Fortescue
The New Force in Iron Ore

Company Insight
the intelligent market update

# Fortescue Metals Group Ltd

**Highlights of interview....**

- FMG's capital strategy and recent approaches to the debt markets
- Terms and conditions achieved, and potential future debt market approaches
- FMG's expenditure profile and how it will be financed
- Financing optionality and natural hedging
- The outlook for Fortescue obtaining an investment-grade credit rating.

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Fortescue Metals Group Limited (ASX code: FMG, market capitalisation A$19 billion). A lot has changed with Fortescue's debt profile over the last 12 months - can you explain your strategy and its execution since you came on as CFO in March 2010?

**Chief Financial Officer, Stephen Pearce**
The strategy is about simplifying the capital structure of the company to allow it to grow as we envisage over the next decade or so. The company's original greenfields project finance facility was very successful in getting the Chichester Hub up and running. It enabled the creation of significant value but the facility was highly restrictive and Fortescue's rapid growth meant that it had served its purpose. Accordingly we approached the markets in October last year and refinanced the project debt with a US$2 billion unsecured, covenant-light bond issue. We then went back to the market in December for an additional US$1.5 billion of expansion funding. Both times we experienced terrific support from the international bond markets and we were able to achieve the terms and conditions we'd sought. Thus, our initial move in terms of simplification was extremely successful.

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Recently, after returning to the US debt markets seeking US$1.5 billion, you announced that only $500 million was transacted. Can you explain this outcome and its impact on your thinking?

**Stephen Pearce**
The US$1.5 billion package identified two components: a US$500 million revolving credit facility and potentially, a US$1 billion term loan. To a large extent the approach was opportunistic as the markets were performing strongly when we first launched the deal and

we had just under $2.5 billion of cash-on-hand. We experienced strong demand and the term loan book had bids in excess of the $1 billion we were looking for. Pricing however wasn't as sharp as we wanted for the term loan component so we decided to walk away from that part of the offering at that time. Our strategic approach to the market was deliberately ahead of the funding requirement. We have both time and choice, and therefore we were able to be quite disciplined in relation to the pricing. In terms of our forward thinking, because of both our cash-on-hand position and our strong cash from operations, we continue to have choice and a number of different strategies. We'll put the right facility in place at the right time, which may include going back to the international debt capital markets as and when circumstances are suitable.

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The recent $US500 million revolving facility is a new style of facility for Fortescue. What are its key features?

**Stephen Pearce**
It is a bank facility as distinct from a capital markets facility which is a first for Fortescue and a reflection of our maturing credit profile. It demonstrates that the banking and debt markets recognise the strength of the business we've created and the underlying cashflows. The facility was originally based on a syndicate of 5 banks that has grown to 9 and comprises both Australian and international players. With the strength of this support the facility limit has been increased to US$600 million.

The loan is unsecured with a 3 year term – of itself a unique feature for a company of our current credit rating. Pricing is a very competitive margin of 325 basis points which will reduce as our credit rating improves. Importantly a lot of the terms are aligned to our bond terms and conditions, which again is unique for a bank facility. We see this alignment in finance facilities as important for our growth plans.

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How would you describe the general climate in the debt markets when you were overseas? To what extent did Fortescue further explore the markets for FMG paper, and what was the outcome?

**Stephen Pearce**
We've had tremendous support from the world's capital markets on both occasions. Financial institutions around the globe understand and like the Fortescue story. They really appreciate the strength of the current operations and what we will create as we expand to 155mtpa. The fact that Fortescue offers an Australian domiciled business with direct exposure to China and broader Asia is well understood and appreciated.

However, as has been widely reported, there has been recent weakness in investor risk appetite and bonds and equities have suffered. While this affected the pricing of our recent proposed debt issue, we all recognise that markets are cyclical and we will continue to look at funding options and monitor these going forward. We will consider the right time to return to the market noting that during the early part of 2011 there were a record number of bond issues. While activity has slowed since then, we are confident that markets will bounce back. There is no question that exposure to Chinese growth remains one of the few bright spots on the investment radar.

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Do you intend to approach debt markets again in calendar 2011; if so, under what conditions and to what extent?

**Stephen Pearce**
We will support our development team by putting other debt facilities and arrangements in place, and so we are likely to go back to the market at some point during this year. Exactly what the form of approach will be and exactly what markets we'll access is still work-in-progress.

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What is the current status of Fortescue's plans to expand production to 155mtpa and what is the likely expenditure profile each financial year for the ramp-up?

**Stephen Pearce**
Progress is very strong. Our expenditure commitments are ramping up strongly as we sign contracts and issue purchase orders with our key suppliers and construction companies. As recently announced, we've targeted end-calendar 2012 for completion of the physical construction for both the Chichester and Solomon Hubs with the period of ramp-up targeted for completion by end-June 2013.

In terms of expenditure profile, our forecast for financial year 2012 involves about US$5.5 billion of which some $5 billion relates to the expansion project and the balance covers more general capex. Of course, the exact timing and quantum will depend on the timing of invoices and so on. The balance of the expansion capex will be spent over the 2013 financial year with a possible small tail extending into 2014.

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With the most recent raising, can you now illustrate how those annual expenditure profiles will be financed with reference to cash-on-hand, available facilities and annual operational cash flows?

**Stephen Pearce**
We're now generating significant cashflows from our core operations every month due to our growing production volumes and the high iron-ore prices. Cash on hand has increased since March 2011 even with the completion of construction to 55mtpa. Our established debt facilities of about $3.5 billion are fully drawn, and we have spent some $350 million of the $8.4 billion expansion budget.

