Diversification – A Shield for Big Miners in a Challenging Environment

Special Report

INVESTMENT RESEARCH & ANALYTICS

Date: December - 2020

The global pandemic COVID-19 hit almost all sectors severely in 2020 and mining is no exception. Challenges such as weak demand, higher fixed cost, and volatile commodity market aggravated the situation. However, many large-scale mining companies have adopted a product diversification strategy over the last few years, which helped them limit their losses. Furthermore, higher iron ore prices and exposure to China (major economies recovering faster than the others) are buttressing big miners amid the current crisis.

Large-scale, diversified product portfolio

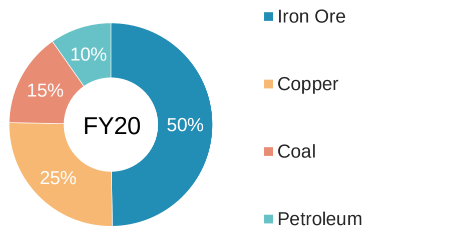
Many mining companies have expanded their product portfolio over the past to hedge themselves against volatile commodity prices. Majors such as BHP Group (BHP), Rio Tinto (RIO), and Anglo American plc (AAL) have engaged in M&A to diversify their product portfolio.

For instance, BHP, formerly known as BHP Billiton was founded in 2001, following a merger between Australian Broken Hill Proprietary Company Limited (founded in 1885) and Anglo–Dutch Billiton plc. Similarly, RIO was founded in 1873 when a multinational consortium of investors purchased a mine complex on RIO's site in Huelva, Spain, from the government. Thereafter, the company has grown through a series of M&A and diversified itself across many commodities. Formerly known as Anglo American Corporation, AAL was founded in 1917 in Johannesburg, South Africa, and started its business in gold mining. In 1945, AAL ventured into the coal industry with the acquisition of Coal Estates and thereafter added various other commodities to its portfolio.

Exhibit 1: Commodity diversification helps miners weather difficult times

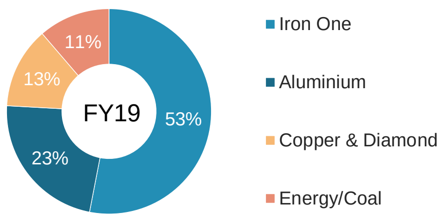
BHP

- Iron ore constitutes 50% of total revenue, after a recent rally in its prices. The share of other commodities is low due to weak prices.
- On average, iron ore contributes 37% to total revenue, followed by copper (25%) and coal (15%).



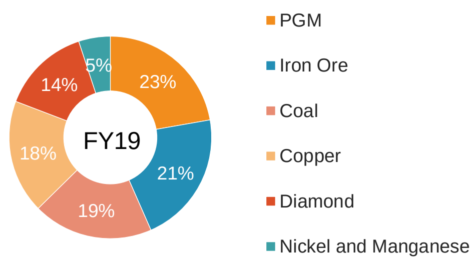
RioTinto

- RIO is the world's second largest metals and mining company, behind BHP, producing iron ore, copper, diamond, gold, and aluminium.
- Although RIO has diversified its product portfolio, iron ore comprises more than 50% of total revenue.



ANGLO AMERICAN

- AAL has the most diversified product portfolio of the three.
- Platinum group metals (PGMs) account for 23% of total revenue, followed by iron ore (21%) and coal (19%).



