EQUITY | RESEARCH

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COMMODITY ASSUMPTION REVISION | COMMENT

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Iron Ore: Price Forecasts Upgraded

Market Tightness Warrants Further Upside

Event

We have reviewed our iron ore supply/demand model since our previous price upgrade in April 2007. In the intervening period, the seaborne market has tightened further as Chinese demand continued unabated and supply remained constrained. As such, we have materially lifted our forecasts for JFY2008 and JFY2009. In addition, we have lifted our long term assumptions for lump, fines and pellet products.

Summary

- Based on a forecast tight market, expected to prevail for at least the next two years, we have increased our near- to medium-term pricing forecasts for both lump and fine material. Specifically we have upgraded our forecast next year to an increase of 35% (up from 10%) to USc138.60/ltu for lump and USc108.60/ltu for fines, while the following year has been upgraded to an increase of 10% (from 5%) resulting in USc152.40/ltu for lump and USc119.40/ltu for fines. In addition, we have moved our long-term forecast from JFY2012 to JFY2013. We have also increased our long-term forecast prices for both lump and fines by US$0.10/ltu to US$0.60/ltu and US$0.45/ltu respectively.
- In keeping with the above lump and fine price increases, we have also upgraded our pellet prices proportionally. Our long term Direct Reduction (DR) pellet price is increased from US$0.73/mtu to US$0.85/mtu, while our long term Blast Furnace (BF) pellet price is now US$0.77/mtu, up from a previous $0.70/mtu.
- Besides prices, we have also reviewed operating costs for all companies. Broadly we have increased near-medium term costs in line with industry averages. We have also increased our long term assumptions in line with company guidance or comparative industry analysis.

Recommendations and Price Targets

- Our increased valuations and price targets are summarized in the table below. Of the majors, AAL's valuation has decreased after we incorporated our recently revised gold and platinum division assumptions.
- Of the juniors, the valuation of MMX and SPH have increased the most by ~20%. We have upgraded our target price on both to A$4.50 and upgraded our recommendation on MMX from Sector Perform to Outperform.

Stock	Price	NAV		Target		Recommendation	
		Previous	Now	Previous	Now	Previous	Now
AAL	£27.63	US$41.92	US$39.86	£34.00	£34.00	SP-A	SP-A
BHP	£13.75	US$18.62	US$19.77	£17.00	£17.00	OP-A	OP-A
MIS	A$2.48	A$10.84	A$11.40	A$4.25	A$4.25	OP-S	OP-S
MMX	A$4.00	A$7.60	A$9.01	A$4.25	A$4.50	SP-S	OP-S
RIO	-	-	-	-	-	Restricted	
SPH	A$3.01	A$4.77	$5.73	A$4.00	A$4.50	OP-S	OP-S

Priced as of prior trading day's market close, EST (unless otherwise noted).
All values in CAD unless otherwise noted.
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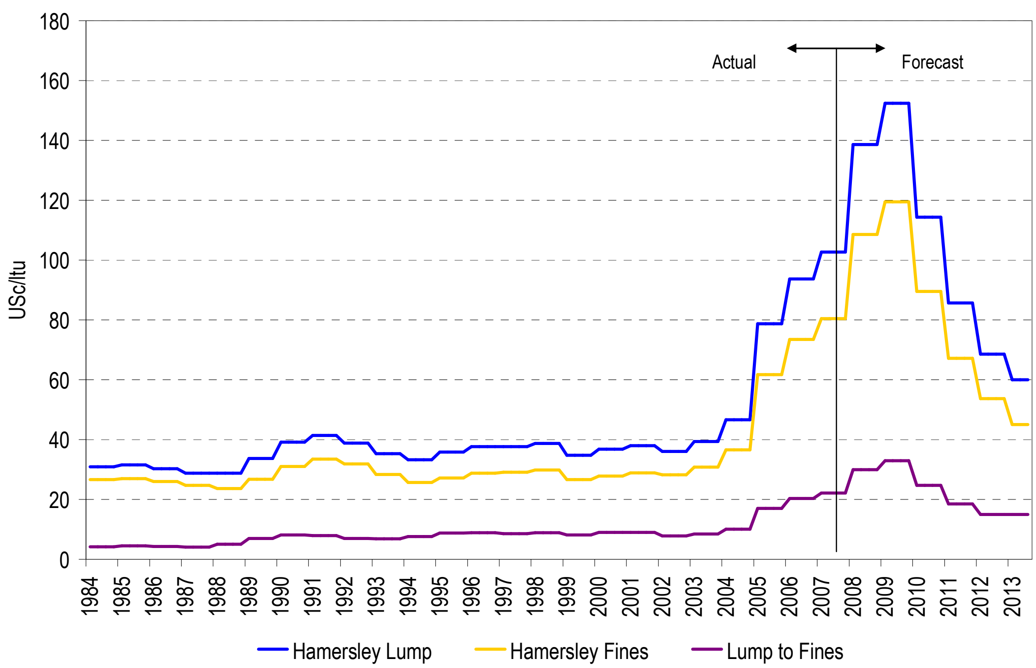
Commodity Price Forecasts

