ACTION

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Commodities

Mineral Sands: Forecast Upgrades And Conference Feedback

Commodities | Australia

- We attended last week's minerals sands industry conference in Hong Kong organised by TZMI, and have upgraded our price forecasts for zircon and selected TiO2 feedstocks based on our discussions with both producers and consumers of these commodities.
- For **zircon**, there are clear signs that the market has already moved into notional deficit, with both producers and consumers confirming that inventory levels are extremely low. We understand that producers are allocating tonnages (i.e. rationing) to major customers. We expect the market to tighten further in the medium term. We think the market will achieve balance through limited thrifting and substitution on the demand side, and a supply response from producers (e.g. reactivation of idle capacity) but that these events will only kick in at higher prices.
- Remarkably, given price trends in almost all other commodities, **titanium feedstock** prices have stagnated over the past decade in nominal terms, and declined sharply in real terms, due to cap-and-collar pricing contracts which expire over the next 18 months. We believe that some "catch-up" in pricing is long overdue, but that the miners' case will be helped further by, like zircon, feedstock markets heading into a period of notional deficit.
- Our revised price forecasts, earnings estimates and valuations are presented in Tables 1 and 2. **These are significant upgrades**, yet we judge that there remains some upside risk to our revised numbers. We retain ILU ($7.32) as a Conviction BUY, and MDL ($1.27) as a BUY. We believe that the upside potential from earnings attributable to higher feedstock prices is yet to be priced in, and that investment exposure to these commodities will be rewarding in the medium term.

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Table 1:

GS&PA Price Forecast for Zircon and Titanium Dioxide Feedstocks (US$/tonne)

	2009	2010f	2011f	2012f	2013f	2014f
Zircon	**889** *889*	**912** *909*	**1246** *1125*	**1321** *1140*	**1351** *1170*	**1351** *1200*
Rutile	**540** *540*	**639** *570*	**819** *670*	**913** *725*	**950** *725*	**950** *725*
Synthetic Rutile	**418** *418*	**477** *455*	**649** *560*	**743** *615*	**780** *615*	**780** *615*
Ilmenite (Sulphate grade)	**78** *78*	**110** *110*	**126** *110*	**143** *110*	**150** *110*	**150** *110*

Note: GS&PA price series for rutile and zircon are adjusted to take into account expected premia for "bagged" vs "bulk" shipments. All prices are in US$/tonne, basis fob Australia. Previous forecasts in italics.

Source: TZMI; GS&PA Research estimates

CHANGES TO EARNINGS ESTIMATES AND VALUATIONS:

Table 2:

Company (Reccommendation)	2010e EPS			2011e EPS			2012e EPS			2013e EPS			Valuation (A$)			12-month Target Price		
	Old	New	Change	Old	New	Change	Old	New	Change	Old	New	Change	Old	New	Change	Old	New	Change
	A¢ps		%	A¢ps		%	A¢ps		%	A¢ps		%	A$/share		%	A$/share		%
Diversified																		
BHP Billiton# (NR)	368.6	**369.3**	0.2%	408.3	**410.3**	0.5%	399.1	**401.4**	1%	382.9	**386.1**	1%	NR	**NR**	NR	NR	**NR**	NR
Rio Tinto*# (BUY)	668.5	**669.5**	0.1%	795.1	**795.0**	0.0%	778.6	**786.4**	1%	692.7	**701.1**	1%	65.54	**67.13**	2.4%	104.94	**106.58**	1.6%
Base Metals																		
Iluka* (Conv. BUY)	1.2	**3.9**	223.8%	30.0	**51.1**	70.4%	55.5	**90.0**	62.4%	72.6	**115.1**	58.5%	7.43	**8.60**	15.8%	9.00	**9.50**	5.6%
Precious Metals																		
Mineral Deposits+ (BUY)	4.7	**4.7**	0.0%	6.6	**6.5**	-1.6%	8.0	**6.3**	-22.0%	9.1	**6.8**	-25.2%	1.36	**1.44**	5.8%	1.35	**1.35**	0.0%

EPS in US¢ and Valuation in US$, + EPS in US¢ and Valuation in A$, * December year end, ^ March year end
Source: GS&PA Research estimates

Note: RIO's share price is $87.40.

The commodity price upgrades are clearly a positive for **Iluka Limited (ILU)**, with earnings and valuations increasing significantly. It must be noted that FY10 earnings are coming off a low base, which leads to the large % increase. ILU is our only mineral sands producer currently in production and thus benefits greater during the next two years. We have subsequently lifted our 12-month Target Price to $9.50 (was $9.00).

