THE MINING MARKET REMAINS IN THE DOLDRUMS, CURBING PROFITS AND LEAVING THE COMBINED MARKET CAPITALISATION OF THE WORLD'S TOP 40 MINERS SOME 16% POORER DURING THE COURSE OF 2014. FOR THE LARGE MINING COMPANIES IN THE IRON ORE SECTOR, HOWEVER, THE CURRENT MARKET DISTRESS IS AN OPPORTUNITY TO SLOWLY STRANGLE SMALLER RIVALS AND GRAB MARKET SHARE, A STRATEGY THAT COUNTER-INTUITIVELY SEES THEM GROW PRODUCTION.

Survival of the fittest

BY DAVID MCKAY

Andrew Mackenzie

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Earlier this year BHP Billiton was slapped with a fine by the US Securities Exchange Commission (SEC) after it failed to properly monitor a programme under which it paid for dozens of foreign government officials to attend the opening ceremony of the Beijing Olympics in 2008.

Given the other problems with which BHP Billiton has to deal, especially in the current metal price meltdown, that's no big deal, right? The fine, some $25m (R310m), is like dealing in fractions for a company that hands over up to $10bn (R124bn) in tax to the Australian fiscus every year.

Yet the fact that the fine was actually penance for contravening US anti-bribery laws gives some insight into the supercycle during the 2000s, when investors flocked to mining shares, CEOs were bullet proof and the commodity 'upcycle' was forecast to last decades, not the decade that actually materialised.

The Melbourne-headquartered group was sponsoring the Olympics – an outlay in marketing that would be unimaginable today – but as the *Australian Financial Review* explained it, Beijing was China's 'coming out' party. The world "... stood on the doorstep of tectonic change as China turned to global resources markets to feed the reformation of its domestic economy," the newspaper said.

BHP Billiton, buoyant with the opportunity to supply the materials needed to support the growth of China's middle class, treated 176 government officials and employees of state-owned enterprises to three- to four-day hospitality packages including event tickets, luxury hotel accommodation, meals and business class airfares.

Marius Kloppers, then CEO of BHP Billiton, took a seat at the opening ceremony beside the president of Chinese state-owned alumina producer, Chinalco's Xiao Yaqing. Even the mines minister of Burundi was invited to attend, despite his country's civil ructions at the time – no matter – such was the aboundless appe-

tite for commodities that it was perhaps likely that 584mining firms would have to cast their nets far and wide.

Six years later, and with SEC having concluded its investigation into BHP Billiton's Beijing excursion, China's economy had taken on a somewhat different look. It was still growing, but the 14% gross domestic product growth of 2007 – that saw Kloppers seize a seat next to a potential trade partner – had slowed to a shade over 7%. Perhaps oddly, BHP Billiton fell afoul of the regulators for another, completely different, reason.

In May, Australia's senate said the trading behaviour of the group, now led by Andrew Mackenzie, and its rival Rio Tinto, ought to be subject of an inquiry. The inquiry aimed at proving whether the two companies were deliberating maintaining high iron ore exports, especially to China, even though there was a chronic market over-supply. Prices for the mineral had ridden the rollercoaster up and down: tripling in the three years from 2008 to $191 (R2 371) per ton only for the price to crash to below $50 (R620)/ton this year.

The view was that the injudicious pursuit of market share, rooted in the ambition that was manifest in the outlay at the Beijing Olympics in 2008, was now hurting the prospects of smaller players and, therefore, constituted unfair trading behaviour. Whereas everyone was invited to Beijing, the tenor now was that this was the survival of the fittest, or in this case, the largest.

BHP Billiton and Rio Tinto, as well as Brazilian company Vale, control about 78% of the world iron ore market. Based on the comments of its executives before the inquiry was mooted, they were seemingly intent on increasing their grip over supply. The Australian firms alone said they expected to increase market share to 70% by 2020, equal to some 900m tons following aggressive expansions.

This was despite reports that demand was falling, although in absolute numbers, it was still high. Citigroup estimated that iron ore demand would fall to 982m/tons in 2025, from 1.18bn tons in 2020.

