

# Rocks & Stocks

## FMG's contango conundrum

FMG's share price is hovering around a 12 month low driven by weak iron ore prices and mostly driven by the weakness in the price for lower grade ores such as FMG's 58% Fe products. During August the spread between the benchmark 62% Fe and FMG's 58% Fe product tightened up to its historical average of ~\$10/t (from \$18.60/t in June), a positive sign in our view, yet FMG's share price continued to weaken. We also note iron ore & steel price futures are in contango, a positive development suggesting that prices may be at a floor.

### Rocks & Stocks



"I'm pretty comfortable with the iron ore price oscillating around the US\$110/t mark, it could wander down to US\$80/t, it could wander up to US\$140/t"

Andrew Forrest,  
Chairman, Fortescue Metals Group,  
May 2014

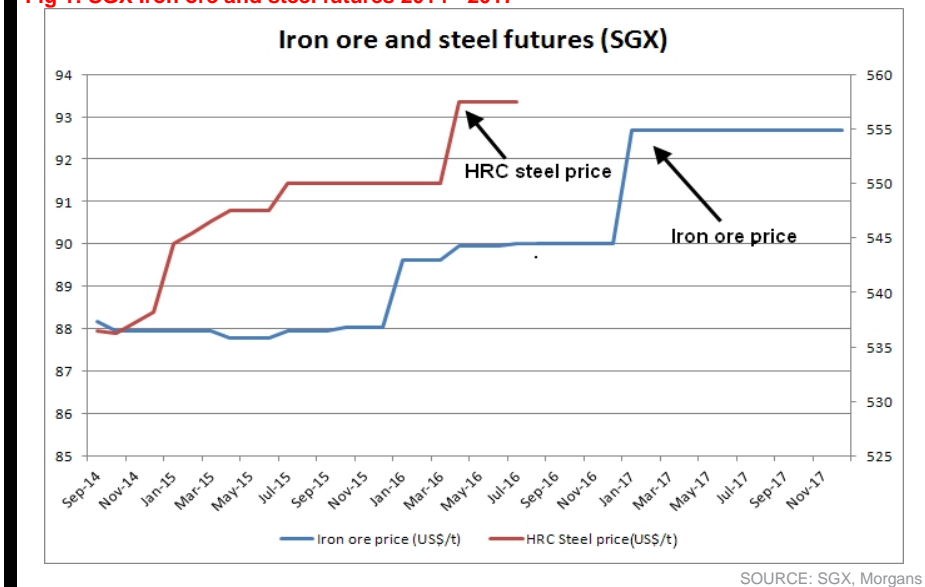
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Fig 1: SGX Iron ore and steel futures 2014 - 2017



**FMG's FY14 result** ▶ FMG's FY14 result of an underlying NPAT of US\$2.73bn was broadly in line with market expectations. Our current target price of A\$4.45ps is based on a 25% discount to our base case NPV to reflect what we view as a negatively skewed risk reward investment in the event of lower iron ore prices being sustained for an extended period.

**The Spread has returned to long term averages** ▶ FMG sells 58% Fe products at a discounted price to the benchmark 62% Fe reference price. The difference is ~US\$10/t but in weaker markets the discount gap widens and rose as high as US\$18.60/t in June 2014. Lately though we've seen this figure return to its trend with 62% Fe at ~US\$87/t and 58% Fe ores at ~US\$77/t implying a ~US\$10/t discount. For FMG it's important as a US\$5/t reduction in the spread is equivalent to an increase in margins of around 33% illustrating just how sensitive FMG is to iron ore price change.

**Futures activity suggests improved prices in FY15 and beyond** ▶ Iron ore and steel futures activity monitored on the Singapore Stock Exchange (SGX) show that futures prices for benchmark 62% Fe are improving over the next 3 years (see Figure 2) – effectively a contango in pricing.

