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Just a stumble

Shares of Cleveland-Cliffs, Inc. (CLF on the Big Board) have slumped by 25%, to $7.32, since an upbeat June 28 analysis in these very pages. They have fallen by 35% since their peak in July. We write to acknowledge our hapless timing but to reiterate our bullish judgment.

Cliffs, you'll recall, mines iron ore, converts that ore into pellets and sells those pellets to Midwestern steel mills. It generates free cash flow, pays a qualified dividend (now at the rate of 3.3% a year) and is building a next-generation plant to produce something called HBI, for "hot-briquetted iron." HBI is a feedstock for electric-arc steelmakers like Nucor Corp.

Cliffs was on the bargain counter in June, we contended, trading as it did at 5.6 times estimated 2019 earnings, or 5.9 times enterprise value to earnings before interest, taxes, depreciation and amortization. The single-B-rated Cliffs 6¼s of 2040 changed hands at 87⅛ for a yield-to-worst of 7.5%. The earliest bond maturity was (and remains) 2024.

When we published in June, about 10% of the Cliffs free float was sold short (excluding the number of shares sold to hedge the company's convertible bonds). Today, that figure is 27.6%.

The bears are not mistaken that worldwide manufacturing weakness has pulled the rug out from under steel prices or that Vale S.A., the giant Brazilian iron-ore producer, has similarly upended pellet prices. A relaxation of Chinese environmental restrictions and the persistence of the Sino-American trade dispute have also cast shade.

Then, again, these difficulties are likely to prove cyclical, and they are hardly unknown. The S&P Metals and Mining index is more deeply discounted from the S&P 500 today than it was even during the 2008–09 financial crisis (based on enterprise value to forward Ebitda, a 47% discount vs. a 35% average discount during that period, according to Morgan Stanley).

Long-term buyers of Cliffs iron pellets pay prices keyed off three factors, none of which is on the upswing: the price of iron ore, the price of pellets as a premium over the ore price and domestic U.S. steel prices.

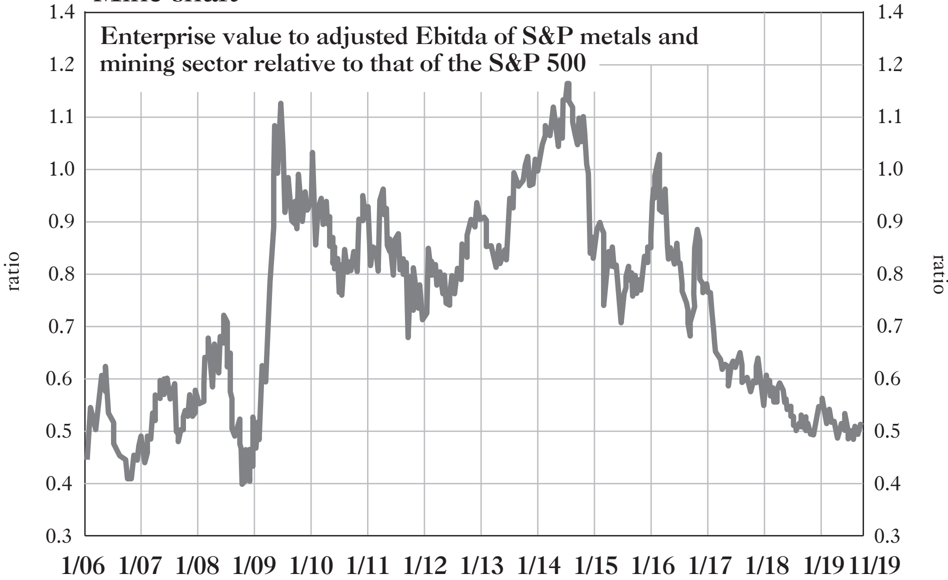
From $120 a ton in July, the cost of ore has plunged into the $80s. President Trump and President-Until-Further-Notice Xi share some of the blame (or credit, depending on how you're positioned), as do whatever or whoever is behind the recessionary tendencies in Europe. Then, too, as the fatal collapse of Vale's earthen dam in January served to lift iron-ore prices, so the economic, if not the human, recovery from that catastrophe has served to reduce them.

The pellet premium to the ore price has similarly dropped, to $35 from $70, and here again, Vale has played its role. For one thing, the Brazilian giant unilaterally extended price relief to its struggling European steel-making customers. For another, it rejiggered its pellet-pricing formula in such a way as to depress the premium of pellets to ore. As for domestic American steel prices, they're quoted at $540 a ton,

After the fall

source: The Bloomberg

Mine shaft



sources: The Bloomberg, Morgan Stanley Research

40% below the $940 they fetched in July 2018.

