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Commodities

Iron Ore Market Outlook

Commodities | Australia

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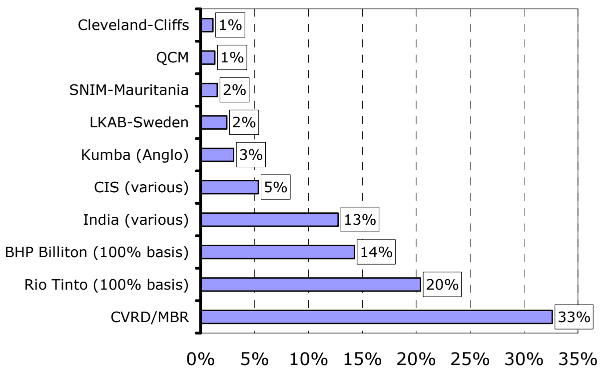
Contract prices set to rise for sixth consecutive year:

- Our base case assumption is that contract prices for iron ore (sinter feed) will rise by 30% for JFY 2008/09 delivery.
- We continue to see upside risk to this forecast. Iron ore spot prices, ex-India, are now trading at a premium of ~40% versus Brazilian material and ~120% versus Australian (basis CIF China, assuming spot freight) - the wider this spot:contract premium becomes, the greater the upside risk. Our upside forecast scenario is +50%.
- A concerted push, on the part of Australian producers, for CIF price equalisation (closing the freight differential) could further enhance earnings for Australian suppliers of iron ore. However, Chinese buyers remain strongly opposed to any modification to the established benchmark system.
- Last year the iron ore negotiations were completed in near record time - CVRD and Baosteel agreed a 9.5% price rise on December 21st. With hindsight this was a generous outcome for the buyers; we anticipate a more protracted negotiation process this year - an agreement may not be reached until 2Q08.
- Our medium term view (next three years) is that demand for seaborne iron ore will continue growing at ~10% pa (80-90 million tpy) but the miners will struggle to match this demand growth until 2009/2010.
- Our longer term view is for supply and demand in the seaborne market to be more closely aligned from 2010. Indeed, five years from now we estimate that the market will be tending towards over-supply as a plethora of iron ore projects/expansions come on stream, exerting downward pressure on iron ore prices.
- Key uncertainties regarding the strength and duration of the current price cycle include:
  - responsiveness of high cost Chinese and Indian iron ore production to falling prices/returns - un-tested as yet - could be "sticky",
  - supply-side discipline from the incumbents - should be effective given the high industry concentration but the emergence of new entrants such as FMG and MMX, could limit the impact.

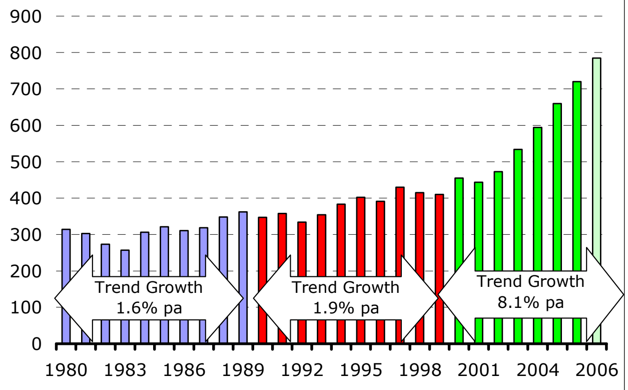
Seaborne Trade in Iron Ore - a fast growing market with a positive industry structure.

Iron Ore: Market Share Seaborne Trade, 2007 (est.)



Source: GSJBW Research Estimates, Company Data, CRU International

Seaborne Trade in Iron Ore million tonnes



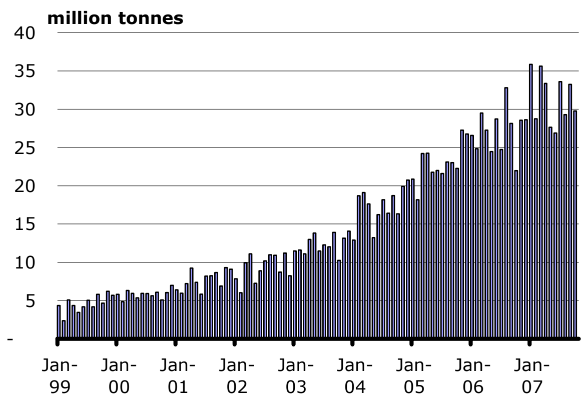
Source: GSJBW Research Estimates, Company Data, CRU International

- As the chart on page 1 shows, during the 80's and 90's seaborne trade in iron ore increased at a trend rate of 1.5-2.0% pa, broadly in line with global steel production. However, since 2000 growth in seaborne trade has averaged just over 8% pa, driven by surging Chinese steel production.
- In comparison with many other industrial minerals/metals, iron ore enjoys a relatively concentrated industry structure, with the top three suppliers controlling 65-70% of global seaborne trade. On a five year view we anticipate a slight reduction in the 3-firm concentration ratio as new entrants such as FMG, MMX, and CSN build up a meaningful presence in the seaborne market.