Exhibits 1 and 2 summarize the main changes to our iron ore pricing forecasts. Specifically we have:

- Upgraded our near-medium term forecasts in JFY2008 (USc138.60/ltu lump, USc108.60/ltu fines) and JFY009 (USc152.40/ltu lump, USc119.40/ltu fines). **Since we last upgraded our iron ore prices in April 2007, the seaborne traded market has tightened considerably. Demand, particularly from China, has continued unabated while supply from almost every producer remains constrained. As such, we are lifting our forecasts for next year's negotiations, JFY2008 to prevail from April 1st, from an increase of 10% to an increase of 35%. In JFY2009 we have lifted our forecast from an increase of 5% to an increase of 10%. The following two years are still forecast to be down 25% each year, although this is now taken from a far higher base.**
- Upgraded our long-term price for premium lump material and fines by US$0.10/ltu **to US$0.60/ltu and US$0.45/ltu respectively.**
- Extended our long-term price forecast from JFY2012 to JFY2013

Exhibit 1: Revised Iron Ore Price Forecasts



Source: RBC Capital Markets estimates

Exhibit 2: Revised Iron Ore Price Forecasts

Japanese Fiscal Year Prices			JFY08	JFY09	JFY10	JFY11	JFY12	JFY13
Hamersley Lump	**Revised**	**(USc/ltu)**	**138.6**	**152.4**	**114.3**	**85.7**	**68.6**	**60.0**
Hamersley Lump	Previous	(USc/ltu)	112.9	118.6	88.9	66.7	50.0	50.0
Revised Annual Δ		(%)	*35%*	*10%*	*(25%)*	*(25%)*	*(20%)*	*(12%)*
Hamersley Fines	**Revised**	**(USc/ltu)**	**108.6**	**119.4**	**89.6**	**67.2**	**53.7**	**45.0**
Hamersley Fines	Previous	(USc/ltu)	88.5	92.9	69.7	52.3	35.0	35.0
Revised Annual Δ		(%)	*35%*	*10%*	*(25%)*	*(25%)*	*(20%)*	*(16%)*

Source: RBC Capital Markets estimates

Earnings and Price Target Changes

Exhibit 3 summarizes the changes to our earnings forecasts, valuations and price targets for a number of key Australian iron ore companies in our coverage universe.

