Industry Background and Analysis

Analyst: Michelle Ridsdale

History

Iron ore is used primarily in steel making. World crude steel production was 1,385mt in 2010, dominated by China, and has grown at an average rate of 5%pa since 2000. China’s rapid steel production growth has reformed the world steel industry, shifting the centre of gravity from the USA and EU to China. In 2009 China produced 46.6% of the world’s crude steel due to the combined effect of a GFC induced slowdown in production from North America, Europe and Japan, and the Chinese government RMB4 trillion stimulus package.

The emergence of Chinese demand has led to:

- sustained higher prices and supernormal profits for producers,
- new entrants – most notably the growth in Chinese domestic iron ore production which is ~40% of world total production,
- pricing system has moved away from the annual negotiated benchmark to quarterly index pricing and spot sales,
- iron ore product quality deterioration as high quality reserves are depleted
- global steel industry consolidation as well as policy induced consolidation of Chinese steel mills.

The iron ore industry is characterized by high barriers to entry due to the extensive infrastructure required to transport bulk commodities to market. Historically, the development of major iron ore regions has been sponsored by Asian growth, notably the Japanese sponsored opening of the Pilbara in the 1960’s. This trend continues today with the Chinese sponsored development of African iron ore regions and magnetite deposits such as the Midwest region of Western Australia. Long term iron ore sales contracts underpin the substantial investment required by mining companies to add capacity.

In addition, the extensive infrastructure required to transport iron ore lends itself to economies of scale which has led to three major producers dominating the seaborne iron ore trade: RIO, BHP Billiton and Vale. In 2010, the majors produced almost 70% of total seaborne traded iron ore.

Iron Ore Products

Iron ore is traded as lump (>6.3mm), fines (between -0.15mm-6.3mm), concentrates (>-0.15mm) and pellets (agglomerated concentrate). Lump and fines ores are classified as DSO (Direct Saleable Ore) as they require only crushing and sizing to produce a saleable product. Lump is the only traded iron ore product that can be introduced directly into the blast furnace and therefore attracts a pricing premium of ~20%. Fines must be sintered and concentrates pelletised before introduction to the blast furnace. Blast furnaces in different regions use different quantities of lump, fines and pellets. These differences often relate to the historical regional nature of the iron ore market and the iron ore types available nearby.
The price obtained for iron ore is calculated by: reference/spot fines price (in dmtu) * Fe% * (1-moisture%) * premium/discount

The premium or discount applied is determined by the Value In Use (VIU) – which is the calculated benefit of introducing a specific iron ore product into a specific blast furnace. A high VIU and the associated pricing premium could be derived from:
- ability to direct feed (eg lump and pellets)
- physical characteristics (eg coarser grain size if fines and stronger if lump)
- mineralogy (eg magnetite over hematite)
- chemistry (eg less sulphur and phosphorus).

In addition, freight premiums for Australian ores and quality premiums for Brazilian ores have been negotiated historically.

### Iron Ore Demand

Demand for iron ore will be supported by the continued urbanization and industrialization of the developing world such as China, India, the CIS and the Middle East. The steel intensity graph shows Chinese steel intensity growth will flatten from the extraordinary growth during 2000-2009. China’s latest 5 year plan targets development of inland and rural areas that will include significant infrastructure projects and support steel production and iron ore demand.

By 2018, crude steel consumption is forecast at ~2000mt and seaborne iron ore trade is forecast at ~1600mt. This requires 100mt of iron ore capacity to be added every year until at least 2018. This forecast growth matches the extraordinary growth seen during 2003-8 on a volume basis.