Our earnings changes for **BHP** and **RIO** reflect the changes to our forecasts for TiO2 feedstocks and zircon, but we have also incorporated changes to our assumptions for other Industrial Minerals and ERA following last week's presentation.

We have now included **Mineral Deposits Limited's (MDL)** Grand Cote Mineral Sands Project into our earnings forecasts (previously only in valuation), which accounts for the drop in earnings in FY12-13. We forecast production to start in June 2013, hence the majority of the following earnings changes are the result of interest forgone following large capital expenditure. Following the commodity price changes, MDL's valuation rises 5.8%.

Another company to benefit from a rise in mineral sand prices is **Base Resources (ASX: BSE).** We do not formally cover BSE, however we note that a bankable feasibility study was completed in 2006, and production is forecast to commence in FY13.

TZMI CONGRESS: General Feedback

We attended a major global mineral sands conference in Hong Kong last week, organised by industry consultants TZMI. The conference drew record attendance of some 300 participants, with a wide geographical representation. According to the conference organisers zircon/feedstock producers (89 delegates) were the best represented industry group, followed by pigment makers (50 delegates) and zircon processors/consumers (42 delegates). Geographically China (74 delegates) and Europe (57 delegates) were the best represented regions.

Our reasons for attending this event were to improve our understanding of the zircon and feedstock markets and, in particular, to gain a perspective from the industries that consume these commodities.

The mood at the conference was very upbeat, and the organisers commented that the markets are currently as buoyant as anything they have seen in the last 15 years. Not surprisingly, zircon/feedstock producers are talking enthusiastically about tightening market fundamentals. We found the buyers of these commodities understandably reluctant to talk in too much detail about the price outlook, but all agreed that the markets are tightening and that they are adopting various strategies to ensure security of raw materials supplies.

Returning from the conference we have made significant upgrades to our price forecasts for zircon, rutile, synthetic rutile and ilmenite (Table 1).

- For zircon, we believe that the market has already moved into notional deficit (some two years earlier than we had previously envisaged) and we have adjusted our supply/demand balance accordingly and raised our price forecasts (Tables 1 and 3).
- For the pigment industry we believe that availability - particularly for the higher grade rutile and synthetic rutile - is also tightening and, crucially, this is happening at a time when the cap-and-collar contracts that have suppressed prices over most of the past decade are coming to an end. We intend to model these commodities in due course but it is clear from industry expectations presented at the conference that demand projections currently exceed the supply that is likely to be available from mature incumbent assets (from which output is dwindling) plus the limited number of greenfield opportunities that can be brought into production over the next three to five years.

ZIRCON: Already in Deficit?

The zircon market in 2010 has already tightened beyond our expectations. At the beginning of this year, we were looking for a c. 100,000 tonnes surplus, but resurgent Chinese imports and a number of minor, yet cumulatively significant, supply disruptions have changed this picture significantly.

Producers are telling us that they have no inventory and that they are allocating tonnage to their customers; consumers we spoke with confirmed that their inventories are also low and that they are working on essentially a hand-to-mouth basis, although given the scale of imports into China this year we suspect that inventories of raw materials (and/or product?) have rebuilt there to some degree. Nevertheless, these observations suggest that the zircon market has already moved into notional deficit in 2010.

Our modelling suggest that this deficit will widen throughout our forecast period (Table 2). But of course "negative stocks" is not an option in any physical commodity market which is why, in the absence of inventory to accommodate such deficits, we refer to the forecast shortfalls as "notional". Limited thrifting and substitution on the demand side will combine with a limited supply response from producers to balance the market but, importantly, both of these responses will only occur at a higher price.

- On the demand side, we understand that the potential for substitution in the ceramics sector is very low, and that thrifting has already pretty much reached practical limits. Indeed, the trend away from glazed tiles in favour of porcelain actually implies *rising* zircon intensity. Demand elasticity is low in this sector because the cost of the zircon in a ceramic tile is typically less than 1% of the tile's selling price. It is therefore in zircon's foundry and refractory applications (c. 22% of overall zircon demand) that we would expect limited substitution in favour of refractories such as chromite or olivine to provide something of a safety valve.

- On the supply side, we believe that producers have the potential to squeeze a little more tonnage out of their operations, including the potential for reactivation of currently idled mines. We note, however, the concentrated industry structure and the message from major producers that this sort of supply response will only occur if the business case for higher production or mine reactivation is sound. Clearly this means higher prices.

