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HD **Arrium's rude awakening**

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There are echoes of the global financial crisis in Arrium's whopping $754 **million** capital raising that highlight just how unprepared many in the industry have been for the implosion in **iron ore** prices.

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Arrium, the steelmaker formerly known as OneSteel, is seeking to raise almost its entire market value in **equity**. This is even more unusual given the **company** was paying out dividends to shareholders just under a month ago.

It is one of the largest rights offers the market has seen for a while and reminds many seasoned investors of the rash of emergency raisings companies were undertaking in the global financial crisis.

The move shows just how quickly the **iron ore** price has deteriorated.

While the commodity has lost 40 per cent of its value in the past nine months, it was a sharp 12.5 per cent fall to US$83 a tonne in the last month that set the alarm bells ringing for Arrium chairman Peter Smedley and his advisers at UBS.

Arrium, which was spun out of BHP in 2000, will not be the first **company** whose fortunes are linked to **iron ore** to go cap in hand to shareholders.

While it does have first-mover advantage by shoring up its balance sheet before the financiers come knocking, there is no dressing this up as good news either.

Arrium missed an opportunity to shore up its balance sheet when an **iron ore** price recovery last year saw its share price in good shape, topping a high of $1.81 in early January.

Instead, it has taken a rude awakening to address the huge amount of debt on its balance sheet.

Arrium which had a market capitalisation of $888 **million** at Friday's close, was carrying net debt at June 30 of $1.7 **billion**.

This will fall to $976 **million** once $732 **million** in net proceeds from the raising are thrown at the problem, reducing interest costs by $20 **million** a year.

The **company** is paying the price for a spending spree just before the financial crisis. Arrium has transformed under Smedley to become the nation's fourth-biggest **iron ore** exporter.

It acquired rival Smorgon Steel and took on a lot of debt when it bought grinding media business Moly Cop for $US932 **million** ($1 **billion**).

Its **iron ore** capability has expanded quite significantly to 13 **million** tonnes a year.

The timing of that expansion has been unfortunate.

Many shareholders will not be happy about doubling their investment in the company in the current market conditions.

But the raising has also been structured to attract new investors.

Arrium's gearing was at 31.4 per cent before the raising, which meant a lot of fund managers would not touch the company with a barge pole.

This will now fall to 17.9 per cent, which should open the door for new investors who have been wanting to get back into the company.

Arrium's desire to broaden its investor base is reflected in the structure of the raising, which includes a $656 million entitlement offer and an institutional placement of $98 million.

A renouncable rights issue means Arrium can focus a bulk of the raising on existing shareholders, who can either take up their rights, sell them on market or renounce them and get paid through a bookbuild.

This is a fairer system for retail shareholders, which is important in this case as Arrium's shareholder base is made up of 60 per cent of institutions and 40 per cent retail.

This is a hangover from the BHP demerger, which meant it started life with a large register.

But a key motivator in the structure was to attract new investors who may find it safe to go back into the water now that the debt is being paid down.

While the board has acted responsibly to deal with the threat of a further decline in iron ore prices, the rationale for such a massive raising still has many investors scratching their heads.

The spin is that the raising is a continuation of chief executive Andrew Roberts' strategy to reduce the company's debt which he has been doing although not on the scale of Monday's announcement.

But Roberts, who inherited the job from Geoff Plummer last July, did not see this coming when he delivered a solid set of annual results last month.

It was not just the price drop alone that led to the decision. Roberts says the negative market sentiment, the collapse of Western Desert Resources a week ago, and commentary from the majors also contributed.

He says the decision to pay out $40 million in dividends, which is arguably small compared to the size of the raising, was made in the context of a record year when Arrium doubled the size of its business and iron ore prices trading sideways from June 30 to mid-August.

It is easy to argue that with the benefit of hindsight, Arrium should have repaired its balance sheet earlier – a lesson many companies learnt the hard way in the global financial crisis.

But this is something that would not have been playing on the board's mind when iron ore was trading above US$100 a tonne and the business was making significant free cashflow.

When the price deteriorated over the past three weeks, the board was advised to take a long-term approach to the problem rather than trying to predict where iron ore prices might go. It is understood there was no pressure from Arrium's banks but enough people in the company were spooked that it would be caught out if prices kept falling.

The board looked at other options but selling a major asset for a fair price would be difficult in the current environment.

The board also needed a solution quickly and in a way that it could control. This is not unlike the approach BHP Billiton chief Andrew Mackenzie took with his decision to spin out half the mining giant's assets rather than opting for asset sales in a tough market.

While there is rationality in Arrium's approach, no-one can accuse it of being prepared for a rainy day.

Some analysts have been warning this could happen for some time.

Deutsche Bank said in June that a drop in the iron ore price to $US75 would require Arrium to raise equity, Western Desert Resources has been the most high-profile victim of the **iron ore** price implosion after falling into receivership a week a go. More are expected to follow.

A string of **iron ore** players have break-even prices about US$83 a tonne and look vulnerable, according to analysts.

Rio Tinto, BHP Billiton and Fortescue, meanwhile, are continuing to ramp up supply.

The raising is not the kind of swan song Smedley envisaged as he prepares to hand over the job to Jerry Maycock in November.

There will inevitably be comparisons to the $1.2 **billion** takeover bid from Korean steel group Posco which Smedley rejected in October 2012.

With the benefit of hindsight that now looks like a bad move but shareholders would never have supported the bid at the time, particularly when **iron ore** prices were healthier than they are now.

While the consensus of analyst forecasts point to a price recovery, Roberts says one or two things still need to change before prices come down. This includes tight credit conditions in **China** and deeper discounts for lower grade **ore**.

Arrium's decision to swap debut for **equity** does give it some headroom around its covenants and should insulate it against further price deterioration.

This will be helped by further cost reductions and a strong **mining** consumables business.

But there is no hiding the fact this is not an ideal situation and a sign of more bad news to come for others leveraged to the **iron ore** price.

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Matthew Stevens is away

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