



Fortescue Ltd FMG

\$26.78 0.46 | 1.75% (5:25PM 07-May-2024) Trading Status: Trading

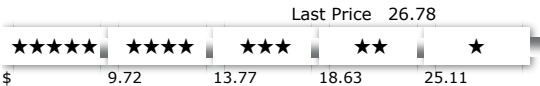
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Morningstar Analyst Rating™

★
(04:00PM 29-Apr-2024)



Style Box™

Morningstar Sector
Basic Materials

Market Cap
82,455 M

Fair Value
\$16.20

Fair Value Uncertainty
High

Economic Moat
None

Capital Allocation
Standard

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|----------|--------------------|-----------|---------|------------|--------------|-----------|-------|--------|
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Business Strategy and Outlook

Updated: 04-Apr-2024

Fortescue's FVE Reduced by 6% on Lower Near-Term Iron Ore Prices; Shares Overvalued

Fortescue is the world's fourth-largest iron ore exporter. Margins are well below industry leaders BHP and Rio Tinto, and some way behind Vale, meaning Fortescue sits in the highest half of the cost curve. This is a primary driver of our no-moat rating. Lower margins primarily result from price discounts from selling a lower-grade (57% to 58% iron) product compared with the 62% iron ore benchmark. The lower grade is effectively a cost for customers through a greater proportion of waste to transport and process, additional energy/coal per unit of steel and lower blast furnace productivity. This results in a lower realized price versus the benchmark. In the 10 years ended June 2023, the company realized an approximate 23% discount versus the 62% benchmark.

Fortescue increased rapidly thanks to favorable iron ore prices, aggressive expansion, and historically low interest rates. Expansion from 55 million metric tons of capacity in fiscal 2012 to around 190 million metric tons by 2023 was unprecedented. Fortescue built much of its capacity around the China boom peak and baked in a higher capital base than peers. This means returns are likely to lag the industry leaders who benefited from building significant capacity when the capital cost per unit of output was lower.

Fortescue has done an admirable job of reducing cash costs materially versus peers. However, product discounts remain a competitive disadvantage. The addition of about 22 million metric tons a year of iron ore production from the 69%-owned Iron Bridge joint venture allows Fortescue blending options. Iron Bridge grades are much higher, around 67%, meaning Fortescue could blend most of its iron ore to increase its average grade to between 58% and 59%.

Fortescue is a China fixed-asset investment play, with practically all of the company's iron ore sold there. In the long term, we see demand for steel in China declining as the country's stock of infrastructure matures and with the rate of urbanization past its peak.

The company's strategy is to transform into a diversified iron ore and clean energy company. Its green energy initiatives are at an early stage, but the company has big ambitions in the space.

Financial Strength

Updated: 04-Apr-2024

Fortescue's balance sheet is strong, thanks to the elevated iron ore price and accelerated debt repayments. Net debt peaked near USD 10 billion in mid-2013, roughly coinciding with the start of expanded production. Net debt as of the end of December 2023 was USD 0.6 billion, which compares favorably to trailing 12 months EBITDA of around USD 11.5 billion. We think net debt/EBITDA will remain comfortable for the foreseeable future and forecast the ratio to remain below 0.5 through to fiscal 2028. That said, given the operating leverage in Fortescue, we think there is a reasonable argument that Fortescue should run with minimal debt on average through the cycle.

Risk and Uncertainty

We rate Fortescue's Morningstar Uncertainty Rating as High. The price of iron ore and unit costs are the primary drivers of our fair value estimate. The key risk to cash flow is a slowdown in Chinese fixed-asset investment and the consequential impact of steel demand, iron ore demand and ultimately the iron ore price. The expansion of low-cost iron ore supply is another key risk, namely the recovery in output from Brazil, after the Vale tailings dam disaster in 2019, and in the longer term from the likely development of iron ore mines in Africa. Fortescue's cash margins are lower than the low-cost industry majors and so it will be most affected if iron ore prices fall materially.

In the global financial crisis, demand for steel declined rapidly, affecting iron ore prices. Industry pricing power will be tested if Chinese demand for steel slows and total consumption eventually shrinks as we expect. The company wisely focused on debt repayment and financial risk is now low. Provided Fortescue does not embark on another large debt-fueled expansion, or substantial green energy acquisitions, the balance sheet is strong and maintainable.