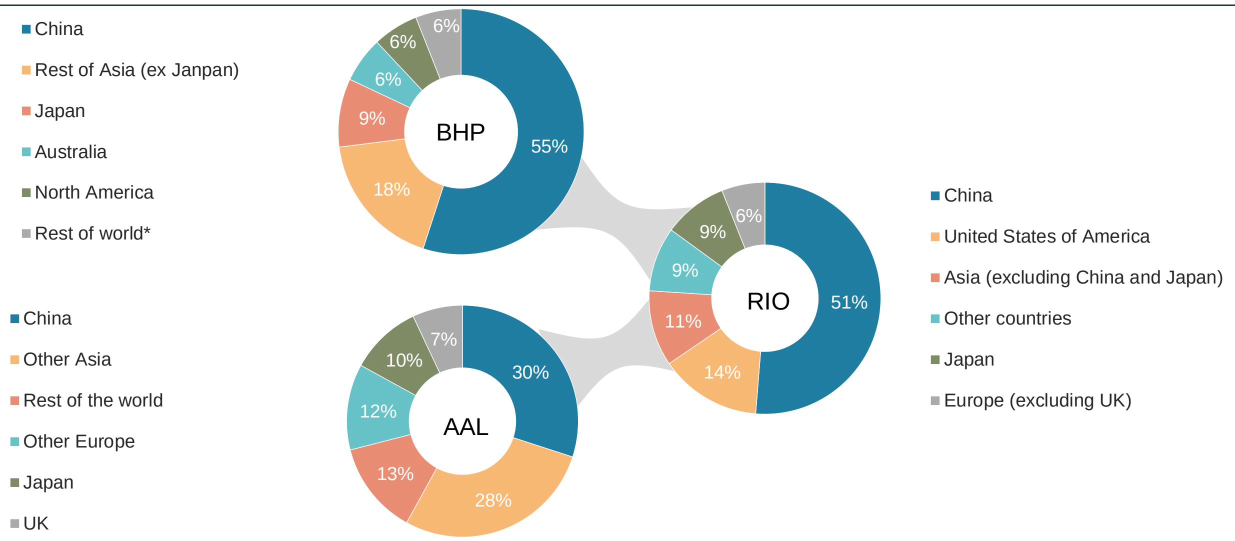
Source: *Company fillings; PGM includes palladium and platinum; BHP financial year ended June; AAL and RIO December ending; donut graphs represent revenue by products*

Heavy exposure to China would benefit amid current crisis

Apart from commodity diversification, miners attempt to invest in various geographies with the aim of preventing excessive concentration in any one market. Geographical diversification not only helps companies mitigate business and operational risk but also creates growth opportunities. However, China remains the strongest market for miners, as it is the largest consumer of commodities worldwide.

Almost 50% of BHP and RIO's revenue and 30% of AAL's revenue come from China. Although greater exposure to only one country can be considered a concentration risk, it has proven beneficial in the current scenario. Demand from China has also improved since April, while the rest of the world is still struggling to cope with COVID-19. China's faster growth compared to rest of the world would boost miners' financials in the coming years.

Exhibit 2: AAL most balanced company by geographical revenues



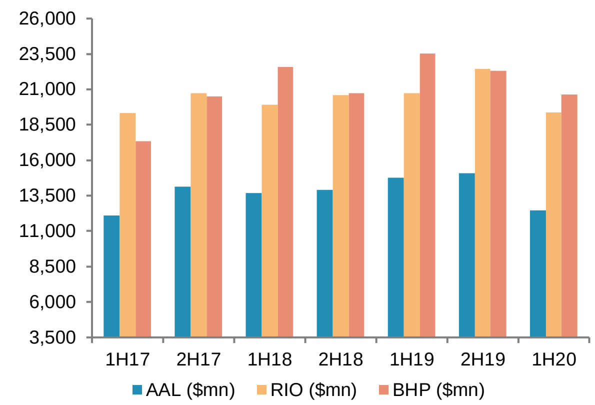
Source: *Company fillings, Geographical revenue bifurcation of BHP (FY2020), AAL & RIO (FY2019), *Rest of world includes 4% Europe share*

Diversification provides a cushion to big miners' financials

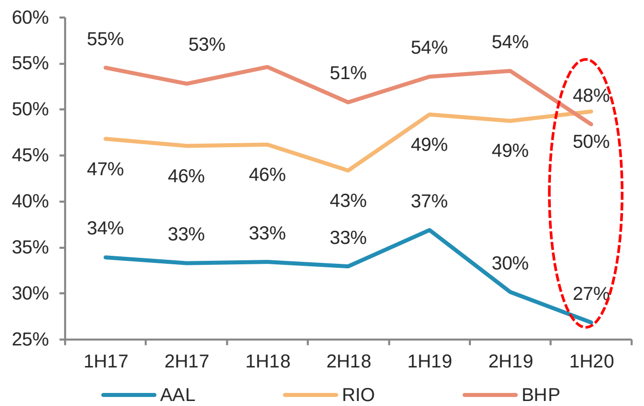
Product diversification aids miners to mitigate downturn in one market and support their product segments with strong developments in another. The rally seen in iron ore prices in 2Q20 reassures that diversification is the right path to take in difficult market conditions. Iron ore prices rose to $103/t in June 2020, the highest level since July 2019. Supply shortage mainly from Brazil due to disruption in weather and the COVID-19 crisis, coupled with demand from China, led to an increase in iron ore prices. According to Bloomberg consensus, the prices are expected to remain stable at $106/t in 2020 and 2021, higher than $93/t in 2019. In 1H20, revenue declined by just 6.6% y/y for RIO, whereas it dropped 15.6% y/y and 12.4% y/y for AAL and BHP, respectively. While BHP and AAL reported a moderate contraction in EBITDA margins, RIO posted an improvement. The company's better performance was mainly due to a higher share of iron ore in total revenues. The overall financial performance has been healthy for all miners even during the pandemic.