Table 3:

Zircon: Global Market Balance and Outlook ('000 tonnes) GS&PA Commodities Research

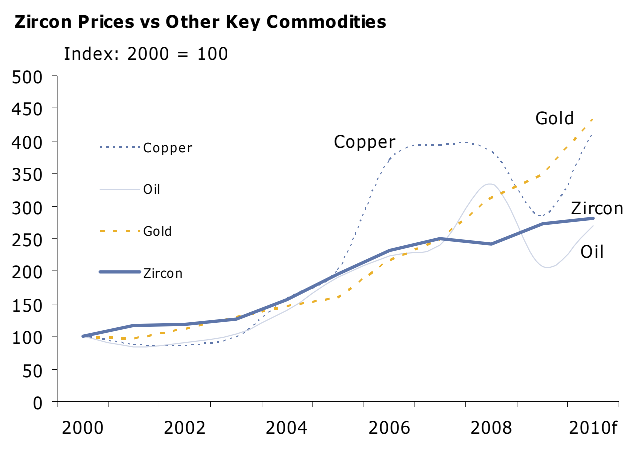
	2005	2006	2007	2008	2009	2010f	2011f	2012f	2013f	2014f	CAGR '98-'07	CAGR '08-'14
Consumption												
North America	160	147	146	121	90	98	103	108	109	109	*-2.7*	*-1.7*
% change	*0.0*	*-8.1*	*-0.7*	*-17.1*	*-25.6*	*8.9*	*5.0*	*5.2*	*0.8*	*0.0*		
Europe	406	386	380	300	225	238	245	259	269	272	*1.4*	*-1.6*
% change	*0.2*	*-4.9*	*-1.6*	*-21.1*	*-25.0*	*5.8*	*3.0*	*5.8*	*3.6*	*1.1*		
Japan	61	59	57	45	35	40	42	43	43	43	*-3.6*	*-0.6*
% change	*-3.2*	*-3.3*	*-3.4*	*-21.1*	*-22.2*	*14.3*	*6.0*	*2.2*	*0.0*	*0.0*		
Oth. Asia	174	182	190	163	138	157	172	183	193	201	*6.6*	*3.6*
% change	*5.5*	*4.6*	*4.4*	*-14.2*	*-15.3*	*14.0*	*9.0*	*6.5*	*5.6*	*4.2*		
China	312	363	392	421	395	506	561	606	654	702	*14.4*	*8.9*
% change	*11.0*	*16.3*	*8.0*	*7.4*	*-6.2*	*28.0*	*11.0*	*8.0*	*7.9*	*7.3*		
Rest of World	87	84	90	111	98	110	116	121	126	132	*1.9*	*2.9*
% change	*-5.4*	*-3.4*	*7.1*	*23.3*	*-11.7*	*12.2*	*5.0*	*4.6*	*4.4*	*4.2*		
Total Consumption	**1200**	**1221**	**1255**	**1161**	**981**	**1149**	**1239**	**1321**	**1394**	**1458**	***3.8***	***3.9***
% change	*2.9*	*1.8*	*2.8*	*-7.5*	*-15.5*	*17.1*	*7.8*	*6.6*	*5.6*	*4.6*		
Production												
Australia	429	476	586	501	412	491	566	603	636	611	--	--
South Africa	399	407	375	398	355	355	411	430	415	415		
India	24	24	27	30	32	38	40	40	40	40	--	--
USA	164	143	121	124	75	85	85	85	52	50		
China (incl. from imported concs.)	82	131	130	107	64	70	40	40	40	40	--	--
Rest-of-World	91	96	87	78	134	141	153	176	232	236		
Less: disruption allowance	--	--	--	--	--	47	78	82	85	84		
Total Supply	**1189**	**1277**	**1326**	**1238**	**1072**	**1133**	**1217**	**1292**	**1330**	**1308**	***4.4***	***0.9***
% Change	*3.6*	*7.4*	*3.8*	*-6.6*	*-13.4*	*5.7*	*7.5*	*6.1*	*3.0*	*-1.6*		
Notional Surplus (Deficit)	**-11**	**56**	**71**	**77**	**91**	**-16**	**-21**	**-29**	**-64**	**-150**		
Annual Average Price												
GS&PA Price series*	**628**	**725**	**783**	**750**	***889***	***912***	***1246***	***1321***	***1351***	***1351***		

Notes: *GS&PA forecast of average realised fob price for Australian producers.
Source: TZMI; Company Data; GS&PA Research estimates

A further factor in our thinking regarding pricing outcomes is the extraordinary pressure on producers in South Africa and Australia due to strong local currencies (AUD and ZAR) versus the USD. To some degree we have already factored this into our thinking with recent price forecast changes (*Daily Cable*, 14/10/2010), but this was a major theme at last week's conference, and we believe that producers will seek still more aggressive USD price increases in order to defray the adverse margin impact of strong local currencies.