Chinese Imports of Iron Ore - the mainstay of seaborne trade.

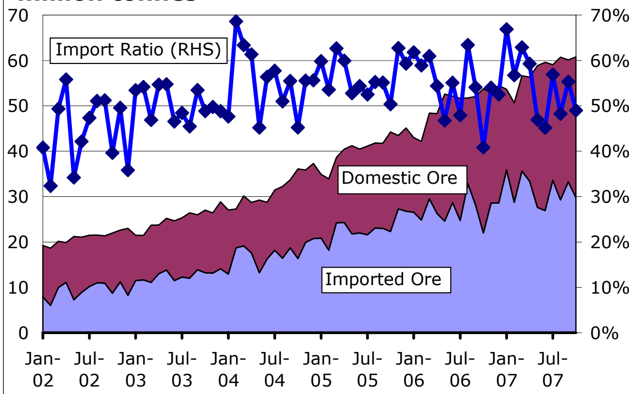
- China is on track to import 375-380 million tonnes of iron ore this year, accounting for ~48% of global seaborne trade.
- Australia is the main foreign supplier of iron ore to China accounting for ~38% of the country's total imports. We estimate that Brazil and India will account for ~25% and 22% respectively, despite the relatively high landed cost of iron ore from these locations - symptomatic of a market in structural under-supply.
- As the chart below shows, China has responded to five consecutive years of rising international prices (and the prospect of a sixth) by expanding production of domestic iron ore. Indeed, this year China is on track to achieve its fourth consecutive year of iron ore production growth of 25-30%. However, China is not well endowed with good quality iron reserves - average head grades are declining and conditions are difficult in some mines. Many are small scale, using old equipment and rely on supplying local steel mills that produce low quality steel. In general the Chinese iron ore industry is resource inefficient and environmentally damaging.
- Whilst maximising domestic Chinese production of low grade iron ore, may bridge the gap in the market created by a shortage of supply from the incumbents, it is not the solution to China's long term iron ore requirements. Our medium term view is that China's import dependency for iron ore will rise as the steel industry restructures and relocates towards coastal locations and new sources of iron ore supply are developed overseas, some of which will involve Chinese financial participation. Implicitly the high cost, resource inefficient Chinese production will be squeezed out of the supply chain.

Chinese Imports of Iron Ore



Source: CRU International, China Customs

Chinese Consumption of Iron Ore million tonnes



Source: GSJBW Research Estimates

Seaborne Trade Balance - market could remain supply-constrained until 2010.

- Our abridged seaborne market balance is shown on page 3. Our base case assumption is that the market remains under-supplied through 2008; is very closely balanced in 2009, before moving to modest oversupply from 2010.
- The key variables in formulating the seaborne balance are:

– **Chinese pig iron production:** we have assumed +18% in 2007, +14% in 2008, and +10% in 2009 and 2010.

- **Chinese domestic iron ore production (and average Fe grade):** we have assumed +25% in 2007, +10% in 2008, and +3% in 2009 and 2010. We assume an average Fe grade of 29%, falling to 28% from 2009.
- **Growth in iron ore exports:** we have assumed an additional 51 million tonnes in 2007, progressively rising to an additional 106 million tonnes in 2010.

- We believe the main risk to our forecast is that we could be under-estimating China's future iron ore import requirement (either through higher pig iron production or lower domestic iron ore production - or a combination of both).