Exhibit 3: Higher iron ore prices provide cushion to revenues and EBITDA margins in 1H20

Limited fall in revenue ($/mn)



AAL's EBITDA margin impacted on lower iron ore share

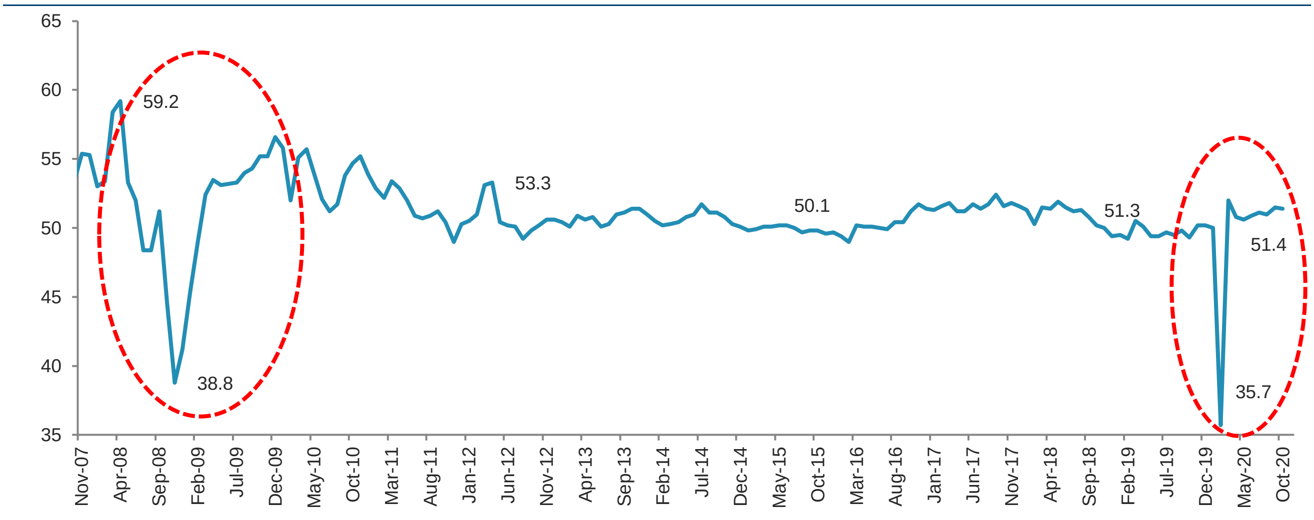


Source: *Company fillings, Adjusted BHP's revenues & ebitda to compare with RIO & AAL (due to year end difference)*

Recovering demand in China likely to support prices

- **Strong recovery in China's PMI after pandemic on resilient exports sector and stimulus-led infrastructure expansion**
  China's Manufacturing Purchasing Managers' Index (PMI) rose to 51.4 in October 2020, after touching a 15-year low of 35.7 in February 2020. The impact of the pandemic on China's PMI seems to be replicating the pattern of the 2008 financial crisis. China's PMI fell to 38.8 in November 2008 and rebounded strongly to 56.6 in just one year. In 2020, a sustained improvement in PMI was seen due to high exports and from stimulus of ~$500bn. Conversely, the global outlook is still bleak as many Western countries (UK, France, US) are now battling a second wave of the pandemic.

