

FROM THE CAPITAL

Why bet on the impossible?

More lithium cannot be used than actually exists

John Robertson*

There's not a snowball's chance in hell that mainstream lithium market forecasts will be realised. So, before joining the rush, investors need to ask: "What is really going to happen and are there better investment alternatives?"

The lithium market is widely, if not universally, seen by analysts as the most robust of the metal markets. Usage growth depends little on the momentum of global economic activity. Technology advances and attempts to use energy more efficiently are the drivers.

Burgeoning numbers of lithium mining aspirants are typically stoking excitement with charts and data showing demand for lithium running well ahead of the amount being produced.

This is simply not a feasible outcome. More cannot be used than actually exists. The charts are an idealised form of analysis used to lure investors into a belief about the underlying strength of a market.

A serious investor needs to ask what is actually going to happen. Logically, there are barely a handful of alternative potential outcomes.

Aggressive project development may lead to a more rapid rise in supply than is currently anticipated, giving industrial users all they need.

Conventional wisdom considers this an unlikely outcome, although the queue of new entrants and supply potential grows by the week as extraction techniques are also being advanced. Views of supply potential are changing, but project



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gestation time is the constraining factor.

Alternatively, manufacturers of batteries may decide to compete aggressively for the limited available supplies.

Pushing up lithium prices to choke off demand assumes differing pain thresholds among battery makers.

It implies some makers will move to other technologies or be willing to postpone plans to accommodate unfavourable market conditions.

Either way, the amount used will end up below forecast levels.

Lithium producers could connive in this outcome by embracing the BHP Billiton strategy to price their output on the spot market without regard to longer-term relationships or value support.

Almost certainly, this course will result in an eventual price collapse to around or below the production costs for the bulk of the industry as the battery makers take commercial revenge as soon as market balances tilt in their favour, possibly as soon as two or three years.

A third feasible outcome is for battery manufacturers to use their relative economic strength to prevent a price free-for-all. They could contract for what they can get and, at the same time, underwrite future production expansions in exchange for long-term prices closer to costs of production.

Orocobre, which is already phasing up production, and others still planning an entrance expect production costs in the vicinity of US\$2,000-\$3,000 per tonne compared with current prices extending past \$10,000/tonne.

Investor salivation at the resulting margins shows how quickly lessons are forgotten. The argument for the gap between lithium production costs and prices being sustained is the same as the argument in favour of \$150/tonne iron ore and \$110/barrel crude oil. There is no reason to believe the fate of lithium miners will be any different.

The reaction to what is happening in the lithium market would be more exuberant in cyclically stronger conditions. Since mid February, the Global X lithium exchange traded fund, for example, has risen 39%. Without a continuing infusion of new investors moving money from other sectors or reducing their cash holdings, further gains are not impossible, but become harder to achieve.

Momentum loss is a greater risk near the bottom of a cycle prior to the sector being able to muster the escape velocity needed to power super-normal returns.

From an investment risk management standpoint, more opportune exposures such as in uranium (or even coal) may exist for more value-oriented longer term investors tempted to put a toe in the investment water.

There has been a 40 percentage point difference in favour of lithium between the returns from the Global X lithium and uranium exchange traded funds since the beginning of 2011.

Much of the same back story attaches to the outlook for uranium demand as for lithium. The same excess demand pattern put forward as typical of the lithium market is expected from more widespread adoption of nuclear power.

Long lead times for power plant construction provide a high degree of confidence about the amounts of uranium needed. Indeed, investors may legitimately have greater confidence about the outlook for uranium use than the outlook for lithium.

In contrast with the lithium market, where there is an influx of potential new producers, uranium producers are battling to stay afloat and explorers are looking at alternative commodities through which they can more easily source funding. Uranium prices are generally insufficient to validate new production.

Implicitly, investors have concluded that the prospective growth in uranium demand is too far into the future to warrant a re-pricing of equities presently. The Global X uranium ETF price is 2% below where it was at the beginning of 2016 and still trending lower despite sitting 90% below where it was at the beginning of 2011.

So intense is the excitement over the lithium market that another 30-50% return from lithium exposed companies could be possible even as the rest of the mining industry languishes in a cyclical trough.

It would be foolish to deny the possibility. Many explorers will display share prices highly leveraged to the announcement effect of lithium mineralisation within their tenements.

But the diminishing chance of a 50% gain from lithium could be significantly less than the rising chance of a 100% return from uranium-exposed companies, which would still leave them 80% below where they were at the beginning of 2011.

In short, investors should exercise caution about too readily climbing on the lithium bandwagon without adequately weighing the relative risks and opportunities in a still cyclically weak market. ■

Key figure

\$1,000

Price per tonne of lithium, compared with expected production cost of \$2,000-\$3,000/t

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