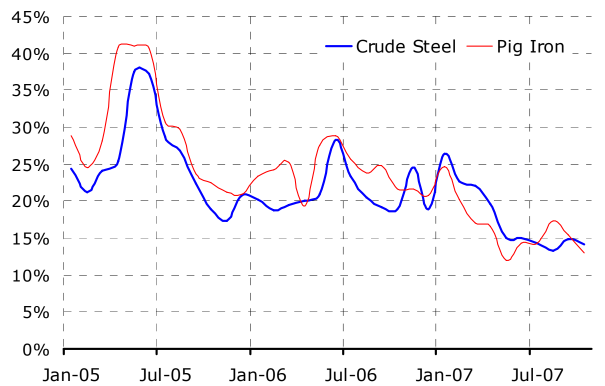
Iron Ore: Global Seaborne Trade Balance (million tonnes)	**2005**	**2006**	**2007 (f)**	**2008 (f)**	**2009 (f)**	**2010 (f)**
Seaborne imports of iron ore	657	720	790	873	957	1046
year-on-year change (million tonnes)	*63*	*63*	*70*	*83*	*84*	*89*
year-on-year change (%)	*11%*	*10%*	*10%*	*11%*	*10%*	*9%*
Composition of seaborne imports:						
China	275	326	379	451	528	607
year-on-year change	*67*	*51*	*53*	*73*	*77*	*78*
Japan	132	134	137	138	136	136
year-on-year change	*-1*	*2*	*3*	*1*	*-2*	*0*
W. Europe	121	122	126	127	124	123
year-on-year change	*-6*	*1*	*4*	*1*	*-3*	*-1*
Rest of world	128	137	148	157	169	180
year-on-year change	*3*	*9*	*11*	*9*	*12*	*12*
Projected Growth in Seaborne Trade (Demand)	63	63	70	83	84	89
Potential Additional Export Availability (Supply)	77	41	51	69	88	106
Potential Under/Over Supply	**14**	**-22**	**-19**	**-14**	**5**	**17**

Source: TEX Report, CRU International, UNCTAD, GSJBW Research estimates.

Steel - Chinese production growth is slowing while steel prices stabilise

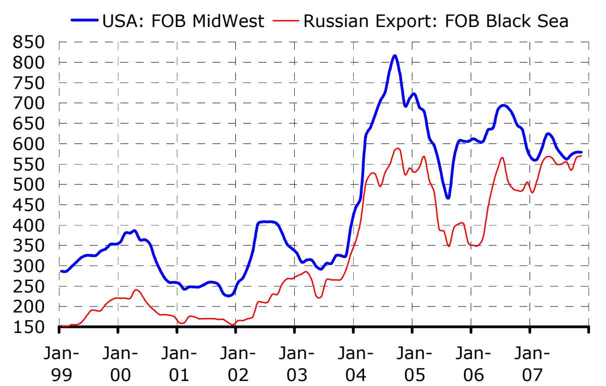
- As the chart below shows, the rate of growth of Chinese crude steel and pig iron production has slowed significantly during the course of 2007, from an annualised rate of ~25% at the start of the year to less than 15% currently. We have factored this into our projections - we are currently forecasting 14% growth in Chinese pig iron production growth in 2008 which equates to an additional 66 million tonnes, versus an estimated 70 million tonnes of incremental pig iron production this year.
- The steel price outlook is also critical to the iron ore negotiations. So far this year international steel prices have held up much better than we had anticipated, despite a surge in Chinese exports of steel products. However, Beijing is progressively replacing export incentives on steel products with export taxes and this is starting to have an impact on steel exports. If excess steel products start accumulating in the domestic market it could put pressure on Chinese steel prices with obvious implications for steelmakers' raw material affordability. Our base case assumption is that steel prices will be higher in 2008 than 2007 but they will not rise by the full extent of our projected raw material price rises, leading to margin compression in the steel sector next year.

China: Production of Steel and Pig Iron
% ch. y/y



Source: Reuters, IISI

Steel: Hot-Rolled Coil Price
US$/t

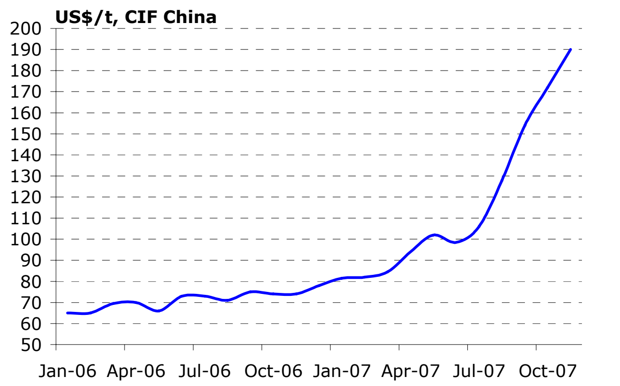


Source: CRU International

Surging spot prices - upside risk to our +30% contract price forecast

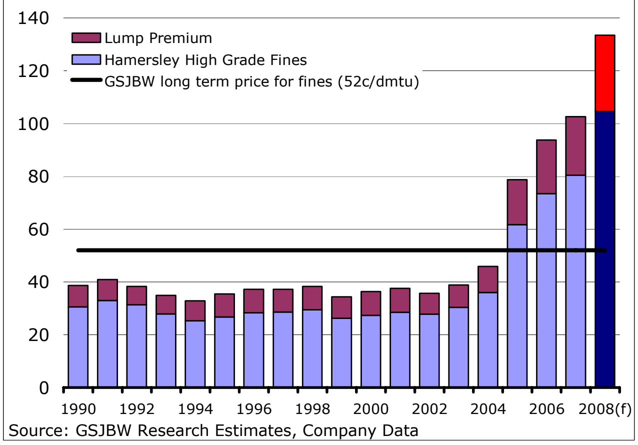
- Iron ore spot prices, ex-India, have almost doubled during the past five months and are now trading at an approximate 40% premium to Brazilian material and a massive 120% premium to Australian (both comparisons are on a CIF China basis, assuming spot freight).