Exhibit 4: Steady recovery in China's PMI



Source: *Bloomberg*

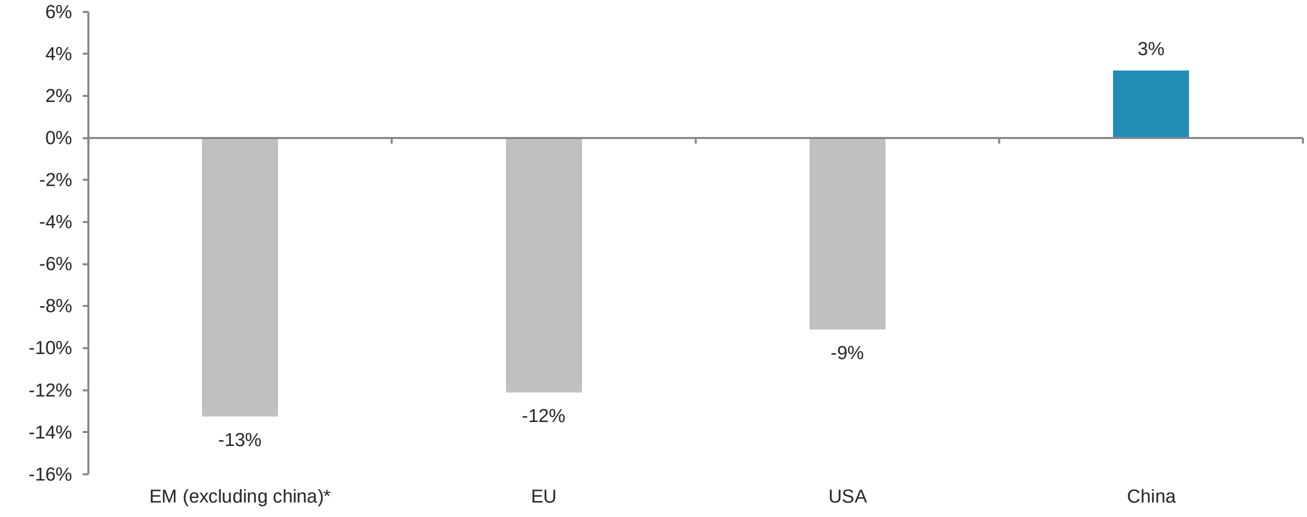
- China's exports grew 11.4% y/y in October 2020, recording the fastest pace in the last 18 months. Recovery in medical equipment supplies, record shipments of electronic products, and subdued manufacturing activity worldwide bolstered Chain's exports in the middle of the COVID-19 chaos. Higher domestic and overseas demand, coupled with the stimulus package, would continue to lead to a sustained improvement in China's PMI.

Exhibit 5: China's October 2020 exports highest in 18 months

Source: Eikon

- **China's GDP growth likely to surpass rest of the world's GDP in 2021**
  The world's second largest economy shrank 6.8% in 1Q20 as China struggled with coronavirus. Implementation of nationwide lockdown and social distancing measures severely impacted the economy in the first quarter. However, the country was successful in containing the spread of the virus and initiated a stimulus package worth $3.9bn through various subsidies to bolster its weakening economy. Consequently, GDP grew 3.2% in 2Q20. On the other hand, GDP of developed countries such as the US and Europe fell 9.1% and 12.1%, respectively, and that of emerging markets (excluding China) shrank ~13.2%.