> "The Chinese economy is almost 25 times the size it was 25 years ago, and over the next decade 170m rural Chinese will move to an urban environment."

Global demand for seaborne iron ore, meanwhile, would drop to 1.57bn/tons from 1.68bn/tons over the same period.

Mackenzie came out swinging, however.

He argued that stemming production from BHP Billiton would seriously undermine Australia's commitment to free trade and send "the wrong signals" to the company's customers – a view that won the support of both Australia's Trade and Investment Minister Andrew Robb and Industry Minister Ian MacFarlane, and even threatened to split Australian Prime Minister's Tony Abbott's cabinet.

These events serve to show the cyclical nature of the commodities market.

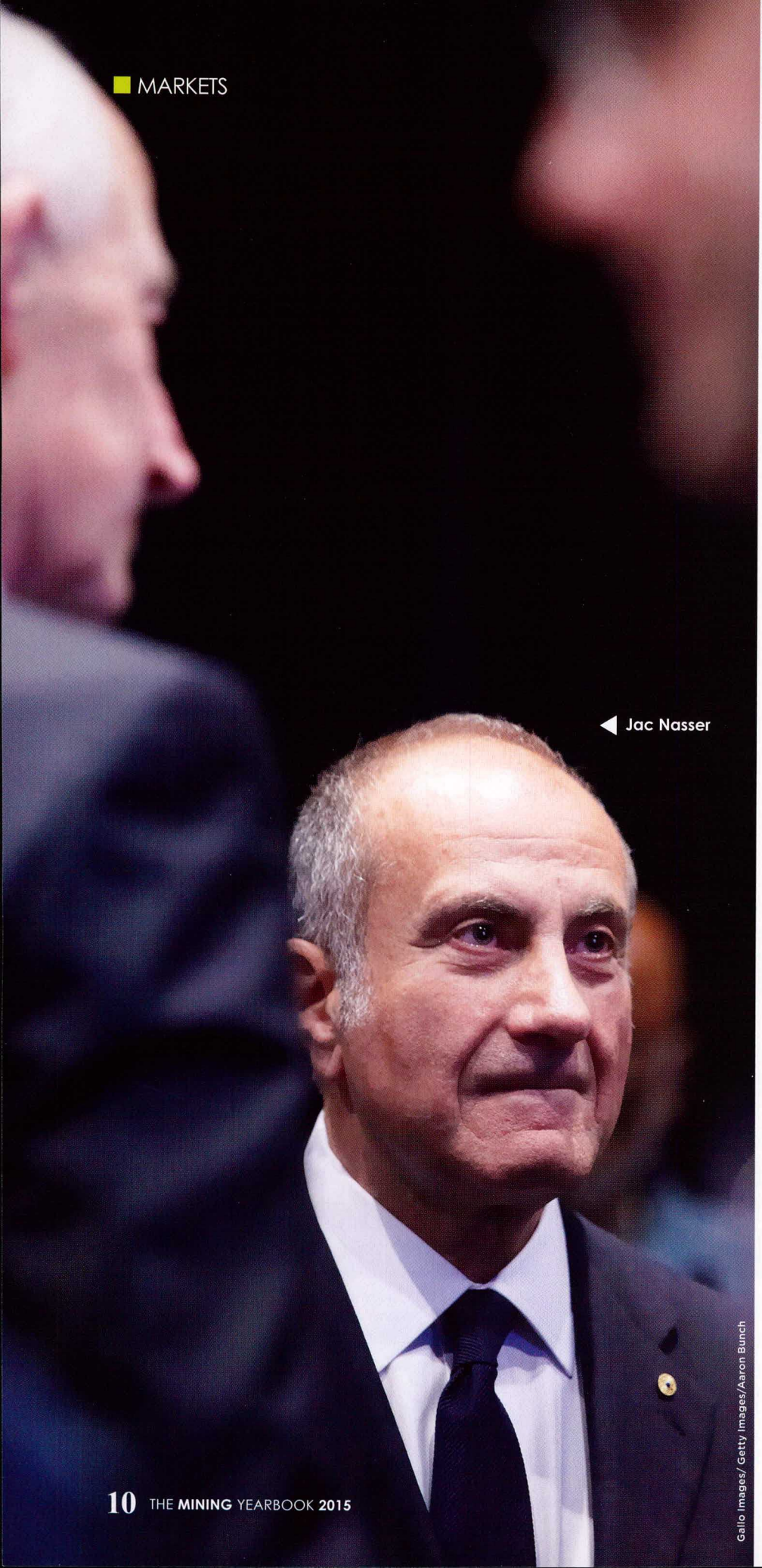
Take Western Australia, for instance, the hub of Australia's iron ore industry. Whereas it was once placed by *Time* magazine among the most valuable real estate in the world, it was more recently the grateful recipient of a AUS$500m (R4.8bn) cash payout by the federal government after it complained about the impact of falling mining royalties and GST revenue.