Exhibit 3: Earnings Changes

		EPS Estimates				% Δ								
Company		2006A	2007E	2008E	2009E	2007E	2008E	2009E	NAV	% Δ	Target	% Δ	Rating	Price
Anglo *	New	**4.29**	**4.81**	**5.12**	**5.19**	**(3%)**	**(7%)**	**(11%)**	**39.86**	**(5%)**	**£34.00**	**0%**	**SP-A**	**£27.63**
	Old	4.29	4.98	5.53	5.82				41.92		£34.00		SP-A	
BHP*	New	**1.74**	**2.30**	**2.77**	**3.35**	**1%**	**1%**	**6%**	**19.77**	**6%**	**£17.00**	**0%**	**OP-A**	**£13.75**
	Old	1.74	2.29	2.75	3.16				18.62		£17.00		OP-A	
Midwest	New	**0.01**	**0.01**	**0.05**	**0.16**	**0%**	**0%**	**60%**	**11.40**	**5%**	**$4.25**	**0%**	**OP-S**	**$2.48**
	Old	0.01	0.01	0.05	0.10				10.84		$4.25		OP-S	
Murchison	New	**(0.02)**	**(0.08)**	**0.01**	**0.08**	**0%**	**0%**	**34%**	**9.01**	**19%**	**$4.50**	**6%**	**OP-S**	**$4.00**
	Old	(0.02)	(0.08)	0.01	0.06				7.60		$4.25		SP-S	
Rio Tinto*	New	-	-	-	-	-	-	-	-	-	-	-	**Restricted**	
	Old	-	-	-	-	-	-	-	-	-	-	-	**Restricted**	
Sphere	New	**(0.02)**	**(0.04)**	**(0.02)**	**(0.01)**	**0%**	**0%**	**0%**	**5.73**	**20%**	**$4.50**	**12%**	**OP-S**	**$3.01**
	Old	(0.02)	(0.04)	(0.02)	(0.01)				4.77		$4.00		OP-S	

* EPS and NAV in US$. Price targets GBP for BHP, RIO and AAL. All other data for the iron ore juniors in A$.

Legend:
U – Underperform
SP - Sector Perform
A - Average Risk
OP - Outperform
AA - Above Average Risk
TP - Top Pick
S - Speculative Risk

Source: Company reports, RBC Capital Markets estimates. *Note: AAL, BHP, and RIO earnings and valuations in US$, all other companies in A$.

Below we summarise recent company events that impact the most on our forecast earnings and valuations.

Anglo American (AAL) – Earnings and valuation have declined as our increased iron ore forecasts have been more than offset by significant reductions in gold output from AngloGold and platinum production at Anglo Plats.

BHP Billiton (BHP) – We have increased our near-medium costs to reflect the latest cost increases in its FY07 financial results. Our long term forecast costs have also increased from US$17.50/t to US$22.50/t to be more closely aligned with the other majors.

