House Mountain Partners

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LITHIUM, LIQUIDITY, AND FREE CASH FLOW

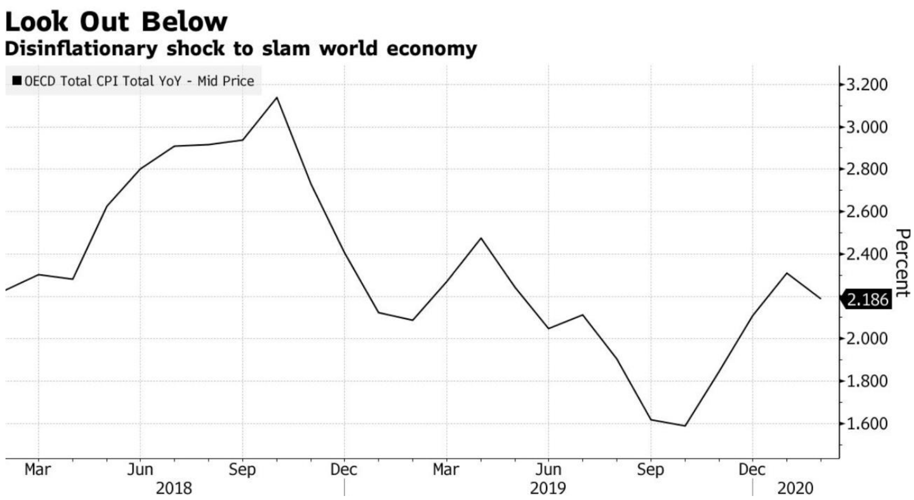
How Humility, Skepticism, and Opportunity are Leading To a New Investment Playbook

COVID-19 has forced a huge dose of humility on the investing public after so much continuous wealth creation. Many are skeptical that all is lost. There is, however, a huge opportunity in the new economic future and particularly the commodity sector.

The best-case scenario of a V-shaped economic recovery could be looking more U or L-shaped with no identifiable end in sight to COVID-related impacts to the global economy. While a recession of some length and tenacity is all but certain, the duration is subject to an increasingly vociferous debate.

With upwards of 11 trillion dollars pledged by global central banks to stimulate demand and global interest rates near or below the zero lower bound, this may not be enough firepower needed to bring a global economy at a standstill back on its feet (if equity returns are any indication). Additionally, demographic and debt-fueled headwinds are stark impediments to generating the inflation global central banks are intent on desperate for.

This [disinflationary shock](#) spells trouble for producers of all goods along supply chains as margins will be tighter owing to diminished pricing power.



Source: Bloomberg

Production costs may fall as well but end user demand will be the ultimate arbiter of pricing flexibility. We are all about to get a lesson in the elasticity of demand with respect to lithium and the broader energy metals complex.

What are the implications for lithium miners and investors? This is a small corner of the commodity universe, but one of the last real vestiges of growth in the sector and is worth further study.

The miners are facing a conundrum. In recent years lithium miners have made bold pronouncements about capacity expansions to grow "along with the market". The idea here is to maintain market share and ensure that the oligopoly remains largely in place with only a few new entrants that can scale and survive at lower prices. This all makes perfect intuitive sense but when you look at the results of this strategy both in terms of free cash flows (shown below) and share price total returns, one wonders if this was the best course of action.

	Q1 2018	Q2 2018	Q3 2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019	Q4 2019	TOTAL	TOTAL RETURN
ALB	-10.3	-46.8	-37.6	-59.1	-161.2	-55.1	-46.5	130.4	-286.2	-56.29%
SQM	91	69.3	80	68.2	11.3	52.2	30.7	11.4	414.1	-59.02%
LTHM			24.5	-0.7	-25.7	-2.3	-27.6	-70.6	-102.4	-72%

Source: Bloomberg; Data in millions of USD; Total return includes dividends

Pricing and contracting strategies should also be judged here as these factors are important and influence financial statement metrics.

Free cash flow (cash from operations – capital expenditures) serves as the arbiter of truth on the financial statements and at the end of the day gives one a more transparent view clear view of how profitable a company truly is relative to earnings per share. This transparency promises to become more important as the lithium market evolves from the post-COVID doldrums and demand re-appears.

To be fair, the FCF data above shows only the tail end of the recent lithium boom, but even stretching the return data back to 2015 leaves SQM as the “star performer” with a total return of 15.97%. This would indicate that their contracting strategy was a wise one – at least from a FCF generation perspective. Beyond this, the blood in the streets of lithium land runs wide and deep.

LESSONS LEARNED – THE MORE THINGS CHANGE…..

There are lessons here for companies and investors alike. One of the takeaways for companies involved in the lithium ion supply chain (miners, battery manufacturers, OEMs) is the need to hedge against pricing risk and have slack embedded in your supply chains. Supply chain flexibility is an area that the industry must innovate in if hopes of millions of tonnes of lithium demand are to come to fruition. It doesn't matter what demand growth looks like over an extended period. Lithium has proven to be subject to the same violent cyclical gyrations as traditional commodities.

The poor share price performance of lithium companies and inability to bring quality supply to market on time only amplify the case for a small, more localized, robust supply chain where more immediate visibility could have prevented substantial destruction of shareholder wealth. It is true that a more localized supply chain will increase costs and lower efficiencies (a higher op ex but a lower cap ex), but perhaps this is the price we pay for increased self-sufficiency and control. Trade war dynamics, COVID, and a slowing global economy require that supply chain reconfiguration become a major aspect of corporate strategic planning.

For investors, it is remarkable to me how the lessons don't really seem to change from cycle to cycle. While COVID has plunged the global economy into a truly unprecedented calamity, relying on price spikes to claw back returns lost in previous cycles won't work. As an example, if you lose 50% on an investment, you need the investment to rebound by 100% just to get back to zero.

Technology and human ingenuity to do more with less indicate that the long-run trajectory of commodity pricing is down rather than up. In the coming re-build of localized supply chains, companies which can generate free cash flow at lower demand levels and leverage technology to achieve this goal should perform.

It is difficult to know what to think from one day to the next in the current environment, but it is clear that the old playbook of globalized supply chains and momentum investing lead to unhappy returns when an unforeseen global shock such as COVID hits the economy all at once.

I have always been guided by humility, skepticism, and opportunism in investing and it would seem that those attributes are in increasing demand in the current environment and going forward.

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