Trader

28 April 2015

Recommendation summary

Kumba reported 2014 earnings down 29% with operating profits down 32%. No surprises there – the question is to what degree 2015 earnings will fall and that is pretty much a function of the iron ore price and the rand dollar exchange rate. With every Australian iron ore miner shovelling apace out of Port Hedland, pricing has been commensurately weak but has turned up of late. Lower cost extraction tonnage, particularly Australia and Brazil, is pushing aside higher cost tonnage. However, Kumba is not badly positioned and has the capacity to ride through a market with $50 to $60 per ton pricing. A weaker rand will help as will the quality of saleable grade. My revised earnings estimates though have earnings 80% lower in 2016 than in 2011 with the dividend 92% lower, partly on an assumption of higher cover to retain cash. Provided the iron ore price does not fall to below $35/t, the estimated free on board (FOB) cost level for Kumba, then underlying cash flow should hold up and take Kumba through this cyclical trough. Tonnage is expected to show a modest rise over the next two years. Other than Kolomela, no new growth angles are apparent and rail and ports logistics capacity puts a cap anyway. Kumba raised cover to 1,7x in H2. I am maintaining a Trading Buy and Portfolio Buy.

Kumba Iron Ore

Withstanding the downturn

Earnings estimates revised down but financial positon sound

Kumba Iron Ore, owned 69.72% by Anglo American plc and 12,88% by the Industrial Development Corporation of South Africa, is at the sharp end of falling iron ore prices. As with all things commodity, what goes down also tends goes back up at some point. Kumba has the structure to stomach the trough and thus able to capitalise when things turn.

Listing data		
JSE code	KIO	
Name	Kumba	
JSE sector - Industrial metals & mining		
Share price 24 April 2015	16000 cents	
Shares outstanding: *diluted*	322 million	
Market cap ZAR	R51,5 billion	
Market cap USD	$4,2 billion	
Effective free float band	15%	
Major shareholder	Anglo American 69,72%	
Recommendation		
Trading:	Buy	
Portfolio:	Buy	
Key estimates for 2015 - December year end		
NAV forecast per share	7290 cents	
Shareholders' equity forecast	R23,4 billion	
Revenue forecast	R36,3 billion	
EBITDA forecast	R9,2 billion	
Trading profit forecast	R6,3 billion	
Earnings forecast	R3,56 billion	
Valuation metrics - F2015 estimates		
EV/EBITDA	6,7x	
Forward PE	14,3x	
PEG ratio	n/a	
Gross dividend yield	2,3%	
Net dividend yield	2,0%	
Dividend cover on earnings*	3x	
Return on opening equity	17,0%	
Price to Book	2,2x	
Fair value	16000 cents	
Target price	22000 cents	
Three year CAGR in EPS	-37,0%	
Earnings per share and Dividends per share		**% chg**
EPS (a) F2013 cents	4808	23,8
EPS (a) F2014 cents	3432	-28,6
EPS (f) F2015 cents	1115	-67,5
EPS (f) F2016 cents	1018	-8,7
EPS (f) F2017 cents	1808	77,6
DPS (a) F2013 cents	4004	
DPS (a) F2014 cents	2334	
DPS (f) F2015 cents *	370	
DPS (f) F2016 cents *	339	
DPS (f) F2017 cents*	603	

** dividend cover of 3x assumed rather than 1,2x in 2013*

T +27(0) 11 214 8007
F +27(0) 11 214 8028
E privatebroking@gt247.com
W gtprivatebroking.com

Surplus iron ore worldwide could more than double to over 400 million tons by 2018 on current trends even as Chinas imports rise only slightly to 960 million tons. Majors such as Fortescue, Hancock, BHP, Rio, Vale and Kumba have all increased supply to a greater or lesser extent.

In 2014, 160 million tons were added collectively on top of 75 million tons in 2013. Current estimates suggest 100 million tons in 2015, 80 million tons in 2016 and 40 million tons 2017 through 2019.

Port Hedland in Western Australia is quite a place to visit and is today the largest bulk-export terminal in the world. Ships bob in the water waiting to come in and load for passage to China and elsewhere. In recent months it has shipped the most iron ore on a daily basis – a record 1,27 million tons each day in February.