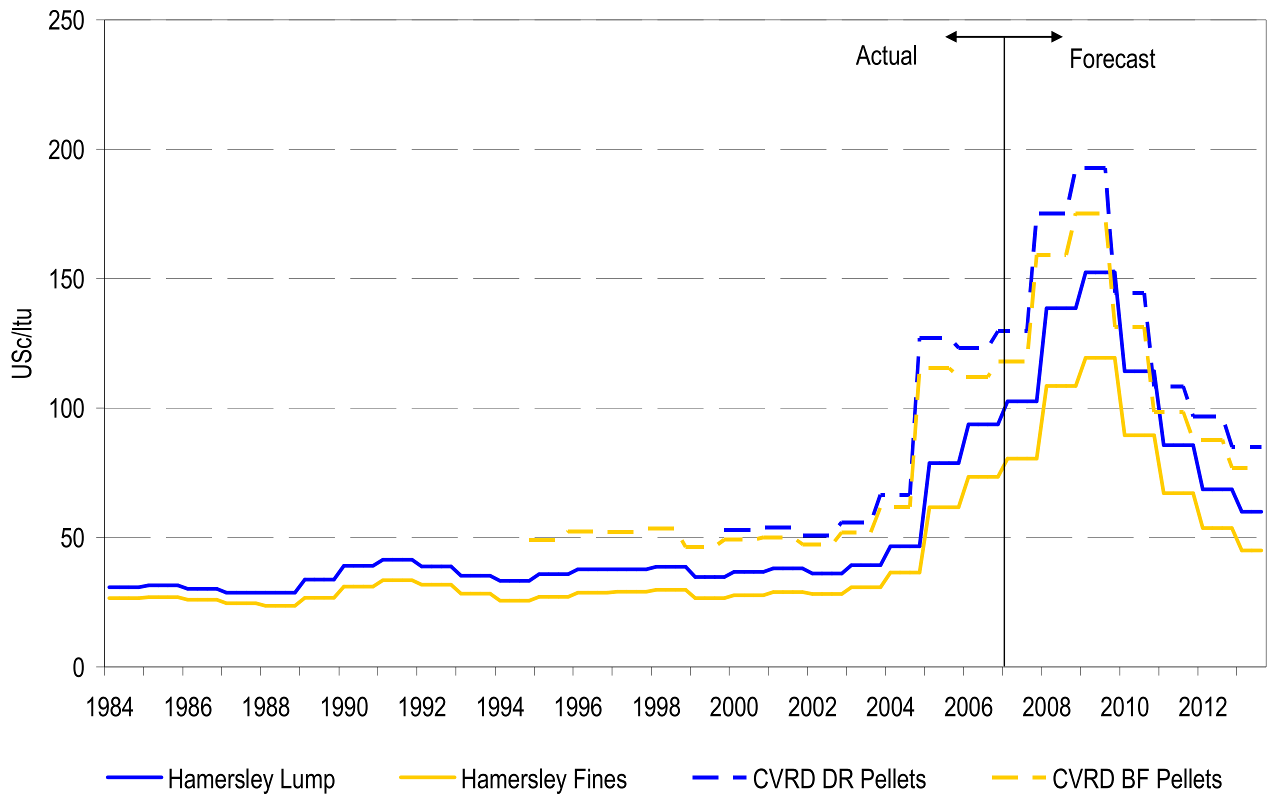
Midwest Corporation (MIS) – We have slowed our forecast ramp-up of Koolanooka and increased costs in the next few years due to anticipated shipping delays at the port of Geraldton. In addition, we have increased our forecast opex at Weld Range from A$21.60/t to A$26.90/t (July 2007 scoping study A$26.57/t). The number of shares on issue has also been adjusted to fully account for the recent 1:7 rights issues and placement to raise A$67m. Our risk weighting has been maintained at 40% of the total Weld Range valuation until such time as the company releases an upgraded resource statement, expected in the latter part of CY2007. The net effect of the above has seen our valuation increase slightly from A$10.84/share to A$11.40/share. Note that the recently announced Yilgarn Infrastructure Proposal, whereby 5 Chinese banks have committed up to A$3 billion for development of the port and rail, increases confidence in the project.

Murchison Metals (MMX) – Forecast costs for Jack Hills Phase I have been increased in the next few years due to anticipated shipping delays at the port of Geraldton. In addition, we have increased our long term forecast cash costs at Jack Hills Phase II from A$16.20/t to A$22.10/t. Our risk weighting is unchanged at 50% of our valuation. The net effect of the above has seen our valuation increase from A$7.60/share to A$9.01/share. Note that the recently announced 50/50 Mitsubishi cooperative agreement and their commitment of $1.5bn in equity for development of the port and rail provides for increased assurance towards project development.

Rio Tinto (RIO) – Restricted

Sphere Investments (SPH) – We have proportionally increased our forward pellet price assumptions in line with our iron ore lump and fines movements (See Exhibit 4 below). In addition, we have upgraded our long term Direct Reduction (DR) pellet price from US$0.73/mtu to US$0.85/mtu, while our long term Blast Furnace (BF) pellet price is now US$0.77/mtu, up from a previous $0.70/mtu. The premium for DR pellets above BF pellets is maintained at a consistent ~10% moving forwards. On the cost side, we have increased our assumptions for Guelb el Aouj from a long term cash cost of A$35/t to A$40/t (~US$33/t). The net effect has been an increase to our NAV from A$4.77/share to A$5.73/share.

