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Miners See Record Profits as Glut of Ships Reduces Rates: Freight Markets

By Michelle Wiese Bockmann - Jul 19, 2011

The largest glut of ships in history means the cheapest freight rates relative to iron-ore prices in at least a decade, helping Rio Tinto Group and BHP Billiton Ltd. (BHP) to generate record profit.

The cost of transporting iron ore to China from Brazil, the biggest route, is now equal to 10 percent of the value of the commodity used by steelmakers, compared with 64 percent in 2003, according to data compiled by Bloomberg. That proportion probably won't rise much until at least 2013, said Sverre Bjorn Svenning, the director of Fearnley Consultants in Oslo who correctly predicted a slump in freight rates in March.

Iron-ore prices doubled in three years as mining companies failed to keep pace with record demand from steel mills, supply shortages that are also being found in everything from copper to corn. Some of that steel was needed for the biggest ever ship- building program. The expansion caused rates for capesizes, commodity carriers three times the size of the Statue of Liberty, to slump about 95 percent as iron ore soared.

"It's a dream for an iron-ore mining company: the highest commodity prices and the lowest freight prices," said John Banaszkiewicz, the London-based founder of Freight Investor Services Ltd., which estimates it handles about 40 percent of all forward freight agreements, traded by brokers and used to bet on transport costs. "Freight used to be a critical part of the delivered cost of iron ore and now it's almost nothing."

Freight Derivatives

Capesizes cost $11,314 a day to charter in the single- voyage market, compared with a peak of about $234,000 in June 2008, according to the London-based Baltic Exchange, which publishes rates for more than 50 maritime routes. Traders of freight derivatives anticipate costs no higher than $18,075 through 2016, data from the bourse show. Rates are volatile, rising or falling 18 percent or more in all except one of the last 12 months.

Shipping accounts for about 80 percent of world trade in goods, the United Nations Conference on Trade and Development estimates.

Global demand for iron ore will rise 7.3 percent to 1.84 billion tons this year, while supply will advance 2.5 percent to 1.81 billion tons, UBS AG said in a report July 12. Iron-ore fines, a grade of the material, will average $251.90 a ton this year, 41 percent more than in 2010, the Zurich-based bank said. It anticipates $243.50 next year and $230.70 in 2013.

Freight Costs

Lower freight costs increase the mining companies' share of the iron-ore sale price, said Johnson Imode, an analyst at Standard & Poor's Equity Research in London. The effect of freight on their profit is hard to gauge because they don't disclose contract terms, he said.

Rio, the world's second-largest iron-ore exporter behind Vale SA (VALE5), will report net income of $18.9 billion this year, 32 percent more than in 2010, according to the mean of 18 analysts' estimates compiled by Bloomberg. Iron ore accounted for 68 percent of the London-based company's profit last year. Its shares rose 41 percent in the past 12 months.

BHP, based in Melbourne and the third-largest iron-ore exporter, made $22.3 billion in its fiscal year that ended last month, 76 percent more than a year earlier, the mean of 15 analysts' estimates shows. Iron ore accounted for 26 percent of earnings before interest, taxes, depreciation and amortization in the previous fiscal year. Shares of the company added 26 percent in the past 12 months in London trading.

Economic Growth

The anticipated surge in profit may fail to materialize should economic growth slow. China, which makes more than two out of every five tons of steel worldwide, reported July 13 that its economy expanded 9.5 percent in the second quarter, compared with 9.7 percent in the previous three months.

Japan, the second-biggest steelmaking nation, will contract 0.6 percent this year, the median of 11 economists' estimates compiled by Bloomberg show. Growth in the

U.S., the third- largest producer, will drop to 2.5 percent from 2.9 percent in 2010, the median of 65 estimates shows.

The surge in income from mining contrasts with a slump in shipping revenue. A measure of the combined earnings of the 12- member Bloomberg Dry Ships Index will drop 30 percent this year, according to analysts' estimates compiled by Bloomberg. The dry- ships gauge declined 21 percent in the past 12 months.

The capesize fleet expanded 39 percent to 1,115 vessels in the past two years, and the remaining new ships on order are still equal to 36 percent of existing capacity, according to data from Redhill, England-based IHS Fairplay.

Capesize Fleet

The spare carrying capacity of the capesize fleet stands at about 57 million deadweight tons, or 25 percent of the total, according to Barclays Capital. On average, that much ore would yield about 35.6 million tons of iron, enough to make almost the same amount of carbon steel, according to data on the web site of the Brussels -based World Steel Association. It took 57,000 tons of steel to build the Empire State Building.

The cost of transporting Brazilian ore to China, the commodity shipping industry's biggest route measured by cargo volume and distance, was last at $20.40 a ton, compared with a peak of $108.75 in June 2008, according to Baltic Exchange data.

BHP hired 67 capesizes to haul single-voyage ore cargoes this year, while Rio took 72 such vessels, according to data from Clarkson Research Services Ltd., a unit of the world's biggest shipbroker. The data isn't definitive and doesn't include accords covering multiple journeys. Officials from the two companies declined to comment.

“Miners are in a sweet spot of demand for iron ore and transportation capacity,” said Miswin Mahesh, a shipping and commodities analyst at Barclays Capital in London. “The losers are the ship owners who ordered way too many ships.”

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