One important mining sector participant who didn't side with BHP Billiton's Mackenzie, however, was his opposite number at Swiss-headquartered mining and trading group, Glencore's Ivan Glasenberg.

Glasenberg has a special place in his heart for his diversified mining rivals whom he blames for corporate decadence from which he was publicly absent – as Glencore only listed in 2011 – gallingly for him, just as the commodity price party was ending.

Speaking at the Bank of America Merrill Lynch conference in Barcelona in May, Glasenberg ripped into BHP Billiton and Rio Tinto's unstinting iron ore supply to China, saying that it was short-sighted and damaging. "Oversupply of markets regardless of demand is damaging the credibility of the industry," he said.

Mackenzie has since acknowledged that metal oversupply would continue to hurt the markets for the foreseeable future. "Incremental supply, induced periods of higher prices, will take longer to



Jac Nasser

Gallo Images/ Getty Images/Aaron Bunch

absorb and this means over-supply may persist for some time," he told a gathering of sector executives and Australian lawmakers in June.

Even Rio Tinto CEO Sam Walsh has said that the company didn't plan on pumping excessive amounts of fresh capital into iron ore expansions. "We will, of course, invest to ensure the integrity of the Pilbara blend [iron ore quality from Western Australia], but do not anticipate capital investment in further volume at this time," he said.

Nonetheless, establishing market share by knocking out smaller companies constitutes a form of positioning for the majors for when the markets eventually revive – a likelihood to which Rio Tinto Chairman Jac Nasser referred at the company's annual general meeting in May. "Let us keep in perspective that across the globe, 70m people each year are entering the middle class," he said.

"The Chinese economy is almost 25 times the size it was 25 years ago, and over the next decade 170m rural Chinese will move to an urban environment. The fortunes of the mining industry have always been linked to increasing development and prosperity.

"And this will remain the case, regardless of short-term dynamics," he said.

Said PwC in its annual mining survey, *Mine,* which analyses the performance of the world's top 40 mining companies as measured by market capitalisation: "Major iron ore producers are still expecting to post healthy margins if commodity prices remain low, due largely to the quality of their projects and their focus on operational cuts that are helping to improve margins.

"But smaller players will continue to face difficulties. Some companies in Australia are already up against the wall, while some iron ore mines in China have reportedly closed."

The short-term effects of the oversupplied iron ore market don't make for pleasant reading, however. Goldman Sachs forecast that iron ore prices

would trend down from $52 (R645)/ton in 2015 to as low as $40 (R496)/ton in 2017.

"Steel production and apparent demand in China are negative year-on-year as a shift away from investment-led infrastructure spending has reduced demand, which, combined with a focus on reducing air pollution, has seen apparent domestic demand for steel down 6.2% year-on-year through to end March 2015," said Goldman Sachs.

This would have severe implications for investors who tend to live in here and now.

Companies exposed to the iron ore market would not be able to cover their dividends from free cash flow which, in turn, implied the premiums at which they are trading were unwarranted. As for the remainder of the iron ore supply industry – those vying for the remaining 20% to 30% of market share – they were likely to be knocked out in a game of "survival of the fittest", the banker said.

"With limited production cuts to date from high-cost Chinese iron ore miners and no changes to tier 1 producer's pursuit for scale and cost leadership, we believe that the burden of balancing the market will fall on tier 2 producers," said Goldman Sachs, explaining that companies with lower quality assets were the ones most vulnerable to the downturn.