Exhibit 4: Iron Ore Pellet, Lump & Fines Price Deck Comparative



Source: RBC Capital Markets estimates

Iron Ore Market

Exhibits 5 and 6 illustrate our historical and forecast iron ore supply and balance from 2000 to 2010 (forecasts from 2007-2010). We identify the following key points:

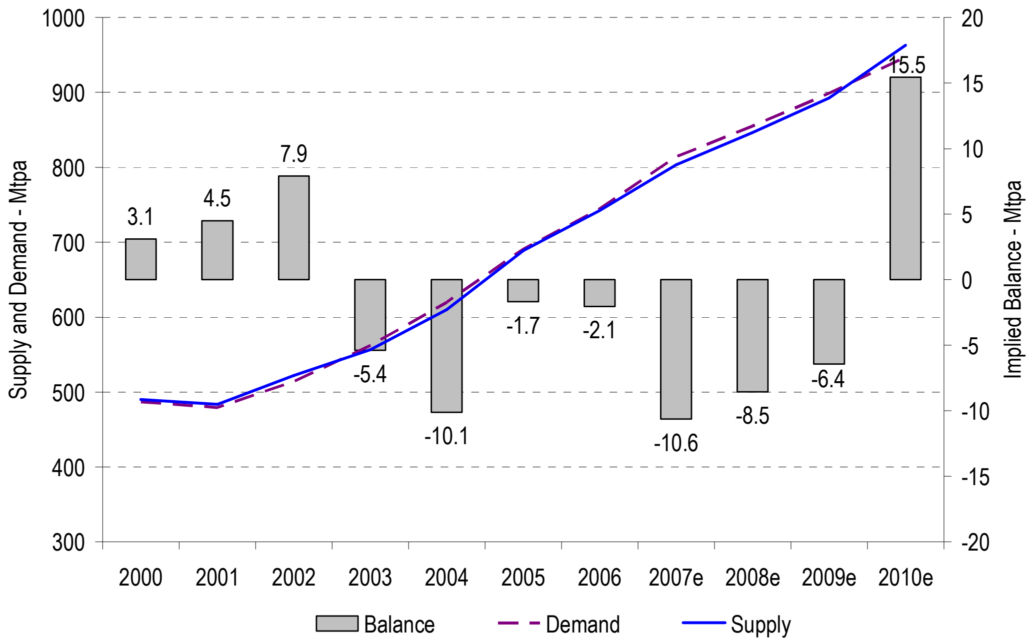
- There are four principal determinants to the world supply/demand balance. These are China on the demand side, and the big three producers – in order, CVRD, RIO and BHP – on the supply side.
- China's insatiable appetite for iron ore imports continues unabated. Total iron ore import growth for 2006 was 18.5%, an increase of 51Mt for the year. For the first seven months of this year, iron ore imports have increased by ~20%, while during July, they were up ~24%. We have increased our estimated imports by 4.5% to 392Mt (from 375Mt) for the current year. Note H1 imports stood at just over 188Mt, although Q2 was 88Mt compared with Q1 at 100Mt. The reasons for this apparent slowdown are unclear, however, perhaps it is indicative of the difficulties accessing imports rather than any specific slowdown. It may also be related to the imposition of increased Indian export tariffs (designed to retain greater volumes in the domestic market)
- On the supply side, Australian exports continue to increase, although they remain constrained below individual corporate aspirational targets; RIO's H1 exports were up 12% at 66Mt over H1/06, while BHP's exports were relatively constant at ~45Mt for the same period. The junior iron ore companies, mainly those exporting through Geraldton, were (and will continue to be) constrained by port capacity with all players suffering significant delays resulting in high (and almost unprecedented) demurrage charges.
- On balance, we see the market remaining tight, with an implied deficit forecast for (at least) the next two years.
- Projected price forecasts have been upgraded significantly as a result. Previously we forecast prices to increase by 10% in JFY2008, and 5% the following year. Now, we forecast prices to increase by 35% next year, followed by a further 10% increase, before trending down to our long-term prices (which have been pushed out one year to JFY2013).
- For lump we are forecasting a long-term price of US$0.60/ltu and US$0.45/ltu for fines. Our long term lump to fines premium is currently set at US$0.15/ltu.

