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HD **Reality check pushes producer to repair balance sheet and cut costs**

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REALITY CHECK FOR ARRIUM AS FALLING ORE PRICES HURT

IF it wasn't apparent already, the bear case for iron ore is now overwhelming after yesterday's move by mining and steel group Arrium to tap shareholders for $754 million in a deeply discounted capital raising.

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With prices now at their lowest level in five years and no let-up in discounting, particularly for lower-grade ores, it was time for a dose of realism from chief executive Andrew Roberts and his board, given that Arrium sits uncomfortably high on the industry cost curve at a cash cost of $US73 a tonne, or $US84 a tonne total cost of production.

Over the past month, as global sentiment around the commodity deteriorated, the rate of decline in prices has picked up worryingly.

The Peter Smedley-chaired Arrium board clearly became engaged as the spot price headed south to its present level of $US82 a tonne, at which the company's key iron ore business is break-even at best.

Roberts, though, has no intention of standing still. Last year's $45m cost-cutting program, which was mainly focused on steel, will now be extended into mining, targeting a further $60m-$90m in annualised benefits.

The objective is to slash Arrium's cash cost of production to the mid-to-high $60-a-tonne range, which is still well ahead of the super-efficient industry behemoths BHP Billiton ($US50 a tonne) and Rio Tinto ($US45 a tonne).

Arrium's problems have been compounded by a balance sheet that remains stretched from its expansion projects, including the $US932m purchase of the Moly-Cop mining consumables business in late 2010, as well as a $600m-plus investment in doubling its iron ore export capacity to 13m tonnes a year.

At June 30, some progress had been made on debt reduction but borrowings were still way too high at $1.7 billion.

While Arrium's gearing ratio of 31.4 per cent was well within the group's 50 per cent-plus banking covenant, its debt load was almost double its market capitalisation, placing it outside investment mandates for a range of institutions.

To haul itself back into calculations, the company had to increase earnings or lower debt. Or both.

Arrium has clearly chosen the latter path — net debt will be slashed to $976m for a manageable gearing ratio of 17.9 per cent.

As a result, the company would be toiling less for its bankers and more for its shareholders, with interest costs to be slashed by $20m, and hopefully some of yesterday's announced cost cuts would fall to the bottom line assuming iron ore prices behave themselves.

Less than a month ago, at Arrium's annual result, Roberts backed Brazilian producer Vale's assessment that prices would settle in a range of $US90-$US120 a tonne, albeit with the potential to go higher and lower in the short-term.

Since then, prices have slumped from $US95 a tonne to $US82 a tonne amid collapsing sentiment, mostly driven by the iron ore market going into oversupply in the past year.

As more capacity has come on-stream, the problem has been compounded by China's slowing economy, with many of the country's steelmakers struggling to sell their product.

UBS analysts say that, at current prices, about 25 per cent of the iron ore industry is now at break-even or making losses.

Last week, former senior BHP Billiton senior executive Alberto Calderon warned of a permanent fall in prices as growth in the Chinese economy became increasingly driven by private consumption rather than investment. Calderon predicted that prices for the nation's biggest export could revert to its marginal cost, and even overshoot to the low $US70-a-tonne range for "some years".

Earlier this month, BHP Billiton boss Andrew Mackenzie said there was a chance of upside in metallurgical coal in the medium-term, "but not in iron ore".

These are testing times for the industry, and the bear case is worsened when it's considered that the substantial decline in prices has been in the face of reasonably steady Chinese demand, meaning that supply problems — not demand — have so far been at fault.

Optimists point to consensus broker forecasts of $US104 a tonne of iron ore, and say that part of the current price malaise is seasonal.

But no one needs any reminding that the bear case, if realised, will have a significant spillover effect on the wider economy.

JPMorgan forecast yesterday that if iron ore prices reach $US70 a tonne by the middle of next year, the terms of trade could fall by a further 10 per cent, with nominal GDP growth easing to 2.6-2.7 per cent and unemployment spiking to 6.7-6.8 per cent.

Bank disclosure EVERY year, the major banks each spend several hundred million dollars pumping out lengthy product disclosure statements that are barely read, if at all, before customers junk them in the recycling bin.

It's a massive waste of resources, given the whole purpose of the exercise is to protect the customer through stringent disclosure.

While there are good intentions behind the tough regime, which came out of the Wallis financial system review, current inquiry head David Murray declared on the release of his interim report that disclosure had not lived up to its lofty ambition.

In short, it had failed, and other options should now be investigated. Instead of accepting Murray's bleak assessment, ANZ Bank and the Consumer Action Law Centre (CALC) yesterday combined to produce a joint submission to the inquiry that calls for improved disclosure through such initiatives as plain English drafting, key fact sheets and electronic delivery of existing information.

It's a unique partnership for the CALC — never before has it joined with the traditional enemy, a major bank, to lodge a submission to a major inquiry.

CALC chief executive Gerard Brody reckons there's an opportunity to get disclosure right, which would benefit the industry as well as consumers.

Brody thinks, as well, that commonsense and timely disclosure, along with other reforms like suitability requirements for the sale and distribution of financial products, could have made a meaningful contribution to avoiding the Commonwealth Financial Planning debacle.

The CALC wants Murray to attack the root causes of the malaise, including a raft of prescriptive legislation about the contents of product disclosure statements, and an overly legalistic approach by the banks to compliance. Here's hoping the other banks get on board.John Durie is on leave and returns next week

CO	bkhlp : BHP Billiton Ltd | bltplc : BHP Billiton PLC
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