Opinion

FROM THE CAPITAL

Atlas Iron braces for second coming

The company has done all it can to lower unit costs, but there are some expenses that are structurally fixed

John Robertson

Atlas Iron needs nothing short of divine intervention if it is to finally dodge the seismic shift in iron ore markets.

David Flanagan, the returning chief executive of Atlas Iron, is on the international capital market hustings chasing down A$180 million (US$133 million) to give the company a fighting chance of surviving until better times.

Atlas closed the doors in April 2015 with iron ore unit production costs around US$61/t (CFR China) after the price had fallen precipitously through $50/t with every sign of going a lot lower.

Flanagan had founded the company and led its management during 2004-2012, while the business headed from a standing exploration start toward an 8Mt annual shipment rate by early 2013 when it was generating over $70 million a quarter in cash from operations.

Helped along by the Abydos Mine, which began in mid-2013, the company had shipped nearly 27Mt of ore when mining ceased in April. A third mine – Mount Webber – was in start up mode. With it, the company had anticipated shipping at an annual rate approaching 15Mt/y.

At this production rate, the company would have remained a minnow among giants in an industry in which size usually differentiates winners from losers. It could redesign regional logistics in its favour only by becoming bigger. When Flanagan relinquished the reins in 2012, the company was trying for a 46Mt/y production rate by 2017.

After stepping down as managing director, Flanagan maintained a high profile in Western Australia, which is used to lionising its local iron ore pioneers. Like Hancock, Wright and Forrest before him, Flanagan was seen as the energetic action man bucking conventional wisdom about what was achievable. He became chancellor of Murdoch University in 2013 and was named Western Australian of the Year in 2014 for his philanthropic work as well as his business accomplishments.

If he regrets having to rejoin the day-to-day fray of the mining industry executive, it does not show. In Melbourne in the past week, he spoke emotionally about how employees, suppliers, government and financiers had enthusiastically joined to save the company from looming disaster.

The company's contractors will have played a potentially vital role in saving the business, if that is the outcome. Contractors have subscribed for shares to the value of A$41 million. The company is looking for another $39 million from a general placement and a shareholder participation offer to raise another $100 million.

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The A$0.05 issue price is a staggering 97% below the company's share price in July 2011 and 58% below the price just before its operations closed earlier in 2015. To help sell the issue, investors will be granted an option exercisable at A$0.075 before July 2017.

With a few days to go before the close of the placement, the company has been speaking confidently about the reception from investors so far but you would expect them to, wouldn't you? Capital market conditions are tough for even the best-positioned companies. The Atlas story has its appealing David and Goliath connotations. It would be churlish on the part of anyone to wish Flanagan and his supporters anything but the very best of outcomes but, realistically, the company is not well positioned.

True, it is far better positioned than it was. It has managed to get its production costs down to as low as $50/t. This colossal achievement relies heavily on the ongoing goodwill of contractors for its sustainability. They are no doubt well intentioned. They are also promised some of the upside from a rise in iron ore prices. Their willingness to help would have also been conditioned by the shortage of other work in the industry. These are not arrangements one could expect in better times.

Much has been made of the use of derivatives to add pricing certainty. The iron ore price derivatives tools that are now available for speculators and producers can be used to smooth the short-term bumps and grinds in the iron ore price, but the effective price received will likely approximate an average of daily prices.

From a valuation standpoint, this changes little. Similar techniques have been practised sensibly by metal producers for a few hundred years. There is a practical benefit. Cautious investors increasingly wary of volatile iron ore prices may be more inclined to invest. The arrangements might also contribute to a lessening in market volatility once the trading suspension is lifted.

Irrespective of hedging, a fall in price below $50/t leaves Atlas in strife. It is hard to see the company doing anything more to keep production going. One suspects that it has shot all its arrows on the cost front, at least all the arrows to which Flanagan has access.

Despite efficient material movement being the hallmark of a successful iron ore miner, Atlas falls short of best practice. It is using trucks to move its ore to Port Hedland while the big players are going by rail. Atlas is doing the equivalent of trying to connect to the internet with a 1990s dial-up service.

This is where divine intervention comes into play. Flanagan was asked last week in Melbourne what was needed to gain access to the nearby rail networks. With disarming honesty, Flanagan's unhesitating response was that it would take the second coming. He was serious and presumably not referring to his own return as chief executive.

That leaves Atlas in a still awkward predicament. No matter how skilled or deserving its executives or committed its stakeholders, they are unable to realise the full potential of their mines. Short of divine intervention, they remain $10/t or so behind the biggest and the best in the industry as long as they are forced to use trucks. ▼

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