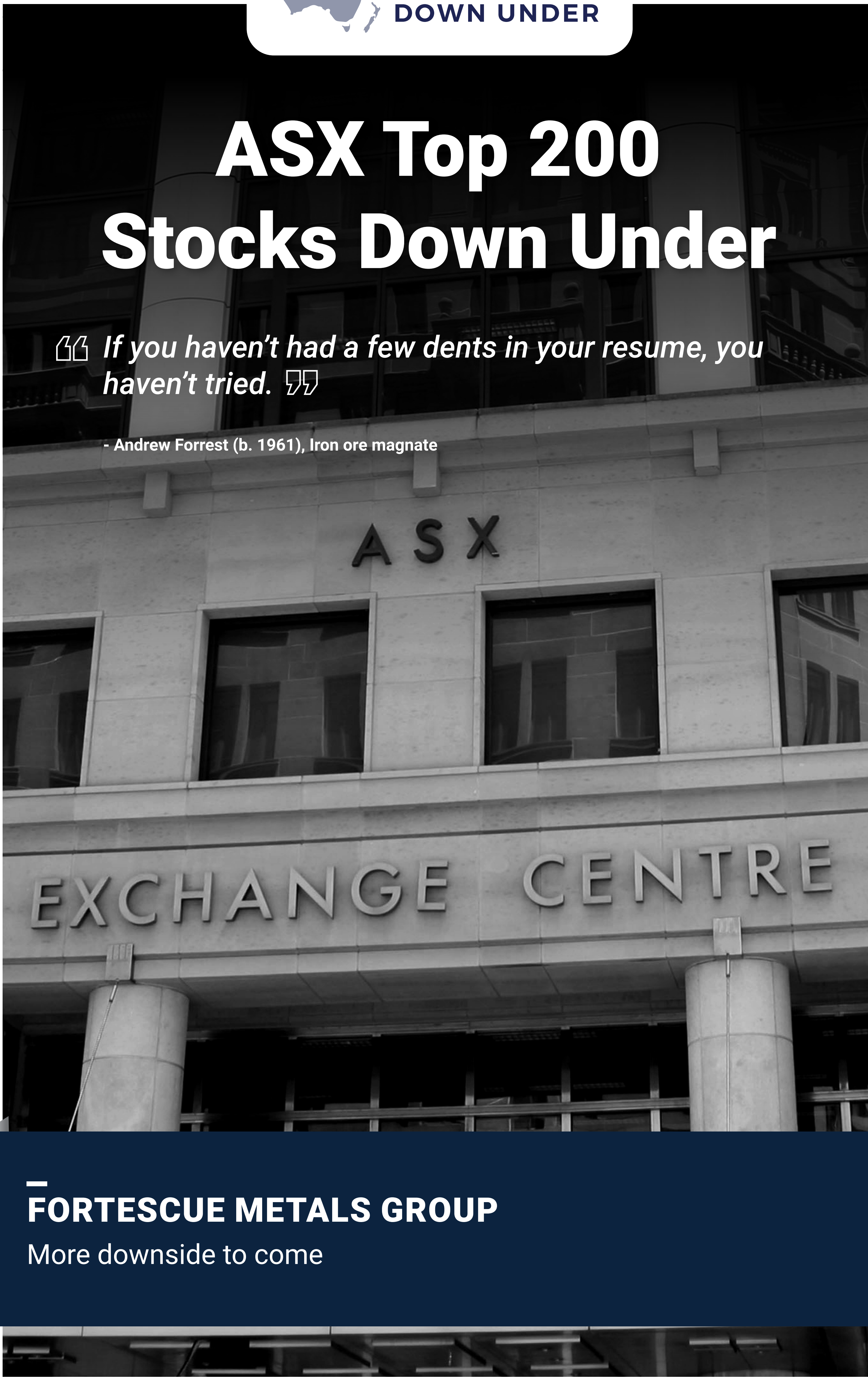
STOCKS DOWN UNDER

26 SEP 2022



ASX Top 200 Stocks Down Under

> *If you haven't had a few dents in your resume, you haven't tried.*
>
> **- Andrew Forrest (b. 1961), Iron ore magnate**

FORTESCUE METALS GROUP

More downside to come

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Stocks Down Under rating: ★★

ASX: FMG
Market cap: A$51.8BN

52-week range: A$13.90 / A$22.99
Share price: A$16.80

Here's another quote by Twiggy. 'You remove the heavy metals out of the ground and you turn that into tables, and houses and bridges and dreams for people in the developing world - I love doing that'. That is the perfect summation of Fortescue's business model. With its shares down over 30% from all-time highs reached in July 2021, you might think the dip presents a buying opportunity. But with declining revenue and earnings forecasts for the next few years, along with an uncertain state of relations between Australia and Fortescue's biggest customer (China), we don't think it is. As impressive as its dividend yield was last year, we don't think it can be maintained.

