

# Case Study Answers

to accompany

## Contemporary Strategic Management an Australian Perspective 2<sup>nd</sup> Ed.

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## **Case Study 3: Fortescue Metals Group Limited**

### **Question 1**

**What are the nature and sources of Fortescue's competitive advantage?**

**Answer:**

Chairman Andrew Forrest has been active as a company director on the Australian mining scene for two decades. The case notes that Forrest is both very experienced and very well networked in the financial, political community - especially in his home state of Western Australia. Forrest has been adept at building positive working relationships with state and federal politicians. Forrest background as an experienced and skilled project manager and project financier on the mining scene has been of value in informing his practice in the Fortescue start-up.

Exploration has been another high priority for Forrest and his team from the earliest days in 2003. It has been recognised as the company with the highest financial commitment to exploration in Australia. The importance of the success of exploration in the mining industry should be emphasised in class discussion.

Many of the original exploration team members remain present and active at the time of writing the case study across the Fortescue operations, helping to identify substantial reserves of iron ore across its 88,000 km<sup>2</sup> Pilbara tenement.

Exploration, iron ore reserves and managing project finance are three areas of competitive advantage for Fortescue.

### **Question 2**

**How has the setting of goals and values assisted Fortescue in achieving strong organisational performance?**

**Answer:**

The case notes exploration has been a high priority for Forrest and his team from the earliest start-up days in 2003. Fortescue has been recognised as the company with the highest financial commitment to exploration in Australia. Many of the original exploration team members are present and active today across the Fortescue operations, helping to presently identify a substantial 11.4 billion tonnes of reserves of iron ore across only 20 per cent of its 88,000 km<sup>2</sup> Pilbara tenement. The exploration team's track record is to add 1 billion tonnes per annum to the resource portfolio of Fortescue, providing the company with a sustainable competitive advantage that will assist future performance.

Fortescue has positioned itself as a low cost producer with a culture that promotes workplace safety and teamwork.

The case notes that Fortescue is also well known for its contribution to the well being of a range of stakeholders beyond their shareholders, and this is evident in the way the company has been developing and operating in the Pilbara since 2005. A number of examples are

provided in the case. For example there has been substantial investment in local communities through Fortescue's Vocational Training and Employment (VTEC) program, housing construction and residential workforce. Fortescue's Summit 300 goal of training and employing 300 Aboriginal people was achieved by 30 June 2011. Fortescue is publicly committed to the Australian Employment Covenant which is a country-wide initiative to create 50,000 jobs for the Aboriginal people. Fortescue has been working with its mining services project partner WorleyParsons on minimising the environmental impact of the dredging program at Port Hedland.

### **Question 3**

**What is the 'state of play' in the mining industry in Australia and globally?**

#### **Answer:**

Mining and mining services are two of the industries in which Australia has national competitive advantage. World leaders including BHP Billiton Limited and Rio Tinto Limited have dual stock exchange listing arrangements with the Australian Stock Exchange and the London Stock Exchange and extensive operations in the Pilbara Region of Western Australia. Hancock Prospecting Proprietary Limited also has extensive operations in the Pilbara region. Competition in this industry in Australia is intense.

The case notes that iron ore mining in the Pilbara region is capital intensive with the need for strong project management skills, access to substantial financial resources, and long lead times for project completions. Distances are vast and accessing a skilled workforce, housing that workforce, and providing community facilities in remote locations is a challenge. The unique challenges of the mining industry, including the need to explore and mine vast amounts of remote territory should be noted to students.

There has been tremendous demand for iron ore and coal from China in the 2000s as well as a rise in commodity prices, and this has assisted contract negotiations for iron ore for the large Australian mining companies.

There are over 2000 companies listed on the Australian Stock Exchange with the materials sector strongly represented in each of the small, medium size, and big company sectors. The success of a start-up such as Fortescue evidences the capacity for new entrants to gain traction in this industry.

There is increasing investment in large mining projects in Brazil and the African continent. Brazil and African countries (e.g. South Africa, Ghana, Zambia, Angola) have lower cost structures than Australia for major resource projects, especially in relation to the cost of labour, and this is a concern to the Australian Government and mining interests.

The Australian workforce is known for its lack of mobility between states within Australia.

### **Question 4**

**How is the Fortescue board of directors structured? What is Fortescue's reputation regarding corporate governance practice?**

**Answer:**

Initially Forrest was non-executive Chairman, however this changed when he was appointed CEO in 2005. The case notes that duality of the Chairman and CEO role is nowhere near as prevalent on ASX listed companies compared to New York Stock Exchange listed companies. Australian and British corporate culture prefers separation of these important roles. Forrest resumed as Chairman in a non-executive capacity in August 2011. There is a trend in the USA to greater practice of separation of the Chair and CEO role. This may be an interesting point of discussion in class, especially a comparison of CEO power (i.e. duality, CEO tenure, CEO stock ownership) and board power issues (i.e. separation, chair tenure, chair stock ownership, outside director tenure, outside director ratio, outside director stock ownership).

Present day Deputy Chairman Herb Elliott has also played a prominent role at Fortescue, having been an independent director from October 2003 to May 2005, then Deputy Chairman to March 2007, after which he was appointed Chairman until August 2011.

CEO Neville Power is the sole Executive Director. There are a further eight non-executive directors and a brief comment on the background of each director is provided in the case.

Forrest has been involved in a long running legal matter with the Australian Securities and Investment Commission in relation to whether or not Fortescue and Forrest misled investors on the status of any legal agreement with Chinese investors to construct a mine, railway and port. A 2009 decision by Justice John Gilmour in the Federal Court found in favour of Fortescue and Forrest. This decision was overturned when ASIC appealed to the full Federal Court in 2011. The matter is now before the High Court. At issue is whether the representations made by Fortescue in 2004 to the market were accurate and could be relied upon. There is a risk Forrest will be banned as a director if his appeal fails.

**Question 5**

**What is the future for Fortescue Metals Group? Explain your reasoning.**

**Answer:**

The case finishes noting that there is an uncertain environment for investment in mineral resources in Australia at present.

The mineral resource rent tax (MRRT) which came into effect in July 2012 is levied at 30 per cent on “super profits” over A\$75 million from iron ore and coal mining operations. Forrest has spoken out against the MRRT. Labour costs in Australia are high. The Australian labour force is known for its reluctance to move between states. Fortescue carries a substantial debt load as at the time of writing of the case. There has been some fluctuation in the price of iron ore on international markets and some uncertainty on future growth rates for the Chinese economy.

Class discussion here should focus on different scenarios for Fortescue’s growth. Key issues are:

- Understanding what the future interest expense of Fortescue will be in the future.
- Understanding what the price of iron ore will be in the future.
- Understanding what future sales revenue and profitability of Fortescue will be given the assumptions made about the price of iron ore.

- Understanding how to capitalise on Fortescues specific areas of competitive advantage.
- Making choices about when and where to action capital investment in mines, rail and ports.
- Should there be a pause in capital investment in mines, rail and ports? If yes, when?
- What is the succession plan if Forrest is banned from acting as a company director?

Facilitators and students answers to these questions can be quite varied but should be created on the basis of sound analysis of financial insight provided in the case (e.g. anticipated iron ore price, export volumes).

The past and present here will very much guide the development of strategy scenarios for the future.