Investment Strategy

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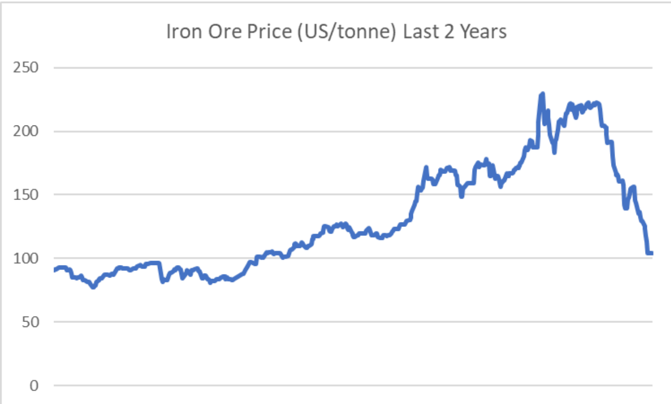
Australian Iron Ore Producers – What Happened to the Iron Ore Price?

Iron ore has plummeted to the lowest in 14 months after China ramped up its commitment to reduce emissions by cutting steel output amid a slowdown in global manufacturing. Spot iron-ore prices are now down +US$130/dmt from a high of US$233/dmt on 12 May to US$105/dmt currently, a fall of 55%.

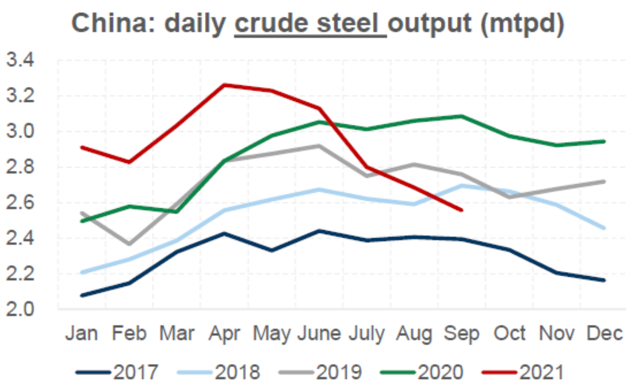
Booming demand and limited supply drove iron ore to record highs earlier in the year but an acceleration in China's efforts to control steel production and weakening global demand is beginning to weigh heavily.



Source: IRESS

China's leaders have signalled that hitting Xi Jinping's target for peak carbon emissions by 2030 remains a key priority. China, which relies on coal to produce much of its electricity, has been struggling with power shortages this year. This has put an additional impost on steel producers to cut emissions by reducing output, especially in the months leading up to the Winter Olympics in February 2022.

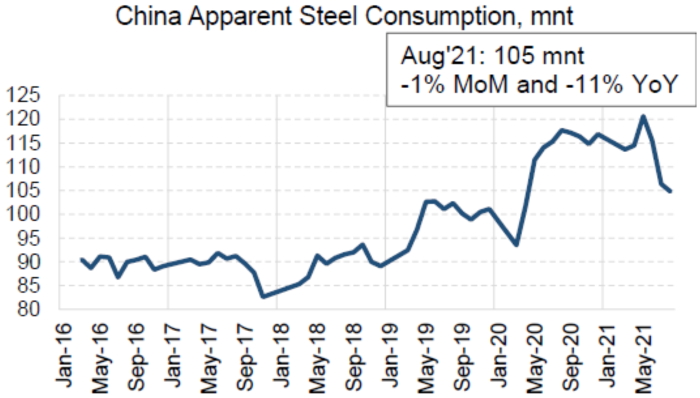
While production climbed 11% in the first seven months of the year, we are now starting to see a drop in production, that will need to continue until the need of the year to meet China's target for zero production growth over 2020.



Source: CISA, Mysteel, Bloomberg

The slowdown in global manufacturing and reopening of the services sector is occurring against the backdrop of the vaccine rollout and Chinese authorities wanting to take steam out of the commodities market.

Domestically, the problems experienced by property developer China Evergrande are potentially seeing a decline in steel demand for residential property development.



Source: Mysteel, China NBS, Bloomberg

What are the Implications -

- For the Iron Ore Price?

We had become increasingly concerned with the iron price through most of this year as it climbed into the high US100's and, eventually in to the US$200's in a mania of speculation and not consistent with where the fundamentals indicated it should be. The recent heavy pull-back has seen all of this speculative price action now disappear, with fundamentals now likely to drive the iron ore price.

In the short-to-medium term, we view an iron price around the US$85 to US$125/dmt as likely, driven by the outlook for the global economic recovery, which is currently growing in a fits and starts fashion. In addition, China's focus on reducing emissions ahead of the Winter Olympics may keep a dampener on steel production in the short-term term. However, Chinese officials have said that while they wanted to stop the development of projects with high emissions and energy consumption, they also wanted to avoid more drastic measures which companies were taking to hit government targets regardless of the economic fallout. Expect ongoing volatility in the iron ore price between now and February 2022.