Fortescue is exposed to a number of low-probability environmental, social, and governance, or ESG, risks which are not material compared with the major fair value estimate drivers: iron ore price; operating leverage; and capital intensity. The dominant source of emissions in the value chain is downstream from iron ore production—their customers' emissions in steelmaking. Should a carbon price be implemented on the customers' use of iron ore, Fortescue could be at a competitive disadvantage. Their lower-grade iron ore comes with relatively higher emissions in the steelmaking process. Due to the lack of diversification in regions where Fortescue operates, community opposition or labor strikes and disputes could pose a threat to operations and future developments.

Economic Moat

We assign Fortescue a no-moat rating. The iron ore produced by its mines generally has less iron content than the 62% iron ore benchmark while also having higher percentages of impurities such as sulphur, alumina and phosphorous. As a result, Fortescue's iron ore is lower quality than that produced by its major competitors such as BHP, Rio Tinto and Vale. This competitive disadvantage results in its iron ore tending to sell at a material discount to the 62% benchmark price, with the average discount over the 10 years to fiscal 2023 being about 23%. The exception is Iron Bridge, which will produce a 67% product. As it is a magnetite deposit, once mined the ore requires beneficiation (where the mined material is crushed into smaller particles and then the valuable ore is separated from the waste). This means cash operating costs for Iron Bridge are materially higher than for the company's other conventional mines. Moreover, Iron Bridge will only account for around 10% of total production on a 100% basis once fully ramped up.

As a commodity producer, Fortescue is a price-taker and needs low-cost mines with long lives and a low installed capital base to support the longer-term excess returns needed to justify an economic moat. Once product discounts are taken into account, and assuming Vale's costs normalize, Fortescue sits around the 75th percentile of the industry cost curve.

We note that the company averaged ROIC of about 24% in the 10 years ended June 30, 2023 and around 35% in the five years ended June 20, 2023. However, the last decade has been characterized by average iron ore prices that are far in excess of our long-term midcycle estimate of USD 60 per metric ton. Iron ore prices averaged about USD 110 per metric ton over the five years to 2022 and around USD 100 per metric ton over the 10 years to 2022. These prices have mainly been driven by generally increasing crude steel production in China, helped in recent years by the iron ore majors expanding production at much slower rates than they did in the early part of the last decade.

If we assume prices instead converge toward our midcycle estimate of roughly USD 70 per metric ton from 2028, we estimate that Fortescue will generate a ROIC below its WACC of around 9.5%. Accordingly, we don't assign a moat to Fortescue.

Given the Chichester, Solomon and Western Hubs are hematite mines and also share the same railway and port infrastructure, we treat them as one integrated production center when assessing their moatworthiness. Most of the assets—approximately 70% of the invested capital base—sits within port and rail, essentially in perpetuity infrastructure assets. The remainder of the invested capital base sits with the mines. New mines are periodically developed to continue to feed and utilize the installed infrastructure base.

We assess the Iron Bridge mine separately. It is a different type of mine (magnetite) with materially different product price, unit operating costs, unit capital costs and margins. Also, it uses separate infrastructure (namely, a pipeline) to transport its concentrate to Port Hedland.

Looking at these hubs/mines in turn:

Chichester, Solomon and Western Hubs—these mines produce ore with an iron content of around 57%-58%, lower than the 62% benchmark. This lower-quality ore generally receives a discounted price from steelmakers as they have to use more iron ore and coking coal to produce a metric ton of steel compared with higher-grade iron ore, while also resulting in higher CO2 emissions. Once we adjust for the lower iron ore content, the cash costs for extracting ore from these mines place Fortescue's conventional operations well into the upper half of the iron ore cost curve. We also note that Fortescue's assets are relatively new compared with those of BHP, Rio, and Vale, who constructed much of their mines' infrastructure when unit capital costs were far lower, resulting in Fortescue having a higher unit capital cost, too. This lack of cost advantage, and our reticence to forecast iron ore prices remaining above the marginal cost in the longer term, means we don't think they will generate excess returns in 10 years, and so we don't deem them moatworthy.

