AFR - Iron ore's decade of living large keeps copper in the shadows

Peter Ker

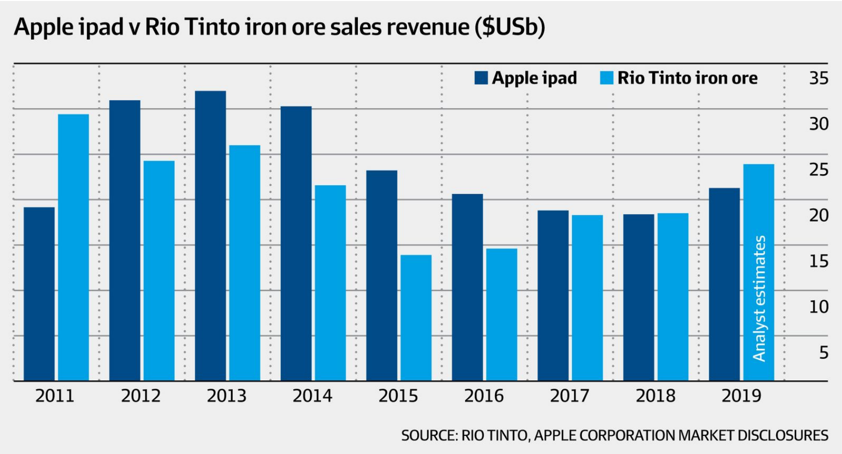
Resources reporter

Dec 20, 2019 — 4.47pm

Apple iPads were the hot new thing in 2012 when Rio Tinto's then-chief executive, Tom Albanese, nominated the tablet devices as perhaps the only business in the world that was more lucrative and more attractive than his Australian iron ore division.

As the decade draws to a close, it might be time to reconsider the comparison.

Revenue from Rio's dusty, 53-year-old network of iron ore mines, railways and ports will, for the second consecutive year, exceed the amounts generated by selling iPads from Apple's sleek and minimalist stores.



That iron ore is still delivering such extraordinary wealth to Australia on the eve of the century's third decade is perhaps the single biggest - and certainly the most significant - surprise to emerge from an extraordinary decade for the local mining sector.

Australia's investment community, politicians and media, including this reporter, have spent the past decade in furious and frequent agreement that iron ore's best days were in the past.

This narrative was abroad as early as 2011, when iron ore prices peaked near $US190 per tonne. It went mainstream in 2012 and 2013 when prices slumped to around $US80 per tonne, routing government budgets and putting the survival of upstarts like Fortescue Metals Group in serious doubt.

The theory was that burgeoning iron ore supply and the cooling pace of growth in China would ensure a reversion to the cheap iron ore of yore.

The big miners, BHP and Rio, did little to dissuade the nation of the view, as they pumped up production and assured shareholders they would be the last ones standing amid a price slump.

Fast forward to fiscal 2019 and Australia exported a record $77 billion worth of iron ore, and is tipped by the Department of Industry to set a new record in fiscal 2020 by shipping $81 billion worth of the steelmaking ingredient.

Sure, the tragic supply curtailments in Brazil have played a big role in this year's very strong iron ore prices.

But so too has Chinese demand for iron ore defied all sceptics.

In 2014 and 2015 Australia's iron ore miners were ridiculed for their belief that China would produce 1 billion tonnes of steel per year by 2025.

Annual steel production in China declined by more than 2 per cent in 2015 to just over 800 million tonnes, and the argument seemed to be settled.

But extremely strong growth in the Chinese property sector triggered renewed steel demand growth in 2016, and it hasn't stopped.

China produced 928 million tonnes of steel in 2018 and is tipped by UBS to produce 983 million tonnes in 2019.

Both UBS and Platts believe the billion tonne milestone will be breached in 2020.

One of the architects of the billion tonne narrative, Rio's chief economist of more than a decade Vivek Tulpule, had the last laugh at an investor briefing in October.

"Steel production in China approaching a billion tonnes and I think you may have heard somebody say that in the past," he quipped.

