Is Teck Resources Ltd.'s Dividend Unsustainable?

Description

The outlook for metallurgical coal, copper, and zinc miner **Teck Resources Ltd.** (TSX:TCK.B)(NYSE:TCK) continues to grow ever gloomier. Despite remaining profitable, the headwinds from weak economic growth in China are threatening to derail its growth plans and the sustainability of its 5% dividend yield.

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Now what?

Economic growth in China, the world's largest consumer of steel-making coal, copper, and zinc, continues to slow. Its GDP for 2015 is expected to grow by 7%, which is markedly lower than the 7.4% reported for 2014 and 11.3% a decade ago. While Beijing is focused on implementing measures to stimulate economic growth, there are signs that the situation is far worse than officially acknowledged.

This is extremely bad news for Teck. Almost all of its revenue comes from mining steel-making coal, copper, and zinc. Any decline in China's economic growth doesn't bode well for its ability to boost earnings.

However, of even greater concern is that activity in China's construction industry, which is the single largest consumer of steel-making coal, has ground to a halt. Idle cranes, empty construction sites, and the skeletons of half-finished buildings are common in many cities.

Investments in the industry also continue to fall. This has caused the demand for steel to diminish sharply, causing iron ore prices to fall to their lowest level in a decade and I expect steel-making coal, a key ingredient in steel manufacture, to follow suit.

The pressure this will apply to prices will be exacerbated the growing supply. Mining giant **BHP Billiton Ltd.** has stated that it will boost production to create greater cost-saving synergies and retain market share by driving higher cost producers out of the market.

Meanwhile, the outlook for copper and zinc is almost as gloomy.

China is a global manufacturing hub and accounts for 42% of global copper consumption, while being the world's largest consumer of zinc. However, manufacturing activity remains low, with the March 2015 manufacturing PMI barely above the threshold that indicates growth. China's construction sector is also one of the largest domestic consumers of copper and zinc, so declining construction activity will also impact the demand for these metals.

I also expect overall demand to deteriorate further, with Beijing slashing investments in infrastructure as it transforms China into a consumer economy.

So what?

This will have a significant impact on Teck and prevent it from growing earnings, while ultimately bringing pressure to bear on its share price.

Teck also has considerable financial obligations. It is committed to investing a further $1.6 billion in the Fort Hills oil sands project, which is looking more uneconomical because of the oil rout and a burdensome level of debt. At the end of 2014 net debt totaled $6.4 billion and cost $381 million in interest payments.

Meanwhile, dividend payments are costing it $518 million annually and have exceeded free cash flow for the last two years. This, in conjunction with lower commodity prices that could fall even further and coupled with its other financial obligations, makes the possibility of a dividend cut more likely.

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mattdsmith

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