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Interesting times for iron ore

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The market is hypersensitive to near-term moves in the iron-ore price. Last week, the market was staring into the iron-ore abyss and this week a 4 per cent rise in a day was enough to spark an outbreak of optimism.

BHP Billiton (BHP) has aggressively upped its West Australian production target and now plans to add a further 65 million tonnes of capacity by 2017 at a staggeringly low cost, relative to the peaks of the boom.

Rio Tinto's (RIO) Sam Walsh is on the front foot, espousing the undoubted quality of Rio's iron-ore business under the spectre of a stalking Glencore, which is looking to opportunistically repeat the Billiton experience in merging with BHP.

The extreme sensitivity of Mr Market to short-term iron-ore moves is a sign iron ore is at a turning point. Whether iron ore is at US$75 or US$85 per tonne next week, who knows or really cares? Only *Rain Man* will remember the iron-ore price on 23 October 2014 a year from now.

Spending time trying to figure out next week's iron-ore price is very likely fruitless. The vast majority of value in our fair-value estimates for BHP and Rio lie well beyond the next five years, so that's where our attention is and should be focused.

On demand, China's advance has been rapid and on an unprecedented scale -- we know that. We have no doubt China will continue to build many buildings, bridges, roads, pipelines and railways.

It is the rapid rate of growth in China's consumption of commodities that has driven the boom, with demand growth outstripping supply growth. In volume terms, its consumption of commodities will continue at a meaningful rate, a vacuum cleaner sucking up the contents of Australia's mines.

The question is: What is the rate of growth in China's future steel consumption? China is an outlier for steel consumption per capita, both in absolute terms and relative to other global economies with similar per-capita incomes. Here, we expect China to gradually become more normal relative to historical precedents of development and other countries.

So, while China's steel consumption will continue at an elevated level, growth in steel consumption will slow significantly, possibly flat lining, and that is important to the supply/demand balance for iron ore.

Growth in seaborne iron-ore exports will hinge on steel production growth outside China, as well as exports to China replacing domestic supplies.

Chinese miners are in for a hard time and we expect most of their production to go, replaced largely by new supply from BHP, Rio and Brazilian iron-ore giant Vale.

Slower iron-ore demand growth is a massive shift for the industry. With BHP, Rio and Vale still keen to expand, those three majors are taking no prisoners.

In the crosshairs are the high-cost miners, which have enjoyed very strong returns through the boom but have no sustainable cost advantage and generally lack life. No-moat, very-high-uncertainty small-cap iron-ore miners are set for a much rockier road than the highly profitable last five years.

Arrium (ARI) is the poster child for what not to do. As an aside, it is still a stock you can get a margin loan on, which is a staggering thought. It already has leverage from high costs and significant debt. The idea of putting a further layer of investment debt on that is a worry -- leverage cubed is far from prudent.

Morningstar's Income Portfolio provides an excellent counterpoint to the concept that more risk equals more return. By biasing to quality, sustainable earnings and dividends, and by avoiding those extreme loss events that come from poor stocks in a downturn, the overall performance has been excellent.

A margin loan on a high-cost iron-ore miner is almost the antithesis of the philosophy of the Income Portfolio.

Back to Arrium, the lessons are clear. Firstly, focusing on the short-term commodity price makes no sense, particularly at the peaks and troughs. Cycle lows and highs aren't sustainable and extrapolation is dangerous.

Secondly, sustainability of earnings in any price-to-earnings (PE) ratio must be scrutinised. As the global financial crisis hammered home, not all earnings are equal yet the use of a PE implies an equivalency in the quality and sustainability of earnings.

Thirdly, high-cost miners should not use debt lest they want to be exposed as swimming naked when the tide goes out.

With Wesfarmers (WES) and its purchase of Coles, bankers let them down and are now paying the price. Few imagined that debt markets would freeze as they did -- it's a rare occurrence. But the turning of the tide in resources is much more frequent and it's hard to chalk up debt-related issues for a high-cost miner as bad luck.

More broadly, Rio, BHP and Vale are decimating the top end of the cost curve. By expanding iron-ore output at a faster rate than demand is growing, the only way the market can balance is for high-cost supply to exit.

Conventional wisdom has been that Chinese domestic supply would do the balancing, but we no longer think that will be enough. We see pressure falling on the likes of Arrium, Atlas Iron (AGO), Mount Gibson Iron (MGX), Mineral Resources (MIN) and even Fortescue Metals (FMG).

As a player with much more debt than peers, and much higher cash costs, Fortescue's options are limited. They will be forced to cut costs to survive. But ultimately, if BHP, Rio and Vale want to push production hard, they could cause trouble for Fortescue.

It's even clearer now -- Aquila Resources was extraordinarily lucky to get taken over and Mineral Resources very fortunate not to be the acquirer.

Despite expecting a lower long-term iron-ore price now, the narrow moats are intact for all of the big three iron-ore miners, underpinned by cost advantage. High-quality mines, scale, as well as integrated, dedicated rail and port infrastructure are requirements to effective competition.

For those outside BHP, Rio and Vale, the difficulty in achieving all of those competitive requirements has worsened from very tough to near impossible. Of the big three the moat is strongest for BHP, thanks to diversification and low costs, and is weakest for Vale.

Vale's is at a cost disadvantage into Asia due to distance and therefore transport costs, while planned expansions will come at a much higher capital cost than anything BHP and Rio are doing now.

An interesting angle could be that BHP and Rio are pushing expansions hard now to encourage all other players, including Vale, the weakest of the three, to back off. There is a grab on for market share.

We see those three majors emerging with a combined share of more than 70 per cent of the seaborne iron-ore market.

If they can manufacture a rational oligopoly where supply is disciplined, returns for those three moat companies may be better than we now expect and we can certainly see why Glencore would want a slice of that action. But at the moment, the aggressive expansion behaviour suggests otherwise.

We have had a mild preference for BHP over Rio for some time now, but given BHP's balance sheet, more diversified earnings base, superior yield and valuation, that preference has strengthened.

BHP is still a Best Idea but with the weaker outlook and single commodity focus, we no longer have Rio as a Best Idea.

Morningstar Individual Investor Conference

The Morningstar Individual Investor Conference is fast approaching. On Friday 24 October, Peter Warnes and I will be on the equity research panel. We're looking forward to sharing with you the parts of the market we think are most attractive, as well as answering your questions.

You can join us for only $79 in person using the promo code YMW. Can't make it in person? We're also streaming the event so you can watch it wherever you are. Just use the promo code Streaming for the $49 price.

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