Iron Ore: Chinese Spot Price (63.5% Fe)



Source: GSJBW Research Estimates, CRU International

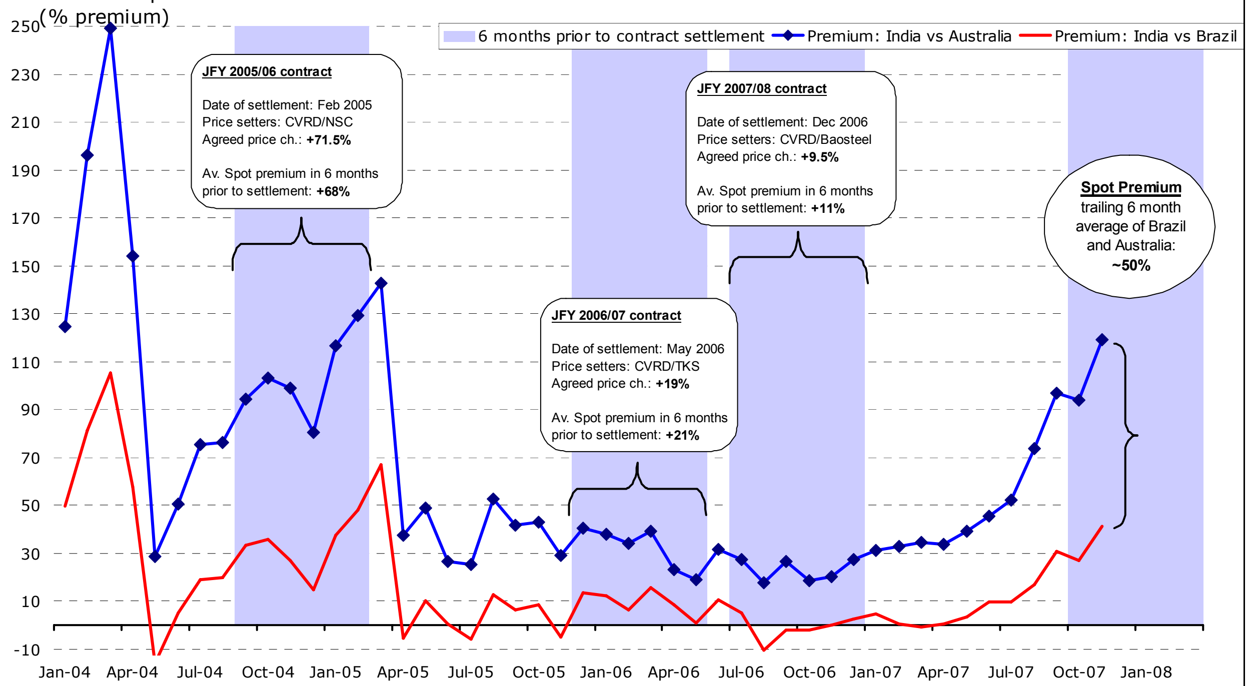
Iron Ore Contract Price (USc/dmtu)



Source: GSJBW Research Estimates, Company Data

- As India has grown in importance as an exporter of iron ore to China, the Chinese spot price has become a more reliable marker and, we believe, a reasonable leading indicator of contract prices. In the chart below we have plotted the percentage premium/discount for spot iron ore shipments from India (63.5% Fe) to China versus the estimated cost of contract shipments from Australia and Brazil (assuming spot freight rates).
- Our analysis shows that over the past three years there has been a close correlation between the six month trailing average premium (prior to the date of contract settlement) and the actual contract settlement. For example, last year the combined average spot premium for India versus Brazil and India versus Australia in the period Jul-Dec 2006 was 11% and the contract settlement was 9.5%. If history is a guide to the future and the relationship holds for the 2008/09 negotiations there is clearly upside risk to our +30% price forecast - the chart points towards a 50% contract price rise which is consistent with our upside price scenario.

Iron Ore: Spot Premium vs Contract



Source: CRU International, GSJBW Research

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[1] EVA™ is a registered trademark of the U.S. consultancy firm Stern Stewart

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