Insight Conversation: Christopher LaFemina

The managing director of global metals and mining equities research at investment bank Jefferies talks to Diana Kinch and Paul Hickin about market trends as the COVID-19 crisis gradually eases, and how the industry might develop in the longer term

The global coronavirus crisis has placed varying degrees of stress on metals supply chains around the world. Shutdowns among key metals consumers such as auto industries and construction negatively impacted steel and aluminum, while there has been a flight towards gold and other precious metals as safe havens, and other products such as iron ore have shown resilience despite the economic downturn.

As metals markets look to a post-COVID-19 future, LaFemina's commentary ranged over consolidation and supply reduction, the possibility of another wave of protectionism and trade wars, and "greening" metals production.

Metals prices have been on a rollercoaster since the beginning of the COVID-19 crisis. Can we expect volatility to diminish now that many countries are emerging from lockdowns?

I would say the volatility in metals markets has been driven by two separate, but both critically important factors. First is obviously the demand impact from the coronavirus. We had a collapse in demand in China in January and February. China has begun to recover, but US and European demand has been very, very weak. And the significant weakness in demand globally has driven a lot of the volatility in the markets.

The second factor is the impact on supply due to lockdowns. Mines getting shut down in various regions around the world have made the impact of the pandemic on metals markets not as serious as it would have been otherwise. So markets have shifted into surplus in some cases, but not really to problematic

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levels. Inventories, more recently, have begun to decline again because of the supply impact effectively offsetting the demand weakness and some evidence of a recovery in China.

But our view is as long as you have dramatic swings in demand due to lockdowns or lockdowns being lifted, you will see continued volatility in commodity markets. It's not uncommon for commodity prices to experience a lot of volatility at troughs in the cycle. And it's hard to argue that the first quarter of 2020 from a demand perspective, at least, was not a trough.

Do you think the coronavirus pandemic will significantly change companies' business models?

Even before the pandemic came, the mining sector was in the midst of a really serious fundamental change. And if you look back to the history of the industry, mining companies tended to go into downturns with a lot of debt, and the industry tended to get in trouble in the weak points of the cycle because of over-leveraged balance sheets.

So in 2008, that's what happened. Companies had made big acquisitions and built very expensive projects at the peak of the cycle and then lo and behold, the downturn happened when we least expected it and companies got in trouble. The same thing happened in 2015.

One of the notable differences even before 2020 is that the balance sheets effectively became sacred. So I think this kind of focus on financial strength and flexibility, and ability to withstand the volatility in markets and withstand deep downturns, is a relatively new phenomenon in mining.

I would think that the pandemic impact will only enhance that kind of philosophy, which is that balance sheet is sacred. We need to be conservative around capital allocation in general.

Are we going to see any more merger and acquisition activity on the mining scene in the near future? In theory, some of the assets are quite cheap, and companies like Rio Tinto and Anglo American have been talking about acquisition and diversification.

This is a very important question. The answer will be different than it has been in prior cycles. Historically speaking, mining companies like Rio Tinto or BHP, for example, had very large organic growth pipelines, and they were growing their production at least in line with global GDP growth. And they had a portfolio of options, projects that were not necessarily economic

at the time, but over time would become economic and would be developed.

This pipeline of organic growth really limited the need to go out and buy growth. Now it doesn't mean that companies didn't make acquisitions anyway, but the point is they had organic growth pipelines. Because of the China supercycle and an expectation that demand might be good for a very long time, a lot of these projects that would have essentially been out-of-the-money options became in the money and were ultimately developed.

So the downturn we saw in commodity markets that began in 2011, I would argue, was more a function of supply growth than demand weakness. You had a lot of investment in new capacity, capital expenditure went to all-time high levels. All this new mine capacity came online, you had a world of new supply that crushed commodity markets and drove the downturn in 2015.

Ultimately, that supply has effectively all been absorbed into the markets today. And now those same companies that delivered that organic growth simply don't have the growth.

So, rather than going out and spending on acquisitions or even on high risk projects, the bias in the industry has been instead to return capital. But when these companies do want to grow again, they won't be able to do so on a large scale organically... the only option really is to go out and acquire growth.

And then the question is, do you go ahead and buy stakes and assets, do you buy individual operating assets? Do you go out and spend a lot more money in exploration? Or do you go out to make large-scale acquisitions?

I do think the industry will transition to a little bit more of a growth mentality as the global economy recovers and that will lead to an increase in M&A activity. Again, probably starting small, but ultimately becoming, as we've seen in prior cycles, large-scale transformational type deals.

In terms of where they will look, it's pretty clear that the major miners, at least, want more exposure to copper and they want more exposure to kind of new-age commodities, battery materials, for example. Things like lithium, maybe even potash, but again, copper and nickel. I think these are the commodities where the investment will go in the future, not only for organic growth projects over time, but also in terms of M&A.

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How do you see the US-China trade dispute playing out, or wider trade wars and protectionism?

If you look at the Chinese economy, what are the drivers? I would say it's consumer spending. It is net exports. It's fixed asset investment and it's industrial activity.

Well, the consumer is weak because of the pandemic. Exports are weak, partially because of trade issues. What does that leave for the Chinese government to stimulate their economy? It's the old economy stuff – fixed asset investment, industrial activity.

We're seeing an increase in industrial activity in China already from the downturn from the first quarter and also fixed asset investment. So at least in the case of China, less exports means more fixed asset investment domestically, less exports means more investment in infrastructure domestically, more steel demand domestically.

