Fundie's not-so-favourite – lessons to learn from Arrium

by David Buckland

The history of Arrium

The demerger of OneSteel Limited, the manufacturer and distributor of steel products throughout Australia and New Zealand, from BHP occurred in 2000. Five years later the Whyalla Steelworks were converted to magnetite iron ore feed, thereby creating a new revenue stream for the company by freeing up the hematite iron ore reserves for export sales. OneSteel was soon exporting 6 million tonnes per annum and with the appreciating iron ore price, the strategy appeared well founded. The acquisition of WPG Resources in 2011 lead to a doubling of iron ore exports to 12 million tonnes per annum and the Whyalla port capacity was also doubled to 13 million tonnes per annum.

In 2007, OneSteel acquired the Smorgon Steel Group, and activities were broadened to include some domestic mining consumables. In 2010, this division was expanded by the acquisition of the Moly-Cop Group mining consumables business from Anglo American, making the re-named Arrium the global leader in grinding media.

On the surface, Arrium's diversification from steelmaking into mining and consumables appeared logical, particularly given the threat of low-cost Asian steel imports into Australia and the strongly rising commodity prices. The financials, however, tell a different story, and this is why it is important for investors to fundamentally assess a company's progress, or lack thereof, over time.

Back in September 2014, on the back of five-year low iron ore prices, Arrium announced a deeply discounted $756 million equity raising. Underwritten by UBS at $0.48 per share, the company said $732 million would be used to reduce debt, which stood at $1,708 million at 30 June 2014. This was more than triple the earnings before interest and tax (EBIT), from continuing operations, in fiscal 2014 of $530 million. Pro-forma net debt would therefore be cut to $976 million, assuming the operating environment didn't get worse.

Worst-case scenario

Unfortunately for Arrium, that is exactly what has happened, and in recent months the iron ore price has declined a further 20% from US$80/tonne to US$64/tonne. Before we analyse the rights or wrongs of supporting the deeply discounted rights issue at $0.48 per share (the prevailing price was $0.72 per share) I think it is important for investors (rather than speculators) to take a forensic look at some of the numbers in the period since 2007, and I'll ask you to be the judge on whether this is a company you want to invest in.

1. The number of shares on issue have increased by more than four-fold from 723.8 million to the current 2937.3 million;

2. Shareholders' funds have increased from $1.6 billion to an estimated $2.9 billion, meaning shareholders' funds per share on issue decreased from $2.20 to sub $1.00;

3. Net debt has increased from $770 million to an estimated $1,300 million;

4. Return on shareholders' funds, or normalized net profit after tax (NPAT) to shareholders' funds, has generally trended downward from a peak of 13.5% and this will likely be negative in fiscal 2015, and negligible in fiscal 2016;

5. Cash flow generated from operations and negative cash flow from investing activities were almost identical, in that they both aggregated to around $3.86 billion over the eight-year period 2007-2014.

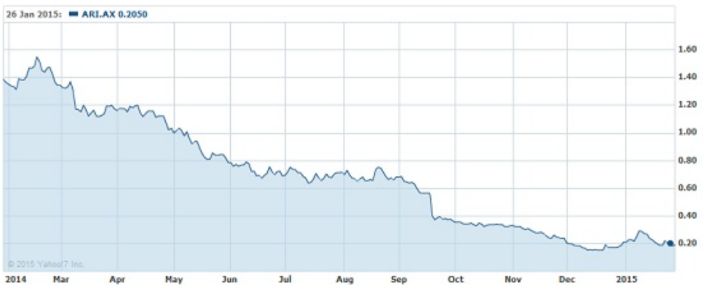
This is an unhealthy situation, in that some additional debt and capital raisings were required to assist with the payment of dividends.

6. The announcement of asset impairments has become the rule rather than the exception with an aggregate $2.24 billion reported over the past three years, including this week's announcement of the impairment of $1.17 billion from the closure of the Southern Iron operation and $130 million from the steel and recycling division.

I would argue that despite the excitement behind the company's diversification strategy from steelmaking into mining and consumables, the fundamental numbers I have presented generally represent a business in relatively poor health.

To that end, the serious downturn in the price of iron ore, the difficult outlook for the steel division and the relatively high indebtedness have all conspired to send the Arrium share price, which peaked in mid-2008 at above $6.00 per share, down to the current $0.20.

Arrium (ARI)



Source: Yahoo!7 Finance, 29 January 2015

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