FROM THE CAPITAL

Pushed too far

Cliffs CEO Lourenco Goncalves slams iron-ore manipulation

John Robertson

The chief executive (CEO) of Cliffs Natural Resources did not hide his contempt for BHP Billiton and Rio Tinto when he briefed analysts on the company's first-quarter earnings.

Lourenco Goncalves took over as chairman, president and chief executive officer of Cliffs in August 2014 following a proxy fight that culminated in the ousting of the company's previous management. He is transforming the Cliffs business model as he backs away from the seaborne iron ore and the coal trades to become a more focused domestic supplier of material inputs for US steel mills.

Goncalves has added his weight to that of Fortescue Metals Group chairman Andrew Forrest in blaming the business practices of the big two Australian iron-ore miners for an unnecessary loss of industry profitability.

The world's four largest iron-ore miners – Vale, Rio Tinto, BHP Billiton and Fortescue – with Hancock Prospecting will have added nearly 50% to their 2013 production rate (845Mt) by 2016, according to announced plans. Underpinning this seemingly headlong rush to raise production is a critical and possibly mistaken view about China's economic structure. BHP Billiton thinks Chinese steel production will keep rising until the mid-2020s and not fall until after 2030.

Framing a business around growing Chinese steel volumes has ignored some obvious economic pressures and the way China's government is managing the restructuring of its economy. Many of these forces could have been foreseen. Writing for HighGrade.net in November 2012 when the iron-ore price was US$120/t, I proffered the following based on my economic modelling:

"Steel production in 2016 could be about 5% higher than in 2012 but would start to decline thereafter, leaving it at around 2012 levels in 2020. In this circumstance, miners should be assuming that Chinese demand is, for all practical purposes, near its peak. This scenario suggests little scope for iron ore mine expansions."

Goncalves put a slightly more sinister characterisation on the strategy behind the major two Australian producers. There is less analytical incompetence on his reading of the situation and more of a deliberate attempt "to take Fortescue out of the picture".

Goncalves believes the threat of continuing increases in capacity is "terrorising the market" because the expansions will not be realised.

Push has come to shove... iron-ore minnows forced towards a financial cliff aiming attacks at 'manipulating' majors

The "lip service and empty threats", according to the fired up Cliffs CEO, are a deliberate attempt to "scare the shit out of everybody".

Andrew Forrest earned a rebuke recently from Australia's competition regulator when he dared to say that the iron-ore miners should put a cap on production. Goncalves said the big two themselves should be the focus of attention by the ACCC because "what they're doing is not right".

He also criticised BHP Billiton, Rio Tinto and Vale for manipulating the iron-ore pricing index for strategic proposes. "If it was LIBOR, people would go to jail", he said in a reference to actions being brought in the UK and the USA against several global banks for manipulating daily interest rate benchmark settings.

Squabbles over market share that create excess capacity and depress prices are not unusual. The airline industry and soft drink and beer markets, among others, have had similar experiences in Europe, the USA and Australia.

The financial bloodletting can be hard to stop but it is usually stemmed when shareholders make it clear to direct ors that their patience has ended. Once shareholders realise that large profit gains can be had from relatively modest behavioural changes, the pressure rises quickly.

The same is likely to happen in the iron-ore market. The first evidence will be tentative market testing by the majors to determine how much they have to adjust output to optimise profit outcomes.

They must avoid market rigging allegations but they are all confronted by the same circumstances and will eventually react the same way when they are told by angry shareholders to maximise profits having done enough to warn off any interlopers wanting to start new mines or keep high-cost mines operating, if that was their intent.

Goncalves thinks directors are inherently more cautious than management in such matters and will refuse to allocate the required large amounts of capital for expansions in the event management seeks permission to spend the money.

Goncalves has staked out his position as explicitly as a CEO could. He has decided to stop capital spending and exploration in favour of running his own WA mines to the end of their 3-4-year working lives. He says he has no intention of closing the mines earlier than this and will match the two majors in any cost reductions they make. He described himself as being relentless and "their worst nightmare" if the two WA majors continue trying to close competitors by cutting costs.

Companies caught up in battles for market share often find it difficult to extricate themselves. Uncertainty about how their rivals will react delays a change in approach, but a personal loss of face also plays a role. Sometimes, a new group of people must take over a business to restore more sustainable market conditions.

The financial hemorrhaging might have to occur over more than one reporting period before the pressure to change course makes a difference. By then, the small fry might have already been wasted. Ironically, the ones to suffer the longest are those that have started the fight. There is no reason to believe that the iron-ore market will differ from other markets in which similar events have played out.

When the change comes, the best investment returns will most likely come from those surviving companies most leveraged to a change in conditions. That will tend to mean companies such as Fortescue Metals Group or Atlas Iron, which have survived near death experiences through the goodwill of their financiers and suppliers, or Cliffs, which will have removed itself from the fray. Meanwhile, those who have instigated the price fight will be forever poorer for the experience. ▼

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