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HD **Material Matters: Thermal Coal, M&A In Oz Resources, Mount Gibson**

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-Thermal coal advantages erode -PanAust signals more M&A -Mount Gibson strategy disappoints

By Eva Brocklehurst

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Thermal coal demand is in structural decline and the first blow was delivered via the shale gas revolution. That's Citi's assessment of the sector. Alternative energy sources such as wind and solar are also experiencing declining costs while the spread of unconventional gas production techniques is set to erode coal's long time cost advantage over alternative electricity sources. Citi also notes thermal coal is facing strong supply growth, and this should remain the case in 2014 and 2015, waning thereafter as capex falls. Supply curtailments may increase but the analysts do not expect this will be enough to push prices higher. Project delays and reduced capex are expected to eventually return the market to equilibrium ...but at lower prices compared with recent years.

Citi observes Australian projects have dramatically succumbed to the reality of lower prices and high capex intensity. Aside from minor brownfield expansions the only significant greenfield thermal coal project is Whitehaven Coal's ((WHC)) Maules Creek. There are plenty of resources but, with most of the infrastructure capacity being utilised, the next generation of projects are largely in areas which require significant rail and port infrastructure investment. The broker forecasts average ex-Newcastle prices of $72/t in the June and September quarters with a rebound in December quarter. The 2015 price forecasts has been downgraded to $79/t but a moderate recovery is expected thereafter.

Demand in the Pacific Basin is expected to outpace supply while the opposite is the case in the Atlantic Basin. Citi observes India has passed China as the largest source of incremental thermal coal demand. These two are expected to account for around 45% of imported coal by 2020. Supply growth is currently led by Australia which is expected to contribute around 40% of global supply growth over 2013-2015. Colombia and Indonesia are the other main sources of incremental supply.

There have been six major Asian-led merger and acquisition deals in Australia's resources sector over the past 12 months, notes UBS. These transactions are mostly focused on copper and iron ore. The sixth and latest in that scenario belongs to Guangdong Rising Assets' recent bid for PanAust ((PNA)). The price, at $2.30, has been rejected as too low by the board, but the data room has been opened to allow for due diligence in the hope that a better offer may be forthcoming. Guangdong Rising Assets holds a 23% interest in PanAust. UBS believes, from an equity perspective, 2014 was always going to be difficult for PanAust in terms of free cash flow.

Moreover, with managing director Gary Stafford signalling his retirement in the next 18 months, UBS takes the view the stock is vulnerable. The offer captures some exploration and development upside but UBS feels further value is unaccounted for, especially ahead of the finalising of the Frieda River acquisition and the soft copper price.

Talking recent deals generally, UBS thinks they show that Asian interests are not shy about what Australians would deem as marginal assets. UBS suspects investors could re-visit the exploration and development potential in resource names which have recently been discounted, as the momentum is with free cash flow growth rather than development potential. UBS wonders whether Asian investors are more confident in the longer-term outlook for commodities.

Speaking of mergers & acquisitions, JP Morgan believes Mount Gibson Iron's ((MGX)) strategy creates uncertainty. The broker is wary that the company could spend its cash on acquisitions rather than distribute it to shareholders. Brokers recently made a site trip to Koolan Island, the company's flagship project. JP Morgan observes this is the jewel in the portfolio with expectations it will ramp up to 4mtpa the end of the year. Koolan Island has a reserve grade of 64% iron with low deleterious materials. A third of the product is sold as lump and the mine life is seven years. There is limited capacity to push the operation above 4mtpa and extension to the main pit would require a further pushing back of the sea wall.

CIMB notes the company has listed growing via acquisition as a priority, as well as lengthening the life of the business which, while positive, the broker notes is yet to show significant progress. The company has extended the last mining year to FY21 from FY20 by incorporating additional reserves and the Shine project. CIMB believes it is important that management balances returning cash to shareholders with growing the business for the longer term. After the visit CIMB was more confident that the major shareholders, Shougang and APAC, support pursuing growth opportunities. Citi is confident that management can meet production and cost guidance for this year but, given the board's reluctance to return cash, struggles to see any catalyst, given the bearish picture on iron ore. This broker notes a preference for the acquisition of an early stage, mid west project.

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