Opinion

FROM THE CAPITAL

Exaggerated claims overstate zinc market potential

Great story-telling power should come with greater responsibility

John Robertson

Ironbark Zinc chief executive Jonathan Downes has been using an upcoming shortfall in global zinc supplies to rally investors for his Citronen zinc project in Greenland, but his recent presentations are a reminder that companies rarely assess market information dispassionately.

What executives are allowed to say about the characteristics of their mineral deposits are carefully circumscribed by regulators in case they mislead. Disturbingly, fewer constraints are placed on outlandish, misleading or unqualified claims about the markets in which they operate.

Deficient future supply is a common argument mounted by companies looking to ramp up investor enthusiasm. The looming deficit argument usually assumes unique prescience despite ample evidence of strong herding instincts within the mining industry. The assumption that everyone else stands still while one company takes advantage is usually wrong.

Downes went further than most in his selective use of self-serving market data. He hung his investment pitch on the unique positioning of zinc markets. Zinc, he said, was the only metal whose inventories had already fallen for four consecutive years. Zinc's fortunes were already locked away, he opined to a large gathering of predominantly retail investors recently.

According to the International Lead Zinc Study Group (ILZSG), inventories fell in 2013 and again in 2014 but have not fallen either in absolute amounts or relative to consumption for four straight years. Downes' central supporting argument for an investment was wrong.

Dogmatic assertions about likely market size also usually ignore how sensitive metal usage rates are to changes in global growth momentum. Extrapolating a 3.7% annual growth in zinc consumption could, as Downes suggested, result in such a large cut in inventories that zinc prices would soar but the average consumption growth rate is closer to 3%, significantly down on the assumption he chose.

The average boosting 6.5% estimated consumption increase in 2014 was one of the five largest experienced in the zinc market in the past 35 years and followed a prior year of above-average growth. More often than not, growth in the next year tends to be weak and even non-existent under these circumstances.

Better hold on there … robust annual zinc consumption has been followed in the past by a slump in use

We are already seeing signs in China of stalling raw material use. China's steel production in the first two months of 2015 has been estimated by the World Steel Association to be 0.2% lower than in the corresponding period of 2014. The ILZSG's estimate of global zinc usage in January 2015 was 1.5% lower than for January 2014. Usage in January 2014 was 6% higher than a year earlier and indicative of the outcome for the year as a whole.

If there was no zinc consumption increase in 2015 before growth rises to 5% over the subsequent five years, the industry could replicate its average post-1990 growth outcome but inventories would remain higher throughout than they were at the end of 2014. The argument for a price increase will have evaporated.

The Ironbark Zinc inference about the state of the market is just one of an infinite array of plausible outcomes, all of which are highly sensitive to nuanced changes in the momentum of global economic activity.

The Ironbark Zinc representation of how markets behave also assumes that what happens to the US dollar will have no bearing on the level or direction of US dollar denominated prices. This is despite a solid body of evidence to the contrary, a 25% rise in the US dollar and at least a risk of it going higher.

Companies are entitled to views but their public expression should come with some obligations. Factual accuracy and an acknowledgement of the uncertainty attaching to their preferred market outcomes would be good for a start if they are going to urge people to use their conclusions as the foundation for an inherently risky investment decision.

If the primary driver of investment success is going to be a rise in zinc prices, Ironbark Zinc may be just one of many companies with greatly improved investment returns, leaving investors with several further considerations.

Those companies most leveraged to a cyclical improvement in markets often have relatively high cost structures or otherwise doubtful development outlooks. Any investor trying to determine how best to position a portfolio to take advantage of a zinc price rise needs to match the nature of the companies to which the benefits will accrue with how much risk he or she is prepared to incur.

If one stock alone is to be plucked from the pack of options, an investor needs to decide whether that single company should be an explorer, an existing producer, a company high on the cost curve to maximise leverage, one with organic expansion opportunities or, like Ironbark Zinc, still in the development phase and looking to fund a new project.

Within this context, investors need to be wary about company-specific equity risks no matter how confident they are about the commodity market outlook. Higher-than-anticipated capital costs, delays in ramping up production, bad weather and unexpected geological conditions are just a few of the factors that so often intervene to prevent a company reaping the rewards of higher prices.

An investor could reasonably conclude that a commodity-based instrument offering direct (and certain) access to a return from a zinc price rise would be preferable to holding an equity.

Alternatively, to modify equity risk, a selection of zinc-exposed companies with differing cost and development attributes may make more sense than a single stock. This could be done by purchasing multiple positions or, possibly, through one of the growing number of commodity-themed exchange-traded funds.

Everything would have been so much simpler if we could have accepted unthinkingly that there had been four years of zinc inventory decline leading to a single investment option. ▼

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