Mining Journal

Miners positioned for recovery

A V-shaped recovery from the damaging economic effects of the COVID-19 pandemic does not translate automatically into strong mining industry investment returns.

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Last week's 'From the Capital' column described three scenarios for how the coronavirus pandemic will impact economic and business outcomes.

Of the three scenarios, beginning to reopen shuttered businesses during May, with accompanying social distancing practices, intensified community testing and rapid containment of any fresh coronavirus outbreaks, is easily the most favourable.

While numbers of deaths tragically mount, fatalities are generally undershooting biostatisticians' early forecasts giving rise to expectations among investors that scenario one is the most likely of the three to eventuate.

For once, the relative isolation of the mining industry from population centres has been an advantage. Its operating model is more or less intact. In other industries, even a near-term recovery in economic activity will require a strategic reappraisal of how business is done. Survival cannot be assumed.

Miners will usually thrive on improving global growth momentum. The strongest growth in metal demand coming out of the 2008-2009 financial crisis came in 2010 when global GDP growth accelerated by 5.5 percentage points to reach a since unsurpassed 5.4% pace.

The upward forecast revisions typifying a rising growth environment usually translate into larger capital allocations to the mining sector by investment strategists.

Something similar would be consistent with the first COVID-19 recovery scenario. Still unresolved, and critical to the outlook, is how much of a hit does metal use take

before the onset of this strong growth phase.

Historical relationships suggest a 7-10% contraction in use of metals like copper, zinc and aluminium in the event of a 3% contraction in 2020 global GDP.

A potential upward swing of as much as nine percentage points in global GDP growth between 2020 and 2021 should spur a historically large increase in metal demand. Although a growth reversal of that size is beyond the bounds of experience over the past 50 years, metal usage increases of 10-15% would be reasonable assumptions based on how markets have reacted in the past to unusual surges in economic activity.

> “ **Capital for the mining sector could be in shorter supply and more expensive**

In the most attractive scenario for the industry, metal use in 2021 could edge toward 2018-2019 levels. Something higher is only an outside chance as long as global GDP lags 2019 levels.

Equity markets are likely to take their cue from what happens to metal prices. The direction of prices will depend to a large extent on how speedily metal output is adjusted to swings in demand.

On its own, the scenario one demand path would come with mounting metal inventories. Coupled with already planned increases in available supplies through a pipeline of exploration and development efforts from earlier years, miners could be facing weakening prices as the rest of the business world is getting back to work.

The recent oil industry experience is throwing up some unexpectedly extreme lessons about how commodity markets can react in the absence of timely supply-side management.

At the same time, efforts to manage production levels can send distress signals to potential investors. Oil and gas exploration and production stock prices fell as much as 37% during 2019, according to the SPDR sector ETF, well before the demand destroying effects of the COVID-19 outbreak.

BHP and Rio Tinto, the world's leading miners, had experienced near unbroken rising trends in their share prices over more than three years coming into 2019 and before cyclically high valuations retarded further progress. They have shed around one-third of their value since late January.

More often than not, mining equity investors limit the downside by anticipating recovery and place a lid on the upside by keeping an eye on valuation.

BHP, the most important contributor to sector equity price indices, has reported earnings before interest and tax of US$24.7 billion for 2019 with iron ore and copper prices averaging $78 per tonne and $5,843 per tonne ($2.65 per pound), respectively.

Since 2000, investors have paid an average of 3.3 times EBITDA for BHP with peak valuations at times of cyclical strength, as in 2008 and 2010, of around 4.2 times EBITDA.

If BHP can replicate its 2019 financial effort by 2022, a valuation consistent with historical averages suggests a prospective share price gain of around 35%. At peak 2000-2019 valuations, consistent with a genuine V-shaped recovery lasting through 2021, the return would be extended to 70% over two to three years.

The leading stock in the sector, although hardly typical of the whole, suggests some optimism about the return opportunities with a favourable wind at its back.

Second-tier producers of metals and energy materials typically do not have the cash resources with which to cushion a fall in demand or cyclically depressed prices. Demand destruction of any magnitude threatens their earnings and, possibly, survivability even with a swift restart to commercial activity.

Finance availability will be one of the challenges for the more capital hungry parts of the industry, including explorers, those companies with development ambitions and operators with working capital

shortfalls.

Huge expansions in government funding needs and reduced corporate and personal savings rates will add to competition for funds globally. Traditional retail sources of funding for early stage mining activities will also have been damaged by loss of personal incomes during 2020, ongoing high unemployment and the fall in the value of superannuation portfolios.

Financial markets are already showing a desire to differentiate strongly between risk categories. Advanced-country government-bond yields are trading near historically low levels, while the value of low-rated corporate debt has deteriorated.

Even under the most propitious of post-coronavirus scenarios, capital for the mining sector could be in shorter supply and more expensive.

Needless to say, these capital-shortage tendencies would prove even more uncomfortable in either the second or third of the three post-coronavirus scenarios. These alternatives will be looked at more closely in 'From the Capital' next week, along with the potential for gold mining or energy metals to resuscitate the industry's investment prospects.

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