2 Big Reasons to Avoid Teck Resources Ltd.

Description

It is very likely that value investors are circling **Teck Resources Ltd.** (TSX:TCK.B)(NYSE:TCK) today. After all, the company is trading at levels not seen since 2009, and before that, 2003. In fact, the last two times Teck hit current price levels (about $9.40/share), prices proceeded to increase substantially over a fairly short time frame. In 2003, prices rose steadily to a high of nearly $50 by 2008, and in 2009 prices rose to $61 by December 2010.

With this in mind, and with both Teck's valuation and entire mining sector valuations being near cyclical lows, it may seem tempting to buy into Teck and collect the 3% yield while waiting for a recovery. This, however, may be a bad idea. In 2008 during the last commodity price crash, Teck shares fell to lows of $4.77, and it is entirely possible prices could go there again due to a variety of factors.

While Teck may have additional downside, but just as important is the fact its upside is limited because the macroeconomic conditions that drove its shares to record highs after the previous downturns are no longer present. Here are the two biggest reasons to avoid Teck.

1. China's economy is slowing permanently

This is the biggest reason to avoid Teck. Teck produces three products: coking coal, copper, and zinc. Currently, China is the biggest buyer of everything Teck produces, including its largest product, metallurgical, or coking coal, which is a key component of steel production.

The previous large increases in Teck's share price were due to prices of its main products increasing dramatically because of a phenomenon known as the "commodity super cycle," which was driven by explosive growth in China. Before 2008, China rapidly became a manufacturing superpower as millions of farmers moved into newly built cities to work in factories. After the crash in 2008, China began a massive investment program in real estate and infrastructure projects, which skyrocketed demand for coal and copper.

Historically, China's growth rate averaged over 10%, but things are changing. China's economy is gradually slowing, and the OECD estimates China's growth will only be 3.5% by 2020. This is because China's working-age population is peaking, wages are rising, making labour less competitive, and massive amounts of investments have created extreme real estate oversupply.

The end result is that China, which uses more steel then the rest of the world combined, will not be needing to import as much coal. With coal prices currently sitting at a decade low (approximately US$95 per tonne), many analysts have long-term forecasts of $130 -150 per tonne.

2. Teck is at risk of asset impairments

Low coal prices mean that Teck may need to “write-down,” or reduce the value, of its coal assets, something known as an impairment. This can have a negative effect on Teck’s earnings and share price.

Currently Teck’s coal assets are valued at about $15 billion, which is the amount recorded on the balance sheet. This amount, however, is based on long-term prices of US$185 per tonne. Teck estimates that if long-term prices were to fall below US$140 per tonne the company would need to reduce the $15 billion value currently recorded on the balance sheet to reflect the actual value of the asset based on lower prices.

According to analysts at TD Bank, long-term prices dropping below $140 could potentially lead to a $2 billion impairment (which would reduce the value of Teck’s coal assets to $12 billion). This is bad news because companies are required to report an impairment on their income statement, which means Teck’s earnings would take a hit. It would also reduce Teck’s equity. This could be a problem since Teck is required to keep its debt levels at less than 50% of its debt and equity combined.

With analysts estimating that long-term coal prices will be US$130 per tonne, and many others reporting similar numbers, the risk of an impairment is certainly there.

CATEGORY

1. Investing
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TICKERS GLOBAL

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