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COMPANIES

Awash with cash

As supply shortages hit in the mining space and reserves of key energy transition metals fall, the majors are handing record dividends back to investors

April 13, 2022
By **Alex Hamer**

The mining sector is awash with cash. But in a boom and bust space where earnings are now at decade or record highs thanks to soaring commodity prices, some say the focus on payouts could ultimately worsen the longer-term challenges facing these companies.

The lessons from the last bear market, which ran until around 2016, have been heeded by the generation of leaders who took over giant companies laden with debt from the low price conditions of the most recent downturn.

That repair-focused cohort is also now largely out the door, replaced by similarly finance-focused successors who were in the background during the bear market and worry about running debt up again through ambitious acquisitions.

This has led to record dividends and share buyback programmes, as cash is used not to multiply mineral reserves but to keep investors happy. Now, with supply not being maximised, the invasion of Ukraine has raised more questions about production given that Russia is a major exporter of nickel and copper.

In the energy space, where a similar dynamic is evident, oil and gas companies have said skyrocketing prices are partly the fault of investors who have demanded supply discipline over recent years. There are other factors at play, too. In a world increasingly governed by sustainable investing considerations, even mining bosses are talking up 'future-facing metals' and the industry's positive contribution to the energy transition, in an attempt to bring in new investors keen to put their assets towards companies that are part of the shift to greener energy and lower emissions.

The problem (and opportunity) is demand for metals such as copper and nickel is only going to increase further, due to catalysts such as the transition to electric vehicles and a greater share of renewables feeding power grids.

Supply already being stretched should ensure prices and therefore earnings stay at elevated levels. But new investors seeking growth will be left disappointed if their money is only going towards maintaining cash profit margins rather than, say, new nickel supply for wind turbines or helping to create the next **Tesla (US:TSLA)**.
Massive payouts to investors are certainly popular, but they increase the risk of further pain down the line, as the energy transition stalls from a lack of copper wiring or nickel for electric vehicle batteries.

In short, the question for the world's biggest miners is: what is the best use of their record cash flows?

Traditionally, when miners are flush they have tended to answer: merger and acquisition activity. This time around, things aren't so straightforward. **BHP (BHP)** chief executive Mike Henry made clear in an earnings call last month that acquisitions were not top of the company's priority list. "We're only going to pursue the right opportunities at the right time, at the right price," he said. "We do have a strategy where we intend to grow value, but our means to growing value comes through driving better performance out of the business we already have, looking at how we can go about liberating more of these huge resources that we have in copper and nickel already." He put M&A below exploration and "early-stage entry" into projects in terms of interest.

Rio Tinto (RIO) boss Jakob Stausholm takes a slightly different approach, saying that while his company would never be a "high-growth" offering, "we have the competencies in Rio Tinto to be the right owner of a number of assets that we don't have today".

The problem is those perfect projects – cheap, large scale, in a friendly jurisdiction – aren't out there. Subdued levels of M&A activity reflect this. In pure capital expenditure terms, the big players have remained buttoned-down in this bull market.

The majors aren't winding down, but in most cases their existing big greenfield projects have been in the works for several years. BHP is building a potash mine in Canada at a cost of $5.7bn (£4.4bn), while Rio Tinto has the difficult Oyu Tolgoi underground build to finish and has launched a full buyout of the listed owner of its stake in the project, **Turquoise Hill Resources (CA:TRQ)**, for $2.7bn.

Outside of the big two, **Anglo American (AAL)** is finishing off a new copper mine in Peru, Quellaveco (greenlit in 2018), and looks set to spend billions on the Woodsmith fertiliser mine in North Yorkshire.

M&A appetite can have long-term as well as short-term consequences for the industry, because key mining projects are rarely discovered by the majors that build them.

Juniors or mid-caps usually do the early work, and if they identify something with big promise they will then sell that on to a major. BHP et al have their own exploration teams, who also do the reverse and hand sub-scale projects down to smaller peers. But big discoveries are rare enough, and getting rarer. The Big Australian's Escondida mine, the world's largest copper producer and the last major discovery of its kind, was found by a joint venture between Getty Oil and Utah Mining in the early 1980s, which BHP then bought out.

