Metals and mining

The worst appears over but risks remain

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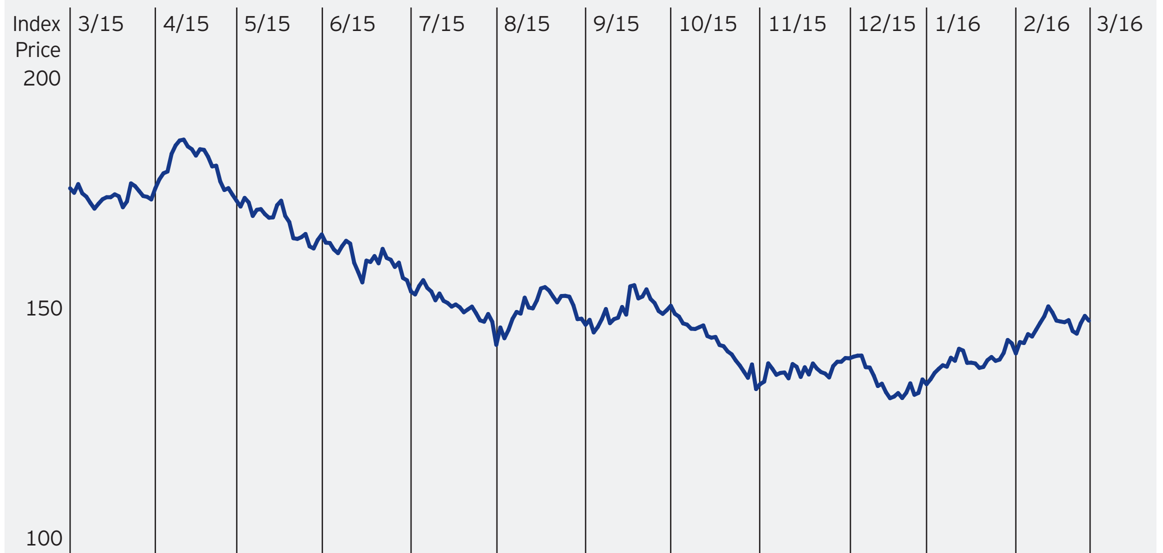
Executive summary
A rebound in metals prices has led to a rebound in the bond prices of a number of metals and mining companies. The question now is whether value remains in metals and mining bonds. There are ample reasons to be bearish on the metals and mining sector – the supply-demand picture for metals remains challenged, for example, with uncertainty around Chinese demand a key factor. However, there are market-supportive factors as well. We believe modifications in company behavior, the exit of weaker players from the market and a weaker US dollar may mean that the worst for the industry is behind us.

Key takeaways

- Based on our view that the worst has likely passed for the sector, we see value in metals and mining bonds, as yields remain well above historic norms.
- Despite stresses in the metals and mining sector, the leading companies in the industry have demonstrated an ability to remain profitable and demand, while far from robust, has not collapsed.
- However, we believe it is essential to distinguish between those companies well-positioned to survive a prolonged period of depressed metals prices and those at risk of failure.
- We focus on top-tier companies that are cost leaders in their sectors with strategic assets and strong balance sheets.

Since early January, metals prices have turned sharply higher. Apparent drivers have been a weaker US dollar, improved sentiment about China and a recovery from overly bearish price levels. As seen in Figure 1, the Bloomberg Base Metal Price Index is up 15% y ear-to-date, reflecting a strong, broad based recovery. Following that move, we have seen a strong reaction in the bonds of metals and mining companies. Investment grade and high yield metals and mining bond yields are tighter by 300 and 500 basis points, respectively, according to the Barclays investment grade and high yield indices.[1] After such strong moves, the question now is whether there is still value in metals and mining bonds.