Iron Bridge—producing ore with an iron content of 67%, we estimate it will represent around 15% of midcycle EBIT. We assume that Iron Bridge ore will earn a premium of around USD 32 per metric ton above our assumed midcycle 62% benchmark price of roughly USD 70 per metric ton. However, with unit costs more than double those of the company's conventional mines, we don't think it will generate ROIC above WACC for at least 10 years and so also don't deem it moatworthy.

Fortescue Energy—we estimate that the company will spend about USD 6.3 billion on Fortescue Energy over the five-year forecast period. Fortescue Energy is focused on investing in green energy and materials, specifically in relation to green hydrogen and green ammonia, with the goal of producing 15Mt of green hydrogen by 2030. Its efforts in this regard are at an early stage and have no certainty of success. However, given the expenditure is small on a relative basis, we assume that Fortescue will earn its cost of capital. Hence we believe that Fortescue Energy doesn't contribute nor detract when determining whether Fortescue is moatworthy.

Exploration projects—these are an immaterial part of Fortescue and way too early in their potential development to assign any of them a moat. Typically, exploration projects are high risk and involve significant exploration and development expenditure to bring into production—if viable. In the absence of success, expenditure on exploration represents a net drag on overall returns on invested capital for the group. However in this case, Fortescue's expenditure is relatively modest relative to earnings, spending about USD 170 million in fiscal 2023 versus about USD 2 billion in EBIT.

about USD 170 million in fiscal 2023 versus about USD 7 billion in EBIT.

Fair Value and Profit Driver

Updated: 04-Apr-2024

We reduce our fair value estimate for no-moat Fortescue to AUD 16.20 per share, down from USD 17.30, driven by lower near-term iron ore prices.

We now assume iron ore averages about USD 100 per metric ton from 2024 to 2026 based on the futures curve, down from roughly USD 120. However, we raise our assumed midcycle iron ore price to roughly USD 70 per metric ton from 2028, up from around USD 63 previously. This is based on our updated estimate of the marginal cost of production, driven by inflation pushing up and steepening the industry cost curve. Strong demand from China, which accounts for around 70% of the seaborne iron ore trade, is supportive of near-term prices. However, longer term we expect demand from China to moderate as steel production peaks and starts to decline as its economy moves away from one reliant on fixed-asset investment to a more consumption-based economy. China's falling population along with rising scrap-based production also contribute to reduced demand for iron ore, in our view. We also think additional supply is likely, led by Simandou and Vale. Hence we expect a long-term price substantially below the current spot around USD 100 per metric ton.

Cash flow is discounted at an 9.4% weighted average cost of capital, based on a long-term capital structure comprising 25% debt and 75% equity. The pretax cost of debt assumption is 8%. Our 11% cost of equity reflects very high systematic risk, specifically Fortescue's lower margins relative to industry leaders BHP, Rio Tinto, and Vale, and somewhat higher debt levels relative to peers. Our fair value estimate equates to an enterprise value/EBITDA exit multiple of 6 in fiscal 2026.

Capital Allocation

Updated: 04-Apr-2024

We assign Fortescue Metals Group a Standard Capital Allocation Rating.

Fortescue has benefited from high iron ore prices in recent years which, along with a focus on debt repayment and cost reductions, have resulted in a sound balance sheet. The firm is increasingly focused on dividends, which we think is appropriate and in shareholders' interests, given that future external conditions are likely to be less favorable. Should the company revert to significant procyclical rapid expansions or acquisitions, we would likely downgrade the Standard rating. We see the Iron Bridge development as a modest add on to the existing operations, but do not think it enhances the company's competitive position. We think it reflects a fair rather than exceptional investment, in keeping with our Standard rating. In addition, the company's investments in green technology are early stage. While laudable from an ESG perspective, particularly given the company's aims to lower carbon emissions, it's not yet clear whether these investments will bring competitive advantage or add shareholder value.

After previous management stripped costs from the business, the recovery in iron ore prices from 2016 sees Fortescue on a sound operational and financial footing. The focus has now shifted to shareholder returns and incremental expansion through Iron Bridge.

The company's rapid expansion during the boom peaks, driven by founder and Chairman Andrew Forrest's exuberance, and its lower-grade iron ore products bake in a permanent cost disadvantage for Fortescue relative to the lower-cost majors. Fortescue's invested capital base is inflated as a result of investing during a boom, and dilutes returns. High levels of debt funding were a tailwind for returns on equity and earnings per share in the boom.

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