Smaller exploration-level spending has continued, however.

Rio bought a lithium project in Argentina in December for $985mn, while BHP spent an initial $50mn on a stake in a nickel project in Tanzania in January. But more advanced greenfield projects seem to be off the table – London investors are still waiting for BHP to add to its 13.6 per cent holding in copper hopeful **SolGold (SOLG)**, with no joy yet.

Overall, dealmaking activity is a fraction of the levels seen last time the miners were this flush. In 2006, global mining M&A hit $140bn, while 2010-2012 represented another peak, climbing from around $60bn to over $80bn, as per Bernstein data. But even as earnings surged in 2020 and 2021 thanks to much higher iron ore, gold and copper prices, the value of M&A deals remained around $60bn.

Bernstein analyst Bob Brackett said Ebitda margins for the industry were now at the same level as 2006 and higher than 2010-12. Yet there is no sign of miners pursuing the kind of mega deals that are still evident in other cash-rich sectors, as demonstrated by **Microsoft (US:MSFT)**'s $68bn deal to buy video game company **Activision Blizzard (US:ATVI)** earlier this year.

Nice flow

In the meantime, the cash keeps coming. In 2021, Rio paid $16.8bn in dividends and saw its free cash flow almost double on 2020, to $17.7bn. BHP paid a $7.6bn half-year dividend for the six months to 31 December, and had total free cash flow of $9.7bn, also close to double the previous year. Its financial year runs to 30 June.

Free cash flow yields across the sector doubled between the fourth quarter of 2021 and 2020, according to Bernstein, to 10 per cent. Operating cash flow – free cash flow minus net investing cash flows – is at a record high, well ahead of even the China-driven bull market of the 2010s.

Higher commodity prices have driven this free cash deluge, and lower capital expenditure (capex) has also ensured that money can be handed straight to investors. Rio and BHP's capex has not neared the highs of a decade ago, when Rio hit almost $18bn (2012) and BHP reached $24bn (2013). Forecasts for 2022 do show increases from last year, but these are to the order of around 10 per cent, with Rio's forecast at $8bn.

Caution over future prospects may be influencing investment decisions. The earnings of the past two years won't stick around forever, especially with inflation eating into margins.

While supply issues for key metals such as copper and nickel should support prices, iron ore is a different story. Prices here are still at elevated levels above $160 a tonne, but China's real estate slowdown has hit demand for steel, and price forecasts from brokerage Liberum indicate the party is soon to end, with a 2022 average estimate of $100 a tonne for June.

That will have consequences for bottom lines. The earnings mix varies between the majors, with Rio and BHP the most reliant on iron ore.

