Despite Beating Expectations, Investors Should Avoid First Quantum Minerals Ltd.

Description

What: Canadian metals miner **First Quantum Minerals Ltd.** (TSX:FM) saw its share price move marginally higher after it released its fourth-quarter results late last week.

First Quantum surprisingly beat expectations for its fourth-quarter 2014 financial results, posting a profit that was higher than analyst estimates on the back of increased copper output and lower production costs. This has been the key driver that has lifted its share price marginally in recent days.

So what: There are signs that First Quantum's future is not as rosy as some analysts believe these results indicate.

The largest consumer of base metals, including copper, globally is China, and its economy is currently facing stiff headwinds that threaten to derail growth. These headwinds will have a significant impact on First Quantum, which derives 72% of its revenue from copper. A significant proportion of the remaining revenue is derived from other base metals, including zinc and nickel.

China has overbuilt, and activity in its construction sector continues to decline. Investment and activity in real estate development for December 2014 declined for the 12th straight month, and analysts expect this trend to continue; it is estimated that up to 28% of housing stock remains vacant.

Another threat to the demand for copper is declining industrial activity, with the metal being a key component in a range of industrial processes. Industrial activity in China, the world's single largest manufacturing economy, contracted in January 2015. This was the fourth consecutive month where industrial activity declined.

It will also be some time before there is an uptick in manufacturing and construction activity in the Eurozone, which is still caught in a deep structural economic slump, despite the ECB's stimulus plan.

On top of these threats, First Quantum is experiencing other problems that will impact its financial performance. These include changes to Zambian taxation laws that saw royalty rates for open pit mines more than triple from 6% to 20%. This will cause First Quantum's royalty costs to increase significantly because its Kansanshi mine in Zambia is responsible for around 60% of its total copper production. The end result will be declining cash flows from that mine and an overall higher cost base for its operations.

Now what: These issues, as well as softer copper prices, threaten the company's ability to meet the net-debt to EBITDA covenants on three of its credit facilities, totaling $3.5 billion. This has forced it to reduce capital expenditures and implement a range of measures to reduce costs. This is certainly a red flag for investors, because if copper prices collapse further, the company's existence could be threatened.

The poor industry fundamentals for base metals miners created by declining construction and industrial activity in China have already had a significant impact on copper prices. Earlier this year copper hit a five-and-a-half year low and with China's economy continuing to slow, I don't anticipate a strong rebound any time soon.

I believe the company does not offer investors any significant upside from current levels. It makes better sense for investors to look elsewhere for superior returns.

CATEGORY

1. Investing
2. Metals and Mining Stocks

TICKERS GLOBAL

1. TSX:FM (First Quantum Minerals Ltd.)

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Author
mattdsmith