We will fund our capex requirements from the approximate $2.5 billion of cash-on-hand, the undrawn facility of $600 million, additional facilities to be obtained during the balance of this year, and two years of strengthening cashflows over the construction period. We anticipate operational cashflows over this financial year of just under US$3 billion and if prices hold, next year should be closer to US$4 billion. Looking further out, the expansion tonnages related to our 155mtpa target, will start to kick in and assuming prices remain reasonable, cashflows should be even stronger.

We could almost finance the massive expansion out of existing cashflows, but I value certainty and we will seek a healthy buffer in the current environment. Thus, if we have a shorter sharper peak in cash requirements, by using a combination of financing sources, we believe we will be in a position to have the expansion well-and-truly funded with plenty of buffer.

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Under different levels of stress-test - can you still achieve your expansion targets?  And what would be the impact on your key coverage ratios?

**Stephen Pearce**
Yes we can most definitely achieve our expansion targets. We're putting in place a robust capital structure that will see us through – not just the short/medium term – but also all future phases of the commodity cycle when commodity prices go up and down. We're putting facilities in place that will see us with plenty of room under our capex commitments.  At the same time our forecast credit metrics, including the various standard EBITDA coverage ratios, remain strong even based on conservative assumptions of volumes and prices.   The ratings agencies are recognising the core strengths of our business model with upgrades initiated after our half-year 2010 results were released. Importantly for Fortescue, our debt facilities don't have a high number of ratios that must be met.  Our unsecured arrangements are relatively covenant-light which gives us the flexibility to achieve our expansion objectives. Both our growth ambitions and cash requirements have been explained clearly to the debt markets and we've established plenty of capacity to achieve our objectives, and the foundation for a strong and robust capital structure.

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How would you describe the level of optionality in Fortescue's current financing?

**Stephen Pearce**
Optionality is really important to us. We're funding long-life assets and therefore they should be funded with longer maturity debt, but we're also generating significant operational cashflows which will increase further as we grow to 155mtpa. So we've created significant optionality that will allow facilities to be taken out early if the opportunity arises, and as we move from a short/medium capital structure to a longer-term structure.

Optionality means the opportunity for early repayment from cashflows with the knowledge that our baseline longer term maturity profile gives us greater certainty to withstand any iron-ore price downturn.  We can therefore pay out, or leave facilities in place until the full term with a spread of maturities across our debt portfolio.

To put this whole point in context - in the current environment of historically high iron ore prices - the payback period for our expansion tonnes is around 2 years.   While such extraordinary returns will not last forever, the short to medium term opportunities created by these conditions can be factored into our capital structuring.

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How does Fortescue intend to use hedging strategies to address potential cost pressures? And what is Fortescue's attitude to settling trades in Yuan rather than USD?

**Stephen Pearce**
On hedging, our policy is to keep things as simple as possible. We're in a fortunate position that we're largely a USD company. We report, sell and borrow in USD and we try to structure as many of the costs as possible in USD. So we establish a natural hedge in most things we do. We do incur AUD construction and operating costs, but there is very strong alignment between the AUD/USD exchange rate and the iron-ore price. This correlation, which we calculate and track internally through the Wells Correlation Index, is about 80 to 85%. At this level, it provides a high degree of natural hedge and while a currency impact flows into our cost structure, it is also flowing into our revenue structure via very high iron-ore prices. The degree of correlation means we don't need to go to markets to provide hedge cover and that allows us to keep things very simple.

We don't see settling in Yuan at any time soon. Our business and the world iron-ore trade is conducted in USD and our debt and costs – as we have seen - are hedged naturally against revenues. So to take on an RMB exposure, without the ability and maturity in currency markets to cope, really doesn't work for us at this time.

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What is the outlook for Fortescue obtaining an investment-grade credit rating?

**Stephen Pearce**
I think it is highly probable. We already have investment-grade credit metrics on almost every measure but the agencies have to get comfortable with our rapid growth; since they are used to seeing growth achieved over a longer period of time. We are working very closely with the rating agencies, and you would have seen the recent upgrades following our half year results. This trend should continue over the next 6 to 12 months as we report strong full-year underlying profits and cashflows. So I'd think they will move fairly quickly in rating agency terms to upgrade our status - as they absorb the completion of our expansion to 55mtpa and complete their reviews of our reporting in August this year. We think it will be almost impossible for them to ignore the strength of our business. Further, we're steadily maturing and de-risking, and we have in place the cashflows, most of the debt, and progressively, the contracts and commitments for the next stage. So, it really comes down to execution and as time goes on we believe that execution certainty will be increasingly recognised.

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So how would you summarise the change in Fortescue's financing arrangements over the past year?

**Stephen Pearce**
Essentially it has been a year of transformation. We've moved Fortescue's financial structure onto the same commercial platform as its operations, simplified our balance sheet, and restructured long-term debt to suit both current operations and future requirements.

What has been surprising is how quickly it has all happened. With the strength of demand for Fortescue's credit, we've been able to establish very favourable terms and conditions, enormous expansion capability and balance sheet optionality, all on an unsecured basis. Production increases are delivering strong cashflows and our expansion works programs are underway. Finally, Fortescue's credit metrics will continue to improve as we deliver against our growth plans, so we fully anticipate that financial markets and ratings agencies will continue to look favourably upon our strengthening financial profile.

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Thank you Stephen.

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