Figure 1: Bloomberg base metal price index

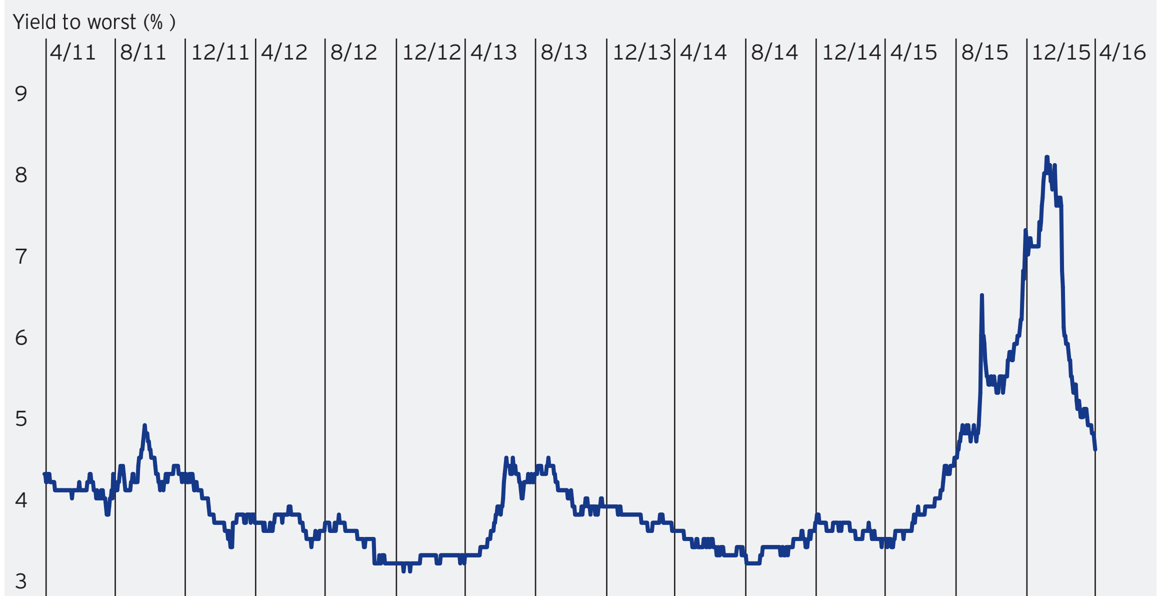


Source: Bloomberg Base Metal Price Index, data from March 23, 2015 to March 21, 2016.

There are ample reasons to be bearish on the metals and mining sector. In particular, the supply-demand picture remains challenged, with uncertainty around Chinese demand being a key factor. That said, there are supportive factors as well: modifications in company behavior, the exit of weaker players from the market and US dollar weakness. Weighing the various factors, it is clear that the overall backdrop for metals is far from robust and significant uncertainty remains, leaving the potential for prices to give back some or all of their recent gains.

However, it is important to note that in December and January when sentiment was at a nadir, investors' worst fears failed to materialize – prices did not fall to extreme bear case levels. In addition, the leading companies in the industry have demonstrated an ability to remain profitable and demand, while far from robust, has not fallen off a cliff. We think that has bolstered investor comfort with the industry, at least as far as the top-tier operators are concerned. This marks a key shift in sentiment as evidenced by the significant narrowing in bond spreads across the major miners from all-time wide levels to levels more in line with fundamentals.[2] In our view, this is a key adjustment and leads us to believe that there is a strong probability that the worst has passed for the industry.

Figure 2: Global metals and mining yields have declined



Source: Barclays Global Credit Index – Metals and Mining Sector, data from April 14, 2011 to April 13, 2016.

Based on our view that the worst has likely passed for the sector, we see value in metals and mining bonds as yields remain well above historic norms as indicated in Figure 2. However, as detailed below, we believe it is essential to distinguish between those companies that are well-positioned to survive if the current environment of depressed prices persists and those that are at risk of failure.

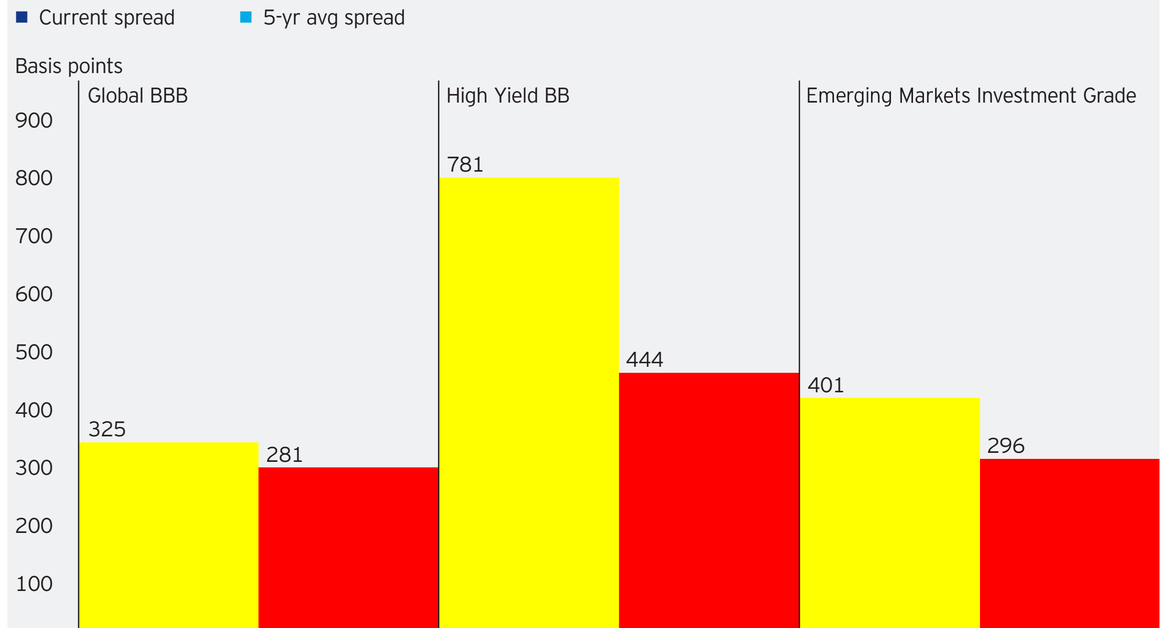
What fundamental attributes do we look for in high yield metals and mining companies?

