Teck – Invisible Base Metals Giant

We have bemoaned the thinning of the ranks of Canadian mining majors in recent years and the situation has not gotten worse, but neither has it got better. The ranks of the “fallen” include those iconic names like Noranda, Inco and Falconbridge, which were all severe losses to the top of the mining ecosphere in Toronto and losses to Canadian management and control. Nothing has reappeared to even vaguely replace the eclectic nature of Noranda, nor the heft of Inco in the Nickel space.

On the plus side HudBay has pulled itself out of a decades-long swoon and is now on a growth path that makes it a junior major, however on another front Lundin has not done anything interesting for years. Barrick and Goldcorp constitute the gold majors but the former is definitely a tarnished object after its massive Pascua Lama *faux pas*. Then there are the two invisible majors, Teck and Sherritt. Sherritt continues to suffer for its art in Cuba while the blowout at Ambatovy in Madagascar continues to weigh on the stock despite the nickel recovery and the Cobalt boom. That one of the world’s major cobalt producers cannot profit from such a rollicking boom is pretty damning. Meanwhile Teck has had the indigestion to end all indigestions from its spectacularly mistimed move into coal in 2008, for which it is still paying the price.

Despite its low profile, Teck is North America’s largest producer of steelmaking coal but also is a major miner in Zinc and Copper. Finally it seems to be awakening from its post-prandial lethargy and a recent deal seems to signal its regaining its mojo.

The San Nicolas Deal

We were spurred to cast our beady eye upon Teck Resources in late June when it announced that its Mexican subsidiary had entered into a binding agreement with a subsidiary of Goldcorp Inc. to purchase its 21% minority interest in the San Nicolás Project, located 60km southeast of the city of Zacatecas on the Mexican plateau, at approximately 2,150m above sea level, for cash consideration of US$50 million. This takes Teck to 100% of the San Nicolás Project.

The transaction was intriguing because the deal was so long in the cooking, and also because in 2015 Teck had been mooted as a seller of San Nicolas rather than as a developer of the asset. A BFS on this project was published as long ago as 2002 when the 21% under discussion was held by Western Copper (which subsequently became part of Goldcorp). At that time the estimated mineral reserves included in the mine plan, totalled 65mn tonnes with an average grade of 1.32% copper, 2.04% zinc, 0.53g/t gold and 32.1g/t silver. These reserves include 1.9mn tonnes of proven mineralization with an average grade of 0.71% copper, 3.51% zinc, 0.94g/t gold and 44.8g/t silver; and 63.3mn tonnes of probable mineralization averaging 1.34% copper, 2.01% zinc, 0.52g/t gold and 31.7g/t silver.

The current resource of Zinc/Lead at San Nicolas can be seen in the table below:

Teck - Zinc/Lead Resources

	Measured Tonnes (000's)	Grade %	Indicated Tonnes (000's)	Grade %	Inferred Tonnes (000's)	Grade %	Teck Interest %
Zinc							
Red Dog					200	11.5	100%
Pend Oreille					2,900	6.1	100%
Antamina	19,600	1.2	135,600	1.6	493,300	1.5	22.5%
San Nicolas			91,700	1.7	10,800	1	100%
Lead							
Red Dog					200	3.8	100%
Pend Oreille			50	0.4	2,800	1.4	100%

Interestingly on its website the company no longer shows a

Reserve for San Nicolas probably due to the antiquity of the last calculation.

The, admittedly ancient, BFS from 2002 had envisioned an open pit operation producing 230,000 tpa of copper concentrates and 190,000 tpa of zinc concentrates. That Teck has chosen this moment to clean-up the ownership structure of the project is illuminating and would seem to suggest that this major is moving back into development mode on some long-mothballed projects.

The Zinc Operations

Firstly we should note that Zinc takes a backseat to coal and copper at Teck at this time. However, it is our sentiment that this could be rebalanced over the medium term via the “resolution” of the coal “problem” and a move to develop San Nicolas. The current Zinc output of Teck Resources comes from its Red Dog and Antamina mines (with some minor production at Pend Oreille). In the first quarter of 2017 the Zinc in concentrate production fell to 130,000 tonnes from 165,000 tonnes in the same period last year, part of this being blamed on lower grades at Red Dog. Teck lowered its 2017 zinc guidance to 590,000-615,000 tonnes from 660,000-680,000 tonnes previously, due to weather and electrical equipment failures at Red Dog.

The Zinc division racked up a first quarter gross profit of $164mn on increased operating costs and a 23% decline in output at the Red Dog mine. In 2016, Zinc made up 26% of Teck’s gross profit.

Then there is the Trail Lead/Zinc smelter which processes some Teck production but is also well-known as a tolling facility for many others.

This facility produced 312,000 tonnes of refined Zinc in 2016 alone. As we noted in our recent Bunker Hill research note there is potential for the revival of Zinc/Lead production in the Couer D'Alene region of Idaho with concentrates being easily shippable to Trail for refining. Trail is a unique asset in North American base metal smelting.

The Coal "problem"

We fell heavily out of love with Teck on the eve of the Crash of 2008 when it made the almost ruinous decision to acquire Fording Coal. After all this time, in our humble opinion, coal is still proving to be a drag and a distraction for Teck.

The company sold 5.9 million tonnes of steelmaking, or coking, coal, at an average realized price of US$213 per tonne, in 1Q17. Total Q1 coal production was 6.1mn tonnes, 8% lower YoY, and production costs rose sizably by $13 to $56 per tonne. Spot prices for steelmaking coal stabilized at US$150 to US$160 per tonne in the first quarter, nearly half the level of US$300 briefly reached last November. Teck has reaffirmed a second-quarter sales forecast of at least 6.8mn tonnes of steelmaking coal.

To put this division in perspective, Teck Cominco (as it was then known) paid $14.1bn for Fording Canadian Coal Trust in mid-2008 and that amount is still higher than the whole market cap of Teck some nine years later.

A demerger into two vehicles would not deprive Teck shareholders of coal exposure upside (if there is any) but would make Teck into a cleaner base metals play.

Debt Obsession?

After any near-death experience the mind becomes focused. Teck, since 2008, has been using cash flow and profit to cut debt. This debt stood at $5.1bn at the end of the March quarter. Thinking about it a company that has a market cap of over $13bn, debt of only $5.1bn and cashflows and bottom line that are strong should not be obsessing with debt. In 2015, Teck cut its twice-yearly dividend two times.

In our opinion the company should be using the low interest rates of current times to issue long-term bonds at low rates and instead of dedicating profits to debt repayment instead it should be paying a rising proportion of its net profits as a dividend. In a positive sign the company has indicated to the market that, after completing its debt reduction plan, it will consider increasing or revising its dividend policy.

Conclusion

Frankly the company would be rewarded by the market if it split off the coal assets and set them free. Teck should take its cue from RTZ which is doing just that (though as a trade sale) at the moment in Australia.

It looks like the company is going to hit the development trail again with the consolidation of ownership at San Nicolas, which would signal the end of its retreat period since 2008. With Bunker Hill talking of potentially sending product from Idaho to Trail, that might also be a potential bolt-on once its viability has been proven.

With a P/E of only 9 times (TTM) the company looks very inexpensive even if one must tolerate the presence of the coal assets for the short to medium term.