Mining Journal

Viewpoint > From-the-capital

Miners face funding cost rises

The cost of capital for mine development is skyrocketing despite unprecedentedly low government bond yields, as signs of financial market dysfunction emerge.

John Robertson*

19 March 2020

The equity market has been undiscriminating in dishing out losses over the past two months. Sector leaders like BHP, Rio Tinto and Freeport-McMoRan have all lost 40-50% of their values between mid-January and Wednesday this week.

The 51% median decline in US-dollar equivalent prices across the universe of ASX-listed resource companies has been little different to the losses among the market leaders. The ASX small resources share-price index, made up predominantly of second tier producers facing an earnings contraction, has fallen 47%.

Existing producers will be the companies most susceptible to institutional capital allocation decisions. Price recoveries for them will most likely coincide with that of the broader market. So, too, will any further weakness.

Greater certainty about the extent of the COVID-19 economic impact will eventually allow a reassessment of their earnings potential and a recalibration of appropriate market prices. Pending that, equity markets will aim to put in place a buffer against downside risk.

The vast bulk of stocks in the sector do not face an uncertain near-term earnings threat simply because they have no near-term earnings. Their values should be tied to the chance of a discovery and whether the extent of any mineral find would be sufficient to support mine development a decade or more from now.

Even an unusually deep recession this year should matter little to the valuations of the earliest-stage participants in the industry. The finance text books might even suggest more attractive project values with the prospect of indefinitely lower

government-bond yields.

In reality, the cost of funding for these capital hungry businesses is on the rise. Company directors should be keeping an eye on the yields of below investment grade debt for a guidepost to funding prospects.

The newest funding scare might have coincided with the onset of the coronavirus pandemic but can be linked to the slump in oil prices and the deteriorating survival chances of a swathe of indebted US oil exploration and development companies.

“ **The next step up in the gold price will be when markets stabilise and wealth begins to build once again**

The US oil boom has centred around easy land access in places like the Permian Basin and specialist funding institutions keen to lend cheap Fed-subsidised money. Companies from as far away as Australia were enticed by a business model almost certainly doomed to failure.

New drilling techniques led to very quick production starts. Relatively short operating lives for new wells, measured in months of peak production rather than years, meant increasing numbers of wells were needed to simply maintain production. More wells meant more debt. More debt meant growing reliance on an OPEC cartel, quickly losing market clout, to keep the model afloat.

Now, everyone relying on sub-investment grade funding is suffering. The ICE Bank of America CCC-rated bond yield index has already jumped from just over 11% to nearly 17% in a little over three weeks opening a spread of over 16 percentage points with declining five-year US treasury yields.

CCC-rated bond yields now sit at the highest level in four years. Back then, they were on their way to halving, after having peaked at just under 22% in early 2016. The decline in yields coincided with a rise in the funding sensitive ASX small resources share-price index of as much as 88%. Rising yields during 2015 had come with a 36% decline in the industry equity indicator.

The institutions funding miners are connected by the same financial plumbing to those funding the oil patch. Even if the COVID-19 outbreak is quickly corralled, the mining industry now faces a repetition of the sequence of funding cutbacks that has so badly damaged investment performance in earlier years.

The gold price has taken its lead from the riskier end of the financial market in failing to react positively to the move lower in government bond yields. In another blow for miners, financial markets are disregarding the alleged safe-haven properties of gold.

The safe-haven argument for gold is, in any event, an increasingly outmoded historical figment. Wealthy oligarchs or the scions of kleptocrats might have once needed a discrete financial alternative to their local fiat currencies. These days, penthouse apartments in New York or ownership of British football teams, let alone more conventional financial assets, compete effectively with gold to cloak their sometimes dubiously acquired wealth.

As I pointed out in my February 13 column, gold investments thrive when wealth is growing. Wealth destruction is not good for the precious metal. The next step up in the gold price will be when markets stabilise and wealth begins to build once again.

Gold miners could also have expected a benefit if the much touted zero correlation with other asset classes was being realised. Again, this is another oft repeated myth built on a flimsy analytical base.

More often than not, gold prices have a high or rising positive correlation with the S&P 500 or, at other times, an equivalently negative or falling correlation. The net result is a zero average. There are few occasions when the correlation actually sits at zero.

Feasibility studies, as usual, will ignore present changes in the cost of capital. Directors, abetted by their consultants, will seek to justify projects on the ill-conceived assumption that capital is cheap and supply is plentiful. Later, they will express dismay when projects flop through lack of financier interest.

After coronavirus infections are managed lower, financial markets are likely to remain distressed. Disrupted cash flows will have caused ratings downgrades across numerous industries. Balance sheets will be far shakier than they had been. Corporate funding will remain hard to get as markets face a prolonged withdrawal of central bank support.

Miners might be looking back at the last few years as the good old days when discussing the challenges confronting industry financing in the years ahead.

**John Robertson is the chief investment strategist for PortfolioDirect, an Australia-based equity research and resource stock rating group. He has worked as a policy economist, business strategist and investment professional for nearly 30 years, after starting his career as a federal treasury economist in Canberra, Australia*