No surprise then, that the prices of seaborne irregular little iron balls have plunged by 30% to $120 a ton, from $170 in June.

"Steel prices and pellet premiums are at levels where a lot of producers who make those products aren't making money," Paul Finan, director of investor relations at Cleveland-Cliffs, tells colleague Fabiano Santin. "There would have to be correction in prices or supply curtailments—if we have to wait until curtailments, then so be it, but there is the expectation that there will ultimately be a recovery."

On that score, Vale has lowered its guidance for pellet production by 25%, to 45 million tons in 2019 from 60 million tons prior to the Brumadinho dam collapse. Neither is that revision surprising, given Europe's position as the world's top pellet market and Germany's waning industrial production (off by 4.3% in September, the 11th straight month of decline).

But the long-term bullish case for Cleveland-Cliffs rests not only on a short-term manufacturing recovery, but also on the spread of the green gospel. What makes China's steel so price-competitive is also what makes China's air so unbreathable. A contributing cause to each is the Chinese steel makers' reliance on sinter plants into which they shovel low-grade iron ore rather than clean pellets or even cleaner hot-briquetted iron.

Once its HBI plant hits nameplate capacity in January 2021, Cleveland-Cliffs is expected to generate free cash flow equal to Ebitda minus $220 million ($100 million in maintenance capital expenditures plus $120 million in interest expense). The company's large net operating losses, a legacy of the pyramid-building former front office, mean a long reprieve from the obligation to pay corporate income taxes.

Alert readers will spot the weasel-worded phrase "is expected to generate" in the preceding paragraph. Is expected by whom? By the company, in fact, which is in a better position to know than the Street or even this periodical. And if the sell-side estimates are on the beam, Cliffs will generate $543 million in adjusted Ebitda this year (down from about $750 million in June), translating into $323 million in free cash flow—or would except for the heavy capex required to complete the new HBI plant.

"For reference," Santin notes, "if we assume that Cliffs might be charging about $260 a ton for briquettes, equal to the current average price of pig iron and scrap, and $170 a ton in production cost, the company would be netting $90 a ton in HBI profits for a $171 million contribution to adjusted Ebitda—and an equal amount to free cash flow. This would be nearly a third above this year's adjusted Ebitda.

"In a more normalized world, where Cleveland-Cliffs realizes pellet sales at $100 a ton and HBI at $400 a ton," Santin proceeds, "the company would be generating $1 billion in annual adjusted Ebitda, or $780 million in free cash flow. Thus, after adding pension liabilities to debt, tax refund receivables to cash, the enterprise would be trading at 4.1 times adjusted Ebitda, or five times free cash flow."

At six cents per share per quarter, the 24 cents-per-annum Cliffs dividend delivers the afore-quoted qualified 3.3% yield. The distribution is a fraction of the $1.10 in GAAP earnings per share that the Street expects Cliffs to realize

Heavy metals

source: The Bloomberg

in 2019, or the $0.77 next year, before the projected return of stronger profitability; $1.23 is the sell-side call for 2021 (which indicates a stock trading at 5.9 times that year's earnings).

In the light of earnings, the dividend is more than sustainable, but can it justify an investor's decision to sit still through what could prove a drawn-out down cycle? To match the qualified 3.3% rate, a New York-based shareholder needs a fixed-income pretax equivalent yield of 5.4% (based on a 53.5% marginal tax rate). Compare with the 4.7% dividend available on the iShares iBoxx $ High Yield Corporate Bond ETF, for instance.

High-frequency traders may (or, come to think of it, may not) find comfort in historical precedent. When the U.S. PMI falls below 48, as it did in September (47.8), Morgan Stanley observes, the S&P metals and mining sector has tended to outperform the S&P 500 by an average of 12 percentage points in the following year if a recession materializes, or by 96 percentage points if it doesn't.

Past may or may not be prologue, but insiders, since July, have bought more than $600,000 worth of stock, with CFO Keith Koci leading the way in the sum of $352,700. Koci joined the company in February—he had worked with CEO Lourenco Goncalves at Metals USA Holdings Corp. from 2003 to 2013—and has invested more than $540,000 in CLF. Not a king's ransom, to be sure, but consider what it would imply if Koci were a seller of the same amount.

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