Exhibit 6: Major economies decline in 2Q20 due to pandemic

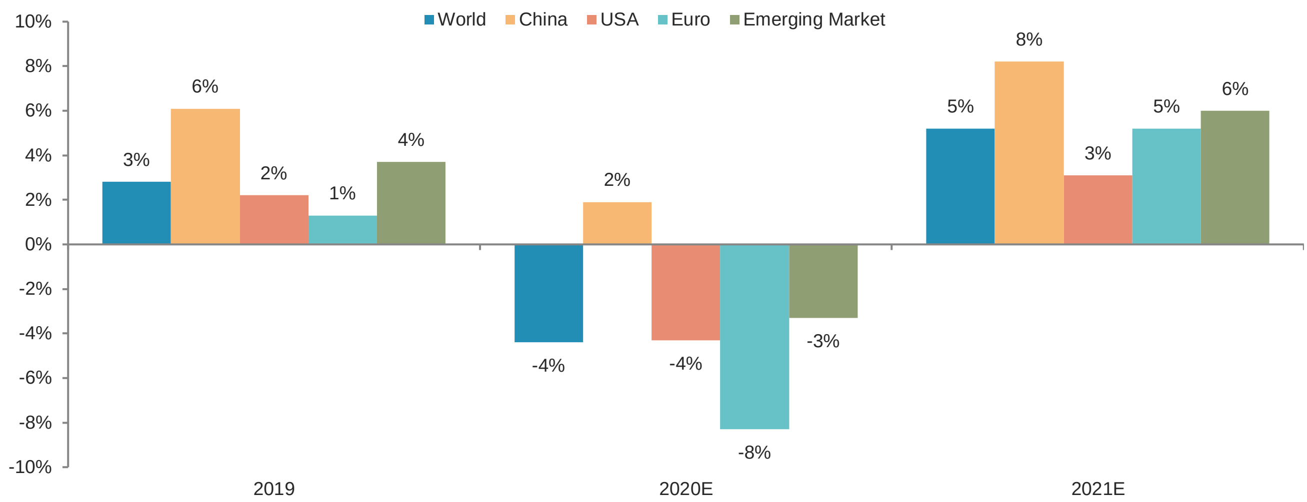


Source: *Secondary research, *Avg. GDP in 2Q20 (India, Russia, Brazil, South Africa, KSA)*

Notably, the Chinese economy expanded 4.9% in 3Q20 due to a resilient export sector and speedy recovery earlier this year. China's weeklong National Day holiday in October 2020 registered more than 630 mn domestic trips, whereas other major economies are still struggling to recover from the contractions triggered by COVID-19.

According to IMF, China's economy is expected to grow 1.9% in 2020 and 8.2% in 2021 compared to 6.1% in 2019. On the other hand, global GDP growth is forecast to decline 4.4% in 2020 and followed by a 5.2% rise in 2021. The US and Europe are likely to record GDP growth of 3.1% and 5.2% in 2021, respectively, much higher than -4.3% and -8.3% in 2020. This gives us confidence that all the major economies would bounce back in 2021.

Exhibit 7: China's growth to outperform global GDP in 2021



Source: *IMF Oct 20 WEO report*

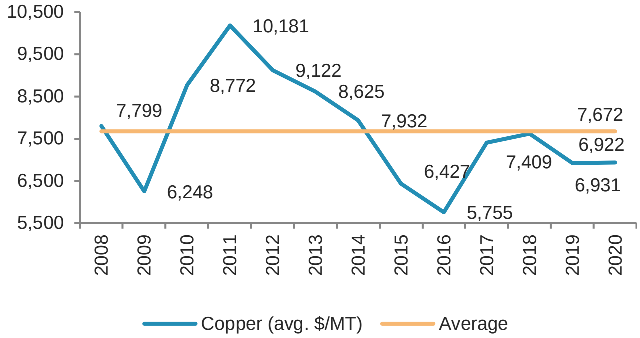
Commodity prices to remain stable as demand improves

Commodity prices plummeted in March 2020 (except palladium prices) due to the outbreak of COVID-19 across the globe, with prices going below 2009 levels. Worldwide travel restrictions announced to cope with the pandemic, along with weak investor sentiment and lower demand, considerably affected price performance. However, commodity prices bounced back from April levels and have witnessed steady growth since then due to the faster recovery of the Chinese economy. Improvement in domestic demand and huge stimulus by the government aimed at various sectors boosted the current prices. Moreover, as lockdown relaxes across the world, demand for commodities is rising, thereby consistently supporting the prices. Most of these prices even reached new highs for the year. In addition to the recovery in demand, positive sentiment in anticipation of the arrival of a vaccine in December 2020 has led to strong commodity price performance.

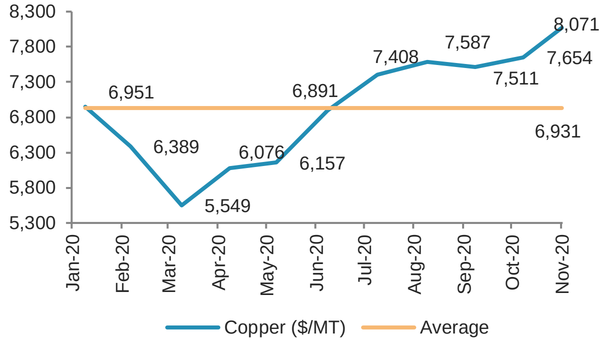
Palladium prices were outliers among the rest of the commodity prices and have shown sustained growth since 2015. The prices have shot up from $625/t oz in 2016 to $2,216/t oz in 2020, driven by supply shortage. Considering palladium is a secondary product of platinum and nickel extraction, miners have less flexibility to increase palladium output in response to rising prices. On the other hand, demand for palladium from car makers has soared due to stricter emission regulations imposed by most of the world governments, especially China, to combat air pollution from petrol-run vehicles. The prices would remain elevated as palladium is a rare metal. More than 80% of it is used in devices (mainly in a car's exhaust system) to convert toxic gases, such as carbon monoxide and nitrogen dioxide, into the less harmful nitrogen, carbon dioxide, and water vapor.

