Teck Resources Ltd.: The Rebound Is Overdone

Description

Teck Resources Ltd. (TSX:TCK.B)(NYSE:TCK) was downgraded to "underperform" from "outperform" at CLSA this week. The research company said the rebound has gone too far. Since the year began, shares have more than doubled. "We believe the stock is pricing in significantly higher copper and coal prices than spot and our estimates for this year and next," CLSA said.

Unless you're a huge commodities bull, CLSA is probably correct in saying the rebound is overdone.

Pricing in too much

According to the *Financial Post*, "investors are valuing Teck shares as if copper was at roughly US$2.60 a pound, zinc was US$1.00 a pound, and coking coal was US$100 a tonne. The actual prices of those metals are US$2.23, US86¢ and US$92.50 respectively."

So based on prevailing market conditions, commodities would need to advance another 10% or so for Teck to be fairly valued. But there's another way the company can close the margin gap.

Throughout the latest downturn, Teck has been relentless in cost cutting, which has allowed many of its major mines to remain cash flow positive. Last year the company beat its guidance for full-year production costs and capital expenditures.

"We've achieved significant sustainable operating cost reductions through our CRP, the cost-reduction program, and our results have been helped by lower oil prices," said CEO Donald Lindsay. "At the mine level, we've reduced our cash unit costs at all operations year over year and, importantly, all of our major operating mines are cash flow positive after sustaining capex in Q4 in 2015."

If cost reductions can continue to beat expectations, Teck could boost profitability without raw materials continuing to strengthen.

Major hurdles remain

Despite impressive efforts in reducing costs, commodity prices will ultimately move shares over the long term. With $9.6 billion in debt, of which $600 million is due next year, Teck needs conditions to improve quickly. Coal mining competitor **Peabody Energy Corporation** filed for bankruptcy this week after weak coal prices left it unable to service debt of $10.1 billion. The situation at Teck isn't that dissimilar, although it can lean on its copper and zinc production.

Despite a small rebound in resources, the situation remains bleak. Coal is in its worst slump since the 1950s, copper is down roughly 50% since 2012, and zinc prices recently hit 1975 levels.

Deutsche Bank released a report last month stating that the "commodity price rally appears to be driven by incrementally positive data from China. We do not expect this trend to continue and still believe supply cuts across most commodities are required … We expect further equity issuances and debt refinancing ahead as the sector continues to re-shape." If the bank is right, the recent pop could be a mere blip in what has been a downward spiral for Teck.

Since hitting all-time highs of roughly $65 in 2011, the stock has seen multiple short-term rallies, all of which proved to be short-lived. The latest rebound looks overdone and the long-term future remains full of pricing headwinds.

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rvanzo