Another factor to consider is the supply side response. For any iron ore miners operating in the third or fourth cash cost quartile, they are unlikely to be making a profit at current iron ore prices, especially given the dramatic increase in shipping costs, and so will likely cease production until the price improves.

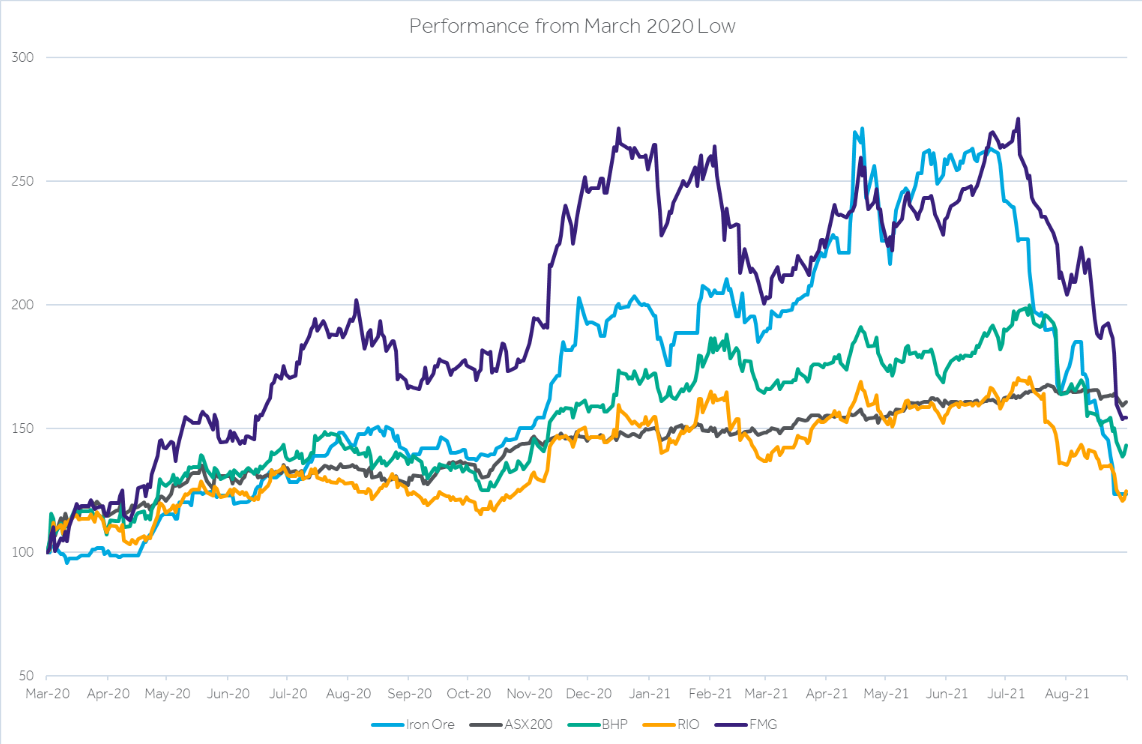
Over the longer-term, we believe an iron ore price around US65 to US$85/dmt appears sustainable given the demand/supply outlook. While Australian and Brazilian producers are likely to increase output at around 3-5% per annum, this is likely to be matched by steel consumption growth. The swing factor here will be the African iron ore mines China is currently developing, with their capacity likely to come online within the next five to ten years.

- For Iron Ore Producer Shares?

Investors looking to buy or hold shares in iron ore producers should be aware that the days of US$180+/dmt are long gone. Consensus estimates are already beginning to factor in the lower iron ore prices in their FY22 and FY23 estimates, resulting in lower profits and dividends. However, the key question for investors to ask is: Has the decline in the share prices of the iron ore producers matched this decline in earnings? The answer, at this stage, is that the share prices of the iron ore miners have perhaps overreacted to the iron ore price decline. However, if it continues to decline and estimates are lowered further, then we could continue to see a steady decline in share prices.

Iron Ore Performance

Iron Ore stocks have significantly underperformed the ASX200 in the past two months, in correlation with the decline in the iron ore price. Clearly, Fortescue Mining (FMG) is the most leveraged exposure to the iron ore price, given it is the only commodity it produces. Meanwhile, BHP and RIO have had less leverage to the upside due to their diversified commodity mixes but have performed poorly recently as iron ore accounts for the bulk of their earnings.



Source: Canaccord Genuity, IRESS

Iron Ore Producer Valuations

Based on current prices, iron ore producers appear attractively priced, although we stress that there may be further downgrades to come for the sector.

Code	Company Name	Current Price ($)	Fair Value Estimate ($)	Current Excess Return (%)	12 Mth Forward P/E (X)	Forecast Dividend Yield (%)
BHP	BHP Group Limited	38.81	48.72	25.5	6.9	11.2
FMG	Fortescue Metals Grp	15.47	18.11	17.1	3.9	19.8
RIO	Rio Tinto Limited	98.34	127.20	29.3	5.7	14.0

Source: Canaccord Genuity, IRESS

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