WILSONS

Major Miners - Can the Party Continue?

Our weekly view on Australian equities.

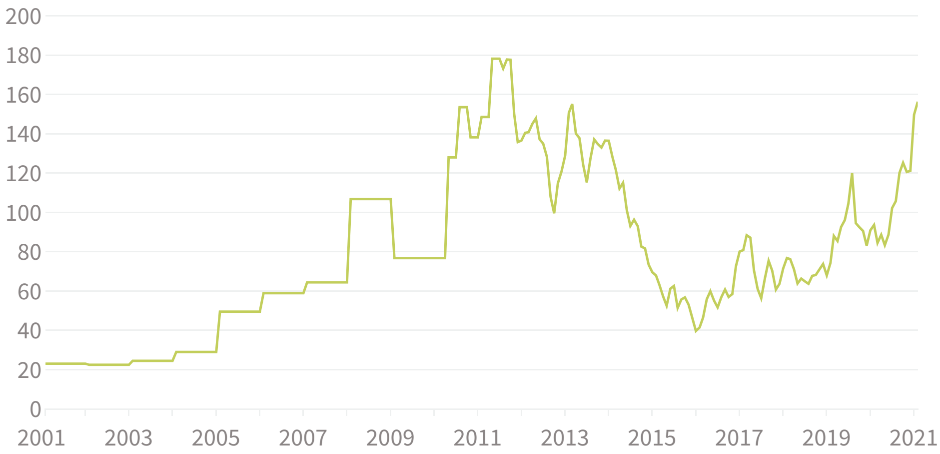
11 February 2021

Have the Major Miners Hit Their Peak?

The share prices of the major miners are trading at close to 12-month highs following an extraordinary 2020 that contained both a global recession and the largest global stimulus program witnessed post-war. This has investors rightly asking whether share prices can rise further?

There are few sectors where the expected direction of key input(s), namely the commodity price(s), can make as much difference to earnings as we see in the resources sector. With a volatile commodity price(s) dictating much of your earnings, can investors make reliable investment decisions when looking at the earnings multiples or dividend yields of the major miners?

Exhibit 1: Iron ore price has seen long periods of elevated levels



Source: Refinitiv, Wilsons.

Resources Earnings Cycle

A resources earnings cycle typically lasts multiple years, with commodity prices often remaining elevated for considerable periods. A typical resources cycle will see a >3x rise in sector earnings from trough to peak.

The current cycle, which began in early 2016, has seen the iron ore price - the most important commodity for the Australian resources cycle - rise by just over 3x. The move in the iron ore price has lifted BHP Group's (BHP) earnings >5x, Rio Tinto's (RIO) by >7x, and Fortescue Metals Group's (FMG) earnings by a staggering 13x.

All have shown remarkable operating leverage to the price cycle. In comparison, volume gains have been subdued, with BHP Group (BHP) and Fortescue Metals Group (FMG) increasing production by 9% and 13% respectively in this period, while Rio Tinto (RIO) production has remained flat.

While these numbers are significant, the recent resources super cycle that lasted 6 years between 2003 to 2008 drove the mining sector's earnings up by more than 7x, before a combination of excess supply and the GFC curtailed both prices and the cycle.

Valuation Challenges

Attempting to value a sector or a company's earnings stream with this level of earnings volatility poses significant challenges. While some investors might subscribe to the random walk view around the iron ore price, we find that prices typically trend for a number of years.

Since the advent of a traded spot iron ore market (2011), the iron ore price has had two distinct periods. Phase 1 from US$180 in 2011 to <US$50 in 2016, and then Phase 2 from 2016 to today. The current period has seen prices double over a 3-4 year period, before exploding higher on a combination of unexpected supply constraints and large scale Chinese stimulus.

Long-term iron ore price assumptions are also important for discounted cash flow (DCF) based valuations favoured by resource analysts. The market typically sees iron ore as having a ~US$65-75/t long-term price, although hard experience has taught us that long-term estimates of prices tend to be pro-cyclical.

An Old Resources Adage

Speak to a veteran mining analyst or resources investor and many will recite an old adage with regard to investing in the resources sector and mining stocks.

To maximise gains, investors should buy mining stocks when price-to-earnings ratios (PE) are high, with earnings dragged down by low commodity prices. Investors should then sell when PEs are low, after high commodity prices have boosted earnings.

Such is the importance of commodity prices, particularly for relatively mature resource companies in driving the earnings cycle, and more importantly, investor behaviour.

To avoid this issue, investors can use earnings multiple based valuations. For simplicity, we look at enterprise value to earnings before interest, tax, depreciation and amortisation (EV/EBITDA) based valuations for BHP Group (BHP), Fortescue Metals Group (FMG), and Rio Tinto (RIO) to remove the noise of non-core impacts on earnings like interest, tax, and depreciation. We make 3 observations:

1. BHP/RIO multiples in this cycle peaked at ~8x, coinciding with the trough on the iron ore price during 2015-2016. As the cycle has matured and the iron ore price has risen, the earnings multiple has trended flat to down.
2. FMG's multiple has remained largely unchanged despite the share price having appreciated 13x over this cycle.
3. Using earnings multiples to make precise and informed investment decisions is an imprecise science. Only the extreme highs and lows are particularly insightful, given they tend to reinforce the beginning/end of the cycle.

