LME Week – Infrastructure Metals to the Fore

Let the cliché’s flow… a week is a long time in politics, what a difference a day makes, the past is another country but when it comes to mining a year ago it seems like another universe. The last week of October is LME Week which has gone from a humble promotional effort by the London Metals Exchange to become a major jamboree of the Great and Good of the metals trading space, whether their metals are traded on the LME or not. The mood this year was the polar opposite of last year. For those who recall this time last year Glencore was teetering on the brink and Noble was hotly rumoured to follow it down the plughole. Fortunately the fears proved not to come to fruition though the gravity of the situation could not be underestimated. That period also coincided with the five-year nadir of a swathe of metals.

The rest, as they say, is history. The clouds parted and sun’s rays dropped upon the scorched earth and mining markets have been on the mend ever since. Indeed, the near-death experiences of two of the world’s major trading houses seemed to be the cathartic event that was required to turn the mining Titanic away from its date with destiny. Indeed it makes one wonder if the sidelining of these large players was what was needed to turn the market upward. Those who thrive on conspiracy theories have often maligned traders (and big banks) as being the hidden hands that would wish the metals markets ill, even when logic might indicate that higher prices would be better for them.

Whatever it was it did the trick. Closures of mines, particularly in base metals, have been given credit for prompting the recovery, but many of the announced closures never actually happened and there was an element of smoke and mirrors to the whole retrenchment process. Still it seemed to work.

The Chief Takeaways

This year LME Week was bordering on the euphoric but tinged with a sense of trepidation with "easy come, easy go" being the thought on everyone's minds. Some of the moves had been so sudden and so stunningly good that it was almost too good to believe. The chief things that struck us were:

- Infrastructure spending is the new mantra with steel potentially being the biggest beneficiary, so much so that we are declaring 2017 to be the year of "Infrastructure Metals".
- Companies are frantically attending as many shows as they can, unsure as to who the investors are these days or what they are interested in
- Loads of unemployed geologists roaming around as money raised is not really trickling down into fieldwork or hiring (yet)
- Coking coal has soared in value while iron ore has continued to languish (excluding some speculative runs fired by Chinese retail interest)
- Alloy metals have moved up strongly. Manganese, Chromite, Vanadium and Zinc have done really well and now nickel has also come to the party. Manganese has rocketed and is at its highest level since 2010
- Electricity industry problems in South Africa have not gone away but low demand for metals has obscured the issue. Now it will come back into play.
- Antimony has moved up strongly due to a secular decline in Chinese production and the shuttering of many polluting roasters
- Tin is very healthy these days as alluvial mining in South-East Asia runs towards the buffers. Hand-wringing as to where future production might come from has not generated much interest from miners
- Lithium has bottomed after a brief sag

- Someone presented the famous “resources clock” showing that ASX-listed golds, in particular, were on the verge of heading into the overvalued end of cycle period

And some important charts presented by Argus Metals at their event:

Manganese:

Vanadium Pentoxide prices rising (Europe up 88.1%, China up 100% YoY):

Lithium prices coming off their bottom:

Antimony picking up again after its swoon:

Conclusion

There were more than a few who, at times, claimed that the slump of the last five years was the end of mining as we know it. Our response was “cut the drama”. I can vaguely recall the 1970s when many miners on the ASX stayed mired, trading at half a cent for the whole of the decade. My first mining share purchase was around $300 worth of BHP shares in 1981 and they were just over $2 per share.

Mining always comes back and sure as day follows night, the light has dawned. Some have attributed the turn to production cuts but we have suspected that many of the announced cuts and disposals were somewhat fake (maybe the reason why copper took longer to rebound than other metals). Our suspicion is that the real reason for the rebound was that production in China of many metals (e.g. Antimony) is now well past its peak. Meanwhile the Chinese, in rebalancing away from US Treasuries, have been stockpiling or hoarding metals as a store of value. Destocking by corporations around the world has also left many end-users operating on a Just-in-Time basis that has now left them scrambling for material for their processes.

A perfect storm of excess cast the mining industry onto the rocks and holed the ship threatening to send it to the bottom. Now a new high tide is sweeping in and lifting most boats (Uranium and Iron ore being obvious exceptions). LME Week partygoers were right to feel ebullient but after the bitter experience of recent years they were not about to go crazy and start counting on markets evolving as they did under the now defunct Supercycle.

When Noble Intentions Go Awry

In the all the kerfuffle over Glencore's problems little attention was given to the other main players in the trader universe. While the old adage "the bigger they are the harder they fall" may sometimes be true, it is not always the case. At least for the moment Glencore seems to have pulled out of its dive, but it seems timely to look at the wider trading house space where mere mention in passing was given to Trafigura and Noble Group during the "Glencore Crisis" and no-one focused on Traxys at all. The latter though is out of the public markets so no-one much has a snapshot on its finances but the first two do have balance sheets that are open to public scrutiny.

The problem for Hong Kong-based, Singapore-listed Noble Group (SGX:N21) over recent years is that its balance sheet has indeed been scrutinized and been found wanting by many who have done so. Nevertheless Noble remains Asia’s biggest commodity trading house by volume as it mines, ships and finances iron ore, coal and industrial metals such as copper, as well as playing a growing role in North American oil and gas markets. It has 120 offices in 38 countries. It also has an agricultural trading arm. According to the Financial Times, in the first nine months of 2015 it moved more than 200mn tonnes of commodities around the world, a 43% increase on the same period a year ago.

