Fortescue hits back at sceptics

Fortescue Metals Group, having confounded the sceptics, is now being re-priced to reflect changing perceptions about its quality.

John Robertson* | 08 Sep 2016 | 8:15 | Opinion

Andrew Forrest's FMG has consistently proven wrong the doubters

Fortescue is the outstanding success story in the recent history of Australia's mining industry.

Few companies in the industry have so comprehensively met their business goals. More than that, Fortescue has had to adjust to iron ore market conditions which have proved catastrophic for other attempted entrants to the industry.

Iron ore producers have generally displayed strong share price gains since the worst of their price outcomes in January.

The share prices of BHP Billiton and Rio Tinto have risen 46% and 33%, respectively. Vale, the other of the three majors in the global iron ore trade, has posted a 163% share price gain.

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At the top of the performance heap is the self-proclaimed 'new force in iron ore'. The Fortescue share price has risen 259%.

The Fortescue market reassessment has not been confined to equity investors.

At the tail end of August, after the company had released its 2015/16 financial results, Fitch, S&P and Moody's upgraded Fortescue's credit ratings. The ratings boosts recognised the company's strengthening balance sheet and improved operational outcomes that had earlier been heavily discounted by investors and analysts appraising its outlook.

The outstanding question confronting investors now is whether markets are continuing to apply a 'scepticism discount' to Fortescue or whether that has been largely eroded by the recent performance differences with its industry peers.

With an answer to that question, investors will be better able to judge whether, even without higher iron ore prices, a Fortescue investment will do better than an investment in one of the other iron ore majors.

"The Fortescue price does not necessarily have to rise to get the job done"

Unfortunately, for all of its operational prowess, Fortescue has adopted some of the industry's bad habits when it comes to explaining its financial results, including a contempt for reporting returns on capital invested.

Most likely, if chairman and founder Andrew Forrest was offered a rental property with an annual income of, say, US$100,000, his first question would be "how much do I have to invest?"

In the corporate presentation accompanying the Fortescue 2015/16 results, the section headed 'Return to Shareholders' refers to earnings, free cash flows and dividends, none of which make any sense as returns to shareholders without some reference to capital.

In a telling indication of the general disdain for ordinary equity, the company does not make a single reference to the amount of equity invested in any of the seven pages within the section of the presentation entitled 'Balance Sheet'.

To access the future income stream of the company, investors have to currently pay around A$16 billion (US$12.3 million), the market capitalisation, plus however much additional capital would be required to sustain the business in future years.

Extrapolating the recently reported 2015/16 results suggests an investor would have to pay around US$15.5 billion to generate US$21.5 billion over 10 years. This would be equivalent to buying a 10-year bond with a yield of just below 4%.

A comparable PortfolioDirect analysis for BHP discussed in last week's "From the Capital " column implied a negative yield. If BHP was priced in line with Fortescue, its market value would be slashed to a fraction of what it is today.

Embedded in the BHP market value is an expectation of a cyclical rise in commodity prices. As also observed last week, a 50% rise in the prices of its principal outputs would lift the BHP bond-equivalent yield to a rather modest 6%.

Fortescue's bond-equivalent yield under the same circumstances would rise to a healthier 18%.

If Fortescue was priced on the same basis as BHP in expectation of such a cyclical swing in prices, its market value should be more than double what it is presently.

Whatever the eventual outcome in the metal markets on which both these companies depend, Fortescue looks to have further re-pricing potential.

Of course, relative re-pricing can be achieved in several ways. The Fortescue price does not necessarily have to rise to get the job done.

The surest way for an adjustment in relative equity prices to occur is with stable or firming iron ore markets which allow all company's share prices to rise but some more slowly than others.

In a weakening iron ore market, in which all companies face downward equity price pressures and in which the BHP price needs to fall more than the Fortescue price, adjustment is likely to take much longer.

Over the long haul, BHP and Fortescue are travelling in opposite market directions.

BHP is enduring a lengthy transition from being Australia's largest, most admired and widely held company to being a still large but only modestly performing miner battling to define a strategy that outlasts a change of chief executive.

Fortescue is gaining fresh respect within investment markets. It is positioning itself to possibly become the iron ore investment of choice among Australian investors.

What had been a fanciful notion barely a few years ago is an emerging reality.

Investors will be encouraged by the latent relative value still to be captured and the company's ongoing success in improving its operating performance.

The outstanding question then becomes: "Will improving operating performance alone be enough for the Fortescue directors?"

A company used to delivering rapid and dramatic growth outcomes may find the temptation to do it again too much to resist.

Hints that the company may extend its business reach beyond iron ore emanate from the west occasionally.

The possibility of a leap into a currently unknown venture will be treated less sceptically after the company's recent record of success but investor scepticism is tough to eliminate and will remain a constraint on a much deserved closing of the value gap if fresh strategic uncertainties are introduced.

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