### Steel Intensity: (Steel consumption, kg/capita against real GDP, $/capita)
Global iron ore supply required to meet demand growth

~100mtpa of new iron ore capacity needed each year from 2011-2018

On a volume basis growth will equal 2003-8

Chinese demand is ~70% of the global growth in seaborne iron ore imports

Chinese demand is pivotal to the growth of the industry with seaborne iron ore imports into China comprising ~70% of the increase in global seaborne iron ore imports between 2010 and 2020. Production from Chinese steel producers has grown significantly from 2007 comprising three of the top four producers in 2009 behind top ranking ArcelorMittal. Three major Chinese steel producers (Shanghai Baosteel, WISCO, and Anshan Steel) have plans to expand capacity to 60mtpa from 20-40mtpa by 2015. Further consolidation in the Chinese steel industry is expected as a result of government policy to concentrate 60% of crude steel production in the top 5 companies in the next 5 years.

Ranking of individual steel producers, 2007 to 2009.

<table>
<thead>
<tr>
<th>Rank</th>
<th>2009 mmt</th>
<th>Company</th>
<th>Country</th>
<th>Rank</th>
<th>2008 mmt</th>
<th>Rank</th>
<th>2007 mmt</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>73.2</td>
<td>ArcelorMittal</td>
<td>UK</td>
<td>1</td>
<td>103.3</td>
<td>1</td>
<td>116.4</td>
</tr>
<tr>
<td>2</td>
<td>40.2</td>
<td>Hebei Steel Group</td>
<td>China</td>
<td>2</td>
<td>33.3</td>
<td>2</td>
<td>31.1</td>
</tr>
<tr>
<td>3</td>
<td>38.9</td>
<td>Baosteel Group</td>
<td>China</td>
<td>3</td>
<td>35.4</td>
<td>5</td>
<td>28.6</td>
</tr>
<tr>
<td>4</td>
<td>30.4</td>
<td>Wuhan Steel Group</td>
<td>China</td>
<td>4</td>
<td>27.7</td>
<td>11</td>
<td>20.2</td>
</tr>
<tr>
<td>5</td>
<td>29.6</td>
<td>POSCO</td>
<td>Korea</td>
<td>5</td>
<td>34.7</td>
<td>4</td>
<td>31.1</td>
</tr>
<tr>
<td>6</td>
<td>27.6</td>
<td>Nippon Steel</td>
<td>Japan</td>
<td>6</td>
<td>37.5</td>
<td>2</td>
<td>35.7</td>
</tr>
<tr>
<td>7</td>
<td>26.4</td>
<td>Jiangsu Shagang Group</td>
<td>China</td>
<td>7</td>
<td>23.3</td>
<td>8</td>
<td>22.9</td>
</tr>
<tr>
<td>8</td>
<td>26.4</td>
<td>Shandong Steel Group</td>
<td>China</td>
<td>8</td>
<td>21.8</td>
<td>11</td>
<td>23.8</td>
</tr>
<tr>
<td>9</td>
<td>26.3</td>
<td>JFE</td>
<td>Japan</td>
<td>9</td>
<td>33.0</td>
<td>3</td>
<td>34.0</td>
</tr>
<tr>
<td>10</td>
<td>21.9</td>
<td>Tata Steel</td>
<td>India</td>
<td>10</td>
<td>24.4</td>
<td>6</td>
<td>26.5</td>
</tr>
<tr>
<td>11</td>
<td>20.2</td>
<td>Anshan Steel</td>
<td>China</td>
<td>11</td>
<td>16.0</td>
<td>17</td>
<td>16.2</td>
</tr>
<tr>
<td>12</td>
<td>17.3</td>
<td>Shougang Group</td>
<td>China</td>
<td>12</td>
<td>12.2</td>
<td>23</td>
<td>12.9</td>
</tr>
<tr>
<td>13</td>
<td>16.8</td>
<td>Severstal</td>
<td>Russia</td>
<td>13</td>
<td>19.2</td>
<td>15</td>
<td>17.3</td>
</tr>
<tr>
<td>14</td>
<td>15.3</td>
<td>Evraz</td>
<td>Russia</td>
<td>14</td>
<td>17.7</td>
<td>17</td>
<td>16.2</td>
</tr>
<tr>
<td>15</td>
<td>16.2</td>
<td>U.S. Steel</td>
<td>USA</td>
<td>15</td>
<td>23.2</td>
<td>10</td>
<td>21.5</td>
</tr>
</tbody>
</table>

The “Majors” iron ore supply response

The major listed iron ore producers have announced plans for significant expansions to fill the ~100mtpa of new capacity required to meet demand. On a volume basis this is equivalent to the growth in capacity witnessed from 2003 to 2008. However, it was Chinese domestic supply which contributed ~40% of this new supply. Therefore the expansion plans are optimistic and unprecedented at almost double the 66mtpa averaged from 2001 to 2007.