Baby Out with Bathwater?

Repeating the scenario seen at Glencore, Noble Group, reported a 60% drop in Q3 profits. These fell to $24.7m in the three months to September, down from $62.6m in the previous quarter. It also announced the departure of its chief financial officer.

In an attempt to pacify concerned investors, counterparties and investors it announced that it was trying to raise $500m from asset sales and was on the hunt for a strategic investor to help it deal with US$3bn of debt repayments over the next year.

The Financial Times quoted the CEO Yusuf Alireza, a former Goldman Sachs banker as “refusing” to provide further details on the $500m in asset sales but said Noble would have the “balance sheet strength” and “liquidity” to roll over the debt and maintain its investment grade credit rating.

Alarm Bells?

No amount of improved cash-flow numbers though can rescue a situation where fundamental numbers in a company’s balance sheet are not believed. The jungle drums around Noble are not new but the beat picked up earlier this year when a relatively unknown research group called Iceberg started raising questions about its accounting policies, comparing the company to Enron, the infamous US energy company that collapsed spectacularly in 2001.

The muckrakers have focused on Noble’s accounting policies, particularly the way it accounts for “net fair value gains” on long-term trading arrangements. In the third quarter, Noble reported net fair value gains on its commodity contracts and derivatives were up US$423m on the previous three months, although they have declined $64m over the first nine months of the year.

As if the Iceberg attack was not problem enough then the evocatively-named Muddy Waters waded in (pardon the pun) with its own reasons to short the stock and Standard & Poors engineered a debt downgrade. Then came the travails of Glencore. One could not ask for a more potent Perfect Storm to engulf a stock.

We must confess to have heard aspersions cast (in private) about the balance sheet and accounting practices last year so this scuttlebutt has been around a while, it’s just that the kimono has pulled open in a most abrupt manner will all on view and no figleaf to hand.

The aforementioned third quarter results did show however that the company has positive cashflow for the first time in a year. The FT quoted the Noble’s CEO saying: “It was important to put this issue to bed”. Mr Alireza told the FT that a chunk of the $318m of cash came from the benefits of lower commodity prices and selling metal stocks. One can only reduce metals stocks once though. The question is then what? Moody’s were unconvinced and put the company’s debt on watch for a downgrade in the wake of the results.

Noble’s CEO also told the FT that PwC, which carried out a review of Noble’s commodity contracts in the middle of this year at the request of the board, had conducted a follow-up review in November and were largely satisfied with the results. The addition of the word "largely" is not helpful in our estimation!

Ripple Effects on X2

On the of the mysteries of recent times has been the curious inaction of Mick Davis' X2 (Son of Xstrata) vehicle. What was supposed to be a Godzilla rampaging through the bargain basement of the mining sector has looked more like a deer in the headlights. We put its inaction down to fear that there may be another leg down and assets may get even cheaper… which seems to have happened. X2 has been mooted as an acquirer of South32, the spinout of Vale's nickel division and various other assets, but nothing has happened.

However, another thing to consider is Noble is one of the core shareholders of X2 and that the private equity fund has not banked all the commitments from its investors but rather has to draw them down when it has a transaction in the offing. As Noble might have to fund a $500m investment in X2 Resources and that is money it arguably does not have X2 might be pulling its punches to "avoid embarrassment" in having Noble say "no can do" which would then imperil whatever the proposed transaction might be leaving all concerned with egg on the face.

With asset sales being the order of the day, we cannot see how Noble will want to step up to the plate at X2 and become even more exposed.

Elsewhere in the Food Chain

Noble's relationships with listed miners are in many ways broader than those of either Glencore or Trafigura with numerous small stakes in a wide variety of names. Notably there is a tendency towards ASX-listed names. This may be because of that market's stronger position in coal listings or just geographical proximity. It’s not limited to listed names only as we had dealings last year with a private Antimony company with assets in Russia that had Noble as a strategic shareholder and as an offtaker.

Interestingly it has been the valuation of a stake in the ASX-listed Yancoal (ASX: YAL) that has been one of the footballs that Iceberg has been kicking. Other names with Noble Group connections (and far from an exhaustive list) include: Gloucester Coal, Xanadu Mines, Aspire Mining, Kaboko Mining, Sundance Resources, Australian Bauxite and Qube Holdings. The number with offtakes must be much higher.

Conclusion

Noble was the “Asian Champion” in the trading sphere. It was curious that while trading houses had a symbiotic relationship with the so-called Commodities Supercycle, the vast majority of the trading houses that dominated this process were outside of Asia, where the Supercycle had its epicenter. Indeed, more often than not it was in Swiss valleys that the metal that drove China’s growth was traded.

Noble was the outlier to this trend. Unlike Glencore it does not have as many banks on the hook and as per the old adage it is sometimes to better to have so much debt that the bankers need to keep you afloat than to not owe all that much. The debt downgrades and threats thereof have the company only one notch away from losing investment grade status, the loss of which would heighten financing costs.

Unlike Glencore which owns mines outright or significant stakes therein, Noble does not have much in the way of marketable assets in its mining “portfolio”. Small minority stakes are a dime a dozen these days.

It may have to tread in the footsteps of Glencore and try and monetize its agricultural trading operations, which remain untainted by the travails of the metal sector. More than a few miners out there must be hoping that Noble too can “pull off a Glencore” and narrowly avoid a sticky end.