Fortescue Metals Group (FMG AU)

February 25, 2015

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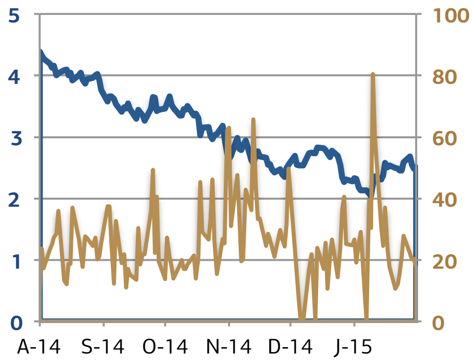
Fortescue Metals Group (FMG AU) one-year share price in AUD (blue) and volume (gold, in mln shares)



Source: Bloomberg, February 25, 2015

Fortescue Metals Group (FMG AU)

Price	AUD 2.48
Rating	**SELL**
Price target	**USD 1.68**
Difference	**15%**
Market Cap	USD 7.7 Bln
Simple Moving Avg.	26.5 Mln
P/E	4.5x

Source: Bloomberg, February 25, 2015

Restructured or Acquired?

– Cash loss when iron ore plunges below USD 55/dmt post CNY

Steel prices have fallen faster than iron ore this year. Steel demand will disapoint post CNY. We expect these factors will combine to make the Platts 62% fe index fall below USD 55/dmt. That is the new break even point for FMG that now claims all in costs are USD 44/dmt. We struggle to believe FMG costs are now that low and do not believe they can move costs any lower this year.

– FMG quality discount to remain high in 2015

FMG discounts to the Platts 62% indes were as high as 16% when prices plunged in April last year. We expect the same to happen again this year and for discounts to average 14% for the year.

– Prepayments now 14% of annual sales volume

H1 FY2015 FMG prepayments hit USD 1.2 billion, up 20% on the half. With falling prices, prepayments now equal 14% of current annual sales volume. As the iron ore market deterioates, we expect these traders that have made these prepayments will no longer roll over these prepayments. Should traders require FMG to deliver against these prepayments then FMG cash reserves will evaporate.

– Valuation: PT USD 1.68 DCF

We hold our price target at USD 1.68. We now think that an acquisition or restructing is inevitable this year.

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Restructured or Acquired?

FMG claims to have reduced all in costs by USD 23/dmt from USD 67/dmt to USD 44/dmt since June 2014. They have been in a desperate cost cutting race to stay ahead of the falling iron ore price.

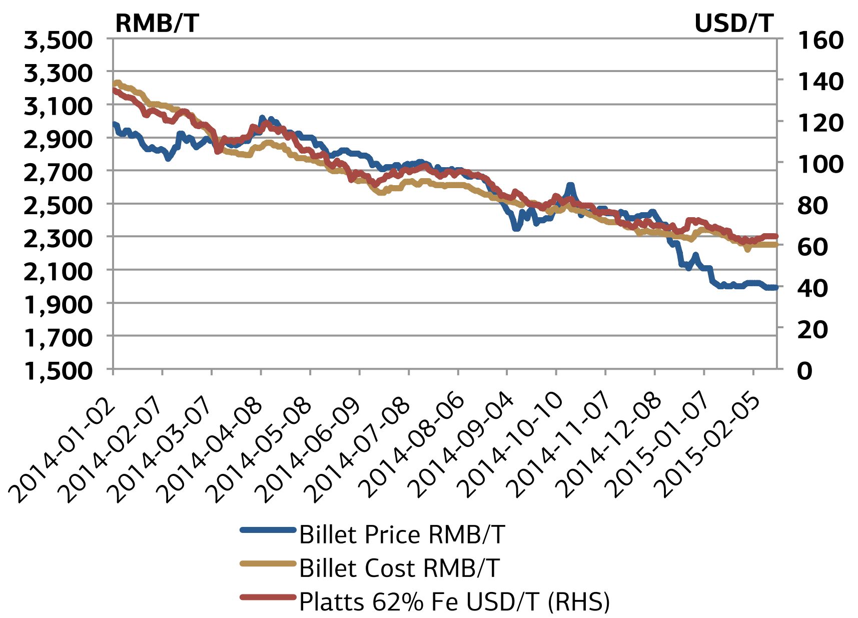
Iron ore prices are about to plunge again to USD 50-55/ton and FMG will no longer be able to reduce costs to keep ahead. FMG will be at or below its cash break-even point at those prices. Although FMG does not have to repay debt until 2017, they may well have to make good on the USD 1.2 bln in prepayments for iron ore well before that date.

