Natural Resources Forum

Buy, Build or Buy Back?

June 2018

Buy, Build, Return ... or invest?

Lee Downham, Global Lead Partner, Mining and Metals Transaction, EY

"Equity valuations are plateauing a little bit, management can't really rely on just commodity prices to drive TSR so share buy backs are going to be seriously considered going forward"

Key points discussed

- After 6 years of commodity price depreciation, debt is under control and capital is being generated in the sector
- Rio Tinto is a good example to use when looking at debt reduction very different to 2-4 years ago
- Management should be able to generate margin improvement, lower financial risk and drive the growth in share price as a result but its not that simple
- In additional the pipeline of new developments has shrunk massively
- The Chinese have taken advantage of the low commodity prices in recent years, taking the risk and putting investment into assets
- The mid-tier sector is significantly smaller than it was, it will be at least another 5 – 10 years until the assets that are in the early stages now will be worth enough to move the needle of M&A
- There remains a reluctance to invest in new builds. As a result, investment in these projects is around a quarter of what it was in 2013
- Simplistically, portfolio optimisation is the process which drives capital allocation. An important aspect is to understand the interaction between different parts of your portfolio and decisions on investment

Introduction to Central Asia Metals

Nick Clarke, Chairman Central Asia Metals

"We would argue that people should buy, build and buy back, but it depends on timing"

Key points discussed:

- CAML Listed in 2010, raised $60m to build project in Kazakhstan, told market it would cost $48m, built it with $39m, so on time and under budget
- Company has produced 72,000 tonnes of copper since then, provided a platform for the growth of the company

- Life of production up to 2030 in Kazakhstan
- As long as you sit on the left of the cash/cost curve, you will pay dividends. We sit at 76 cents per pound so we are at the bottom half of the curve.
- We are going to invest $2.5m in Shuak, an exploration play in the country. Spent $1.5m last year. A surface oxide copper project with potential sulphide material at depth.
- Bought the SASA project for $402.5m last year. SASA asset has 20-year mine life – 11m tonnes material in reserve, underground cabling system, not too complex.
- In 2012 CAML did a share buyback and has historically has a policy to pay back 20% of revenue to shareholders as a dividend.
- Took $60m from the market in 2010, paid back $110m. total shareholder return since IPO is in excess of 20%. More than half of EBITDA has been paid back to shareholders.
- Conclusion:
    - A buy can give you growth and good assets but it's not everything. Plus it is very difficult to find a good asset to buy.
    - The argument for not building – there's a long lead time to build, so were talking 5-7 years to a cash flowing asset.
    - Buyback – sometimes it is better to return to shareholders if you have nothing else to do with the money.

Back from the Brink: A Capital Allocation Story

Philip Lindop, Managing Director, head of Natural Resources EMEA, Barclays

"The job of a true mining executive should be to be countercyclical and to lean into the hurricane of shareholder and market opinion and to buy respectively when everyone else is going the other way but, this did not happen last time around."

- Industry is generating surplus cash again, so this would be operating cash flow after capex, after dividends and buybacks, so essentially how much cash you have left after all is paid and done.
- Cleary there is plenty of cash and our research forecasts are starting to come through the system.
- I think we were all shocked with the way that the sector turned on a dime last year, the operating leverage pronounced by the higher amounts of financial leverage which people were carrying into this.
- Passenger cars have undoubtedly put mining back into the spotlight and made it more relevant.

Build, Buy or Buyback – Where are we in the cycle?

Paul Gait, Senior Research Analyst, Bernstein

"Leading up to and during the supercycle build has been the priority which has always been the case with cash in the mining industry except in the crisis years."

- During the supercycle the cumulative cashflow for the top 50 mining companies was $1.7 trillion and $1 trillion of that was spent on building new mines and new capacity.
- The volume of tonnage response of the recent downturn was far more muted than that of the financial crisis in 2007 and 2008 where Vale took 45% of its tonnage off the market and Rio did something similar.
- We have come back from the recession extremely quickly, the mining industry is now generating above normal EBITDA margins, however if you look at capital employed which we take as a forward looking proxy for the incremental return on investment rather than the cashflow the industry is generating you get a very different story.
- The market gives credit to the build decision only when the tonnes hit the market, which also explains the fact that company valuations track implied daily revenue baskets almost identically.
- Markets are stunningly inefficient. Equity markets value short term risk far too high and long term stability in commodity prices too low.
- Our conclusion is that, if we expect to see a continuation of global economic growth, we must also expect to see a continuation of trend mined commodity output growth.

Artificial Intelligence Insights on Mining and the Impact on Buy-backs

Grant Fuller, Co-founder Irithmics

"Capital and funding requirements of mining companies are very unique – we have developed an algorithm identifying the trends of investors in the mining industry."

- The machine learning algorithms do not use binary statements from bullish to bearish, rather they use 80 different properties to identify different investors. This can be extrapolated into a heatmap and then see how the heatmap evolves over time.
- Investor's expectations, earnings, expenses can be seen with these algorithms, most importantly dividends and buybacks.
- Technology can help provide visibility on shareholder dynamics, with the case study of Melrose (analysing patterns in shareholder votes in key decisions for the firms).
- Buy-back – will probably be cheaper, cost less cash and will have less disruption. Looking at the data, I would anticipate that we see a large number of M&A transactions, and for those not able to find a suitable acquisition target, buyback is an appropriate use of that capital.

Buy, Build or Buy-back – The Perspective from Zimbabwe

Mark Learmonth, Chief Financial Officer, Caledonia Mining

"Recent developments in Zimbabwe may herald a more conducive investment environment. Not only this but Zimbabwe has high prospective potential as it has been ignored by international investors for 30 years."

- We are getting to the end of a significant building phase.
- Our Plan is to distribute cash back to shareholders in dividends.
- We anticipate and increase in cash-flows from 2020 makes a buyback and increased dividends compelling. This also establishes a "base line" to evaluate all other options.

- We plan to add another shaft, effectively creating a new mine underneath their current mine. This is based on good exploration results. Cash-wise, we expect production to increase to 80,000 Oz/y from just under 60,000 Oz/y.
- Any new investment should eventually enable Caledonia to pay a higher dividend per share.
- Buybacks and increased dividends create the base line against which all other options are evaluated.

Discussion Panel

Overview:

- Mining requires a long-term investment outlook. Investors nowadays are looking for medium-term and want to see the dividends quicker.
- Always a deficit between demand and supply. Investors need to fill the gap and thus we need to be builders. If you are a long-term investor, you need to understand resources. All research is done in house.
- We must note the rapid growth of Chinese investment in the developed and developing countries. Most notable in Guinea and the DRC. Building capacity in copper and aluminium.
- US-China tariffs could be very problematic – the tariffs will define how consumers act e.g. what cars they will buy etc. However, it is very difficult to predict how the war will affect which areas.
- Another of the big questions that is changing the look of the mining sector is a call for it to be more responsible for its actions, partly due to the rise of millennials.

Speakers:

Paul Gait

Senior Research Analyst, Bernstein

Philip Lindop

Managing Director, Head of Natural Resources EMEA, Barclays

Enna Pariset

Managing Director, Head of Corporate and Commodities Coverage Switzerland, BNP Paribas

Peter Ruxton

Principal, Tembo Capital