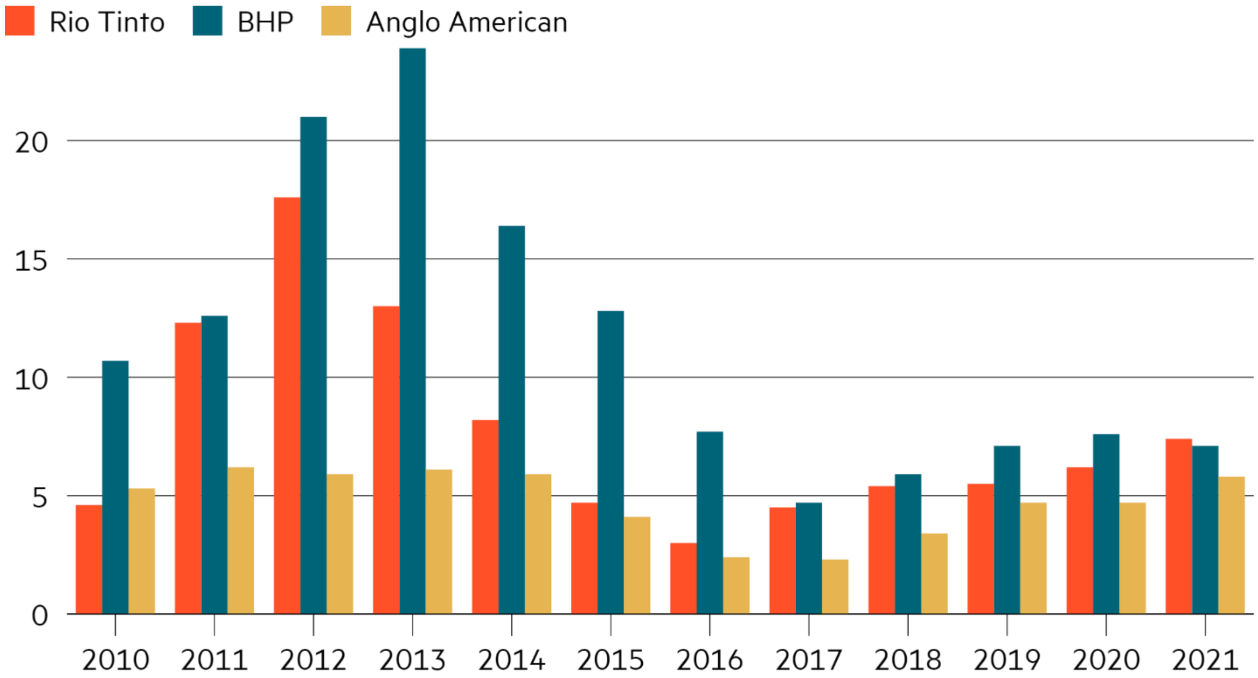
The raw material provides 60 per cent (BHP) and 72 per cent (Rio) of underlying Ebitda, as per the most recent results. Anglo has more base metals exposure, as does Glencore, suggesting the ride could continue for these two for longer. In any case, a return to lower earnings levels would not spell an end to payouts, and the supply 'discipline' – meaning limited new projects are brought online – shown during this bull market means the price highs might stick around longer this time.

But when billions aren't going into big greenfield mines like Quellaveco, companies tend to use it on acquisitions: "This rejection of greenfield investment seems to tie with a preferred path to consider inorganic acquisitions at the right price for the right companies [or] assets," says Bernstein analyst Brackett.

Yet that's not happened so far. BHP was rumoured to be working on a sizeable merger or takeover earlier this year but Mike Henry has made clear, as highlighted above, that spending on early-stage projects or brownfield expansions will come before chunky acquisitions.

MINING CAPEX STAYS SUBDUED

Capital expenditure, US$bn



Source: FactSet

Thumbs up

For many of their investors, this approach is the right one. "We love to see this kind of discipline in the mining sector," says Rob Crayfourd, co-fund manager for **CQS Natural Resources Growth and Income (CYN)**.

There is a good reason investors are keen for the industry to avoid the profligate ways of a decade ago: miners chucked away billions and billions of dollars on terrible deals. Rio Tinto led the way with the $38bn Alcan acquisition in 2007 and a 2011 purchase of a coal mine in Mozambique for $3.7bn, the combined write-downs for which topped $20bn.

BHP also threw cash around at the time, spending close to $12bn on US onshore oil and gas assets into which it plunged tens of billions of capex, only to take several write-downs before selling to **BP (BP.)** in 2018 for $10bn.

So it makes sense that investors are pushing hard for it not to happen again. One middle ground, given the kind of share prices seen at the moment, might be company combinations, as seen in the gold mining sector at the end of 2018. But **Barrick Gold (CA:ABX)** and **Newmont (US:NEM)** managed to get their deals done before the gold price hit a new record high, and base metal miners have missed that mark by some way. That leaves increased investment, the case for which has been made by none other than BHP itself, in a report produced with Legal & General Investment Management in the first week of April. "There will be no energy transition without a very large increase in the production of critical minerals," the report says. These include copper, nickel, lithium, and others. It says the onus is on investors to "mobilise the capital" needed to ensure this supply happens.