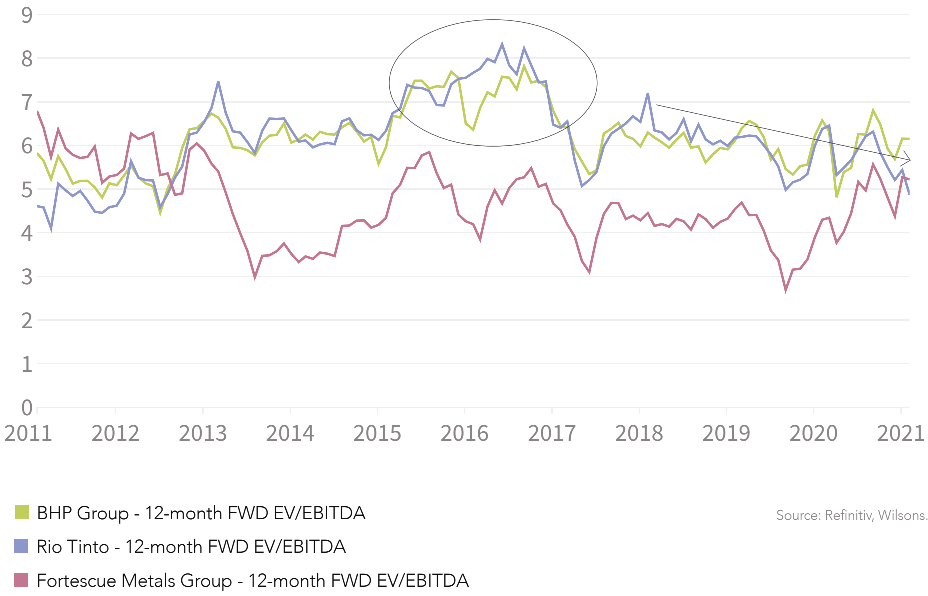
Does Management Provide a Signal?

The dividend payout ratio can often provide a signal around the outlook for the business. The large boost in the dividend payout ratios for BHP Group (BHP) and Rio Tinto (RIO) in 2015 (trough cycle) was a function of low earnings and management signalling to investors to hold the faith. The timing so happened to correspond to the bottom of the iron ore price.

The abandonment of the progressive dividend policy of both BHP Group (BHP) and Rio Tinto (RIO) in 2016 to a simple percentage range of earnings provides greater signalling than in the past, where the focus was on raising the absolute level of dividend payments every year.

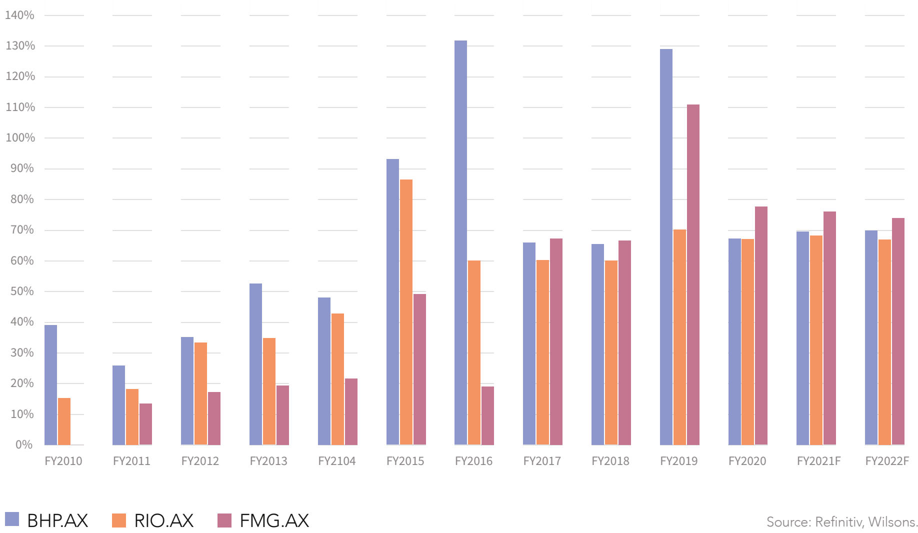
The market currently assumes a flat payout ratio for the major miners, despite the elevated levels of free-cash-flow (FCF) they will generate this year and likely next. It is not out of the question that as this cycle matures, the payout ratios of the majors will move to the top end of their stated ranges.

Exhibit 2: Earnings multiples for the miners peaked when the iron ore price troughed in 2015/16



Source: Refinitiv, Wilsons.

Exhibit 3: Management signalling through dividend payout ratio



Source: Refinitiv, Wilsons.

