



The Case for Buying Teck Resources Ltd.

Description

Teck Resources Ltd. (TSX:TCK.B)(NYSE:TCK) may be Canada's most troubled stock. Shares are down 66% this year alone, and since the start of 2011, shares have declined steadily to the current low of below \$9 per share—85% below the high in 2011.

The bearish case for Teck is well known. Its key products—coking coal and copper—have had spot prices fall 76% and 50%, respectively, since 2011. The result is that coking coal is at a decade low and copper is at a six-year low.

More important than the decline in these products are the prospects for recovery. China is by far the largest consumer of Teck's products, and the decline in these products have been the result of a slowdown in China's double-digit growth as the economy transforms from being an export and investment-led economy to a household consumption-focused economy.

This means China's historical growth rate—which averaged over 10% over the past three decades—is set to decline permanently. In fact, the OECD estimates China's growth will fall to 5% by 2020. Couple this with a weak yuan, a strong U.S. dollar, and little to no inflation, and the outlook for Teck's commodities may seem grim.

Fortunately, there may be a bright side.

Coking coal prices may have bottomed

Any discussion of Teck's prospects needs to start with a look at the outlook for its key commodities. While it is true that explosive growth in Teck's commodities (like what was seen both before and after the 2008 crash) is almost impossible, it is not overly optimistic to assume that prices have bottomed and may be poised for conservative appreciation over time.

Teck's key product is coking coal, and while the demand picture from China looks weak, there is conservative growth outside of China. Coking coal is mainly used to make steel, and crude steel production is estimated to grow at a 2% compound annual growth rate between 2015 and 2019 thanks to growth from India, Europe, and Japan, Korea, and Taiwan.

The supply picture, however, is bullish. Currently, 30 million tonnes of production cuts have been announced globally, with 50% being implemented by the end of 2014. The end result is that the market is now oversupplied by about 10-15 million tonnes.

Teck itself recently announced 1.5 million tonnes of coal production cuts by shuttering its six Canadian mines for a three-week period, resulting in a 22% drop in production. Teck is not ruling out further cuts as the year progresses. Most importantly though, more cuts from other suppliers are likely on the way.

Currently, 25% of coking coal production is not cash flow positive based on current prices, which should result in production declines. This is especially true for American producers; not only are these producers typically higher cost, but they also receive no currency benefit since their operations are based in the U.S. and coal is priced in U.S. dollars. Analysts also estimate costs in China are 50% cash negative.

The end result is that many forecasts see the coking coal market slowing coming back into balance. **RBC**, for example, is expecting metallurgical prices to rise from below \$100 currently to \$130 per tonne by 2018.

Teck has plenty of liquidity to withstand any weakness

Teck is currently in the midst of funding its multi-billion dollar Fort Hills oil sands project, which is expected to cost \$2.3 billion annually in capital expenditures over the next three years. With declining cash flows due to falling product prices, the picture could be bleak for Teck.

Fortunately, Teck has ample liquidity available to fund its capital program, even in a worst-case pricing scenario. Currently, Teck has \$1.5 billion in cash available. On top of this, the company has a US\$3 billion unused credit facility, which it has just extended until 2020, and the company also just secured an additional US\$1.2 billion line of credit. This means the company has over CAD\$6.5 of liquidity.

The best part? Using RBC's price forecast (with coal prices rising to \$130 by 2018), Teck will not even need to deplete its available cash to fund its capital program.

CATEGORY

1. Investing
2. Metals and Mining Stocks

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1. Editor's Choice

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