"Our commodities team estimates that about 10% of tier 2 production capacity must be displaced each year until 2018 and iron ore prices must remain below the marginal production cost for the remainder of our forecast period," it said.

The recent efforts by BHP Billiton, Vale and even Fortescue Metals to stem iron ore production has left some analysts unmoved that market difficulties are far from over.

Investec Securities analyst Hunter Hillcoat said that cutbacks were really motivated to pressure to reduce capital rather than any authentic concern the iron ore market might be flooded. "The market has reacted positively to recent communications from iron ore producers, interpreting such actions as a disciplined supply response from key market participants," he said.

"We would argue otherwise, noting that all growth plans remain firmly on track and that proposed production changes are cosmetic and will have little to no immediate impact on continuing oversupply in the seaborne iron ore market," he added.

Production cuts – even if it was for reasons of prudent internal capital allocation – would not stimulate iron ore prices in the future, Hillcoat argued. "We expect iron ore to recommence its downward path, with prices to average $52 (R645)/ton in 2015," he said, a forecast that chimes with Goldman Sachs' view on the market.

Rio Tinto's Nasser is surely correct that on a fundamental basis, the commodity market's next supply deficit is being written today – as X2 Resources CEO Mick Davis described it last year – but, in the short term, mining companies are slugging it out.

Bhp Billiton, Rio Tinto and Vale are banking on the expectation that the concentrated nature of their combined low cost supply, knocking out the smaller players, should eventually lead to a more stable market in which they will be the undisputed kingpins.

In the case of platinum group metals (PGMs), and specifically platinum, market control by the few doesn't stand for much, especially as new production from lower cost producers could put pressure on the status quo into closures or restructuring. (Although it remains to be seen if large scale restructuring will be allowed by government or unions.)

SA controls about 70% of world platinum production, and about 96% of total world resources, and yet the sector remains deeply troubled by the after-effects of an enthusiasm for expansion that pre-dates the super-cycle.

Goldman Sachs estimated that after creating almost 100% of shareholder value over 2006 to 2010, total shareholder returns since 2010 by the Big 3 – Anglo American Platinum, Impala Platinum, and Lonmin – have declined by more than 50% owing to the poor platinum price.

There is an estimated supply deficit of some 235 000 oz, according to the World Platinum Investment Council (WIPC), but this doesn't take into account above ground stocks which, at about 2.7m oz, is enough to take the shine out of the platinum market.

So great is the apathy that not even a five-and-a-half month strike in the platinum sector during 2014, equal to 1.3m ounces in lost production was able to drive the platinum price higher. Supply from recycling, a relatively new phenomenon, is also keeping a lid on the platinum market.

Analysts think the platinum market will eventually improve. Paul Wilson, CEO of WIPC, said that above ground stocks would fall another 8% this year, while Allan Cooke and Abhishek Tiwari, analysts for JP Morgan, think that US interest rates and an improvement in the world economy will also combine to help platinum out of its current existence in the doldrums, somewhere between $1 300 (R16 141) to $1 388 (R17 234)/oz (versus $1 700 (21 108)/oz in 2012).

"For us, the question is 'when' rather than 'if' platinum prices will move higher with the timing of this call determined by the direction of the dollar and US interest rates, available stocks of metal in the market and the global macro-economic outlook," said Cooke and Tiwari.

Unfortunately, this is no help to the platinum producers in SA, of which more than half are estimated to be burning cash after capital expenditure. JP Morgan said that restructuring was inevitable, possibly through swaps of property.

Goldman Sachs agrees, to a point. It thinks 400 000 oz to 700 000 oz of platinum needs to come out of the market in the next 12 to 36 months, but it's unsure how politically feasible this is based on previous government and union opposi-

tion, even if a leaner industry would have fiscal benefits down the line.

"With potentially 1.2m oz of low-cost supply slated to come online in the next three to four years, restructuring we believe will not be an option," it said in a report dated 14 May.

According to a report by Deutsche Bank analysts Anna Mulholland and Patrick Mann, however, meaningful consolidation in the PGM supply may be possible through the 'logical' combination of Impala Platinum (Implats) with Lonmin.