Top 4 iron ore producers – YOY change in production (mt)

![Graph showing YOY change in iron ore production](Source: Intierra – Resource Intelligence (Actuals), RCR company data (forecasts – adjusted for ramp-up))

Whilst existing iron ore producers have the cashflow to finance expansions, many of the projects are greenfield developments and carry greater risk of potential delay than previous expansions, for example Rio Tinto’s Simandou project in Guinea.

The majority of the expansion capacity is planned to come on line between 2014 and 2016. However, installed capacity is likely to take a few years to ramp-up to full production rates.

Top 4 producers – planned capacity expansions by 2018

<table>
<thead>
<tr>
<th>Company</th>
<th>2010 (Mt)</th>
<th>2018 (Mt)</th>
<th>% of total growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Vale SA</td>
<td>322</td>
<td>533</td>
<td>26%</td>
</tr>
<tr>
<td>Rio Tinto</td>
<td>242</td>
<td>454</td>
<td>27%</td>
</tr>
<tr>
<td>BHP Billiton</td>
<td>137</td>
<td>271</td>
<td>17%</td>
</tr>
<tr>
<td>Fortescue</td>
<td>41</td>
<td>255</td>
<td>27%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>742</strong></td>
<td><strong>1513</strong></td>
<td><strong>97%</strong></td>
</tr>
</tbody>
</table>

Source: Intierra – Resource Intelligence (Actuals), RCR, company data (forecasts)
Chinese domestic supply

Chinese domestic iron ore production grew significantly during 2003-6 as the rest of the world struggled to keep up with Chinese demand for iron ore. In 2010 China produced 979mt, almost 40% of world iron ore production.

Chinese domestic production has continued to grow in 2011 by 12% yoy to compensate for supply disruptions in the seaborne market and encouraged by internal spot price above US$200/t since October 2010. This additional supply is likely to remain until prices fall significantly (below US$130-150/t, dry CFR 62% Fe).

China is forecast to maintain market share over the next decade as sovereignty over supply is a long term strategic goal for the nation and removes the threat of shortage of materials for Chinese industry and development.

Although Chinese iron ore grades will fall faster than at non-Chinese mines and Chinese domestic mining costs are high, China will continue to maximize domestic production until the price differential between Chinese production and imports is negligible.

Chinese domestic production vs iron ore imports to China

Supply from the rest of the world

The table below shows the listed iron ore producers in 2010. Outside of the top 3 major producers there are only ten listed companies that produce more than 5mtpa of iron ore. In addition to these listed companies the following are important sources of iron ore:

- 32.4mt from Arcelor Mittal’s global operations with expansions to 45mtpa
- 23.8mt from India’s NMDC’s
- 21mt from India’s Sesa Goa
- 19.6mt from Companhia Siderurgia Nacional’s Casa de Pedra Mine with expansions to 70mtpa
The Indian steel industry has significant potential for growth as the country industrialises. Indian iron ore production grew significantly in 2003-6. However, Indian iron ore exports in 2011-2020 are predicted to stay static at 140-150mtpa due to infrastructure bottlenecks and domestic demand for iron ore.

Brazilian producers, other than the majors and Casa de Pedra, have flagged ~200mt of potential iron ore projects. Freight rates at current levels will facilitate the competitiveness of Brazilian iron ore into China.

The feasibility of a number of large projects are currently being studied in Africa including: Sphere’s (now Anglo’s) ~40mtpa in Guelb El Aouj, Lebtheinia and El Agareb; Sundance’s 35mtpa Mbalam; CMEC’s 30 mtpa Belinga and Severstal’s 15-30mtpa in Liberia. This is in addition to Rio Tinto’s 90mtpa plans for the Simandou project. Most of these projects have significant infrastructure requirements and are higher risk greenfield projects.