Share price chart

Source: Tradingview

A solid history and a bright future?

Fortescue Metals Group is one of the world's largest iron ore producers and is led by one of Australia's most prominent businessmen in Andrew 'Twiggy' Forrest. Fortescue began in 2003 when Forrest consolidated Pilbara iron ore assets that he already owned into one entity. He also departed his first big venture, Anaconda Nickel, when it came close to collapse. Over the next few years, FMG built railways, port and mines in the Pilbara, just in time for a major iron ore boom that began in the GFC and peaked in 2011. Forrest is still chairman, but has handed CEO duties over to Elizabeth Gaines to give himself more time to focus on philanthropy and his other ventures.

The next iron ore boom began with the COVID-19 pandemic thanks to government stimulus, including in China. In FY21, Fortescue produced 182m tonnes of iron ore and a US$10bn net profit after tax. Obviously, demand was high, but so was pricing – iron ore prices hit record highs at over US$200 per tonne.

In FY22, Fortescue made the 2nd highest net profit in its history, at US$6.2bn off the back of US$17.4bn in revenue and $10.6bn in underlying EBITDA. These figures were down 40%, 22% and 36% from FY21. From an operational performance, it was roughly the same as FY21 with 228.8m wmt (wet metric tonnes) mined and 189m wmt shipped. It paid a dividend of $2.07 per share, marking an impressive 12.5% yield.

A greener future?

Also appetizing for shareholders were the company's ambitions to enter the hydrogen space in the years ahead. This could not only be an additional source of income, but also help power Fortescue's remote operations. While hydrogen production is some time away, the company has acted on its dreams. It founded a parent company Fortescue Future Industries to build a portfolio and it invested an initial US$650m in a new Green Energy Manufacturing Centre (GEM) in Queensland.

It hopes to produce multi-giga-watt-scale electrolysers, with the first rolling off assembly line in "early 2023". On top of that, the company was looking to diversify its iron ore portfolio and is looking at a project in Gabon, called Belinga.

Two big elephants in the room

In the short to medium term, you cannot ignore two big factors that will determine the company's performance: Iron ore prices and China. Iron ore prices have more than halved since 2021 in a period when so many other commodities have gained. Obviously, China is the biggest buyer of iron ore and its COVID-zero policy (combined with its real estate woes given the property sector accounts for 40% of China's iron ore demand) has slowed down steel production and reduced demand for iron ore. Prices are roughly US$95-$100 per tonne at the moment.

While the iron ore companies are saying prices can only going up, analysts disagree. Most recently, Fitch said it expects iron ore prices to average US$100 a tonne in 2023, US$90 a tonne in 2024 and US$80 in 2025. ANZ Research also expects demand to fall as iron ore demand drops, but it is slightly more optimistic on pricing. Inevitably, new iron ore projects (including Rio Tinto's new US$2bn mine in WA, approved earlier this month) will increase the supply and hinder price growth.

Granted, BHP (ASX:BHP) and Rio Tinto (ASX:RIO) face these issues too. But at least these two have other commodities and customers to fall back on while Fortescue does not. The federal government's Resources & Energy Quarterly expects Australia's iron ore exports to rise 2.5% in 2022, then 2.3% in 2023 and 3.6% in 2024. But this will be little consolation if prices are roughly half of what they were in CY21.

Can Fortescue weather the current environment?

For FY23, the company has not given revenue or earnings guidance, but expects 187-192mt in iron ore shipments and US$2.7bn-US$3.1bn in capital expenditure. Looking to consensus estimates for FY23, these are for $15.6bn in revenue and $8.3bn in EBITDA, which would be down 10% and 22% respectively.

Things are not expected to improve in the years ahead with $13.8bn in revenue and $6.9bn in EBITDA for FY24, down 12% and 17% from FY23. In fact, according to consensus estimates, revenues will not begin to grow again until FY27 and EBITDA will still be lower at just $3.4bn. EPS will more than halve from US$2.01 in FY22 to US$0.68 on a GAAP basis by FY27. The company's multiples do look reasonable at first glance - 8x P/E and 4.5x EV/EBITDA for FY23. But we can't justify this for a company with such long-term declines expected for the years ahead.

We do acknowledge that Fortescue's dividend yield for FY22 was impressive, but we think it is unlikely it will be replicated unless revenue and earnings are materially better than the company's expectations and consensus estimates. And that's before you even consider the prospect that it could cut back its dividend payout to fund its hydrogen ambitions.

Two stars.

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