Read Is the Market Understating the Dividend Outlook?

The Nuances of this Cycle

At the risk of saying that this cycle is different, only to be reminded by the market soon after that you are wrong, there are a number of nuances around this cycle.

Our base case is that the iron price likely stays higher for longer than the market is currently assuming, based on 3 influencing factors:

1. Global coordinated fiscal stimulus measures which should see lift in global steel demand ex-China.
2. Low-cost supply growth is difficult to bring online, both in Australia but particularly in Brazil, with Vale S.A (VALE3.SA) reporting another soft quarter of production last week as repercussions from the Dam disaster in 2019 continue. Globally, new supply is increasingly being met with both environmental, regulatory and logistical challenges. Supply growth is less of a feature than previous cycles.
3. China's influence on the iron ore market remains disproportionately large with demand running at +1bn tonnes of demand pa.

What Equity Prices imply

Despite recent upgrades to market estimates for the iron ore price, there still remains a significant fade in price assumptions over the next 2 years. We estimate that BHP Group (BHP) and Rio Tinto (RIO) share prices currently imply iron ore prices of ~US$60/t and FMG ~US$70/t into perpetuity. Another way to look at valuation is the level of earnings upside that the majors have to spot commodity iron ore and currency inputs – and it is significant.

Spot iron ore prices are ~50% higher than market assumptions for both FY21 and FY22. If current prices hold across FY21 and FY22 that should drive a ~40% upside in FY21 earnings (15% for FMG) and ~100% upside in FY22, implying FCF yields in the early teens across all names. All three miners are expected to be net-cash positive by the middle of CY21. This suggests that dividend risks are firmly to the upside.

Exhibit 4: Implied earning upside to spot iron prices

Company		BHP	FMG	RIO
ASX Mcap	A$bn	132	73	43
Earnings				
Market NPAT 2021	US$bn	16.0	8.1	17.7
Spot NPAT 2021	US$bn	21.2	9.4	24.5
Implied upside	%	33%	16%	38%
Market NPAT 2022	US$bn	13.8	5.7	12.6
Spot NPAT 2022	US$bn	25.8	11.5	26.2
Implied upside	%	87%	102%	108%
Valuation				
Market EV/EBITDA 2021	(x)	5.3	4.2	4.2
Spot EV/EBITDA 2021	(x)	4.0	3.4	3.0
Market EV/EBITDA 2022	(x)	5.8	5.8	5.4
Spot EV/EBITDA 2022	(x)	3,3	2,8	2,6

Souce: Wilsons, Refinitiv. BHP adjusted to CY. Spot earnings reflects spot iron ore and spot FX held through 21 and 22.

Are Miners Making Supernormal Profits?

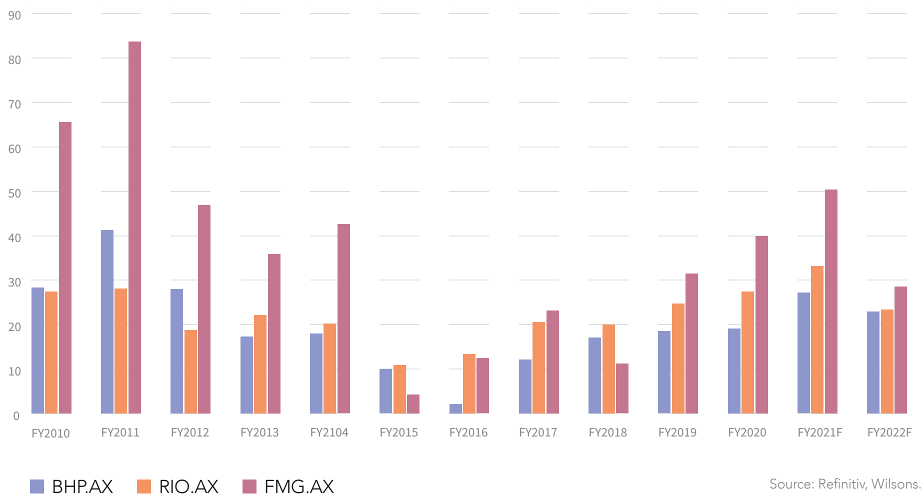
Profitability is healthy and has been rising for a number of years, but they are yet to reach the levels of profitably, measured by return on equity (ROE), that we have seen in prior cycles – even out in FY22E.

With COVID-19 likely to have the perverse effect of extending this economic cycle - given the large stimulus measures in place - the Wilsons Australian Equity Focus List is overweight the materials sector.

The prospect of a stronger-for-longer cycle is likely to lead to an extended phase of very strong cash flow generation for the major miners.

BHP Group (BHP), our key pick amongst the major miners at 10% weighting, offers an attractive diversified mix of iron ore, oil, and copper exposure.

Exhibit 5: Major miners ROEs are very healthy but below prior cycles



Source: Refinitiv, Wilsons.

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Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

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