Steel mills have negative gross margins now, and demand is weak. Ore prices have to fall.

Iron ore price set to fall sharply in March

We are expecting iron ore spot price to be trading in the range USD 50-55/ton by the end of March due to poor steel demand and high cost of iron ore relative to steel prices. We expect the Chinese government will stimulate the economy in the spring due to the obviously deteriorating economy. We do not believe this will lead to a sustained rally in iron ore prices.

Chart 1. Billet price & cost vs iron ore price



Source: Mysteel, Wind, J Capital

Going into the winter months steel prices have fallen 20% and iron ore prices by only 10%. Steel mills have been restocking since the end of December 2014, which has held iron ore prices higher

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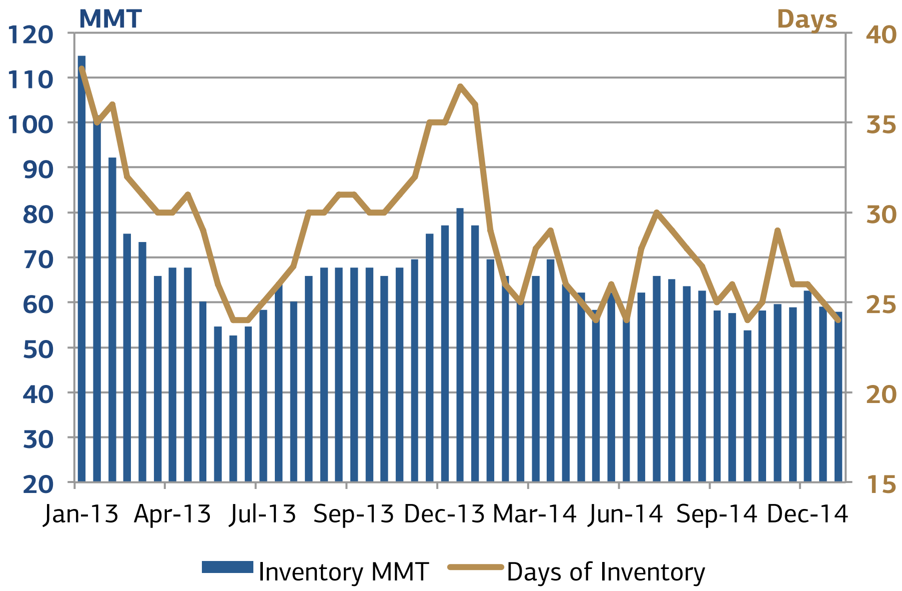
relative to steel prices. Steel mills are now making a loss of RMB 240/t. Steel futures are indicating steel prices may increase by RMB 100/t in March at best. Iron ore prices will need to fall around USD 20/t if steel mills are to reduce loses. Similar circumstances in both 2013 and 2014 saw iron ore prices fall around USD 20/t to bring iron ore prices back into line with falling steel prices when demand disappointed in the March/April period.

Traders have grown very cautious and unwilling to hold inventory. As a result, traders' inventory is low and mill inventory up YoY.

Chart 2. Iron ore inventory at steel mills



Source: Mysteel, J Capital

January and February is a dead zone for data to analyze demand. What we can see at this stage is that steel traders are holding 30% less steel inventory YoY and steel mills around 6% more steel inventory. There has been no fundamental change to the finance environment that steel traders face in these months. We believe they are holding less steel as they expect poor demand and falling prices. Steel mills have already started to slow production.

Iron ore prices will most likely fall throughout 2015 as they did in 2014. Property construction demand for steel will be the key driver of disappointing steel demand all year. We believe Chinese domestic steel demand fell 5% last year and steel production peaked in 2013. Zhang Guanggen, the new Director of the China Iron and Steel Association, also claimed last month that steel production in China had peaked.

Should the government stimulate the economy with loose monetary policy and fiscal stimulus via infrastructure projects we do not see this having a large impact on steel demand. Our view is based on infrastructure demand remaining at very high levels,

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which requires ongoing fiscal stimulus. Core to our view for the drop in demand steel is declining residential property construction. Contraction in new starts in 2014 will lead to lower steel demand from less property under construction in 2015. While monetary stimulus may help property sales, sustained sales growth is required to reduce the excess inventory that will induce a return to growth in new starts. Monetary easing may not halt the collapse of financially challenged property developers. We could still see property developers collapse, which will reduce property under construction. Stimulus may help lift steel prices and spot iron ore prices when they fall, but it will not stop a slide in the iron ore price throughout the year.

