FROM THE CAPITAL

Investor expectations test OZ Minerals

Miner needs help from the copper price to maintain its current valuation

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OZ Minerals needs higher metal prices because investor expectations about its value are stretching beyond the reach of the company's own efforts.

In the context of the life cycle of a mining company, OZ Minerals can be described as being in phase IV, where phase I is discovery, phase II is development and phase III is steady state production.

A phase-IV company could be well known and presently profitable, but typically faces a decline in value due to near-term exhaustion of existing mineral resources.

For some phase-IV companies, this positioning can be terminal. Resource exhaustion often comes hand-in-hand with deteriorating operational outcomes and a parlous financial position.

A phase-IV company can sometimes stall the required decline in market price by holding out the prospect of something better to avert the inevitable. Operational improvements, fresh ore from nearby discoveries and asset acquisitions are the usual carrots dangled in front of anxious investors.

Expectation risk will be high as market values reflect historical outcomes no longer attainable and as investors fail to adjust quickly enough to the change in circumstances.

A phase-IV company will often have a well established presence among investors dating from the days it had been on a growth trajectory as a successful mine developer. A relatively high profile will encourage its use as a proxy for a change in cyclical conditions. Analysts will help by using

Key figure

A$533mn

The cash balance Oz Minerals reported at the end of March 2016

As Prominent Hill winds down, Oz will be searching for ways to maintain value for investors

the prospect of higher commodity prices to bolster an otherwise flimsy value proposition. That will work only if the anticipated more favourable market conditions occur soon enough to save the company from its impending fate.

For several reasons, OZ Minerals is in better shape than most companies at this stage of development but, after a 79% rise in its share price since mid-January, its popularity could pose a challenge. Without a rise in metal prices, the market value of the company could easily flounder before hitting the skids.

The company has shown it is able to operate a large-scale openpit copper mine with satellite underground workings. Appropriate emphasis on cost containment in cyclically weak market conditions by a new management team has added credibility.

The management's operating consistency has contributed to market confidence about the company's outlook. Ironically, being near peak production, having hit record output in 2015, has encouraged optimism rather than anxiety.

The company itself has forecast declining production over 2016-2019 from its Prominent Hill operations. Reductions in copper production from 130,305 tonnes in 2015 to 65,000-75,000t in 2019 are only partly offset by gold production forecasts rising from 113,028 ounces in 2015 to as much as 160,000oz in 2019 as ore stockpiles are tapped.

Prominent Hill struggles on until 2022 with underground resource potential and production from stockpiled ore, but copper output is set to take a further step down.

The investment attractiveness of the company will depend on a combination of continued operational excellence and capacity to develop its Carrapateena prospect in a timely manner with an appropriate return on the invested capital.

At the time of its acquisition in 2011, the company spoke of Carrapateena copper production rates being as high as 150,000t per annum from a target resource of 225-250Mt with a 1.2-1.3% Cu grade. More intense scrutiny showed this came with a potentially prohibitive billion dollar plus price tag. Although it is a large resource, a thick cover overlaying the Carrapateena deposit inflates the project's capital needs.

The latest iteration in the company's scoping studies indicates a more modest 40,000tpa copper production rate over at least 20 years, starting with production costs of US$1 per pound based on a 61Mt high grade resource containing 2.9% Cu. Average annual gold production over the life of the project is estimated at 38,000oz. The company is holding out the hope of a 2017 construction start and production in 2019.

A more frugal but still considerable pre-production capital investment of A$770 million (US$576 million) will be needed. OZ Minerals is unusually well resourced to conduct development activities. It reported a cash balance of A$533 million at the end of March 2016. Nonetheless, existing funds alone are insufficient to pay for a new mine development and source possible acquisitions while retaining the company's low debt standing.

Bringing the Carrapateena prospect into production at the currently anticipated rate would still leave the company with insufficient additional production to avoid a value rundown in the years ahead as its production profile declines and higher capital commitments are incurred. The investment risks are predominantly in one direction.

The outlined plans barely validate the existing share price. Even with the second mine, my valuation of the future cash flows in a neutral commodity price setting falls within 5% of the current market price of the company.

The existing risk profile is heightened by the almost inevitable temptation to seek out new production and development opportunities to backfill the impending value loss.

The company has acknowledged having already conducted due diligence on prospective acquisitions, but its very broad guidance about what it would be willing to pursue leaves investors facing a mergers and acquisitions lucky dip.

A bid for assets with a near-term impact on production will likely prove expensive or in need of a hefty follow-on capital commitment making value extraction doubtful. Purchase of longer gestation assets, on the other hand, will mean little to the value proposition in the near term.

The asset composition of the company and its current market value imply future investment returns will depend heavily (and possibly entirely) on a cyclical improvement in copper prices.

Many investors will want to back the chance copper prices will rise over the next few years. With a current A$1.8 billion price tag on the company, however, there would be hundreds of smaller companies offering stronger investment leverage than OZ Minerals to the same turn in conditions.

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