Exhibit 8: Snapshot of major commodity prices in long term vs. short term

Copper yearly avg. prices ($/MT)

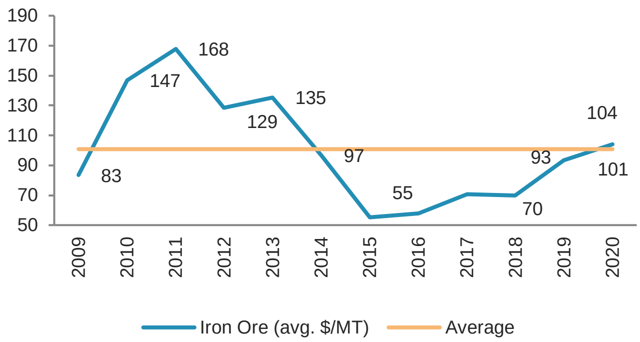


Copper YTD prices ($/MT)

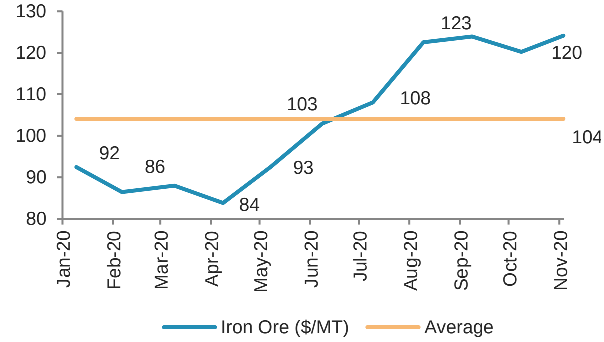


Source: *Bloomberg, Generic copper prices (BB ticker: CU1), 2020 includes average prices till 27 November 2020*

Iron ore yearly avg. prices ($/MT)

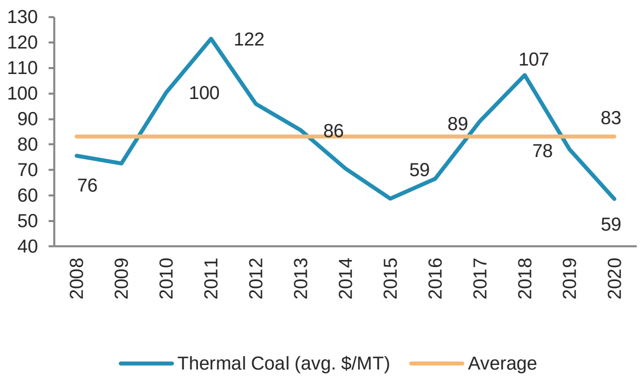


Iron ore YTD prices ($/MT)

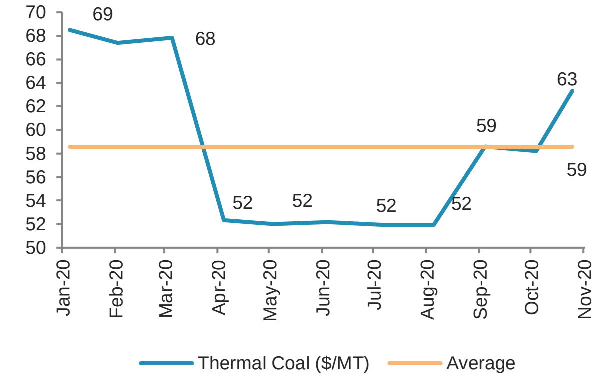


Source: *Bloomberg, Generic iron ore prices (BB ticker: IOR1), 2020 includes average prices till 27 November 2020; iron ore data is available since 2009*

Thermal coal yearly avg. prices ($/MT)