The purest proxy for iron ore prices, Fortescue shares, are at 11 year highs and the company's fiscal 2020 profits are on track to beat the record set in fiscal 2019.

Less than five years since it was courting Brazilian giant Vale as a strategic investor and begging Canberra for an inquiry into the iron ore price collapse, Fortescue is spending billions of dollars on a new mine, billions more on a new magnetite concentrate business, bidding for greenfield iron ore tenements in faraway Guinea and paying billion dollar dividends to its chairman Andrew Forrest.

Any one of those things would have been an unaffordable indulgence back in 2015, let alone doing all of them simultaneously.

Iron ore's incredible indian summer has also granted Rio a reprieve from the severely indebted, punch-drunk state in which it turned up at the start the decade.

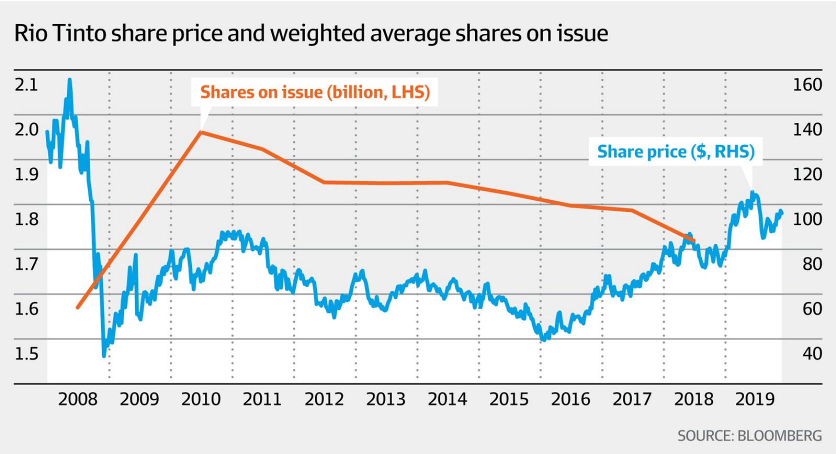
Steel production in China approaching a billion tonnes and I think you may have heard somebody say that in the past
— Vivek Tulpele

The disastrous $US38 billion acquisition of Alcan in 2007, and the subsequent onset of the global financial crisis left Rio prey to an opportunistic takeover bid from BHP, a pseudo-merger with Chinalco and an iron ore joint venture with BHP before it ultimately opted for a $US15.2 billion rights issue in 2009.

Between 2008 and 2010 the number of Rio shares on issue swelled 25 per cent to 1.96 billion, thanks to the fifth biggest rights issue in corporate history.

A decade of extraordinary profits from Australian iron ore and a campaign of asset sales have since fixed Rio's debt problem, with the company now effectively debt free.

Less appreciated is the fact that iron ore has enabled the company to conduct enough share buybacks over the past decade to reverse the dilution created by the 2009 rights issue.



With just over 1.7 billion shares on issue, Rio's register is now the tightest it has been since 2008.

Those who participated in the 2009 rights issue bought shares at $28.29; in the subsequent decade the stock was never lower than $35 and it averaged $64.

In 2019 Rio shares have regularly traded above $100.

Some rivals have tried to portray Rio's reliance on iron ore (the commodity delivered 83 per cent of Rio's underlying earnings in the first half of 2019) as a weakness for a supposedly diversified miner; a failure of risk management that would sooner or later cut the company down to size.