Seeing the lack of company action, governments have already started down this path.

In its federal budget last week, Canada included $1.6bn to fund projects that feed into the electric vehicle supply chain, while Australian rare earths miners are looking to tap US government funding. President Joe Biden said he would use the 1950 Defence Production Act to bring on more non-Chinese supply of the key electric vehicle (EV) and defence materials.

There is therefore a gulf in expectations between certain institutional investors and energy transition-focused parties, be they governments keen to secure critical mineral supplies or investors who still see mining as a growth sector.

"You've got the institutional investors who want that... capital discipline and shareholder returns, [while] new investors into the sector are getting excited about decarbonisation and the role of metals and mining in renewables, in EVs, and the growth associated with that," says James Whiteside, head of corporate coverage for metals and mining at consultancy Wood Mackenzie.

Brackett points to a scenario where BHP could itself play the role of the excited energy transition investor and throw a cash and share combination offer at a copper play such as **First Quantum (CA:FM)** or **Ivanhoe Mines (CA:IVN)**. This would indeed be bold, with perhaps too many shades of the last bull market to get past major shareholders.

Empty shelves

Even if miners changed tack and decided to snap up all the copper and nickel projects out there, there are barriers. Using copper as an example, the energy transition could drive millions of tonnes of extra demand a year, compared with the current production of 25mn tonnes, according to US National Minerals Information Centre data.

"There aren't enough cabs on the rank to even supply that, and certainly not at the current price," says Crayfourd's co-fund manager Keith Watson. Copper is trading over $10,000 a tonne, compared with years of the price sitting below the $6,000 mark, but a further surge would be needed to get more greenfield projects into production.

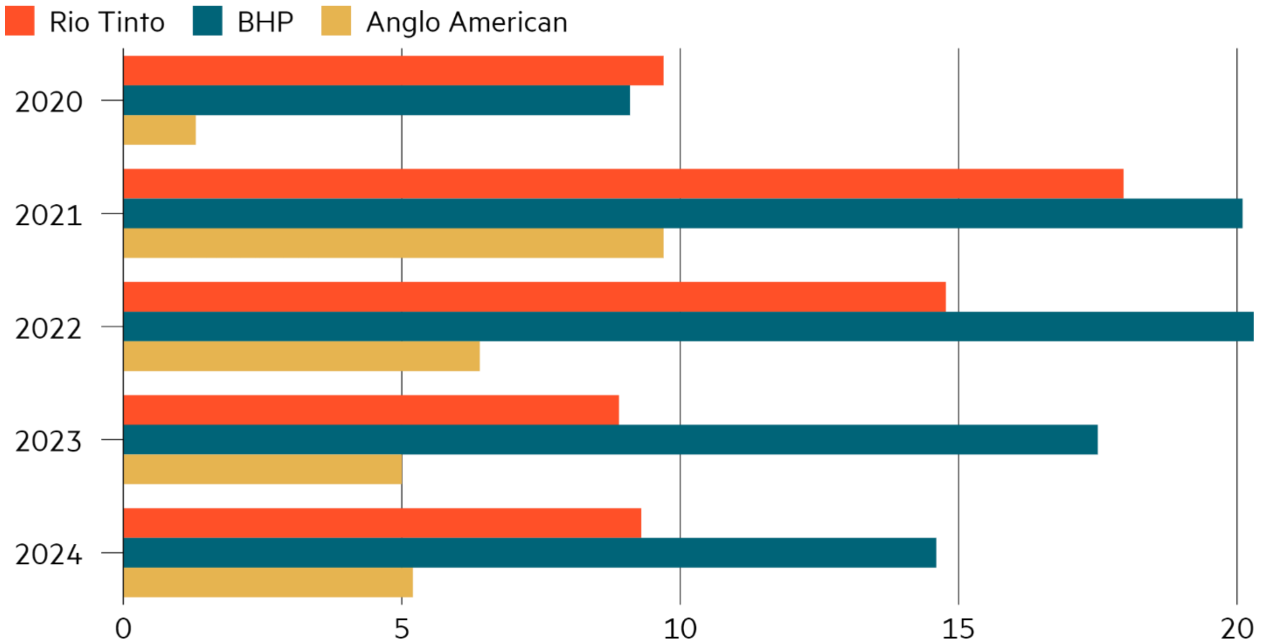
That, coupled with concerns about buying at the top of the market, has likely resulted in the current stasis in terms of deals completed.

