

Teck Resources Ltd.: 3 Strikes and I'm Out

Description

As a value investor, I'm often sniffing around beaten-up companies that are trading at a discount to book value. After the company's shares declined some 70% after reaching a high of more than \$60 in 2011, **Teck Resources Ltd.** (TSX:TCK.B)(NYSE:TCK) certainly meets the criteria.

Teck's book value is more than \$32 per share, which is 80% above Wednesday's closing price of \$17.98. The company's debt level doesn't look terrible either; it currently owes a little more than \$8 billion compared to \$36 billion in assets. Even the company's debt-to-equity ratio comes in at a respectable 0.43.

But as all value investors know, a successful investment is a lot more complicated than just buying cheap assets. There also needs to be a reason why the stock rises. Determining this catalyst is an inexact science at the best of times, and often a value investor will get the catalyst wrong and still have a successful investment.

I just can't figure out what the catalyst is for Teck Resources, so I'm going to pass on the stock. Here are the three main reasons why.

1. Terrible outlook

When identifying long-term opportunities, investors need to be able to ignore short-term noise. But when it comes to the long-term future of coal — which is Teck's main business, accounting for about half of its revenue — I just can't get excited.

There are two types of coal, metallurgical and thermal, which are used for the production of steel and generating power, respectively. Teck is exclusively a producer of metallurgical coal. A slowdown in China's industrial development has hurt metallurgical coal, and the movement away from coal fired power plants has hurt thermal coal.

The average investor doesn't realize just how much coal demand was influenced by China over the past few years. Between 2008 and 2012, China added 5.9 billion square meters in office space. That's the equivalent of 50 Manhattans. That type of over-construction was rampant in the nation's residential market too. It's going to take the Chinese years to absorb their excess real estate supply. It could take decades before the nation builds in a meaningful way again.

This also hurts copper, Teck's second-largest source of revenue, since it is the main part of the wire used to electrify all these buildings. No wonder the price of that commodity is also hitting multi-year lows.

2. Bad timing

The second big strike against Teck is the Fort Hills oil sands project, in which it owns a 20% stake. **Suncor Energy** and **Total** own the other 80% of the project, with Suncor slated to run it when it's

completed in late 2017.

Back in October 2013, when the three companies decided to go ahead on the project, oil was trading close to \$100 per barrel. The outlook for crude was good, so even though Fort Hills had a projected break-even of \$95 per barrel, it got the green light.

Fast forward a little over a year later, and with the benefit of hindsight, we can all see how this project could be a poor investment. The price of oil needs to double from here for it to be viable. Oil does have nearly three years to get there, but at this point, it's not looking good.

3. A dividend cut?

Although I don't think there's an imminent threat of Teck cutting its 5% dividend, it could easily happen in the future.

The cost of Fort Hills was estimated at \$13.5 billion when it was approved. Because these projects tend to go over budget, let's add another 10% on top of that. Total cost is now about \$15 billion.

Teck is on the hook for \$3 billion of the total cost, or about \$1 billion per year. Yes, the company is currently sitting on more than \$1.8 billion in cash and looks to be on pace to deliver about \$750 million in free cash flow for the year, but it currently pays out a dividend of more than \$500 million annually. If everything continues as it does now, Teck won't have a whole lot of cash left by the end of 2016. That's bad news for the dividend.

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1. Investing
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