# Should Investors Worry About Teck Resources Ltd.'s Debt Downgrade?

## Description

On Wednesday, Fitch joined Moody's by cutting the credit rating of **Teck Resources Ltd.** (TSX:TCK.B)(NYSE:TCK) to junk status.

Fitch cut the company's rating to BB+ from BBB- for reasons that seem pretty obvious at this point. Commodity prices are weak, while Teck's debt seems to keep climbing. The company still has major commitments to the Fort Hills oil sands project. And any additional weakness in China is bound to keep metallurgical coal prices depressed.



Does this latest debt downgrade change anything for bulls? Let's take a closer look.

**The bull case**

This debt downgrade doesn't come as much surprise for the folks who follow the company. Teck's debt woes are well known.

But on the other hand, the debt is manageable, at least for now. The company is sitting on $1.5 billion in cash, and has an additional $5.3 billion in revolving credit at its disposal. That's more than enough to cover the remaining cost of Fort Hills, which is projected to be $1.8 billion.

Additional cost cuts have helped as well. The company is actually profitable in today's tough environment, posting $0.60 per share in profit over the last 12 months. And even after the capital expenditures spent on Fort Hills, the company still posted a positive free cash flow over the first half of 2015.

Hidden behind the debt problems are assets that are worth a lot if the price of commodities recover. The company's book value is more than $32 per share, and that's even after accounting for all the debt. If the price of coal, zinc, and copper recover nicely, shares will likely close the gap between their current value of $8.70 and the book value.

And then there's potential from Fort Hills, which is slated to begin production in 2017. If crude recovers to just $60 per barrel and the Canadian dollar is worth $0.80 compared to the greenback, Teck's free cash flow yield on the project approaches 10%. If crude recovers to $80, the free cash flow yield is close to 15%.

Finally, Teck's reserves are second to none. As it stands right now, it can continue to produce coal for the next century without running out of supply. It has approximately 15 years of zinc reserves based on current production, and 30 years of copper reserves. And Fort Hills has a 50-year shelf life.

In today's commodity price environment, nobody cares about long-life assets. But during the next commodity boom, these types of reserves will be important.

**The bear case**

The biggest risk for Teck is commodity prices staying low.

Metallurgical coal is the biggest threat. Approximately 40% of profit comes from coal, while the other 60% comes from base metals. Coal has traditionally been the big profit driver, but the big decline in prices for the commodity has hurt profits.

There's also the issue of additional supply in the market. Both American and Australian producers are dragging their feet on production cuts that are badly needed. Some of these producers look likely to end up in bankruptcy, which would ultimately help the whole sector. It's only a matter of the inevitable happening.



But what happens if China continues to be weak? It's very possible the price of coal could drop even further, which would likely take down the price of copper with it. It's easy to make the argument that China's building boom is over; just read the reports on the empty apartments and office buildings if you don't believe me.

As much as we think the price of coal is as low as it could possibly go, there's still potential for bad news from China to knock it even lower. That's the big risk in an investment in Teck, and that's why both Fitch and Moody's downgraded the debt.

On the other hand, it's easy to make the argument that Teck shares are very cheap, especially if commodities recover. As long as the company doesn't run out of liquidity before that happens, shares of this company could be a huge winner.

**CATEGORY**

1. Investing
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