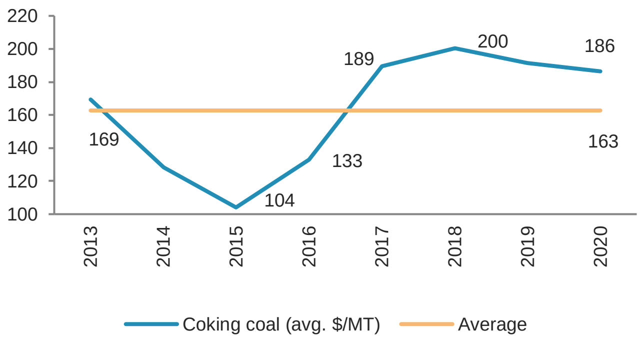


Thermal coal YTD prices ($/MT)

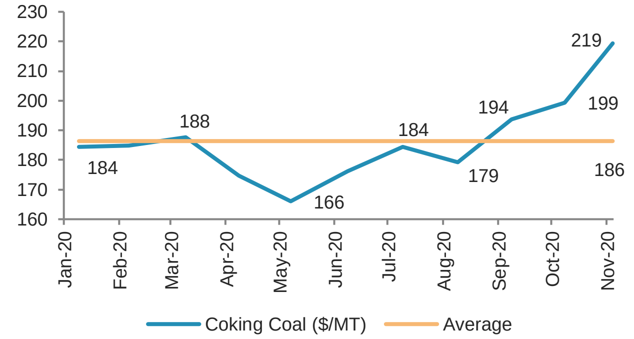


Source: *Bloomberg, Generic thermal coal prices (BB ticker: XW1) , 2020 includes average prices till 27 November 2020*

Coking coal yearly avg. prices ($/MT)

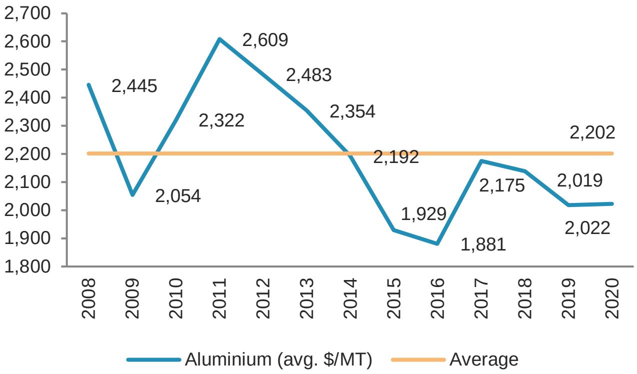


Coking coal YTD prices ($/MT)

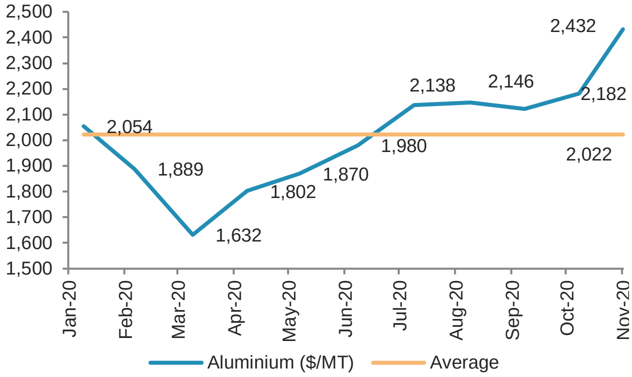


Source: *Bloomberg, Generic coking coal prices (BB ticker: CKCK1), 2020 includes average prices till 27 November 2020; coking coal data is available since 2013*

Aluminum yearly avg. prices ($/MT)

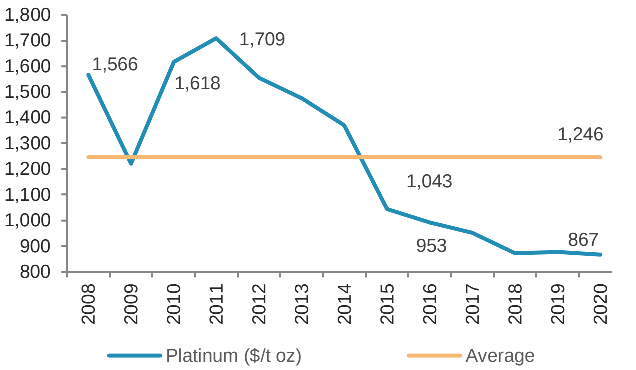


Aluminum YTD prices ($/MT)

