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South32 looks to the future

South32 management ducked the most important question about its acquisition of Arizona Mining: "Why now?"

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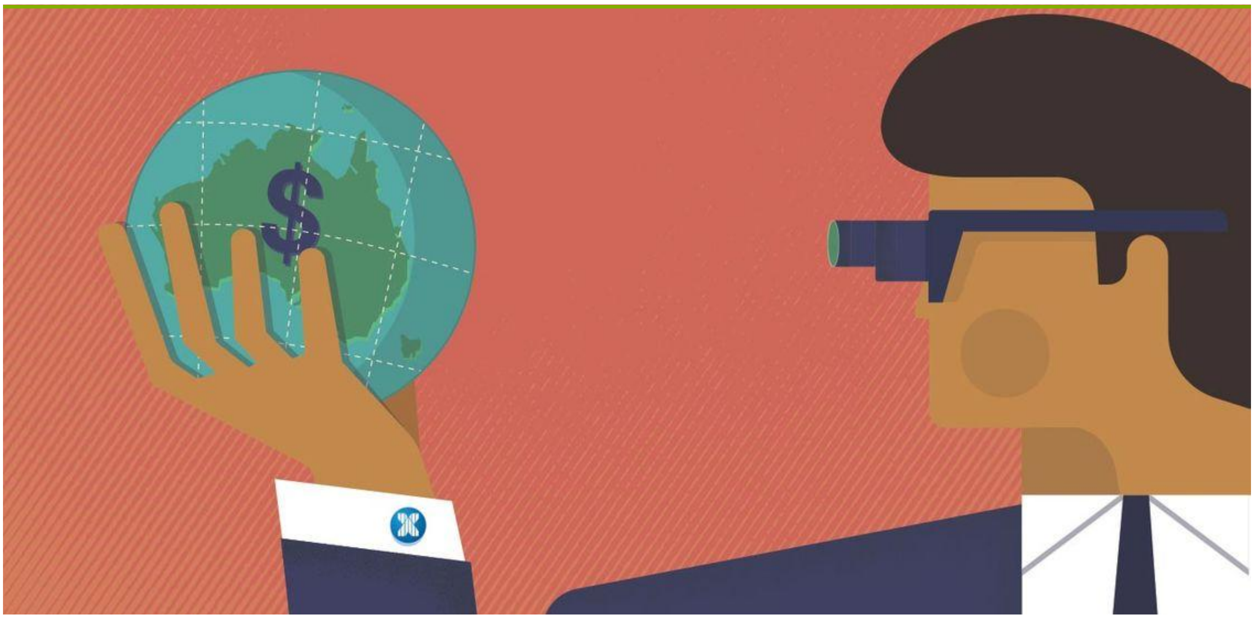

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Earlier this month, diversified metal miner South32 announced that it would pay US$1.341 billion from its cash holdings for all the securities it did not already own in Canadian-listed Arizona Mining, taking its total investment in the company to $1.445 billion.

The aim of the agreed bid was control of the Hermosa lead-zinc-silver project south of Tucson near the US border with Mexico.

A November 2017 resource statement for the Taylor deposit within Hermosa had described 144.6 million short tons of measured, indicated and inferred ore containing 4.1% zinc, 4.4% lead and 2.5 ounces per tonne silver.

In briefing analysts on the day of the announcement, South32 chief executive Graham Kerr was keen to emphasise the resource was open at depth and laterally and came with significant regional exploration potential.

The South32 bid comes against a historical backdrop of mining companies overpaying near the top of a cycle and a generally dismal record among high profile Australian companies - not only miners - buying north American assets.

Kerr referred to having "a deep understanding of the resource" after first visiting the site in October 2016. Since then, and having invested US$104 million for a 17% stake in the company during 2017, the group had gained familiarity with the project through participation in the operations committee and, later, taking a position on the corporate board.

Beyond describing the transaction as "a big step forward", Kerr did not posit an underlying value proposition or suggest why South32 shareholders would be better off with the transaction than in its absence.

> “ **The idea that prices will settle gently on a sustainable long-term value flies in the face of a long history of highly variable outcomes**

Sometimes, the rationale for a transaction seems so blindingly obvious to those immersed in its delivery that they take for granted that everyone will instinctively understand.

At other times, and more ominously, the absence of a stated financial or strategic rationale can also signal such thoughts had not been a meaningful part of the decision making.

Arizona Mining needed to spend US$519 million to get production at Hermosa underway, according to a January 2018 preliminary economic assessment. The incremental investment would generate US$6.6 billion over three decades, according to the study, equivalent to buying a bond with a 39% yield. The return on combined historical equity of US$265 million and future invested capital would be some 15 percentage points lower.

The maths is less compelling for South32. Having to take out the existing owners cuts, the bond yield equivalent to an unexciting 10.2%.

South32 will be hoping for a more sizeable project by quickly building the reserve base. That will help improve the economics but, ultimately, adequate compensation for sector and development risk will require something better than the currently assumed metal prices.

One analyst, in the public briefing, apologetically asked how the transaction fitted with the company's view of the current cyclical positioning of the industry.

Kerr placed greatest emphasis on the imminence of funding decisions, in explaining the transaction timing. He appeared worried that a company with limited financial clout would take near-term financing decisions that might constrain or perhaps damage future development options.

In justification of the decision, executives also cited their use of metal price assumptions below current market levels - and close to the US$1 per pound long-term consensus among broking analysts for zinc - to come to a decision about going ahead with the transaction.

Consensus forecasts of metal prices offer users some psychological comfort but contain fundamental flaws that can render them spurious guides for investment decisions. In short, forecasts are not independent of the market. Mining industry participants, as the South32 example affirms, react to forecasts in a way companies in other industries do not.

So, potential zinc producers with anticipated production costs of US$0.60/lb, for example, will bring on additional production as more analysts concur that prices will settle indefinitely at US$1/lb. In doing so, they will reshape the cost curve and create the circumstances in which metal prices can fall.

Paradoxically, the stronger a current consensus about what happens more than three years away, the less likely it is to be realised.

In forecasting, even the most adept commodity-market analysts typically omit the feedback loop. When they put numbers on what might happen several years away, they become little more than naïve extrapolators of recent prices.

As it happens, average zinc prices over the past 10 years, five years or three years - pick a number - are all within US5c of US$1/lb.

So, unsurprisingly and consistent with the evidence from psychology about decision-making biases, the so-called long-term future zinc price consensus closely resembles history. It is less a forecast than an attempt at a credible working assumption about a dynamic future market.

The idea that prices will settle gently on a sustainable long-term value, as the Arizona Mining study assumes, flies in the face of a long history of highly variable outcomes.

Cost structures provide a lower bound in the event of recession. Substitution effects and supply responses help define the upper end after a period of rapid demand expansion. At any point in time, prices are moving between these wide limits.

For zinc, seven-year cycles falling within a US$0.60-2/lb range could validate an average price assumption over 30 years well ahead of the current consensus. Even then, a low-cost producer might see its margin considerably narrowed or even occasionally eliminated.

The unluckiest might face financial stress if temporarily low ore grades, given the sequence of mining, happen to coincide with temporary periods of cyclical downturn.

The great challenge for any miner is to dodge bringing on a new project as a cycle begins to turn, no matter how attractive 'the long term'.

South32 has been coy about its thoughts on these points and, most importantly, whether a 10% return is adequate compensation for the risks accompanying these complex market dynamics.

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