Short term, it's not clear to me that [protectionism is] a negative. In fact, it could be a positive because it means more investment in China to support that economy. But longer term, it will be a clear negative because it means slower global GDP growth.

Do you feel that the lows of around $4,300 per metric ton for copper are now behind us? And what are your views of the Chinese government taking inventory from local merchants – is this helping to boost sentiment?

The recent data we've seen out of China and anecdotal evidence on the ground in China is that things there are indeed improving.

I would expect there to be significant volatility going forward, but I think copper probably has bottomed. Also keep in mind that mining companies have cut capex guidance for 2020 by, I don't know, 20% on average. Some of those cuts and capex guidance are related to copper projects that are being slowed. And that means that the supply growth outlook for copper is actually a little bit more bullish for the price.

You're not going to have as much supply growth coming online as demand recovers heading into 2021 and 2022. So I think the trajectory, the path of least resistance for copper is likely to be to the upside.

What the Chinese government is doing, I can only guess as to their motivation, but it would, in my opinion, be very wise to build strategic stocks of commodities when prices are low.

As well as having a cyclical component of demand growth in line with global GDP, I think there may actually be some additional demand drivers in copper – EVs, renewable energy and potentially antimicrobial applications, which are kind of unique to the copper market.

Prices for iron ore have held up pretty well this year, and it's being viewed as a safe haven for investors. Do you think it will be a star performer again this year?

Well, it certainly has been so far – the iron ore price is actually up year-to-date. And the market is clearly tight. Chinese inventories have been falling very steadily. And there's definitely some supply issues in iron ore as well. I think the strength that we've seen is totally justified based on the fundamentals. There's not anything unusual going on in that market. This is surely fundamentals-driven. I'm not so sure the enterprise has a whole lot of upside from here.

In other words, if we get a restart of the European and US economies, does that have a big impact on iron ore? Probably not to the same extent as it would in some of the base metals like copper. Here's why. I mean China is roughly 75% of the seaborne iron ore market. And the only end market for iron ore in China is really the Chinese steel industry.

Chinese steel production is up year-to-date, up year-over-year. So that end market has not really been negatively affected by the virus. Demand has grown year-over-year. Europe only accounts for 9% of seaborne iron ore demand. The US accounts for 0%.

So weakness in the US and Europe has not been catastrophic at all to the iron ore market. In fact, weakness in Europe has been offset by supply disruptions elsewhere. The iron ore market has actually been physically tighter despite the impact of the virus. Demand has been okay and supply has been affected.

Which are the metals and minerals you see doing well this year?

If we [see] recoveries in the US and Europe, I think the base metals. So it's copper, nickel, zinc, aluminum – there are supply constraints and partially because, again, my point earlier about a lack of new projects.

I think you're going to see a recovery in demand in the US and Europe. If we do get a recovery in those economies, this will not be offset by a corresponding increase in supply, and prices for pretty much everything should recover.

Now many commodities, we've been [in a] fairly deep cyclical trough. So it's not a surprise that the path of least resistance should be higher. But I do think that the supply constraints will be meaningful over the next 12 or 18 months. So again, it's copper, nickel, zinc, aluminum, even coal prices going higher from here.

About a quarter of aluminum smelters are said to be loss-making at current prices. Do you believe the aluminum industry will go through capacity cuts and consolidation? And what's the size of the surplus capacity that may be removed for good?

I think the aluminum industry needs consolidation and capacity cuts. A lot of new capacity in aluminum has been added in China over the last 20 years. You have too much capacity globally and some of that needs to get shut down and price will be the incentive for that to happen. Smelters need to be, I would argue, permanently dismantled.

There's a few million tons of capacity at least that has to come offline before the market can genuinely get tight. But I think we are in the early stages of that process, and we will see that play out over the next couple of years.

The thing about aluminum is that demand is really not ever a problem, it's kind of the magic metal. Demand for aluminum actually tends to grow faster than global GDP, whereas other commodities grow more in line with formal GDP. The problem has for the last 20 years [been one] of supply. And I think we have the incentive now for some of that supply to finally get taken off line.

The industry would benefit, clearly, from consolidation. Consolidation in commodity markets is almost always helpful. I don't really see evidence that has been happening in aluminum because the industry doesn't appear to want to continue to invest in the commodity.

In other words, aluminum producers are not trying to get bigger. They're trying to get better by fixing their balance sheet by cutting their costs, and I don't really see a strong motivation yet for M&A in the space. I think, again, it's different in copper and the battery materials where companies see that as being – those markets as being kind of structurally positive over a 3, 4, 5, 10 year horizon.

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And what about green aluminum? Do you think the LME will introduce a premium for green aluminum or any other standard?

It's very difficult probably to get to the absolute green aluminum or green metal. Well, there's work being done on inert anodes and there's technology that's being invested in, and this has been the case really since the early 2000s. Companies have tried to make green aluminum. There's no doubt that the investment is being made, and I think over time, there will be progress.

Even things like switching from coal-fired power to hydropower. You use a lot of power to create aluminum. If you're using clean power, that reduces the carbon footprint materially. Whether the LME starts changing pricing, depending on whether it's green, I don't have a view on that, but I do think the industry is highly motivated to become cleaner. And part of it is because of what investors want.

ESG compliance is becoming a very important thing in the world of metals and mining in general. And companies want to be investible. And by being greener, they become more investible. So I think there is plenty of incentive and motivation for them to continue to make the investment.

Will it ever be truly green? Debatable. Will it be greener? I think the answer is yes. ■