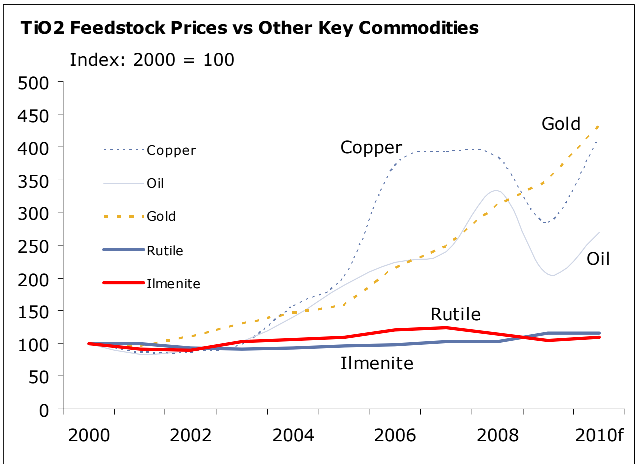
Figure 1 shows a recent history of zircon prices indexed to 2000 and compared with some key commodities. Zircon prices have not been contract-constrained to the same degree as the TiO2 feedstocks and zircon's annual average price profile over the past decade has essentially kept pace with that of oil while underperforming against metals such as gold and copper. Our expectations of price upside for zircon over the next few years are based simply on impending shortage, while for the TiO2 feedstocks we would suggest that some "catch-up" is long overdue.

Fig. 1:



Source: TZMI; Metal Bulletin; GS&PA Research Estimates

Fig. 2:



Source: TZMI; GS&PA Research Estimates

TiO2: "The Commodity that Missed the Boom"

The prices of most commodities have enjoyed what we consider to be a structural change - a step-change - in pricing as a result of the industrialisation and urbanisation in emerging markets at a time when the supply-side was ill-equipped to meet the increase in demand. Even commodities that have remained in oversupply more or less throughout the last decade - such as aluminium - have benefited to some degree, although we would point out that the weakening of the US dollar through much of the ten-year period has been as important a factor as shifting fundamentals.

While zircon prices have enjoyed price increases of a similar magnitude to other key commodities, the same cannot be said for TiO2 feedstocks, the prices of which have endured a decade of virtual stagnation. Figure 2 shows annual average prices for rutile and ilmenite, indexed to 2000 and compared to indexed prices for copper, gold, and oil. In real terms, prices for these commodities have been in decline and, worse, if we then consider the real price trajectories in producer currencies - AUD or ZAR - the declines become severe. Meanwhile, production costs have been increasing, and much was made at last week's conference of the impact of rising power costs (mainly in South Africa), labour costs, and of course the currency impact.

The cause of the price stagnation has been the long-established "cap-and-collar" arrangements under which these raw materials are sold. The result has been severely squeezed margins for feedstock producers with the only mitigation being higher prices for by-prodcuts such as zircon and/or pig-iron. One presenter at the conference described these cap-and-collar contracts as having been "severely damaging" to the industry; another referred to titanium as "the commodity that missed the boom".

So notwithstanding tightening supply/demand fundamentals, we think that prices are due something of a catch-up, particularly given that it is our understanding that the cap-and-collar contracts under which the major producers sell these commodities roll off over the next 18 months. As these contracts expire, we expect the producers to take advantage of their tight industry structure and push for maximum increases in price in return for guaranteeing feedstock supply. We also think it most unlikely that they will recommit to long-term pricing arrangements; much more likely, we suspect, is some sort of shorter term formula, perhaps quarterly-based, in a similar manner to the changes in the iron ore market.

Working in the producers' favour is the fact that the fundamentals are also tightening. As for zircon, output from the incumbent producers is dwindling as orebodies pass maturity, and the price stagnation of the past decade has done little to encourage fresh greenfield investment. Yet demand has enjoyed the same style of growth witnessed for most commodities, courtesy of emerging markets and, as with zircon, the outlook for the next few years appears to be one of increasing shortage. The pigment makers (consumers of TiO2 feedstock) were reluctant to discuss this in detail, but one major buyer conceded that "there are gaps appearing and we are trying to work out how to fill them".

