Small-and-mid cap iron ore firms hit most in Australia's metal & energy sector downturn

by Victor Liu

After enjoying more than a two-decade strong economic growth, China has aimed to switch from an investment-led economy to a consumption-led one, which has held back the country's fixed asset investment and weighed on its economic growth. In 2014, China's annual GDP growth went down to 7.4%, which is the slowest pace in the past two decades. According to IMF, things could get worse as it expects the growth rate to decline to 6.8% in 2015 and 6.3% in 2016. As Australia's biggest trading partner, China purchased nearly a third of the country's exports, most of which are metals, coal and natural gas. The investment and economic slowdown of China resulted in withering demand for resources, such as metals and energy, from Australia. The falling demand for metals and energy has caused the commodity prices to plummet and, in turn, has hurt Australia's metal and energy industry. Figure 1 illustrates that both the metal and energy index in Australia has dropped, while China fixed assets investment growth has slowed down since the end of 2013.

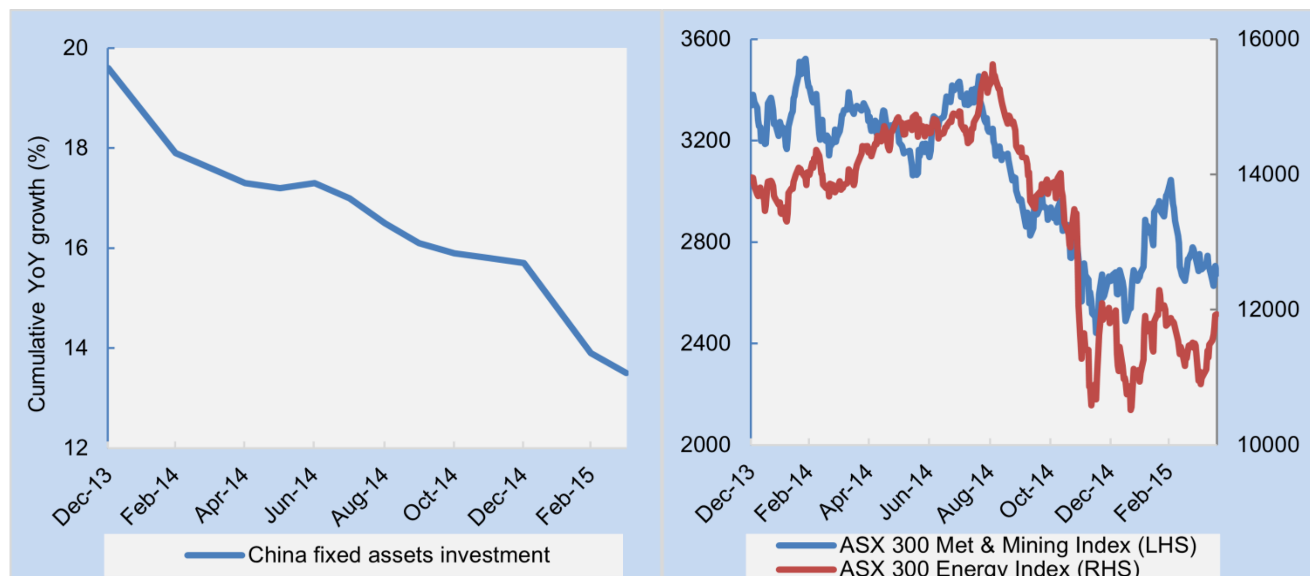

Figure 1: China fixed assets investment YoY growth and Australia's metal mining & energy indexes. *Source: Bloomberg*

The downturn of Australia's metal and energy sectors was also reflected in the RMI Probability of Default (PD). As shown in Figure 2, the RMI aggregate 1-year PD for Australia's basic material sector increased to 18bps on Apr 17, 2015 from 15bps at the end of 2013, while the aggregate 1-year PD for Australia's energy sector rose to 26bps from 13bps in the same period.