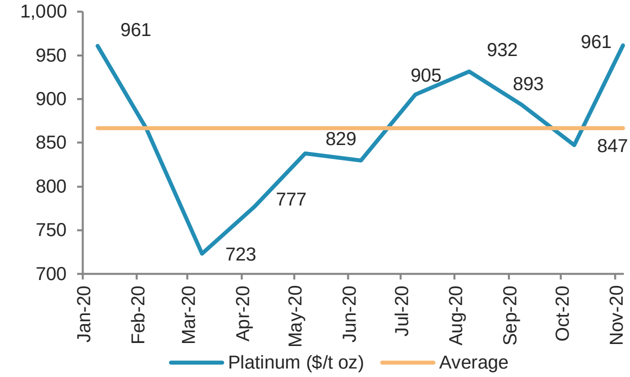


Source: *Bloomberg, Generic aluminum prices (BB ticker: AA1), 2020 includes average prices till 27 November 2020*

Platinum yearly avg. prices ($/t oz)

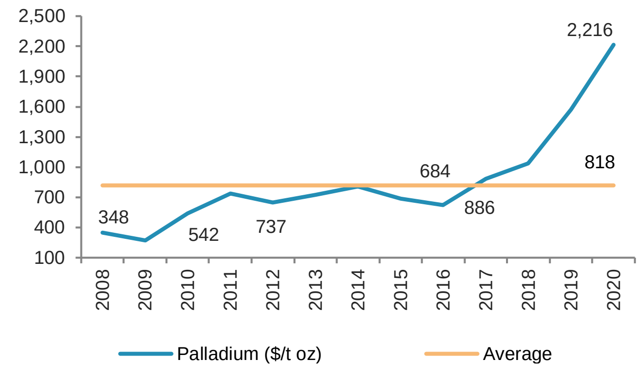


Platinum YTD prices ($/t oz)

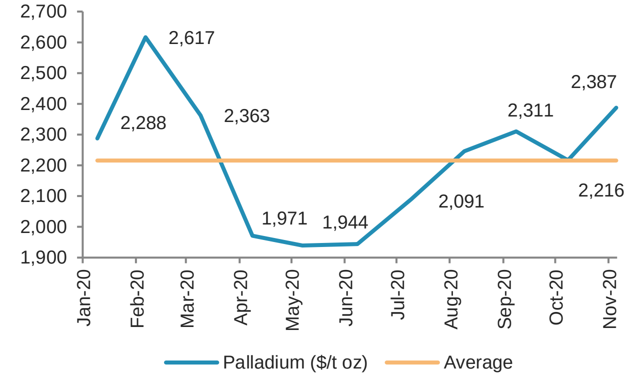


Source: *Bloomberg, Generic platinum prices (BB ticker: PLAT), 2020 includes average prices till 27 November 2020*

Palladium yearly avg. prices ($/t oz)



Palladium YTD prices ($/t oz)



Source: *Bloomberg, Generic palladium prices, 2020 includes average prices till 27 November 2020*

The question is if the current rally is sustainable? Though prices may normalize in 2021, they would be higher than 2020 and 2019 levels. According to Bloomberg consensus, prices would increase in the range of 6–16% y/y in 2021. Growth may be uneven across commodities and depend on end-market demand. Prices are expected to be supported by higher GDP growth in China, in conjunction with recovery in demand from the rest of the world. We believe most of the governments globally would continue to infuse various stimulus packages to support the overall economy. Moreover, the arrival of the COVID-19 vaccine would have a positive impact in the coming months. After its arrival, countries would aim to accelerate their economy by focusing on various sectors such as automotive, infrastructure, and construction. This would generate demand for commodities and further improve the financial performance of mining companies in 2021.

Conclusion

Generating stable earnings would continue to remain one of the key challenges for large miners, especially in tough markets. However, diversification in terms of geography and products would keep supporting their financials and could create opportunity for further growth. China would still be one of the key countries to watch in the near term. More importantly, its higher growth relative to the rest of the world would boost commodity prices and thus improve the financial performance of these miners in the near future. Additionally, the arrival of the vaccine would lead to increased demand worldwide, which again would bode well for mining companies in the coming months.

Business
Research &
Advisory

Investment
Research
& Analytics

Fixed Income
&
Credit Research

Valuation
Advisory

IP Research &
Technology
Advisory

Procurement &
Supply Chain
Intelligence