At a market value of R15.6bn at the time of writing, Lonmin's 750 000 oz a year in production would equal the replacement cost of one of Impala's Lease Area shafts in Rustenburg.

They also calculated potential savings of R1bn a year through the elimination of duplicate processing costs, given that Implats has spare capacity in its refining services. As a result, the capacity utilisation of Impala Refining Services would increase to 80% from 50%, a step that would also improve unit costs.

In the meantime, there's little comfort for the investment world. Investec Asset Management analysts Hanré Rossouw and Daniel Sacks believe that there may be an opportunity because of the way that commodity shares have traded, but not in the case of platinum stocks.

While they believe the platinum price was expected to strengthen to a level where it will trade at a premium to the gold price, the equity market is too optimistic. "It is factoring in a much stronger recovery than is likely, given the significant above-ground stocks of platinum that have accumulated in recent years," they said.

Mining equities, and the companies they represent, around the world have struggled in the past two years. According to a report by PwC, the world's 40 largest companies shed $156m (R1.9bn) in market value during 2014, equal to 16% of their combined value – a decline largely driven by the skidding iron ore price.

The total combined market capitalisation of the top 40 was $791bn (R9.8tr) at the end of 2014 – a level last recorded 10 years ago. Profit adjusted for impairments was also lower in the year, down 9% to $72bn (R894bn) on a combined basis, PwC said.

However, free cash flow improved to $24bn (R298bn) in 2014 from a $3bn (R37bn) outflow in 2013 as a result of the lower capex bill. "This reversal allowed companies to return funds to shareholders without having to increase their debt," the consulting firm said. "In fact, there was a 20% decrease in proceeds from borrowings and a 7% increase in debt repayments."

Nonetheless, PwC warned that the world's major mining companies were "walking a fine line" in attempting to keep paying dividends using debt. "Although not as drastic as in 2013, dividends paid in 2014 consumed all available cash, reducing the balance sheet flexibility of miners in the expected continuing lean times," it said.

Perhaps most worryingly from an SA perspective is the absence of any companies from the country in PwC's top 40, the first time that's happened since the survey was started in 2004, when there were five companies.

However, Investec Asset Management's Rossouw and Sacks think from a board market perspective, the SA mining sector is beginning to show some value, if only because it has been heavily panned over the last three years.

"We believe there is opportunity in the sector at the moment as we calculate value in several mining companies with dividend and free cash-flow yield estimates at attractive levels – despite our conservative margin forecasts," they said.

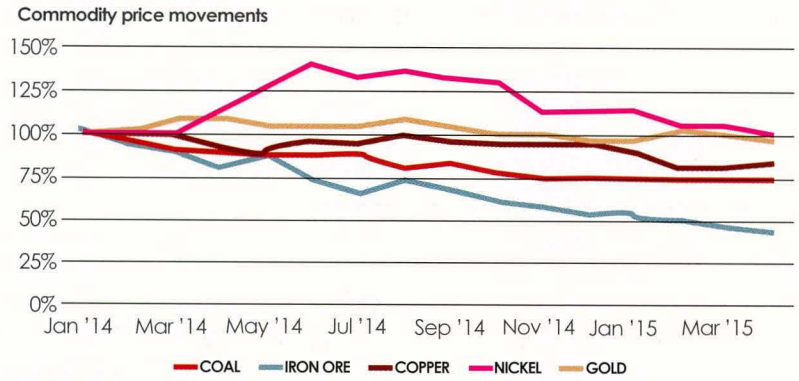
"We expect the sector to recover from cyclical lows through a combination of commodity prices performing above [very bearish] expectations and improving company cost structures," they added.

Said PwC in its annual mining survey: "A slowdown in China's economic growth, to around 7% from double-digit growth in recent years, is expected to weigh on the industry in the months to come.

"However, to put China in perspective, the lower projected 2015 GDP growth will still create about a $1tr increase in the base – more than the combined market capitalisation of the top 40.

"We believe that the reforms being undertaken will place China in a good position to continue to grow over the long term, albeit at a slower pace," the authors said. China accounts for as much as 40% to 50% of global commodity demand."

COMMODITY PRICES CONTINUE TO FALL



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