BHP, Rio Tinto still at risk from China crisis; Iron ore

Australian Financial Review
August 22, 2024 Thursday
Print & First Editions

Section: MARKET WRAP; Pg. 27

Length: 701 words

Byline: Alex Gluyas

Body

Analysts are warning investors against jumping back into the beaten-up mining giants, given Beijing is offering little hope of stabilising China's property crisis, presenting a continuing headwind for commodity prices.

The red flag from Morningstar comes as iron ore's spot prices hover near a two-year low of about $US95 a tonne. Prices have plunged more than 30 per cent this year as weakness in China's construction activity hurts steel demand, leaving mills unprofitable and unwilling to buy the commodity.

That has whacked the valuations of the sharemarket's largest mining stocks - BHP and Rio Tinto are down about 20 per cent this year, and ***Fortescue*** has plunged more than 40 per cent.

Although the Chinese government has increased support for its property sector, Morningstar believes much more needs to be done to stabilise the industry and trigger a sustained rebound in mining shares.

"The price falls are justified in our view and are a rational reaction to demand headwinds from China. All three miners were overvalued. They are now fairly valued," said Morningstar equity analyst Jon Mills.

"There is little for an investor to do but hope for a turnaround in China. We think that is unlikely."

The bearish outlook chimes with that of the hedge fund industry, which has been targeting iron ore stocks. Short positions in Rio Tinto are sitting at the highest level in at least three years and bets against Mineral Resources have hit a record.

It's also been fuelled by a wave of short-sellers in Asia pulling money out of poor-performing Chinese equities and redirecting the funds into targeting Australian mining stocks.

"Asian hedge funds have been aggressively shorting Australian resource stocks as a proxy for what they expect to see from China - weak growth," said Bell Potter strategist Richard Coppleson.

Analysts also agree that ***Fortescue*** is the most vulnerable to lower iron ore prices, given it is a pure-play producer and its margins sit well below rivals BHP and Rio Tinto. That is partly because ***Fortescue*** sells a lower-grade product compared with the 62 per cent iron ore benchmark. This means it costs more for customers because of the waste created when transporting and processing the ore, the additional energy/coal per unit of steel, and lower blast furnace productivity.

This results in a lower realised price compared with the benchmark. In the 10 years to June, ***Fortescue*** realised a 23 per cent discount compared with the benchmark price.

While the eventual ramp-up of ***Fortescue***'s higher-grade Iron Bridge joint venture will help, Morningstar warns that the company's margins will fall more than its rivals if iron ore prices continue to decline.

However, not everyone agrees. Some fund managers - including Ellerston Capital's Chris Kourtis - and brokers are turning bullish on ***Fortescue***, citing its low share price as an attractive entry point for investors. Morningstar has also flagged the risk from BHP's exposure to the Chinese economy, given the mining giant's earnings are dominated by iron ore and copper.

"With demand for many commodities likely to soften as the China boom ends, particularly iron ore... we think the outlook is for earnings to materially decline," Mr Mills said.

BHP is regarded as the most resilient to weaker iron ore prices because of its low-cost and high-quality assets, making it one of the few miners that remains profitable through the commodity cycle.

It's why UBS has nominated it as the best option for investors amid weaker prices, but it also warns that the stock's price-to-earnings ratio is trading up towards its long-term average.

"On a historical basis, BHP does not appear to be especially cheap currently," said UBS analyst Lachlan Shaw, who has a "neutral" rating on the stock.

The broker has the same recommendation for Rio Tinto, and notes that both companies will derive about 30 to 40 per cent of their earnings outside iron ore in the next two years.

The share prices of both closely follow the iron ore price, given it is the core driver of earnings - a trend UBS expects to continue until that equation changes.

That could spell further trouble for both stocks - some analysts predict that iron ore prices will drop below $US90 a tonne.

Load-Date: August 24, 2024