On the supply side we estimate that at least 50 MMT (annualized) of new capacity from RIO, BHP, Vale, Anglo American and FMG is coming to market in Q1 2015. Chinese domestic iron ore capacity has barely decreased since April 2014, even though many mines are now loss-making. Discussions with traders indicate that RIO and BHP are having trouble placing new capacity on contract, and we expect more iron ore will be sold on the spot market. Oversupply is a progressive drag on iron ore prices.

FMG discounts will be 50% higher than guidance

FMG is guiding that discounts, on a unit Fe basis, will be in the range 3.5% to 9.5% in 2015. In 2014, the discount ranged between 6-16% and averaged 12%. We estimate that the 2015 FMG realized price will be at a discount to Platt's 62% Fe index price in the range of 11-16% and will average 14%. We estimate that the average achieved price by FMG so far this year is USD 55/ton, at a discount of 11%. Not only has the price of iron ore halved YoY, but the discount has nearly doubled.

Chinese ore production remains high.

Applying observed discounts in the market to FMG stated product mix consistently understates the implied discount from FMG realized price. The company explains these high implied discounts in different ways each quarter, sometimes it is increased sales of lower quality product and at other times it is that some sales were at FOB rather than CIF prices. We believe that they are selling a lower quality product than they imply and providing higher discounts and rebates to large trading clients.

We believe large trading clients—like Singapore's Prosperity Steel United, which trades around 30 MMT of FMG iron ore—receives discounts and rebates equivalent of around 4% above those FMG provides to steel mills. These large trading companies are the same companies that provide prepayments. As these prepayments

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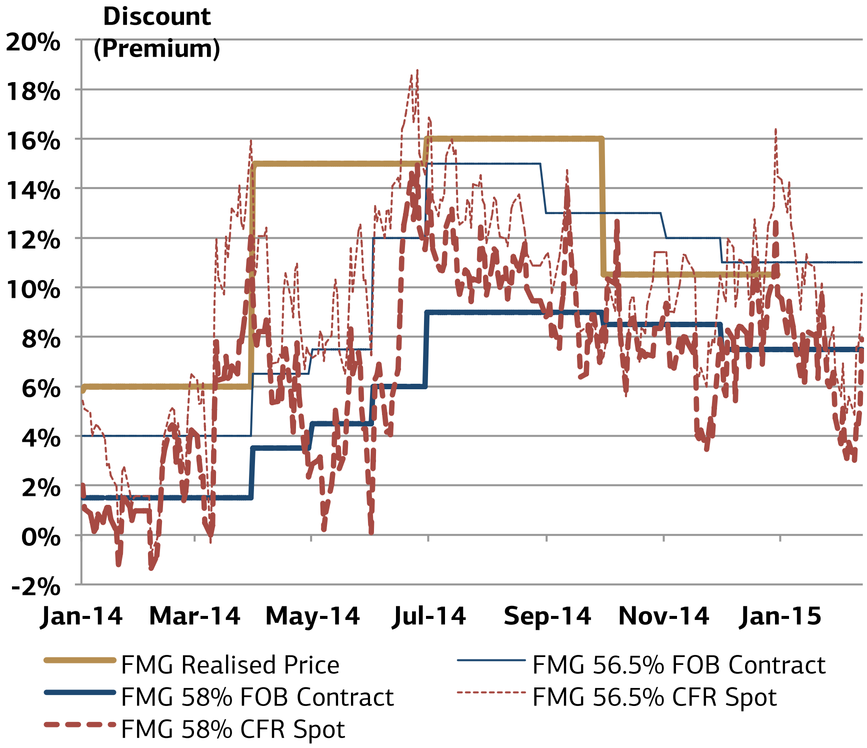
are now rolled over we consider them more as a hybrid loans to FMG with implied interest rates of around 4%.

The discount applied to FMG has nearly doubled.

Chart 3. FMG Product Discount to Platts 62%



Source: Steel Home, Mysteel, Company Reports, J Capital
Note: discount rate determined in a unit Fe basis.

Our tracking of available discount data for FMG products is a good predictor of FMG realized prices. In 2014, FMG's realized price was at a sharp discount to the Platts 62% Fe index price. In H1 FY2015 (H2 CY2014) the discount on a unit Fe basis was 13% (or 19.5% on a straight comparison). This marks a decrease from the 16% discount already observed in Q1 FY2015.