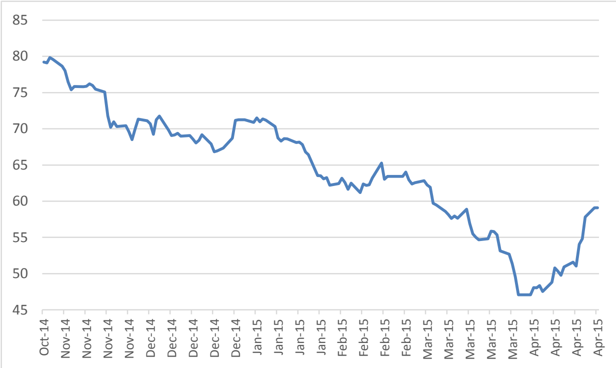
China imported 548 million tons from Australia in 2014, up 32% on a year prior. Brazil shipments were 171 million tons, up 10%. Total world shipments from Australia in 2014 were 718 million tons, up 24%, with Brazil at 344 million tons, up 4%, and with South Africa at 64 million tons, up 2%. Total seaborne trade was 1 454 million tons, up 11% on 2013.

Roy Hill, owned by Gina Rinehart, will add to shipments and means that Australia's iron ore exports will be about 766 million tons in 2015, up 7% on 2014.

In Q1, Vale in Brazil produced 4,9% more iron ore than in the same period in 2014 and is on track for over 300 million tons in 2015. In December 2014, Vale started operating at the N4WS mine, part of the N4W ore body with 1 346 billion metric tons of proven and probable reserves and an average iron (Fe) content of 66,5%.

The fall in prices has done little to dent production and so long as iron ore does not fall to the $30/t to $40/t level for any length of time the prevailing situation is likely to remain. Iron ore remains a reasonable margin mined product for the majors.

Iron ore 62% Fe dry metric ton $



The recent bounce back to close to $60 from recent lows of almost $47 is a rally in what remains a bear market.

The average in 2011 was about $170 per dry metric ton, followed by an average of $130/t in 2012 and then $135/t in 2013. The average for the first half of 2014 was $109/t but by May 2014 iron ore had slipped to under $100/t and ended the calendar year at $72/t. The average for 2014 was $97/t.

The sharp decline in Kumba Iron Ore second half earnings for the year ended December 2014 was expected and priced in.

In the first six months of 2014, EPS dropped by 16% to 2028 cents per share and in the second half the decline accelerated with a 41% decline to 1404 cents per share.

For the full year, earnings per share of 3432 cents was almost 29% down and compared with my estimate of 3347 cents or a 30% decline.

Headline earnings of R11 billion in 2014 compared with R15,4 billion in 2013, R12,5 billion in 2012 and R17 billion in 2011. Operating profit was in fact down by 32% but this was assisted by the R1 billion increase in waste stripping deferred to the balance sheet.

Production increased by 14% to 48,2 million tons with export sales up 4% to 40,5 million tons at an average $91/t free on board versus $125/t in 2013. The export price at the beginning of the financial year was $135/t, falling to a five year low of $72/t by the end of December 2014. Revenue of R47,6 billion decreased 13%.

The rand averaged R10,83 to the dollar versus R9,62, 13% weaker.

As anticipated, the dividend cover was raised for the final 2014 dividend. The final cash dividend of 773cents per share is at a 1,7 times, up from 1,3 times at the interim. The full year dividend was therefore 2334 cents per share.

Capital expenditure was R8,5 billion, up from R6,5 billion with around R5,5 billion likely in 2015. This excludes stripping which could add around R3,3 billion.

Unit cash costs at Sishen came in at R272/t versus R267/t with production at 30,9 million tons versus 35,5 million tons. Kolomela is performing to plan.

Cash flow of R22,9 billion remained robust but net debt has risen to R7,9 billion from R1,8 billion.

My expectation is that net debt could rise to around R15 billion this cycle, in part due to lower profitability.

That would still leave Kumba relatively well geared at around 50% of equity and comparing very favourably to Fortescue in Australia which already has net debt to equity of 100%.

Fortescue recently raised $2,3 billion in senior secured notes at a very steep 9,75% interest rate, repayable in 2022.

