



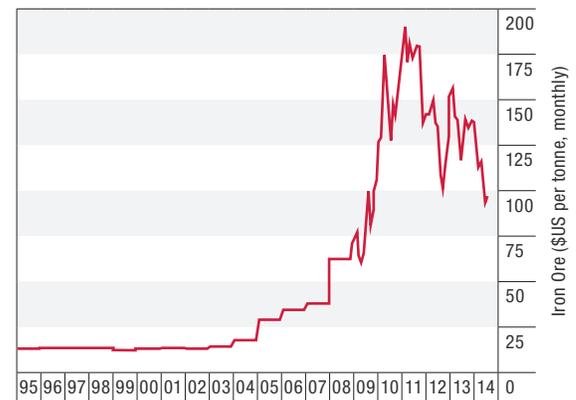
Winning the iron ore price war

Iron ore is Australia's largest export industryⁱ, so when the price of iron ore dives by 40 per cent as it has this year it calls for desperate measures. That's why Australia's mining heavyweights are engaged in a winner-takes-all price war. When the war is over and the battle is won, only the strongest will be left standing.

By early October, iron ore was trading at around US\$80 a tonne. This prompted ratings agency Standard and Poor's to cut its iron ore price forecasts by about 10 per cent to \$US85 per tonne through to 2016.ⁱⁱ

But the 40 per cent price slide since the start of 2014 is part of a bigger story. As the graph (right) shows, the price of the steel-making commodity peaked at US\$187 in February 2011, on the back of insatiable demand from China and a shortage of supply.

Iron Ore Price



Source Data: Index Mundi

Dollar slide

Even the long-awaited fall in the Australian dollar has failed to give the local iron ore industry a breather. A weaker Australian currency should be good news for local iron ore miners because their revenue is typically received in US dollars but their costs are mostly paid in Australian dollars.

But despite the currency fall largely counter-balancing the slide in the iron ore price in recent months, share prices of iron ore miners have continued to slide. This is due largely to foreign investors pulling out of the local market on fears of a slowdown in global economic growth.

Supply soars

For the first time in a decade, new supply of iron ore has outstripped the growth in demand from China and elsewhere.ⁱⁱⁱ Yet the world's biggest iron ore producers are all massively increasing supply despite the precipitous fall in prices.

Snapshots



BHP Billiton has unveiled plans to increase production by 22 per cent to 290 million tonnes over the next two years, Rio Tinto is aiming to lift production by 25 per cent to 350 million tonnes over the same period while Fortescue Metals Group and Brazil's Vale are also increasing production to record levels.ⁱⁱⁱ

Why? The short answer is because the mining heavyweights want to muscle out the competition and consolidate their market share.

According to Deutsche Bank research, 28 per cent of the iron ore industry is losing money at current prices.^{iv} Junior iron ore producer, Western Desert Resources, is the highest profile victim so far after its collapse in September, but more are expected to follow.^v

Over the past decade Chinese iron ore suppliers, many of them state-owned and subsidised, entered the market to break the hold of foreign suppliers. Most of these Chinese miners have high production costs and market observers speculate that BHP and Rio will ramp up production until their Chinese counterparts capitulate.^{iv}

Demand easing

While China's economic growth has slowed, its demand for iron ore remains robust. BHP predicts annual compound growth in steel production of about two per cent to 2030, a prize still worth fighting over.ⁱⁱⁱ

BHP recently announced its aim to become the world's cheapest iron ore producer. It aims to reduce costs by 25 per cent to less than US\$20 a tonne which would see it overtaking Rio as the lowest cost iron ore producer to China.^{vi}

According to UBS, smaller Australian iron ore producers have a break-even point of between US\$80 and \$107 a tonne. By comparison, Rio's break-even cost is US\$45 a tonne and BHP's is US\$49.^{iv}

A period of consolidation

Not surprisingly, analysts are predicting a wave of mergers and acquisitions as the discount war plays out. Rio received an informal merger offer from Glencore in July this year but rejected it as being not in the best interests of shareholders.

Most analysts expect the iron ore price will bounce back once the discount war is over, but that could take some time. Meanwhile, share prices for all the iron ore producers have taken a hammering.

By early October, BHP was down 21 per cent from its 2014 high and Rio was down 17 per cent. Even so, analysts expect both BHP and Rio to increase payouts to shareholders over the next four to 10 years.^{vii}

When the dust settles and if all goes to plan, the mining giants could provide a buying opportunity. If you would like to discuss the outlook for the iron ore market in the context of your investment portfolio, please call us.

i <http://dfat.gov.au/publications/tgs/index.html#exports>

ii Business Spectator, 9/10/14, <http://www.businessspectator.com.au/news/2014/10/8/markets/sp-cuts-iron-ore-price-forecasts>

iii Tough test of BHP's metal by Jennifer Hewett, AFR p.2, 7 Oct 2014

iv \$US20 a tonne beckons BHP, Rio by Matthew Stevens, AFR p.30 7 Oct 2014

v <http://www.smh.com.au/business/mining-and-resources/big-business-names-hurting-as-iron-ore-slump-claims-western-desert-20140908-10dps.html>

vi BHP's big cost crusher by Peter Ker, AFR p.1, 7 Oct 2014

vii <http://www.smh.com.au/business/mining-and-resources/iron-ore-slide-wont-stop-bhp-rio-boosting-payouts-cfs-20141009-113jqk.html>



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