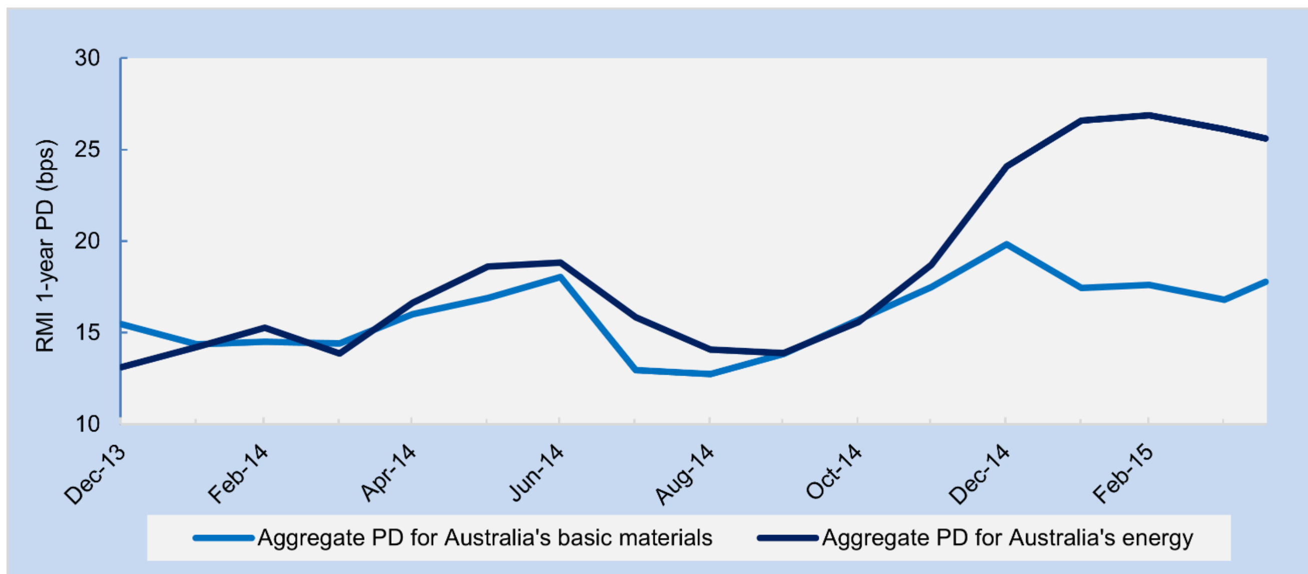

Figure 2: RMI aggregate 1-year PDs for Australia's basic materials and energy sectors. *Source: Risk Management Institute*

The price slump of iron ore, which accounts for the largest proportion (20%) of Australia's exports, mainly due to the lower demand from China, has cast a shadow on Australia's iron ore industry. As Figure 3 shows, the spot price of iron ore has dropped nearly 60% since the beginning of 2014. It is noticeable that while the RMI aggregate 1-year PD of the top 3 iron ore miners, a simple median of the 3 firms, remained flat, the RMI aggregate 1-year PD of the other players, which is a simple median of all iron ore miners but the top 3, soared high from 8bps to 113bps.