### Iron ore production by company in 2010 (>1kt production, exchange-listed only)

<table>
<thead>
<tr>
<th>Company Name</th>
<th>Production 2010 (mt)*</th>
<th>Country</th>
<th>Company Name</th>
<th>Production 2010 (mt)*</th>
<th>Country</th>
</tr>
</thead>
<tbody>
<tr>
<td>Vale S.A.</td>
<td>321.70</td>
<td>Brazil</td>
<td>MMX Mineracao e Metalicos S.A.</td>
<td>5.37</td>
<td>Brazil</td>
</tr>
<tr>
<td>Rio Tinto Limited</td>
<td>242.00</td>
<td>Australia</td>
<td>Anglo American plc</td>
<td>2.70</td>
<td>UK</td>
</tr>
<tr>
<td>BHP Billiton Limited</td>
<td>136.93</td>
<td>Australia</td>
<td>Grange Resources Limited</td>
<td>2.21</td>
<td>Australia</td>
</tr>
<tr>
<td>Kumba Iron Ore Limited</td>
<td>43.39</td>
<td>South Africa</td>
<td>Consolidated Thompson Iron Mif</td>
<td>1.81</td>
<td>Canada</td>
</tr>
<tr>
<td>Fortescue Metals Group Ltd</td>
<td>41.36</td>
<td>Australia</td>
<td>Territory Resources Limited</td>
<td>1.68</td>
<td>Australia</td>
</tr>
<tr>
<td>Eurasian Metals Group Corporati</td>
<td>25.72</td>
<td>UK</td>
<td>Murchison Metals Ltd</td>
<td>1.54</td>
<td>Australia</td>
</tr>
<tr>
<td>Cliffs Natural Resources Inc.</td>
<td>18.00</td>
<td>USA</td>
<td>Northern Iron Limited</td>
<td>1.47</td>
<td>Australia</td>
</tr>
<tr>
<td>OAO Karelsky Okatysh</td>
<td>13.83</td>
<td>Russia</td>
<td>Zijin Mining Group Co. Ltd</td>
<td>0.38</td>
<td>China</td>
</tr>
<tr>
<td>Evraz Group S.A.</td>
<td>13.48</td>
<td>Russia</td>
<td>Tasmania Mines Limited</td>
<td>0.14</td>
<td>Australia</td>
</tr>
<tr>
<td>African Rainbow Minerals Limited</td>
<td>9.29</td>
<td>South Africa</td>
<td>Eldorado Gold Corporation</td>
<td>0.09</td>
<td>Canada</td>
</tr>
<tr>
<td>Ferrexpo plc</td>
<td>7.81</td>
<td>Switzerland</td>
<td>Total</td>
<td>914.46</td>
<td></td>
</tr>
<tr>
<td>Mount Gibson Iron Limited</td>
<td>6.24</td>
<td>Australia</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* All production from operated projects, as reported by Intierra Resource Intelligence

Source: Intierra – Resource Intelligence

### Impact on price

Iron ore prices have been at historically high levels during 1H11 and the domestic spot price in China has remained over US$200/t (dry CFR 62% Fe) since October 2010. We believe iron ore prices have peaked and will be under downward pressure in 2012 as additional supply enters the market and global demand growth weakens. We are forecasting prices to fall to an average of US$160/t (dry CFR 62% Fe); an 8% decrease. However, supply disruptions due to weather or delays to expansions could cause iron ore prices to revisit the highs reached in 2011, as the market will remain tight.

During 2013 to 2015, as significant low cost iron ore supply is brought on line by the four major producers, an iron ore price above US$130/t (dry CFR 62% Fe) is expected to be supported by the marginal high cost producers in China and India.
We note that the market remains tight and is very sensitive to Chinese demand for steel and potential supply disruptions. A 10% increase in Chinese demand and/or supply disruptions equivalent to 10% will support prices remaining at or near current levels.