Breakeven for Fortescue by 2016 will still be around $40/t. With an interest bill running at approximately $750 million, Fortescue's servicing cost is more than Kumba's net debt in 2014.

Net debt for Fortescque is likely to be between $7,5 billion and $8 billion over the next two years, six times that of Kumba at an estimated peak of $1,25 billion, and comparing with equity of $7,5 billion.

This capital structure difference with Kumba also makes Fortescue that much more sensitive on the earnings line to movements in the iron ore price. It also makes the focus on getting C1 cash costs (that is, costs of mining, processing, rail and port per wet metric ton) down below $20/wet metric ton even more important. C1 costs are forecast at $27/wmt for the year ended June 2015, depending on the exchange rate.

The latest Kumba Q1 2015 production report was encouraging.

Total production increased by 7% to 12,2 million tons compared to Q1 2014 and was 2% lower compared to Q4 2014.

Total export sales volumes increased by 22% to 11,5 million tons compared to Q1 2014 and decreased by 2% compared to Q4 2014.

Sishen mine produced 8,9 million tons, up 3% on Q1 2014 and 4% lower than Q4 2014. Waste removal at Sishen increased by 27% to 49 million tons compared with Q1 2014 – this is 200 million tons annualised but should be sufficient to match production guidance of 36 million tons.

Kolomela mine produced another good performance and on track for 11 million tons with 3 million tons produced for quarter, up 18% on Q1 2014 and 9% on Q4 2014.

Production at Thabazimbi mine was 309 000 tons up 97% on Q1 2014 but down 26% compared to Q4 2014 and its remains under review.

Kumba notes that a weak iron ore price necessitates a review of the business and that despite actions already implemented more may need to be done to reduce capital expenditure and lower cost of production.

However, despite good production statistics there is little doubt that with iron ore in the $50 to $60 per ton range earnings will be down in 2015 and possibly 2016, before recovering.

Sishen free on board costs averaged $35/t in 2014 and should remain under $40/t for the forecast horizon. Kolomela is around $32/t FOB.

Sishen on-mine cash costs are running at $25/t with Kolomela at $20/t.

This cost compares favourably internationally and particularly so given Kumba's lowly geared capital structure.

From a labour stability standpoint, Kumba concluded a three year wage agreement effective 1 July 2014 and this should provide some confidence for investors.

I have revised my estimates and now have 1115 cents per share in 2015 compared with an estimate of 1708 cents previously (see "Orekward" dated 29 January).

I have also adjusted 2016 EPS down to 1018 cents from 1224 cents. This assumes iron ore pricing at below $60/t.

My new 2017 estimate is 1808 cents on the assumption of the iron ore price up to $80/t.

I have also increased my dividend cover assumption from 1,5x to 3x in anticipation that Kumba will conserve cash at this point.

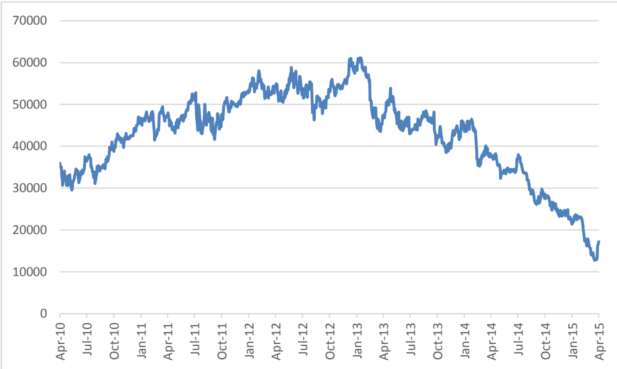
A higher dividend cover on trough earnings of around 1018 cents in 2017 implies a 339 cents dividend versus 4004 cents in 2013. So that is a 91,5% decline.

However, even at the current share price, having come back up to R160 from below R130, that gives a 2,1% yield. Based on my 2015 dividend of 370 cents the gross yield is 2,3% or 2% after withholding tax.

I have retained fair value at R160 with target price held at R220.

There is real value for those with a through the cycle view. An unloved miner that'll more than likely be around to see the next upturn and profit accordingly.

Kumba share price ZA cents



Kumba and the JSE All Share based to 100