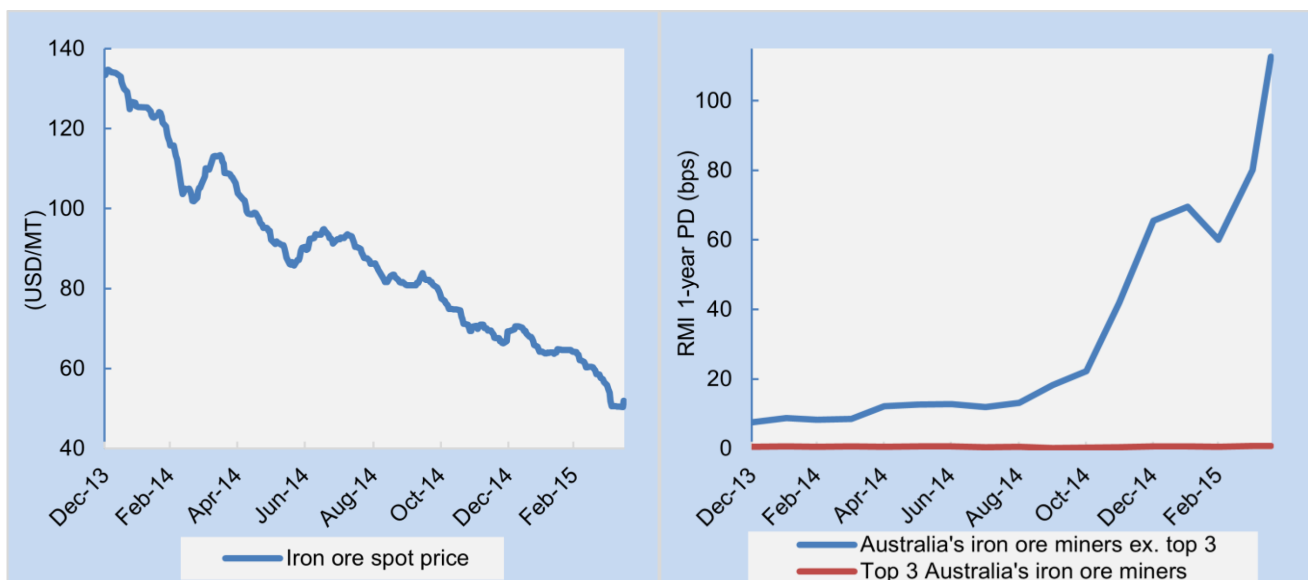

Figure 3: Iron ore price and RMI aggregate 1-year PDs for Australia's iron ore miners. *Source: Risk Management Institute, Bloomberg*

The divergence of the two PD patterns reveals that the top three players suffered less than the other smaller peers as they implemented a last-man-standing strategy. Benefiting from economies of scale, big iron ore miners' production costs are much lower than the small ones. Therefore, despite the iron ore price slump, the top 3 firms didn't stop pumping new supply, which made the price drop further and threatened the survival of small firms with higher production costs. Table 1 highlights the vulnerability of smaller iron ore miners. Although BHP Billiton and Fortescue Metals saw a drop in profitability in 1H 2015, the net income margin for the top 3 players still remained positive. By contrast, the other smaller players have experienced significantly negative net income margins, signaling that these companies might have trouble in their profitability and credit profiles.

	FY 2014 1H (Jul – Dec)	FY 2015 1H (Jul – Dec)
BHP Billiton	24%	14%
Rio Tinto	7%	9%
Fortescue Metals	29%	7%
Iron ore miners ex. Top 3	10%	-121%

Table 1: Net income margin for top 3 iron ore miners and the median of net income margin for other players. Source: *Bloomberg*

Although the top three iron ore miners have recently been downgraded or placed on negative watch by rating agencies, it is the other smaller iron ore miners that the investors should pay more attention to, as the current iron ore price has already undermined those companies' profitability. If the commodity price continues to slide, the lack of profitability might jeopardize the small iron ore miners' debt-paying ability and some default events might even occur.

Credit News

Dollar's rise casts shadow on US earnings

Apr 19. A strengthening dollar is expected to hit some of the largest US multinationals this week, as more than a fifth of S&P 500 companies report results for a quarter marked by a 9% jump in their domestic currency. Currency swings are affecting a wide range of blue-chip behemoths as IBM, General Motors, United Technologies, Coca-Cola and McDonald's are among those set to release earnings by Friday. (FT)

China makes cut in bank reserve ratio to fight slowdown

Apr 19. On Sunday, China's central bank cut the reserve requirement ratio for all banks by 100bps to 18.5%, the second industry-wide cut in two months, adding more liquidity to the world's second-largest economy to help spur bank lending and combat slowing growth. Though the Chinese growth in the first quarter met the official target of around 7%, the slowdown in several areas, including industrial output and retail sales, has caused concern for the government. (Reuters)

