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Iron Ore Remains Close

To Fortescue Metals' Core

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The thing with commodity companies is that the commodity often matters more than the company.

Investors should remember this about Fortescue Metals Group, the world's fourth-largest exporter of iron ore. On Wednesday, the Australian miner showcased an impressive performance in cutting costs and paying down debt during the fiscal year that ended in June. It raised its dividends to 21% of its profit and even guided toward a payout ratio of 30% to 40% soon. Its shares are up 15% since hitting their lowest point this year in June.

But unlike bigger peers BHP Billiton and Rio Tinto, Fortescue mines only iron ore, making it more a bet on this commodity than anything else. The price of high-quality ore with 62% iron content has plunged 31% this year, according to the Steel Index, a Platts pricing unit. And it should stay weak as China's housing market sputters. Miners aren't helping by adding to supply, either.

Worse, Fortescue mines lower-grade ore that it sells for about a 15% discount to the higher-quality stuff. Though the company thinks this level of discount may hold, it is possible Chinese steel mills will turn away from Fortescue's grades to the suddenly cheaper higher-quality ore.

That means the price Fortescue's iron ore fetches may fall faster than it can cut costs. The company's margin for operating profit has already been squeezed to $35 a metric ton between January and June, from $53 a year earlier. In 2011, it boasted a $74 margin.

Fortescue did generate record free cash flow in absolute terms last year by ramping up volumes and lowering capital investments. Yet the amount of spare cash will fall over the next two years, estimates CLSA's David Radclyffe, mostly because he figures iron-ore prices will tumble and hurt margins.

The miner's handle on costs and debt may be a fillip for its bondholders, proof that the fears swirling in the market a few months ago that debt would have to be restructured were overblown. For shareholders, however, Fortescue might have to think twice about boosting its dividend should iron ore's slide continue. This commodity very much remains at Fortescue's core.

-- Abheek Bhattacharya

Youku's Trouble Is Alibaba's

Alibaba's entertainment investments are creating an awful lot of static.

After it disclosed possible accounting issues last week at its recently acquired film studio, news came Wednesday that Alibaba's big bet on streaming video has stumbled out of the gate. Streaming site Youku Tudou, in which Alibaba made a $1.1 billion minority investment earlier this year, reported a net loss much wider than expected for the three months to June, sending shares down 8% in after-hours trading. Youku shares were already 30% below the premium price that Alibaba paid.

The basic problem with Youku is that its business model doesn't seem to make money. It hasn't turned an annual profit since listing in 2010. Its rival, Tudou Holdings, also was unprofitable until the two companies merged in 2012.

A simple comparison with online video sites in the U.S. helps explain why. Google's YouTube gets content free and earns revenue from advertising. Netflix pays for professional content or produces its own, but charges a subscription fee.

Youku and its **Chinese** peers, such as those owned by Tencent and Baidu, are the worst of both. They combine expensive licensed and original programming, plus some user content, and stream it all free, relying almost entirely on ads to earn revenue.

Competition among the **Chinese** streaming sites is stiff as they scrape for finite ad dollars while outbidding each other for content. In the three months to June, Youku's content costs were equivalent to 44% of revenue, up from 40% a year earlier. Investors who might overlook the lack of profits will find little solace from declining revenue growth: Revenue was up 27% from a year earlier, compared with 36% growth in the previous quarter and 42% in the fourth quarter of 2013.

Youku executives say its tie-up with Alibaba gives it access to a huge data set on online shoppers that will help to better target ads. While that should improve advertising performance, it hardly seems like a game changer.

Separately, Alibaba is working on a fundamentally new way to approach entertainment in **China**, namely getting people to pay for content. Though the full strategy remains hazy, it involves a set-top box, content produced at its movie studio, and premium paid content. How Alibaba's Youku**stake** fits into this plan is unclear.

While prepping for what could be the biggest initial public offering in U.S. history, Alibaba looks to have paid a handsome premium for a problematic business. To make this investment work, it may need to transform the entire entertainment landscape in **China**.

-- Aaron Back

Glencore Chief Mines a Buyback

Ivan Glasenberg was out to prove a point. The chief executive of Glencore Wednesday became the first boss of a major **mining company** this year to hand money back to shareholders, announcing plans for a $1 **billion** share buyback on top of the $640 **million** spent repurchasing convertible **bonds** in the first half of the year.

The increased returns to investors, after the $6.5 **billion sale** of **copper** mine Las Bambas, is the proof to Mr. Glasenberg's well-advertised philosophy: that Glencore, with its owner-managers, would resist the grandiose growth projects that unseated other miners. Instead, it would invest only where it saw good returns and not hesitate to return excess cash to shareholders.

That isn't the only area where Mr. Glasenberg can claim some vindication.

Glencore's business is largely performing as promised, helping underpin its suggestion the shareholder payout isn't merely a one-off. Operating profit in Glencore's industrial **operations**, its **mining** and upstream **energy** business, rose 6% as volume growth and cost savings outweighed falling commodities prices and exchange-rate moves.

Capital spending is falling, down 32% on the first half of 2013. That will rise slightly in the second half, when Glencore will also have to deliver the bulk of its annual volume. But the **company** is on track to reduce industrial investment from its guided $8.7 **billion** this year to a maintenance run rate of about $3.5 **billion** by the end of 2015, giving a substantial boost to free cash flow.

Meanwhile, Glencore is winning the argument over its trading business. Dismissed as a black box with a volatile and speculative earnings stream, the marketing unit has actually been a pretty consistent performer through the cycle. First-half operating profit rose 27%.

It isn't all sunshine in Zug, though. The buyback equates to only 1.3% of Glencore's GBP 48 **billion** ($80 **billion**) market value, less than some expected. Glencore isn't immune to project problems either. The Koniambo nickel mine, acquired as part of the Xstrata deal, will ramp up more slowly and cost more than expected.

And the old worries remain. At 13.7 times Jefferies's forecast 2015 earnings, Glencore trades 12% above the sector. It operates in risky jurisdictions and Glencore's debt is much higher than its peers'.

Meanwhile, the **company**'s aversion to spending internally risks underinvesting in assets and creates a reliance on deal-making for future growth.

But Glencore is a bet on its management team's ability to recycle capital in a smart way. Now, at least, investors can be more confident some of that will come cycling back to them.

-- Helen Thomas

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