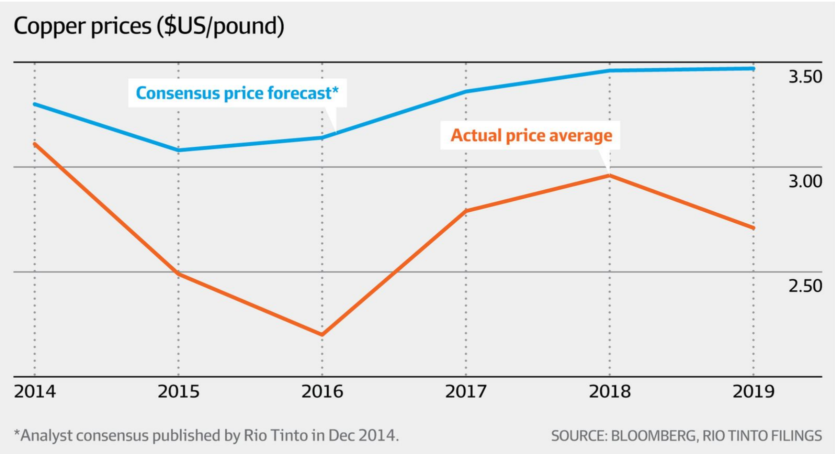
Suffice to say Rio's reliance on iron ore hasn't proved to be a weakness yet, and many of those rivals continue to jealously observe the margin for error afforded to Rio management by iron ore's extraordinary bounty.

Iron ore's longer than expected run of riches has also bought more time for Rio's copper division. Copper was supposed to be the company's growth engine by now, but was almost certainly free cash flow negative in 2019, and will probably spend more on growth than it earns in 2020 as well.

There's another piece of conventional wisdom that persisted through the past decade without ever coming true: The notion that a permanent shortage of copper would emerge in the latter half of the decade as old mines were exhausted and new mines failed to fill the supply gap.

"Copper has been the consensus 'long' for a long time, and iron ore has been the consensus short for a long time. Eventually those predictions will probably be proved right, but they've both defied the market for a long time," said Shaw and Partners analyst Peter O'Connor.

"Coming into 2020, iron ore looks strong and copper looks unlikely to rise above $US3 per pound unless there are unexpected disruptions".



The optimism around copper was more than just a bet on the trajectory of a single commodity price; it came to symbolise the expectation that China's economy would transition from the first phase of urbanisation (where central governments spend on bridges, railways, airports and other infrastructure) to a consumer driven second phase, where domestic appliances, red meat and luxury items became the boom commodities.

"We have seen a lot of construction taking place, the first phase of it, it is very steel intensive. It's the subsequent phases that are more copper intensive, as the lines go in and at the same time the aluminium windows go in, the tiles go on to wall which requires titanium dioxide," said Mr Tulpule in October.

But he suggested China is yet to fully shift into the subsequent phases of growth.

"We would expect to see some of that demand come through a bit later on."

In late 2014, respected industry intelligence firm Wood Mackenzie were predicting the long term shortage of copper would emerge in late 2017 or early 2018.

Rio chief executive Jean-Sebastien Jacques was the company's copper boss around that time, and by May 2015 he had become more bullish than Wood Mackenzie.

"In December (2014) I said it would take three or four years to see the inflection point, but by 18 or 24 months we could start to see some interesting price back into the system," he said at Rio's 2015 annual meeting of shareholders in Perth.

"I can see the light at the end of the tunnel in the next 12 to 18 to 24 months."

Jacques was not alone; Deutsche were also predicting that 2017 would be the inflection point, and copper prices did improve in the three years after Jacques' 2015 comment.

But CRU group's principal analyst Erik Heimlich says supply of refined copper exceeded demand in every year between 2015 and 2018, and he thinks 2019 will see a small surplus of supply as well.

"For all practical purposes, it can be considered a balanced market," he told *The Australian Financial Review*.

Nor does the long promised shift to a full blown shortage of copper seem likely to appear any time soon.

Rio is now telling investors that copper markets will be balanced until 2025, and UBS is predicting an oversupply of copper between 2021 and 2023.

But some are still playing a familiar tune.

Fitch's macro research team reckon a shortage of the red metal will exist for much of the coming decade, bolstering copper prices.

"Beyond 2021, we believe the market will shift back into deficit and remain largely undersupplied as demand will once again outpace production driven by China's power and infrastructure sectors," the firm said in a note this month.

As for iron ore, Citi's research team were also trotting out a familiar line this month.

"With the seaborne market expected to move into a sizeable oversupply in the next two years we see benchmark prices falling to $US60 per tonne in calendar year 2022," they said in a note.

They might be right, but investors could be forgiving for refusing to believe it until they see it.