Fig. 3:

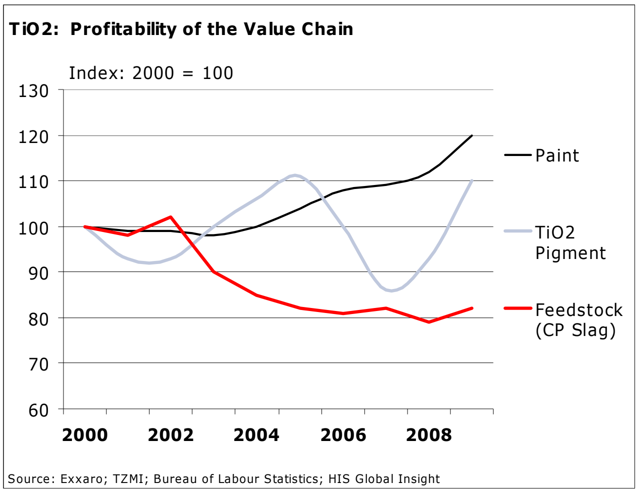
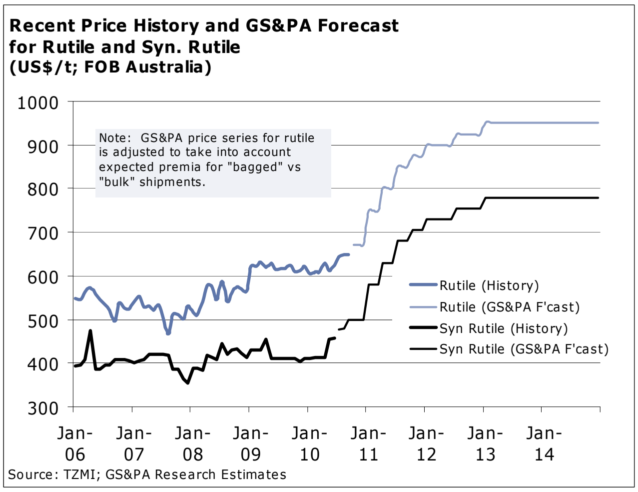


Fig. 4:



Modelling supply and demand for feedstocks is complicated by the range of commodities (ilmenite, rutile, leucoxene), their manner of processing, and the different requirements of pigment makers using the chloride process, versus consumers using the sulphate process. However, projections of supply and demand for TiO2 units presented at the conference all showed markets moving into deficit over the next three years. Like zircon, we would expect "notional deficits" to be eliminated by a combination of thrifting and supply response. However, unlike the ceramic manufacturers, we suspect that passing raw materials price increases through to the end-user may be a little more consequential, since TiO2 accounts for some 27% of the raw materials costs in paint-making. While miners' margins have been squeezed by price suppression over the past decade, pigment makers and paint manufacturers have been raising their prices, so we surmise that higher raw materials costs may be absorbed along the value chain - at least for a while (Figure 3).

We see scope for significant price increases for the whole range of TiO2 feedstocks, but initially we expect rutile and synthetic rutile prices to lead the way because of (a) the timing of contract expiry, and (b) the fact that pigment makers are striving to maximise production from limited capacity and are therefore preferentially seeking the higher grade feedstocks.

We have raised our price forecasts for rutile, synthetic rutile, and ilmenite as shown in Table 1 and in Figure 4. We believe that there remains upside risk to our revised price projections throughout the forecast period.

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Price/Valuation:	The premium or discount to base case DCF valuation at which the stock is trading relative to the average premium or discount across the market.

For Insurers

ROE Trend:	ROE is used as a proxy for EVA™. Rating takes into account the expected level and trend of ROE over the next 2 years.
Balance Sheet:	Analyst's assessment of the quality and strength of the insurer's balance sheet, including conservatism of provisioning, sufficiency of capital, and quality of capital.

For REITs

Strategy:	Used instead of industry structure as many REIT investors are intra rather than inter sector focussed.
EPU Growth:	Ranking of Earnings Per Unit growth relative to other listed Real Estate Investment Trusts. Used instead of EVA™ Trend.
Yield:	Yield relative to the REIT sector average. Used instead of Earnings Momentum.

For NZ Companies

Relevant Index:	If a research report is published by our New Zealand affiliate, GS&PNZ, the recommendation of a company or trust is based on their performance relative to the NZSX 50 Index (Gross) and not the S&P/ASX 200 Index.

[1] *EVA™ is a registered trademark of the U.S. consultancy firm Stern Stewart*

Distribution of Recommendations – as at 30 September 2010

Recommendation	Overall	Corporate relationship* in last 12 months
Sell	7%	0%
Hold	57%	58%
Buy	36%	42%

* No direct linkage with overall distribution as the latter relates to the full GS&PA/GS&PNZ coverage (>250 companies). The above table combines the corporate relationships and recommendations of both GS&PA and GS&PNZ.