The Silver (or Zinc) Lining to the Teck Resources Ltd. Story

Description

Teck Resources Ltd. (TSX:TCK.B)(NYSE:TCK), for better or worse, is only as valuable as the underlying commodities it produces and sells. For Teck, this is metallurgical coal, copper, and zinc. Unfortunately, these three commodities plunged roughly 40%, 33%, and 29% respectively in 2015.

The end result is that Teck shares fell 68% in 2015. While the outlook for metallurgical coal as well as copper are weak due to persistent oversupply and sluggish demand out of China, the zinc market has extremely positive fundamentals.

Zinc is Teck's least-talked-about segment, despite the fact that it has been a large profit contributor for Teck over the past few years. Going forward, this should only improve as analysts from organizations like Macquarie, **Bank of Nova Scotia**, and **RBC** have all flagged zinc as one of 2016's top commodity plays.

Major supply issues are about to hit the zinc market

Analysts at Macquarie recently published a commodity outlook for 2016, and it was overwhelmingly negative. They predict further price deterioration across the board thanks to minimal industrial production growth, which in turn limits demands for commodities. At the same time, there is plenty of supply.

Out of over 20 commodities covered by Macquarie, zinc is the most favourable because major supply constraints and a lack of new supply coming online are set to put the zinc market further into a deficit (where demand exceeds supply). This situation will only increase over time, sending zinc prices upward.

Currently, the zinc metal market is already in a deficit and has been since 2013. As a result of this deficit, zinc inventories have been plunging since companies must draw on available inventories to fund any demand that exceeds production. Over the past two years zinc inventories have plunged from 1.2 million tonnes to slightly under 500,000 tonnes.

This massive 700,000 tonne drop in inventories has taken inventories to levels not seen since 2010. A sharp draw down in inventories typically results in surges in pricing, and this is where the zinc market appears to be heading, since the deficit in the market is expected to only worsen over the next several years.

In 2016 and 2017, analysts at CRU and Wood Mackenzie expect the overall zinc metal market to be in a significant deficit once again, and this should further drop down inventories to critical levels.

The supply shortage in zinc is due to a slew of recent mine closures. One of the more prominent closures was the permanent closure of Australia's century mine, which was the largest mine in the country and one of the largest in the world. After 16 years of operation, Century mine was finally depleted, resulting in the closure of a mine that was responsible for 4% of global output, or about 500,000 tonnes annually.

This is a growing trend—a series of long-running mines are being depleted and shut down, and there are simply no large and advanced development projects set to replace lost production. More importantly, zinc is a fairly scarce resource, and finding new sources of supply is difficult and costly.

Teck is poised to benefit

For Teck, this is excellent news. Teck is a major player in the zinc industry—it's the third-largest producer of zinc and operates the world's largest smelting and refining facilities.

Teck currently owns three major zinc mines with reserves set to last another 15 years. Teck's zinc production is actually growing. Teck restarted its shut-down Pend Oreille zinc mine at the start of 2015, and this mine is slowly ramping up to full production capacity, which it expects to have reached at the end of 2015 (this will not be confirmed until year-end results are released in February).

As zinc prices improve, Teck shareholders should see the difference on their bottom lines.

Teck currently produces about 936,000 tonnes of zinc concentrate and refined zinc annually, and while this pales in comparison to the 26 million tonnes of coal Teck produces, it exceeds the size of Teck's copper segment.

Due to weakness in copper and coal markets, zinc will be the largest contributor to Teck's gross profit in 2015, and should remain a large contributor going forward as prices strengthen and production grows while other prices remain soft.

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