Box D

The Impact of Recent Commodity Price Movements on Resource Companies

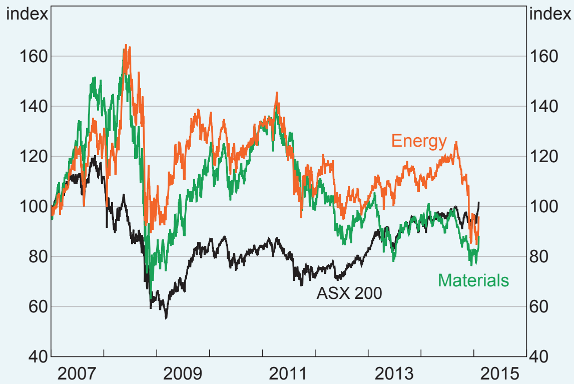
Share prices of companies in Australia's resources sector fell markedly over recent months following declines in iron ore and oil prices, which have led to downward revisions to expected earnings for the sector. Despite substantial capital expenditure over recent years, leverage in the sector remains relatively low, although there is some variability across companies. There has been only a limited increase in spreads on most Australian resource companies' bonds, suggesting that investors view the resources sector in aggregate as being reasonably well placed to cope with the fall in commodity prices. However, some small to mid-sized companies have experienced downgrades.

Resource sector share prices fell sharply over the second half of 2014.[1] More recently, share prices have partially recovered, with materials sector share prices 3 per cent below their mid 2014 level, while energy sector share prices remain around 20 per cent lower (Graph D1).

These developments reflect movements in the prices of key commodities such as iron ore and oil. While the iron ore price has been declining since late 2013, analysts' expectations for iron ore prices were slow to respond. However, further falls in the iron ore price in the second half of 2014 have led to downward revisions to expectations for future iron ore prices and a decline in the share prices of iron ore miners. Smaller iron ore miners have generally experienced larger share price falls than their larger, more diversified counterparts.

1 The resources sector comprises around 16 per cent of the ASX 200 by market capitalisation. Some companies that are closely linked to the sector – such as mining services firms – have also experienced share price falls.

Graph D1
Resource Sector Share Prices
End December 2006 = 100



Sources: Bloomberg; RBA; Thomson Reuters

The decline in the oil price, which began around the middle of 2014, accelerated into the end of the year following the November OPEC meeting. Long-term liquefied natural gas (LNG) contracts in Australia are typically linked to oil prices and, with a number of large LNG projects due to commence production over the next couple of years, the falls in expectations for future oil prices have led to falls in energy sector share prices.

The falls in iron ore and oil prices would be expected to erode profit margins in the resources sector. Indeed, the prevailing iron ore price appears to be below the previously estimated cost of production for some iron ore miners (See 'Box A: The Effects of Changes in Iron Ore Prices'). However, companies have announced a range of measures to reduce their production costs and/or capital expenditure. Other factors such as the depreciation of the Australian dollar and lower fuel prices have also reduced the impact on companies' margins.

With market analysts viewing these cost-reduction measures and other mitigating factors as unlikely to fully offset the fall in commodity prices, earnings expectations for the materials sector in both 2014/15 and 2015/16 have been revised down by almost 25 per cent since the middle of last year (Graph D2). Expectations for energy sector earnings in 2015/16 have been revised down by 40 per cent.[2]

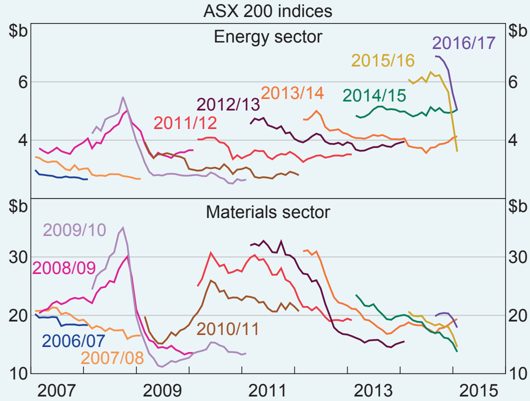
Notwithstanding the substantial capital expenditure undertaken by companies on iron ore and LNG projects over recent years, the aggregate gearing ratio of resource companies remains below that of all listed companies and below its average over the past 15 years (Graph D3). This can be explained by the greater tendency for resource companies to fund their expansion through internal sources or equity raisings rather than debt.[3] With several large projects due to commence production in coming years, many resource companies have scope to reduce capital expenditure from current levels and redirect cash flows to pay down debt. Nonetheless, there is some variability in gearing in the resources sector, with companies that have undertaken debt-funded expansion tending to have higher gearing ratios.

Credit markets have reacted to the falls in commodity prices. Several smaller resource companies have had their credit ratings downgraded or have been placed on a negative outlook or negative credit watch, indicating possible future credit ratings downgrades. The average credit rating of the materials sector remains unchanged since mid 2014 at A- while the average credit rating of the energy sector has declined by one notch to BBB.[4] Credit spreads

Graph D2

Analysts' Forecast Earnings

ASX 200 indices

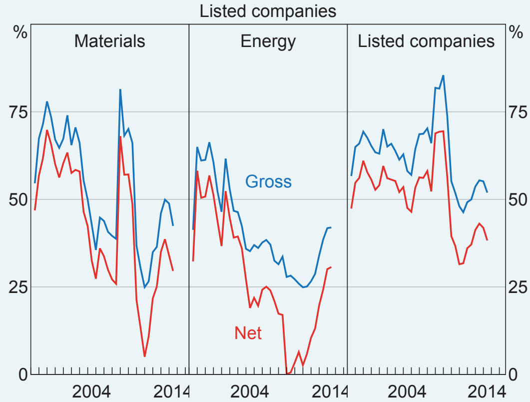


Sources: RBA; Thomson Reuters

Graph D3

Gearing Ratios*

Listed companies



* Excludes foreign-domiciled companies listed on the ASX

Sources: Bloomberg; Morningstar; RBA

on resource companies' bonds have generally increased by more than those for other non-financial companies since mid 2014. The market pricing of the bonds of several companies indicates that the market views their creditworthiness less favourably than the credit ratings agencies. Notwithstanding this, bond market pricing suggests that investors view the larger resource companies in both the materials and energy subsectors to be reasonably well placed to cope with the observed fall in commodity prices.

2 Earnings expectations for 2014/15 in the energy sector have been little changed. The delayed effect on energy sector earnings reflects that a number of LNG projects have not yet begun production, as well as the likely lags between changes in spot prices and realised prices due to existing supply contracts.

3 See Arsov I, B Shanahan and T Williams (2013), 'Funding the Australian Resources Investment Boom', RBA *Bulletin*, March, pp 51–61.

4 These credit ratings are calculated as the average S&P rating of the sector, weighted by companies' total outstanding debt. Unrated companies are excluded from the calculation.