China growth lowest since 2009 as property and manufacturing drag

Apr 15. China's economy expanded at its slowest pace in six years in the first quarter, held back by a slowdown in construction and manufacturing as the government seeks to re-engineer the country's growth model. China's gross domestic product grew 7% YoY in the first three months of 2015- the weakest quarterly expansion since the depths of the global financial crisis in 2009. Fixed-asset investment- which includes spending on infrastructure, factory equipment and property construction- grew at a 14-year low of 13.5% in the year to March. (FT)

Japan poised to overtake China as America's biggest creditor

Apr 15. Japan is set to overtake China as America's largest foreign creditor as the Bank of Japan's latest attempt to end two decades of economic stagnation prompts investors to eke out any returns they can. While China cut its investment in US government securities for a fifth month in January, Japan added USD 7.7bn, narrowing the gap to USD 1bn. (Bloomberg)

Singapore forgoes adding stimulus as growth exceeds forecast (Bloomberg)

Goldman: These iron ore producers may get shafted (CNBC)

Regulatory Updates

China may take cue from Europe to free up more credit

Apr 20. The People's Bank of China is considering allowing Chinese banks to swap local government bonds for cash to boost lending and liquidity in its banking system. This is similar to the long-term refinancing operation used by the ECB, which gives banks access to long term loans with the aim of improving lending to specified sectors. Under the LTRO-like program, commercial banks could use purchased local government bonds as collateral for low interest rate, three year loans from the central bank. Implementing the program would mark a major shift in China's money supply policy as it is intended to provide temporary liquidity to Chinese banks at a time when capital inflows into the country is declining. (The Australian)

Fed may allow banks to use muni bonds to meet liquidity rules

Apr 17. The US Federal Reserve is considering changing a regulation set in September 2014 which disallows banks to use municipal debt to satisfy liquidity requirements. The rule was implemented according to Basel III recommendations, which state that large banks have to hold enough high quality assets to fund their operations for 30 days to ride out short term liquidity disruptions. The central bank had excluded municipal debt when approving liquidity rules in September 2014, as part of their intent to strengthen banks against future financial market turmoil. But banks and top lawmakers in Congress warned that such a rule would result in large capital withdrawals out of the municipal bond market and force the US government to cut back spending on infrastructure projects. (Reuters)

FDIC's Thomas Hoenig says banks should meet capital minimum to get regulatory relief

Apr 15. Recent reform measures suggested by US regulators have focused on easing the regulatory burden for large banks and their supporters but FDIC Vice Chairman Thomas Hoenig said that regulatory relief should only be given to low-risk, traditional banks that did not cause the financial crisis in 2008. Lenders that did contribute to the financial meltdown should not receive any relief. Mr Hoenig decided to base any regulatory relief on the banks' complexity and activities, and not rely on the bank's size. Under this criteria, it appears that many of the commercial banks would pass the test, with the exception of a few banks with more than USD 250bn in assets. (WSJ)

Regulators call for short term loan changes to handle 'too-big-to-fail'

Apr 14. Global regulators are asking for a change to terms of contracts in repo agreements, in a bid to prevent a replay of a 'too-big-to-fail' scenario when Lehman Brothers collapsed in 2008. Under the new proposal, firms trading with a distressed financial firm would agree to temporary waivers of contractual rights to terminate their contracts early, so that regulators and the firm would have more time to arrange for a lifeline to the failing institution. Regulators have implemented such changes to the swaps market, where 18 of the largest banks in the world have agreed to wait up to 48 hours before seeking to pull out of their swaps early when a counterparty is failing. (WSJ)

Fed says people with old student loans are struggling to pay them back (Bloomberg)

Fed has 'tools' for smooth rates lift-off (FT)

Published weekly by Risk Management Institute, NUS | Disclaimer
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