Resources – it’s a cycle but we’re getting closer to the bottom

Dr Joanne Warner | Colonial First State Global Asset Management | 09 Feb 2016

Resources is a cyclical sector. An extended period of high prices has provided the incentive and funding for new projects and expansions, resulting in strong supply growth. Now, after five years of declining prices, more than half the industry is struggling to generate free cash flow. Companies are being forced to respond aggressively by cutting costs, reducing labour and closing high cost production.

This discussion paper reviews where we are in the cycle and highlights which commodities appear to have the best fundamentals for recovery in the medium term. While equity valuations look attractive, risks abound. Commodity prices and economic conditions are likely to remain challenging, so seek out only the robust companies when investing in resources to reduce risk.

For the commodities, China remains by far the largest consumer and, in general, demand has remained robust, growing in absolute terms. However, the rate of growth has declined. The Chinese government has plans to restructure economic growth away from fixed asset investments towards more sustainable consumer-led growth. The service sector now makes up 50% of China's total economy, up from 43% before the global financial crisis. While most commodities are currently in oversupply, those with better prospects for a demand-led recovery are those associated with growth in consumer products, rather than infrastructure and fixed asset investment.

Commodities under particular pressure include iron ore, coal, and steel. It is likely that the world is close to the peak production of steel. Unfortunately, weaker steel demand has coincided with the iron ore supply ramping up. Major new projects in Australia and Brazil are yet to reach full production. Most bulk miners try to increase throughput as a way of reducing their unit costs, exacerbating the oversupply. In addition, today's very low freight rates allow bulk commodities to compete in export markets well beyond their normal geographic range. Steel prices are under pressure globally as surplus Chinese product is starting to makes its way into the export market.

Commodities with more favourable demand outlooks include base metals like copper (electrical wiring and motors) and zinc (corrosion protection for steel), as well as palladium and platinum (legislated use in auto catalysts for cleaner emissions), uranium (zero CO2 emissions), oil and diamonds (the ultimate consumer product with significant pent up demand when economic times improve - just ask any woman!).

Gold remains a wild card. In 2015, around half the demand for gold came from China and India, with sales of bars and coins nearly twice that of jewellery.[1] Chinese investment has been growing over the last few years as the Shanghai Gold Exchange now offers a convenient way for local investors to purchase gold bars or gold-backed ETFs. Gold is quite different to the other commodities because it is not actually consumed and, as a result, investor sentiment will always be the main driver of the price. It serves a dual role as a currency and demand can be negatively impacted by rising interest rates, a strengthening US dollar as well as expectations for low inflation. Demand can be positively impacted by economic crises and political unrest. Gold is often seen as a store of value in an uncertain world.

For the commodity producers, commodity price declines are placing pressure on balance sheets, which not even the largest-cap global mining companies are immune from, especially given their desire to maintain credit ratings. Behaviours are starting to change. Dividend cuts are a good sign. But more change is needed. 2016 will be marked by further cuts in production, capital spending, and dividends, as well as balance sheet restructurings and asset sales. However, for pricing tension to return, more needs to be done to address oversupply.

The price of many commodities is now well below the marginal cost of production. In fact, some commodity prices are so low more than half the industry is failing to covers its costs. This has prompted drastic cost cutting and mine closures. Unfortunately these actions have pushed cost curves down, which in turn has moved price support even lower. In addition, weaker producer currencies and lower energy prices have reduced costs. This has provided enough breathing room for marginal producers to hang on, hoping for a turnaround in the commodity price before the bank comes knocking.

Ultimately the cure for low prices is low prices. A period of stability at weak prices should speed up the necessary restructuring of the industry. It should force the highest cost operations to cut or close production.

For the consumers of commodities, lower prices have improved margins and boosted demand. For example, the drop in the oil price over the last year has been accompanied by a pick-up in vehicle usage. In December 2015, the Chairman of China's State Grid, Liu Zhenya, announced plans to invest a further US$350bn over the next five years to build a highly efficient electricity distribution system that will extend beyond China's borders. The State Grid already accounts for 40% of China's total copper consumption.

For investors, there has been little to attract them to the resources sector over the last five years with negative absolute returns, declining earnings and increasingly strained balance sheets. However, in the last year, there has been a renewal of interest from large scale, long-term pension funds and tactical asset allocators. Sell-side analysts are getting a lot of interest for client marketing after years in the wilderness, and institutions are doing the research on global managers for future resource mandates. For those with a longer term investment horizon, the sector is screening as an opportunity. So far, this has been primarily 'pencil sharpening' rather than putting hands in pockets, but it does underscore that there is pent up investment demand looking for the right market conditions to reweight to the sector.