Exhibit 5: Seaborne Iron Ore Supply/Demand

Seaborne Iron Ore Supply/Demand (Mtpa)	2000	2001	2002	2003	2004	2005	2006	2007e	2008e	2009e	2010e
World Crude Steel Production	**848**	**850**	**904**	**970**	**1069**	**1140**	**1239**	**1326**	**1392**	**1441**	**1474**
Integrated Production (BOF)	607	619	651	682	762	827	902	962	1008	1041	1064
Apparent Iron Ore Demand	1081	1055	1108	1285	1432	1554	1696	1809	1895	1957	2000
Key Consumers											
China	70	92	112	148	208	275	326	392	431	474	521
Japan	132	126	129	132	135	132	134	137	138	139	140
South Korea	39	46	43	43	44	43	43	43	43	43	43
Other	246	215	230	239	233	240	241	242	242	243	243
World Imports	**487**	**479**	**514**	**562**	**620**	**691**	**745**	**814**	**855**	**899**	**947**
Key Suppliers											
CVRD*	153	143	149	194	219	224	243	284	293	305	310
RIO*	109	110	119	134	140	159	168	182	201	211	244
BHP	75	77	82	78	85	97	112	113	116	124	140
Other	153	153	172	150	167	209	219	224	236	252	269
World Exports	**490**	**484**	**522**	**557**	**610**	**689**	**742**	**803**	**846**	**892**	**963**
Implied Seaborne Market Balance	**3.1**	**4.5**	**7.9**	**-5.4**	**-10.1**	**-1.7**	**-2.1**	**-10.6**	**-8.5**	**-6.4**	**15.5**