We track the contract discounts offered by FMG to customers on a FOB basis and as published by Steel Home, a Chinese steel industry information provider. Chart 3 shows the close relationship between the movements in contract prices and FMG realized price discount level. We also track Chinese iron ore trader's port spot prices for FMG product and convert those RMB prices into an implied CFR discount. The changing discounts of port spot prices lead the changes in FMG contract prices. When iron prices are falling port spot discounts spike. When iron ore prices fall in March/April we expect discounts to spike at that time as they did in 2014.

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Cash loss on every ton by March?

Given the above forecast for iron ore and FMG's achieved discounts, we believe that FMG could be making a cash loss on each ton when Platts 62% Fe is at USD 55/ton. In 2014, the iron ore price steadily fell from April to December. With steel demand expected to be worse this year and iron ore supply increasing, we see no reason for this year to be any different. FMG will not be making any cash.

Given the discount levels, FMG probably loses on each ton when iron ore is at USD 55.

Table 1. FMG Free Cash Flow Scenarios

FMG Discount	11%	14%	16%
FMG Realized Price (per dmt)			
Platts 62% USD 60	50	48	47
Platts 62% USD 55	46	44	43
Platts 62% USD 50	42	40	39
FMG all in costs (USD)	44	44	44
Free Cash (per ton)			
Platts 62% USD 60	5.95	4.27	3.15
Platts 62% USD 55	1.79	0.25	-0.78
Platts 62% USD 50	-2.37	-3.77	-4.71
Free Cash (mln USD)			
Platts 62% USD 60	983	705	519
Platts 62% USD 55	296	41	-129
Platts 62% USD 50	-391	-623	-777

Source: J Capital

We have assumed that the AUD will trade at USD 0.70 and that oil prices steady at current levels and therefore used a break-even price of USD 44/dmt break even cost for FMG.

Risk from ballooning prepayments

In H1 FY2015 prepayments increased 20% in value, or 33% in tonnage terms. We estimate that, as of February 20, 2015, prepayments now equal 14% of this year's estimated production. That liability is only increasing with the falling iron ore prices. With less steel demand in 2015, there will be less steel produced and fewer customers for iron ore. Iron ore traders will see margins fall and risks increase. We would not be surprised if FMG's largest customers call in their prepayments instead of rolling them over. FMG now has USD 1.6 bln in cash, USD 100 mln is restricted to be used on the Iron Bridge JV, leaving USD 1.5 bln for operations. If prepaid customers stop rolling over prepayments and instead draw down stock and took delivery on prepaid ore, FMG's cash could evaporate quickly. We now see FMG as a potential go to zero.

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Prepayments are a key risk and have risen by a third in terms of volume.

Table 2. Iron Ore Prepayments as a % of Sales

	Jun-13	Dec-13	Jun-14	Dec-14	Feb-15
Prepayments (mln USD)	369	1,045	1,048	1,236	1,236
FMG achieved price	113	125	82	62	53
Prepaid iron ore (MMT)	3.3	8.4	12.8	19.9	23.3
% of sales (annualized)	3%	7%	9%	12%	14%

Source: Company Reports, J Capital

Restructuring or Acquisition?

When FMG is at cash breakeven, it may consider the price falls as temporary and operate at a loss and wait for the iron ore price to improve. This will deplete their cash reserves. We expect the iron price to stay down and then FMG will be faced with the following choices to maintain cash flow and service debt:

1. Sell off the infrastructure assets
2. Complete a rights issue.
3. Close the high cost Chichester mines to get further cost savings and further cut overhead costs.
4. Joint venture on the Solomon mines

What are the options for FMG?

We consider the first two methods as stop-gaps to bolster cash. Closing the Chichester mines would reduce costs and reduce global supply, which would have a positive effect on price and costs.

Debt holders will not be able to restructure the company until the company defaults. Given the fact FMG could partially sell down ownership of its Solomon mines, default could be held off for some time. We expect that a Chinese investor may well be interested in such an arrangement.

When any of the above circumstances occur the FMG share price will fall significantly. This will make FMG vulnerable to a takeover. However, Andrew Forrest’s 32% ownership stake will make it difficult to be successful. A takeover that had support of debt holders may have a chance.

Valuation: PT USD 1.68 SELL

Our price target remains unchanged at USD 1.68.

Risks

We believe most of the restructuring choices available to FMG will reduce the share price. There is the risk that a lower share price will encourage takeover bids. Such a bid may not be successful but could be a risk for investors holding short positions in the stock.

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