Retail interest is minimal and may remain that way until there is confidence that commodity prices and company earnings have stabilised. However, it is still market consensus to be short resources. Could this mean that we are close to the capitulation point where the last seller has exited? The short sellers will run out of steam eventually, and we've seen periodic episodes of short covering for both oil and gold in recent times.

The equity market is pricing in a multi-year hangover where there will be casualties, but there will also be opportunities amongst the more robust companies for those with a longer time horizon and capital to invest. Volatility is likely to remain in the short term, as trading dominates the market, however more stable long funds will be attracted to the sector when the necessary conditions for a more stable outlook emerge.

It's an interesting time to invest

The resources M&A cycle should crank up soon. Companies with distressed balance sheets and limited shareholder support will be forced to implement self-help. Forced asset sales and M&A activity could present investors with the opportunity to invest at cents in the dollar versus book value. To date, many of the assets put up for sale have had limited appeal. Most assets have been 'non-core' for the seller and that often means high cost, of limited life, or problematic. These assets have limited appeal to buyers and the prices realised at this point in the cycle may not make much of a dent in the seller's debt burden. Should difficult market conditions persist, and banks and equity investors remain on the sidelines rather than stepping in to provide more capital, companies will be forced to sell their higher quality assets. This is where the beginning of the new boom is made. Portfolios of assets can be accumulated by resource companies with strong balance sheets. There may also be competition from private equity and sovereign investors.

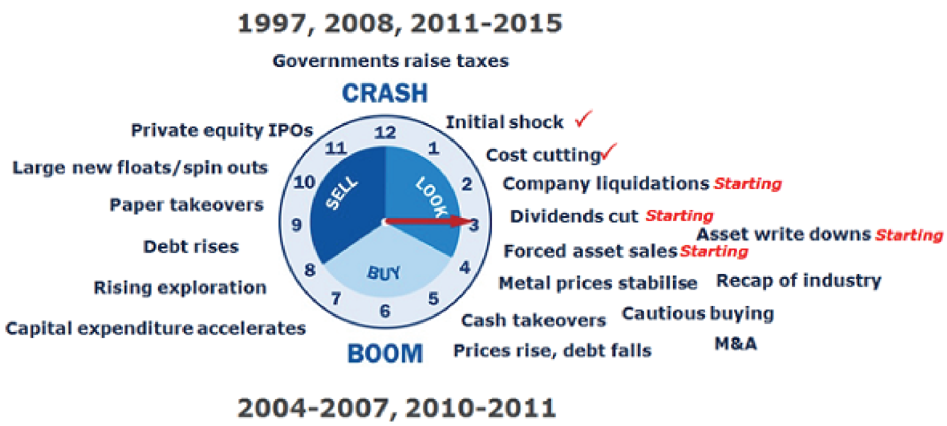
We are already seeing royalty companies taking advantage of this difficult point in the resources cycle. The royalty company business model is to buy a revenue stream of metal, gold or oil and gas into perpetuity in exchange for an up-front lump sum payment. Once regarded as a last resort for financing, royalty companies are now a critical source of capital for beleaguered resource producers. Current market conditions mean business is booming for royalty companies, as the number of investment opportunities explodes.

While we expect 2016 to be another difficult year for the base metal and bulk commodity producers, we continue to view the next few years as a transition to the inevitable upcycle. A period of low commodity prices will lead to mine plans being revised to incorporate lower commodity prices. This will result in fewer tonnes being mined but at higher grades. Reserves and resources will be downgraded, and – perhaps most importantly – mine lives will be reduced. Combine this with the sharp reductions in expansion capex and even sustaining capital spend, and the seeds are being sown for the next commodity upcycle, assuming demand stabilises over time.

The resources sector is unloved, under-owned, heavily shorted and facing a slow grind to re-establish equilibrium between supply and demand. This is incorporated in the prices for equities, with discounts that reflect the negative sentiment.

A contrarian with a longer term approach should be getting quite excited at this point, as long as they are selective in their investments. Robust companies that can ride out the cycle are more likely to prosper on the other side. Against this backdrop, producers with relatively healthy balance sheets and reliable free cash flow generation will likely be the beneficiaries of the excesses of their peers, because they are well placed to upgrade their portfolios through well-timed acquisitions. They could emerge stronger from the trough of the cycle, having acquired desirable assets from distressed sellers at cents in the dollar. A reasonable equity valuation at current underlying commodity prices is ideal. Don't be fooled by 'apparent' deep value. The market cannot really price the risk of a stock that could double when commodity prices recover, but may go to zero before that due to an over-leveraged balance sheet.

Figure 1: The mining cycle clock



Sources: Investec Securities, January 2016. Clock concept, courtesy of Lion Selection Group.

ENDNOTES

1. World Gold Council, 'Gold Demand Trends, Third quarter 2015', November 2015

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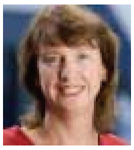

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