We revert to our long term price of US$86/t (fines at 62% Fe CFR) in late 2016 as expansions ramp-up to full capacity and begin to displace higher cost producers especially in China. We maintain a 20% lump premium over fines.

Rising iron ore mining costs supports our long term price. Capital costs for current expansion projects approved by the majors are over 200% higher per tonne than the expansion projects completed to date. Capital costs will increase further as higher grade deposits are depleted and more processing is required to liberate lower grade ores. High manufacturing and fabrication costs are likely as the top four iron ore producers double capacity over the next eight years. Economies of scale will reduce as deeper mines or small deposits are developed. Financing costs will increase as a result of the global financial crisis and the location of some future projects in geo-politically riskier regions. Increased operating costs due to environmental concerns (eg Australian carbon tax), increased royalties, scarcity of human capital and rising energy prices.

For iron ore hopefuls this means there is significant advantage in getting to market before 2015 and/or have a landed cost in China of less than US$86/t. Projects with access to existing infrastructure or smaller projects that can exploit less capital intensive infrastructure options have a significant advantage. In the longer term as markets stabilize, projects selling high quality products or direct feed products and those located closer to China and India will have an advantage.
Iron ore and steel prices and production statistics

**Average Iron Ore Fines Import Price, China**

Source: Bloomberg (Met. Bulletin)

**Average Iron Ore Fines Internal Price, China**

Source: Bloomberg

**Iron ore and concentrate imports, China**

Source: Bloomberg

**Iron ore monthly output, China**

Source: Bloomberg

**China iron ore inventory levels**

Source: Bloomberg

**IISI crude steel production index**

Source: Bloomberg

**Australian iron ore exports monthly value**

Source: Bloomberg

**Baltic Dry Index (shipping costs)**

Source: Bloomberg
Exchange rates: major iron ore producers and consumers

Exchange rate: Australia / USA

Source: Bloomberg

Exchange rate: Canada / USA

Source: Bloomberg

Exchange rate: China / USA

Source: Bloomberg

Exchange rate: Brazil / USA

Source: Bloomberg

Exchange rate: Russia / USA

Source: Bloomberg

Exchange rate: India / USA

Source: Bloomberg

Exchange rate: USA / Japan

Source: Bloomberg

Exchange rate: EU / USA

Source: Bloomberg
Report Contributors

**Australian based analysts**

Michelle Angelique Ridsdale: Michelle has over 10 years’ experience with Rio Tinto Iron Ore where she filled a variety of technical roles (exploration geologist, mine geologist and mining engineer) before moving into corporate analytical roles in planning and global business development. She has equities research experience in gold, nickel and iron ore stocks at Macquarie. Michelle has a BSc (First Class Hons) in Applied Geology from the University of NSW and a Grad Dip in Business from Curtin University.

Tony Parry: Tony has extensive experience in metallurgical process development, (working with MIM Limited for five years) and in mining equity research, equity sales and mining corporate finance (working in London for five years and subsequently Perth). He was a founding Director and CEO of an ASX listed exploration company and has been engaged extensively as a strategic planning consultant to many small-medium enterprises. Tony’s qualifications include a BSc (Hons) in Metallurgy and a PhD in Metallurgy from the University of NSW.

John Wilson: John has a background in mining, finance and equity research. He worked on Wall Street for 6 years and has covered US, Australian and Latin American mining stocks. He has also worked with BHP in their minerals division. Qualifications include an MBA from the Wharton School of the University of Pennsylvania and a Bachelor of Engineering from the University of Sydney.

**Canadian based analysts**

Khaled Sultan: Khaled has a background in oil and gas, mining and equity research. He has 11 years of industry experience, and most recently has spent more than four years focused on equity research and investment analysis. He has worked with one of Canada's top five investment banks in Toronto following the precious metals sector with a focus on gold equities. Qualifications include a Bachelor of Engineering from the University of Western Ontario and an MBA from the Rotman School of Business (University of Toronto).
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