Source: IISU, Tex Report, CRU Monitor, RBC Capital Markets estimates

Exhibit 6: Iron Ore Supply/Demand and Market Surplus/Deficit

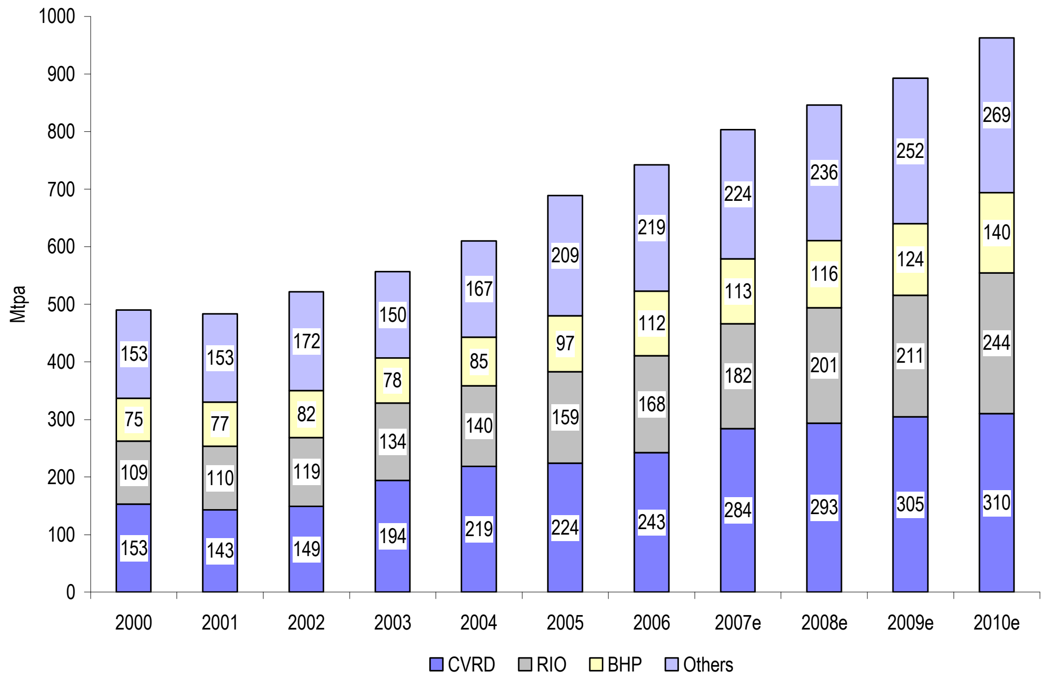


Source: IISU, Tex Report, CRU Monitor, RBC Capital Markets estimates

Exhibit 7 shows the major iron ore suppliers and their projected production increases. CVRD, RIO and BHP supply approximately 75% of total seaborne trade. All three companies are continuing with production ramp-ups into the next few years to meet strong Asian import demand.

- CVRD's iron ore output is forecast to grow 25Mt (or 10.3%) in 2007 to 268Mt and potentially up to well in excess of 300Mtpa by 2010. Depending on Chinese imports, such a level of export growth would likely see the seaborne traded market move into surplus at that time. We also remain mindful of CVRD's stated intention to increase exports by ~50% to 450Mtpa by 2010. Such growth would almost certainly tip the market into surplus by 2010.
- In 2006, CVRD was the largest single exporter to China at 76Mt or 23% Chinese market share. Considering it could ship in excess of 100Mt to China in 2007, its market share would increase to almost 26%. Notwithstanding this increase, it is worth noting that freight rates have recently escalated dramatically and currently stand around US$50/t, indicating that on a CIF basis, the landed cost of Brazilian ores is somewhat more expensive than those from Australia. Meanwhile, we await approval of the company's proposed Carajas iron ore expansion that will add 30Mt of capacity for a total of 130Mtpa by 2009.
- RIO is progressing development plans that could see total output reach 390Mtpa by 2013. Of this, 300Mt is scheduled to be sourced from expansions of current operations with the balance of 90Mt from new developments. The company is currently involved in its Pilbara expansion with the objective of reaching a 220Mtpa output target by 2009 (although we are assuming 2010). RIO states its Yandi expansion is 4 months ahead of schedule while it recently approved an accelerated expansion of Hope Downs from 22Mtpa to 30Mtpa.
- BHP has approved its Rapid Growth Project 4 (RGP4) that will increase production across its WA iron ore operations to 155Mtpa. Initial production from RGP4 is slated for the first half of 2010.