Backroom work has been going into finding mines and early-stage projects to buy, as shown by the small deals done in recent months, but the processes are "really competitive" and majors "don't want to be seen to overspend", says Whiteside.

BHP was rumoured to be planning a bid for **Freeport-McMoRan (US:FCX)** earlier this year. The simplification of its corporate structure in 2021, which saw its dual-structure dismantled and the Australian Stock Exchange becoming its primary home, was explicitly to improve "agility and competitiveness for portfolio reshaping... including increasing its exposure to future-facing commodities".

MAJOR MINERS' FREE CASH FLOW HAS PEAKED ALREADY

Free cash flow, US$bn



Consensus forecasts from 2022
Source: Factset

A Freeport takeover has not come to fruition, however, and a changing landscape for miners in terms of social expectations could partly explain this, on top of the general top-of-cycle feeling.

Freeport's prize operation is the Grasberg copper and gold mine in West Papua, Indonesia, which has a long history of violence – both locals and mine workers have been killed.

All three of the environmental, social and governance (ESG) investing principles have an impact on the mining space currently. Alongside the emissions and environmental destruction involved in building and operating a mine, governments and First Nations groups are holding back on issuing permits to a far greater extent than a few years ago.

Rio and BHP even jointly own a project in Arizona, set to be a major new underground copper mine in a so-called 'tier one' jurisdiction, that has now been blocked because of a land deal that handed the companies a sacred slice of Apache land.

The focus therefore comes back to brownfield expansion, or putting money into growing existing operations. These options are usually covered by existing permits, and as the infrastructure is already in place the cost is far lower than a new mine.

But this is not a given anymore. "It can't be certain that brownfield expansions can be permitted," says Whiteside, flagging water use and other added environmental impacts as a bigger concern for governments now. Even if brownfield options were all without risk, this still leaves forecast supply gaps in the coming years for base metals.

Creeping costs

M&A is always a focus in the industry because it is so asset-based: miners with quality projects will always be targets as new greenfield operations take so long to reach the operational stage. But the current cash flow levels might also be needed just to keep the miners' current assets going, given higher input costs will soon start hitting margins. Current metals prices mean the impact is limited, but those prices won't necessarily persist.

"There are risks to all the commodity prices with the slowdown in China," says Whiteside. "In terms of earnings, you're seeing higher levels of sustaining capex, and increasingly [companies] having to spend more on decarbonisation, and we've seen that in their capital guidance."

Those decarbonisation costs are no small thing: last year, Rio pledged to spend $7.5bn between now and 2030 to cut operational emissions by half. Pressure has remained from activists after this pledge.

Natasha Landell-Mills, head of stewardship at fund manager Sarasin & Partners, pushed investors to vote against Rio's financial statements and auditor at the miner's early-April annual meeting because Rio was not aligning "promised action" on cutting emissions with the "all-important accounting numbers driving real-word capital allocation".

While this is a technical vote, it shows the attention being paid to each aspect of the majors' climate action. Whiteside argues the added green focus and rising costs mean capital might not be available to splurge on new projects.

In the short term, however, it's a prime time to be a shareholder in these companies as they remain inside net debt targets and reap the rewards of higher prices. Top of the pile this year will likely be Glencore, given very strong coal prices and a strategy that sees net debt held at $10bn, meaning buybacks or special payouts when it sits below that level.

The downsides for investors might only arrive in a few years' time, when shortages of metals like copper push prices high enough to result in demand destruction and substitution, triggering either investment in supply that has come too late, or simply a withering of the market. But in the meantime, the dividends keep flowing.