Quickly shifting commodity prices make investing in the metals and mining sector, especially at the riskier end of the credit spectrum, a challenging proposition, in our view. In general, we focus on companies that are cost leaders in their sectors with strategic assets and strong balance sheets that we believe can sustain a prolonged period of commodity price weakness. Specifically we look for:

- **Comprehensive production and operating costs in the top quartile globally**
  We believe it is important to look not just at the basic costs of getting the material out of the mine but also at the investment required to maintain production at current levels and any transportation costs needed to deliver the product to the customer.
- **Only moderately levered balance sheets**
  In this low price environment, every operator has seen balance sheet deterioration. Clearly, all things being equal, credit investors prefer less financial leverage to more. However, the key is identifying those companies with capital structures that are not only sustainable now, but that will remain sustainable over time as the company seeks to refinance debt at significantly higher interest rates. While there is no strict rule, we generally look for adjusted operating cash flow to exceed interest expense by more than two times (assuming an adverse operating scenario), which we believe helps provide a cushion against higher future borrowing costs.
- **Stable cash flow position**
  The key, in our view, is ensuring that basic free cash flow (adjusted operating cash flow after interest expense, capital expenditures and working capital requirements) is, at worst, only mildly negative. Whether driven by low profitability, interest expense, capital expenditure requirements or working capital needs, it is important that a company is in a relatively stable cash flow position. Because it is unclear when we will see a meaningful resetting of metals prices, it is important that companies are in a sustainable position in the current challenging environment.
- **Diversified asset base**
  Having a large asset is base is good, but, in this environment, we believe it is more important to have diversity, both because it offers revenue stream diversification and also because it provides varied options if divestitures are needed. In an environment like the current one, there are plenty of mining and steel production assets for sale making it difficult for those operators in stressed positions to execute sales quickly at fair valuations. However, those companies with unrelated assets or with related logistics and service assets are often in a much better position than their pure play peers.
- **Ample liquidity to cover near-term debt maturities**
  In periods of market tumult, such as we are currently experiencing, capital market access can become quite limited, even for relatively high quality companies. In this type of stressed environment, we take a cautious approach to companies with a significant mismatch between near-term debt maturities and liquidity.

The above considerations represent an investment approach designed to identify companies that are well positioned to weather a prolonged period of depressed commodity prices and asset valuations. Considering the continued negative sentiment toward the industry, we continue to see value in the bonds of such companies, despite their recent strong performance. While companies that do not meet the above criteria can offer substantially greater upside in a stronger commodity price environment, we think the risk remains too high, given the uncertainty about the direction of commodity prices over the intermediate term. As such, we think the more attractive risk-reward trade-off lies with the top-tier operators across the credit universe. As shown in Figure 3 below, even within the higher quality segments of the metals and mining sector, spreads remain well above the average levels of the past five years. While we may not see a return to those averages, we believe there is still significant room for relative spread tightening over the next 12 months. The key risk to our view would be a macro catalyst that would cause metals prices to retest or break though recent lows. This could be driven by unexpected deterioration in demand from key developed and emerging markets, especially China, significant renewed US dollar strength, stronger than expected metals production or a global risk-off catalyst such as geopolitical turmoil.

1 Source: Barclays US Aggregate Metals and Mining Index, Barclays US High Yield Metals and Mining Index, data from Jan. 31, 2016 to March 23, 2016.
2 Source: JP Morgan BBB Metals and Mining Index, Bank of America Emerging Market Investment Grade Metals and Mining Index, Barclays US High Yield BB Metals and Mining Index, data from Jan. 31, 2016 to March 23, 2016.



Source: JP Morgan BBB Metals and Mining Index, Bank of America Emerging Market Investment Grade Metals and Mining Index, Barclays US High Yield BB Metals and Mining Index, data from March 23, 2010 to March 23, 2016.

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