Pondering a lift in equity prices

Shares in mining companies have plunged in 2013. A catalyst for change is not easy to find

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As 2013 ends, mining industry investors are grappling with whether a three-year downturn in equity prices is a mark of irrationality or whether a permanent re-pricing of the industry had been warranted.

Among the approximately 1,000 ASX-listed resources companies, the median change in share prices over the first 11 months of 2013 has been a negative 43%. Since the beginning of 2011, near the peak in market values, median prices have contracted a staggering 78%. The year concludes with genuine doubts about the capacity of many companies to ever produce a positive return on equity invested.

Of course, embracing pessimism just as a cycle is about to turn remains the forecaster's curse. The most glaring reminder of this analytical flaw remains the December 1984 cover of *Businessweek* magazine, which depicted a coffin under a headline proclaiming "The death of mining" just as a new cycle was about to start.

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Amid the most recent market carnage have been a few success stories. Within the Australian market, Sirius Resources NL has identified a new mineral province where one was not previously suspected by many. But even for this most successful of industry exploration efforts, there has been a share price loss of 60% since the spike in the company's market value in the first quarter of 2013.

In a capital hungry industry where survival depends on new funding, existing shareholders are doomed to suffer dilutive capital raisings. Because of companies' funding needs, the rational investor can justify selling as share prices fall lower, rather than buying because companies are becoming cheap, leaving the industry in a potentially nasty death spiral until an exogenous force intervenes.

Investment strategists are left to ponder what, if anything, will catalyse a directional change. To do that, some judgements must be made about how much of the re-pricing of the industry has been cyclical and how much has been warranted by genuine changes in underlying industry value.

Several features of the industry and its operating environment have stood out in 2013 as validating lower share prices.

One of the most compelling features of the industry landscape over the past year has been the frequency of project delays. This is the reason for low prices that most often baffles industry executives who ask, why? Unless something else is changing, a rational market should force share prices lower for every day a project is delayed.

A shortage of skills is harming value. Since the beginning of the most recent cycle, the number of ASX-listed resources companies has nearly doubled. Every one of the hundreds of new entrants has a chief executive and, sometimes, one or two technical staff – most of whom had previously held senior technical or finance roles elsewhere, spreading executive talent ever more thinly.

The gold-mining segment has battled to prove its worth in 2013. Massive changes in prices have been a rational response to an industry bereft of growth with constantly rising costs. As if that were not enough, the industry faces a huge competitive challenge from gold bullion itself, which now acts as the benchmark against which the investment returns of all gold producers can be judged.

A portfolio manager knows that if he buys an ounce of gold today, he will have an ounce of gold in 10 years' time. If he bought the equivalent value in a gold equity, what will he have? The truthful answer is that he would not know. That encapsulates the modern day problem for any gold miner: how to persuade the market that it cannot only hold its value against bullion, but also adequately compensate an investor for risk.

A convergence in global growth between the advanced economies and the developing economies became more evident through the year. National accounts data for the September quarter show that the US and the UK were growing faster than India and Brazil. Once that might have been cause for concern that the global economy was dangerously overheating. Not today. Growth in the two developing economies has petered out.

The dynamism among emerging economies that challenged the mining industry to meet their needs is not currently evident. There is no cause for any additional risk premium.

Many projects, like Minas-Rio in Brazil, have been hit by delays

Chinese growth rates appear to have stabilised at around the minimum consistent with the new government's employment objectives. Unleashing pent up economic energies had propelled the Chinese economy for two decades, but, like the bursting of the dam wall, the water flow eventually becomes a trickle. This is beyond a cyclical problem.

The Chinese leadership understands new sources of economic energy are now needed, but the power of their foreshadowed reforms has yet to become evident and China remains more at risk of falling below its target than exceeding it by an equivalent amount. In the short term, China has kept investing to avert the downside risks. Raw-material markets have benefitted, but the threat of losing the investment impetus saps equity value.

US Federal Reserve monetary policies have been a double-edged sword for the resources industry in 2013. They have kept commodity prices higher than they otherwise would have been through the creation of speculative capital flows and downward pressure on the US dollar.

At the same time, the Fed's policies have encouraged investors to seek out yield – something the vast bulk of the resources sector is incapable of providing or simply unwilling to contemplate. Funds have flowed elsewhere, producing historically large disparities in returns between miners and other equity investments.

In the new year, I will touch on the more positive aspects of the industry outlook as it enters 2014, including the challenge of meeting the material expectations of a burgeoning global middle class. For the time being, these needs are being amply met, albeit with subsidies from increasingly impoverished investors.

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