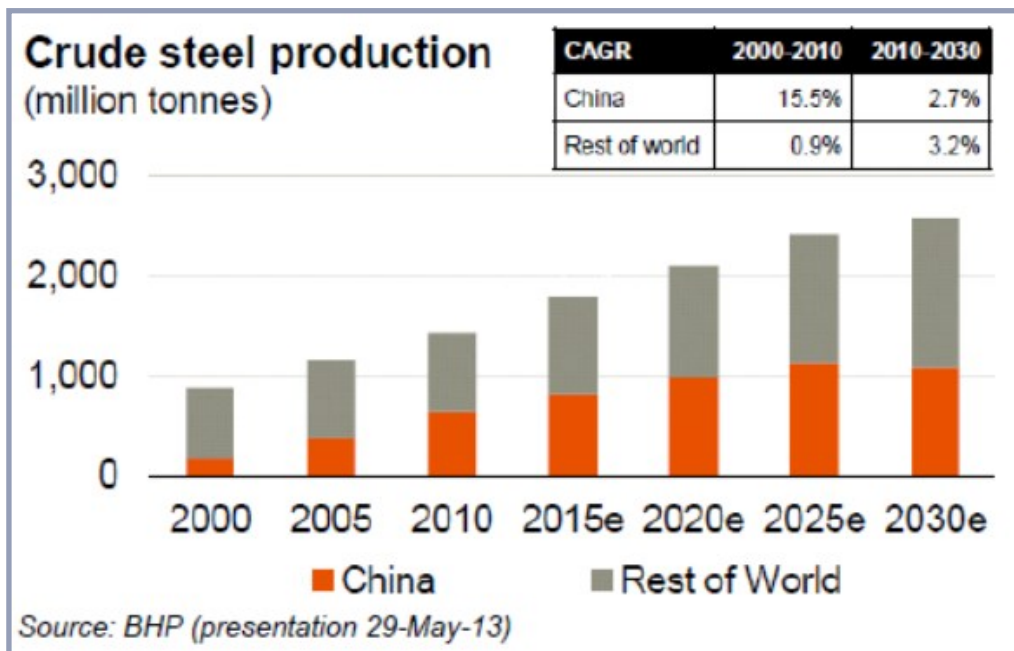
And there's a simple reason for this - iron ore is a bulk commodity, which means it's typically a low-margin business where the stuff has to be dug and moved in enormous volumes in order to generate a reasonable profit. Being a bulk commodity, infrastructure costs are huge, with returns generated over a significant period of time.

The fundamental characteristics of the iron ore business - high capex/ low-margins/large volumes/massive funding requirements/medium to long-term pay-back – are not features that typically attract smaller players into the industry. As a result, iron ore is predominantly the domain of mining heavyweights that can utilise their sizeable balance sheets to minimize exposure to potentially crippling debt levels.

With respect to BHP and RIO's Pilbara production expansions, the new capacity is aimed at meeting demand surges and minimizing the strong price spikes that can be disruptive to the industry.

In many instances the larger producers have touted major capacity expansions that have eventually translated into production on timeframes markedly longer than initial estimates.

## Digger Commodity Review



BHP forecasts China's steel production to peak in about 2025 at about 1.1 billion tonnes per annum. Steel production growth is forecast to moderate as steel intensity per unit of GDP declines.

Iron ore prices have stabilized over recent weeks above US\$90 per ton, but the situation remains tense for higher-cost independent producers. This was reflected in data released recently by Standard & Poor's, which showed that "some miners' key credit metrics might worsen significantly" if iron ore prices stagnate around US\$90 a ton.

"Among the global miners, we consider BHP Billiton, Rio Tinto, and Vale as being the most financially flexible to respond to weakening iron ore prices. They can defer their capital expenditure or sell their noncore assets," the analysis advised. "Nonetheless, we see that BHP Billiton and Rio Tinto have limited flexibility to adjust dividends amid weaker commodity prices due to their commitment to a progressive dividend policy. "On the other hand, downward rating pressures could arise for Australia's Atlas Iron Ltd., U.S.-based Cliffs Natural Resources Inc., and South America's CAP S.A.," the analysts cautioned.

"In our view, producers with a break-even cost of higher than US\$80 per ton are vulnerable to iron price volatility. Rio Tinto and BHP Billiton are positioned at the lowest end of the cost curve due to their competitive C1 and low freight costs to China. In fact, Australian producers generally enjoy a competitive freight advantage due to their proximity to China, compared to producers in Africa, North America and South America." S&P noted that Cliffs Resources and Atlas Iron "have relatively high breakeven costs, because of their relatively high C1 costs or interest burdens".

## Digger Commodity Review

With respect to China, falling grades and volatile prices are making life extremely difficult for China's iron ore miners and threatening to push them out of business. China is typically a swing producer and its mines rely on strong iron ore pricing above \$120 in order to remain viable. However, despite the critical role their output plays in determining China's need for imports, the fragmented nature of the industry makes it difficult to estimate how deeply the miners are impacted by weak pricing. What we do know however is that ongoing price weakness will place significant pressure on China's iron ore producers. Iron ore will always tend to be a relatively low-margin business. The ultra-high pricing environment of the past decade, which encouraged smaller hopefuls into the sector, is in no way typical. Prices are beginning to level-off as supply rapidly catches up with demand.

**I believe prices will average around \$120 per ton during 2014, with prices easing further during the course of 2015 to around \$100 per ton on average. The major advantage for the big iron ore producers is their low operating cost base and greater sales volumes, which is allowing them to continue to generate strong profitability.**

**Kind Regards,**

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The logo for MineLife Pty Ltd, featuring the word "mine" in a bold, black, sans-serif font and "life" in a white, sans-serif font, both set against a yellow rectangular background.

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