Avoid This Stock During a U.S./China Trade War

Description

There is currently no greater threat facing the global capital markets than a full-blow trade war between the United States and China. Although fears of an overly aggressive escalation from either side were briefly mitigated last week after the announcement of “only” 10% duties on an additional $200 billion of Chinese imports (versus 25% duties expected), what little optimism from the news has since faded, following reports of China’s withdrawal from the trade-negotiation table.

With the very real possibility that these trade tensions will get sufficiently worse before they get any better, it might be prudent to avoid some stocks that stand to lose the most from a slowdown in global growth. And of the universe of possibilities on the TSX, thanks to Canada’s trade ties with China, I’ll focus my attention on one particular name in the very sensitive commodities sector: **First Quantum Minerals** (TSX:FM).

High debt balance and project risk

First Quantum is a name that is familiar to those who follow the commodity complex, as it is one of the largest “pure-play” copper names in Canada. Unfortunately, this also means that the company and its finances rely heavily on the direction of copper, which would fall in tandem with a slowdown in global growth from a U.S./ China trade war.

In fact, First Quantum almost became a victim to soft copper prices in February of 2016, when the company warned that it might cease to become a “going concern” (meaning go bankrupt) when copper touched US$2/lb due to breaches of its existing debt covenants.

Now more than two years later, there is still a very real possibility that First Quantum will face a violation of its lending covenants on its senior debt facilities, which require the company to keep its net debt range below 4.5-4.75 times earnings before interest, taxes, depreciation, and amortization (EBITDA). Furthermore, First Quantum is also facing over $1.1 billon of senior notes becoming due in 2021, with subsequent annual maturities ranging from $850 million to $1.1 billion, going out to 2026.

The bulk of this debt was raised largely to fund a takeover of Inmet Mining in 2013, which gave First Quantum an 80% equity interest in the $5.5 billion Cobre Panama copper project. As of its most recent quarter, the project is 76% complete and is scheduled to started production by Q1 of 2019. If, however, First Quantum runs into any unexpected delays with the project as the trade war heats up, we can expect a very sharp pullback in the company's stock price.

While First Quantum has initiated some positive changes in the past two years, such as increasing its copper hedges and renegotiating and paying down debt, investing in the company hinges on two key developments: a peaceful resolution of the U.S. and China trade conflict, and actual production from the Cobre mine. Until we see these two developments take place, First Quantum is too risky of a play in my books.

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