Why First Quantum Minerals Limited Could Still Breach its Financial Covenants

Description

Base metals miner **First Quantum Minerals Ltd.** (TSX:FM) sent investors' hearts fluttering after it released its full-year 2015 results when it stated that there were concerns about a possible breach of its financial covenants. While this risk has since been mitigated, it does highlight the severity of the headwinds facing metals miners at this time.

Now what?

Forecasts predicted that the company would breach its net-debt-to-EBITDA covenant during 2016, because of sharply weak copper prices. This illustrates just how deeply the rout in commodities runs and the risks that the prolonged weakness in base metals prices creates for mining stocks.

You see, copper, which is responsible for generating three-quarters of First Quantum's revenue has been sharply impacted by China's decelerating economic growth. Demand for copper, along with other metals from the world's largest consumer of commodities, fell significantly.

The price of copper and other metals, such as nickel, which is responsible for 11% of First Quantum's revenue, were hit particularly hard, and there is no sign of a meaningful recovery in sight.

While First Quantum was able to remedy the issue by selling its Kevitsa mine in Finland for US$712 million and using the proceeds to reduce its debt, it highlights the considerable uncertainty facing miners. This uncertainty is being exacerbated by the recent bounce in metals prices, and this has given investors hope of a long-term recovery that is increasingly unlikely to occur.

The rebound in commodities prices is based more on perception of a future recovery because of promises by Beijing to implement further economic stimulus measures rather than any tangible change in fundamentals.

Furthermore, while the risk of an economic hard landing in China appears to be diminishing, it should be remembered that previous stimulus measures failed to gain any real traction. This means it is unlikely that there will be any meaningful recovery in copper and other metals for some time.

Then there is China's planned transition from investment-led growth to focusing on domestic consumption as the key driver of economic growth. This means that demand for metals from China will continue to diminish as the focus moves away from investing in commodities-intensive infrastructure to a growing services sector.

In fact, investment bank **Goldman Sachs** believes that copper remains caught in a protracted bear market and prices will remain weak through 2018-2020.

If this occurs, then there will be further financial pressure applied to First Quantum, especially as it's heavily indebted; it holds debt to the tune of US$4.7 billion, or four times its operating cash flow. Fortunately, the majority of that debt does not mature until 2020 or later, giving First Quantum some breathing space for metals prices to recover.

So what?

With no signs of an immediate recovery in copper and other base metals prices, it is difficult to see any improvement in First Quantum's financial position. As a result, it may again face the risk of breaching its financial covenants, especially if copper prices fall further, placing its ability to survive at risk once again.

This, coupled with the uncertainty surrounding the outlook for commodities and China's economy, makes First Quantum an unappealing investment at this time. There are far better opportunities available in industries outside mining.

CATEGORY

1. Investing
2. Metals and Mining Stocks

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1. TSX:FM (First Quantum Minerals Ltd.)

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