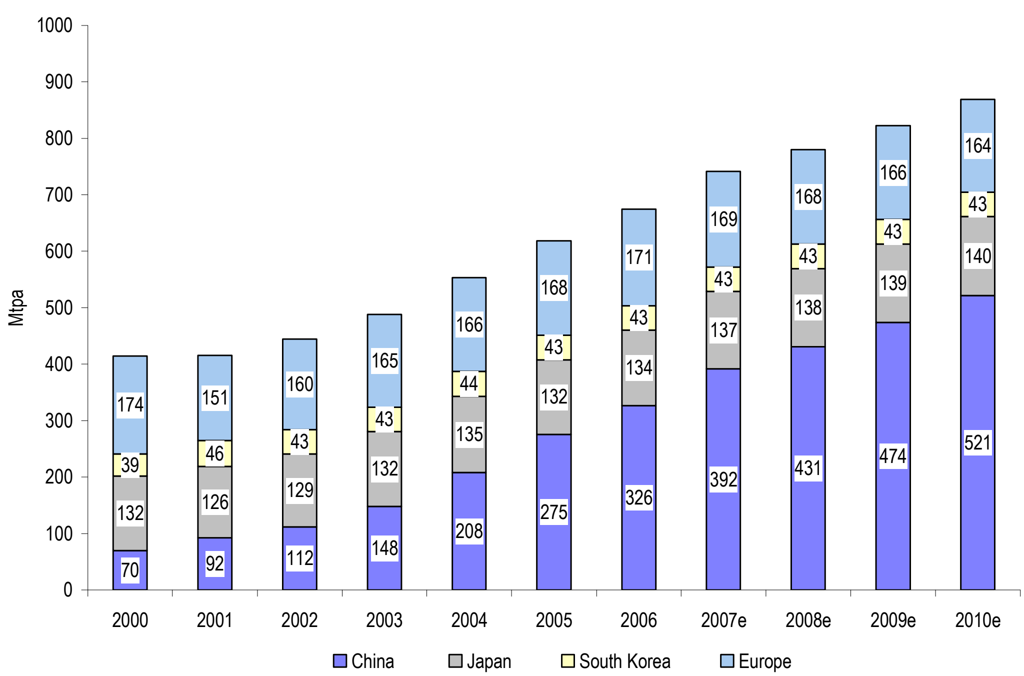
Exhibit 7: Major Iron Ore Suppliers



Source: Company reports, RBC Capital Markets estimates. RIO increase includes 100% of Robe River.

Exhibit 8 below shows the major iron ore importing countries. China remains the key importing country and our forecast indicates Chinese iron ore imports during the period 2007-2010 will grow at CAGR ~10% or an additional 129Mt.

Exhibit 8: Major Iron Ore Importing Countries



Source: Tex Report, RBC Capital Markets estimates

Price Target Impediments

Anglo American plc

We have derived our £34.00 target for AAL by applying normalized earnings to a peak-cycle valuation that assumes metals & mining equities are likely to trade on a market multiple of normalized earnings at this point in the cycle. We apply a 16x P/E multiple to our normalized EPS of £2.12. Our 16x multiple is set at a 20% discount to that of sector leaders.

As with all mining companies, world economic growth, commodity prices and currency fluctuations could materially affect AAL's revenues. Energy prices and environmental considerations could impact operating costs. Variations in these represent risks to our earnings and equity performance expectations.

BHP Billiton

We have derived our £17.00 target for BHP by applying a 20x P/E multiple to our normalized EPS of £0.85. We would argue that a 20x multiple is appropriate for sector leaders like BHP and RIO.

As with all mining companies, world economic growth, commodity prices and currency fluctuations could materially affect BHP's revenues. Energy prices and environmental considerations could impact operating costs. Variations in these represent risks to our earnings and equity performance expectations.

Midwest Corporation Limited

We have derived our 12-month A$4.25 price target by applying a 40% risk weighting to Weld Range based on the evaluation stage of the project. Our NAV assumes long-term iron ore prices of US$0.60/ltu (lump) and US$0.45/ltu (fines) and an A$ rate of US$0.70.

As with all mining companies, world economic growth, commodity prices, currency fluctuations and an increase in the project capex and opex estimates could materially affect our MIS valuation. In addition, variations in these represent risks to our earnings and equity performance expectations.

Murchison Metals Limited

We have derived our 12-month A$4.50 price target by applying a risk weighting to Jack Hills based on the evaluation stage of the project. We have assigned a 50% weighting to the valuation of MMX's Jack Hills project. Our valuation for MMX assumes long-term iron ore prices of US$0.60/ltu (lump) and US$0.45/ltu (fines) and an A$ rate of US$0.70.

As with all mining companies, world economic growth, commodity prices, currency fluctuations and an increase in the project capex and opex estimates could materially affect our MMX valuation. In addition, variations in these represent risks to our earnings and equity performance expectations.

Rio Tinto

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Sphere Investments Limited

We have derived our 12-month A$4.50 price target by applying a risk weighting to Guelb el Aouj based on the evaluation stage of the project. We have assigned an 80% weighting to the valuation of SPH's Guelb el Aouj project. Our valuation for SPH assumes a long-term Direct Reduction (DR) pellet price of US$0.85/mtu and an A$ rate of US$0.70.

As with all mining companies, world economic growth, commodity prices, currency fluctuations and an increase in the project capex and opex estimates could materially affect our SPH valuation. In addition, variations in these represent risks to our earnings and equity performance expectations.

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