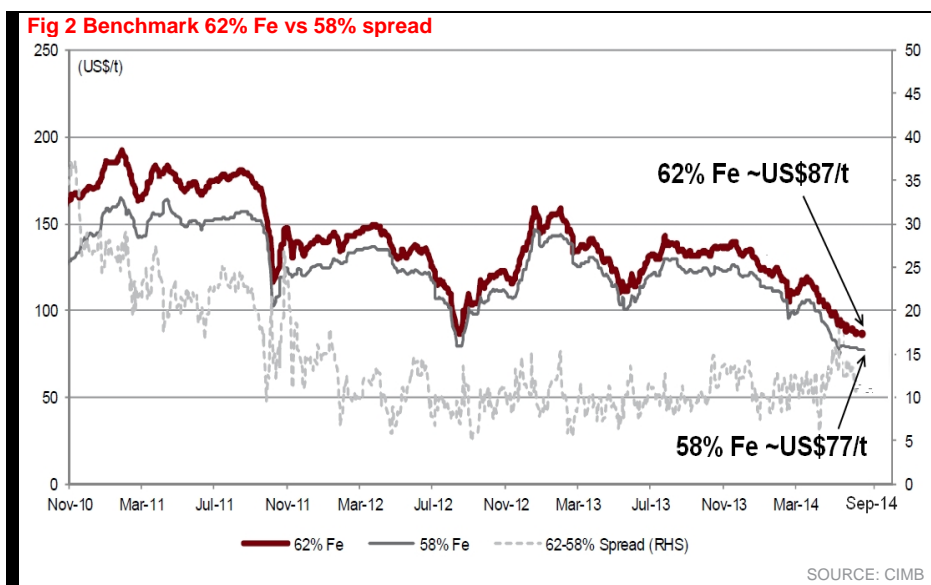
**Activity in the steel sector is muted, but improving outside of China** ▶ Steelmakers in China have kept their October and November steel prices flat suggesting pricing may have bottomed out. Importantly China's steel exports increased 37% in the first 6 months of 2014 as demand improved from the US and Europe, offsetting China's weaker domestic demand. This is a key positive that we need to watch in the second half of the year.

**How to play it** ▶ Our interest in FMG is driven by its potential for upside after the margin erosion that's occurred in June. Whilst we remain cautious on iron ore in the coming 1-2 years the current data suggests the outlook is more positive than the market is pricing into the stock and could present an opportunity.

## The 62% Fe vs 58% Fe spread tightens ►

FMG product is a 58% Fe ore - . Iron ore prices tend to trade historically with a US\$10/t price difference between the 62% Fe benchmark ores and 58% Fe ores. As iron ore prices weaken the gap between the two often increases – and we saw this spread increase to around US\$18.60/t in June this year. In August though the spread recovered to ~US\$10/t, however FMG's price continued to deteriorate.

For FMG its important as a US\$5/t reduction in the spread is equivalent to an increase in margins of around 33% illustrating just how sensitive FMG is to iron ore price change and during July-August this spread price recovered by around \$8/t.



## What's been catching our eye this week ►

### Crusader Resources (CAS) PT \$0.51 Add

CAS announced an update on high grade iron intercepts received from its Posse Iron Ore project in Brazil. Generally CAS grade averages around 40% Fe, so the recent intercepts including 7m @ 69.01% Fe in PODH-021 and 20m @ 56.1% Fe from PODH-012 were highly encouraging. The company has said that once the drill results have been received that the ore interpretation will be updated and a new mine schedule will be implemented to extract the higher grade material.

CAS is concurrently focussing on their Jurueña Gold Project. A 10,000m drill program was scheduled to commence in early August so its likely results aren't far away. Initially the program was targeting high grade shoots and interpreted extensions of the Querosene zone that was the focus of historical drilling which also returned high grade scattered intercepts. It is CAS hope that they can tie these areas together in a coherent interpretation to potentially exploit a smaller but higher grade resource for a near term development option for the company.

### Metals of Africa (MTA) \$0.16 Not covered

MTA announced a capital raising to raise up to \$5.06m through a placement and rights issue. The funds will be used to continue exploration on their Mozambique assets. Its an interesting story – management have been based in Mozambique since 2011 looking for Mt Isa Style base metals deposits and more recently the potential for graphite deposits. The government recently granted MTA their Balama Central concession which sits adjacent to Syrah Resources (ASX:SYR) Balama deposit which is currently the highest grade and largest graphite deposit in the world. MTA plans on a program of Geophysics at Balama Central in September and drilling in October and November to determine the potential of the project.

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