3 miners and how to play them

by Roger Montgomery

Putting aside any societal benefits, the objective of starting a business is usually to generate a profit for its owners. Shareholders are owners of a business and so presumably they are interested in receiving their proportion of the profits.

Thanks to the stock market however, the nexus between a business and its owners can often be lost or forgotten. Instead of seeking to profit from the long-term ownership of a business, ‘investors’ – I use that term loosely – often use shares as gambling chips, betting on nothing more than the ups and downs of prices. The emergence of this approach to the stock market has rendered many good intentions nothing more than speculation, and akin to betting on black or red at the roulette wheel.

One of the biggest recipients of this style of ‘investing’ is shares representing companies operating in the mining, materials and resources sector.

Suppose for a moment I offered you an opportunity to invest in a new business venture through an Information Memorandum (IM). Reading this IM, you discovered that the asset of the enterprise was a licence to explore, and later mine, a vast tract of land situated between four white pegs. The operators are not sure how much valuable ‘stuff’ is underground, nor how long it will take to extract. The operators also don’t know how much it will cost to extract, and once extracted, there is no certainty about the price they will receive for the product nor to whom they will sell the product.

In various forms, this is the basic story of the hopeful mining and exploration business and despite all of the uncertainties, investors pour hundreds of millions if not billions into these speculative endeavours.

The resource sector is highly cyclical because it takes many years to respond to higher prices by developing new mines to take advantage of the buoyant prices. Of course, higher prices also mean that previously marginal ventures can be profitable and so the response to rising prices is often oversupply, which pushes prices back down and send marginal operators out of business and the share prices of even the most profitable operators crashing.

It is interesting to note, in particular, that the iron ore price is 57% higher than the margin cost of the 90th percentile producer, suggesting a significant return to supply will soon get underway at precisely the same time Iron Ore stockpiles on China’s major ports are at decade highs and they arguably don’t need any more fixed asset investment.

The best time to buy commodity business assets is when they priced at scrap or as if they are going out of business. This rarely happens, so generally investors will find investing in more stable and predictable businesses less anxious and more rewarding.

BHP (BHP)

BHP Billiton is the world’s largest mining company but imagine I ran a business to which you extended an additional $38 billion and injected an additional $51.5 billion of equity over the last 10 years. You would expect profits to have risen materially. Yet, despite all those additional resources, profits have declined by nearly 90% from $13.6 billion in 2006 to an expected $1.5 billion in 2016 and about $5 billion in 2017.

The shares remain significantly higher than our estimate of their intrinsic value. **SELL**

Santos (STO)

With one of the largest exploration and production acreages in Australia (including oil in the Carnarvon Basin, LNG in Gladstone and Darwin and exploration in the Browse and Bonaparte basins), Santos is the Asia-Pacific's leading independent oil and gas producer.

The owners of the business have tripled their equity investment to $10 billion over the last decade and lenders have lent five times more debt than the company had in 2006. Despite this, the 2016 profit is expected to be less than 10% of those reported in 2006. Analysts then expect a ten-fold increase by 2018. The bullish forecast for intrinsic value in 2018 is today's share price. **HOLD**

Newcrest (NCM)

Newcrest is the world's sixth largest gold producer. Gold produces no income for its owners and has few industrial uses. Buying gold is a bet on the increasing fear of others. Gold prices tend to rise when speculators believe the prospects of a financial crisis and associated uncertainty has increased. In 1915 the inflation-adjusted gold price was $400 per ounce. Today it trades at $1350 – a rise of 1.1% per annum over 100 years. Shares in low cost gold producers are leveraged to the gold price and Newcrest's future is equally tied. **SPECULATIVE**

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