

The Disruptive Discoveries Journal

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The Collapse in Commodities: Miners at a Financial Crossroads

The implosions of the Greek economy and China's stock market have brought the mining sector to the crossroads that it desperately needs to face. We've discussed the need for this reckoning often over the past three years and believe we may be at the beginning of a correction in the equity markets that will further depress metals prices as the twin headwinds of excess supply and slack demand begin to dominate. The need for global debt deleveraging also looms on the horizon much to the chagrin of politicians everywhere – not only in Greece.

The precipitous decline in China's equity markets with \$3.2 trillion in value evaporating in three weeks has quite simply demolished the metals with gold, copper, iron ore, and oil serving as the unwitting poster children for what happens when things don't go "as planned" in a centrally planned economy.

Gold – Down almost 3% YTD, but down 11% from its 2015 high:



Source: [Bloomberg](#)

Copper – Down approximately 12% YTD and about 15% from its 2015 high:



Source: Bloomberg

WTI – A dead cat bounce?:



Source: Bloomberg

This \$3.2 trillion decline in value in Chinese equity markets is twice as large as the entire capitalization of India's stock market according to Bloomberg. This is a reminder that every bubble must eventually burst – debt inflated or not. All debts will be settled – so says Bernice Cohen in her provocative book, [“The Edge of Chaos”](#). Sadly, this pain has been entirely self-inflicted.

Shanghai Shenzhen CSI 300 – A classic bubble:



Source: [Bloomberg](#)

Much of this unraveling has to do with margin calls. A great deal of the liquidity in the Chinese equity markets has been facilitated by borrowing and the volatility in Chinese stocks is a reminder that leverage is a two-way street. It can work against you more harshly than it can work for you. Clearly, the margin clerks have come calling, and bets on the metals have been furiously unwound to compensate for losses in the equity markets. The great disinflation that began in 1981 may indeed now be morphing into the more difficult deflation of the 21st century.

It appears that metals will be weaker for longer and we may not be truly “at the bottom” as I once thought we were. Nevertheless we will eventually find a bottom as all economic processes dictate. Each metal has its own supply and demand dynamic, but as markets have become more integrated in recent years, correlations have become more positive. Put simply, as one commodity goes, so goes the rest of them, though correlations aren't always perfect. This has served to make calling a bottom a pointless exercise.

M&A To The Rescue

Obviously, the mining sector has been on the receiving end of poor metals performance in recent years more than any other sector. As with any market environment, there is always a survival strategy and it appears we're on the leading edge of it now: M&A.

In recent days, we've seen two deals in particular which I think serve as models for survival in the new “lower for longer” pricing environment. I [wrote last week](#) about the effective merger between Western Lithium (WLC:TSX, WLCDF:OTCBB) and Lithium Americas (LAC:TSX, LHMAF:OTCBB)

and earlier this week Denison Mines (DML:TSX, DNN:NYSEMKT) and Fission Uranium (FCU:TSX, FCUUF:OTCBB) have agreed to a merger combining various strategic assets in the Athabasca Basin.

In each of these cases, asset bases will be consolidated, SG&A will be minimized, and most importantly, cash will be conserved giving investors the optionality and sustainability which is crucial in the current market environment. The WLC-LAC merger will offer multiple assets in varied jurisdictions in a market with lithium demand growing at 10% p.a. The combined entity will have a market cap of approximately \$150 million positioning it as the leading global lithium development story.

The DML-FCU merger will offer multiple uranium assets in arguably the best location in the world for uranium exploration (the Athabasca Basin) along with access to a mill. The market cap of the new entity will be in the \$900 million range placing it second to Cameco (CCO:TSX, CCJ:NYSE) in the uranium sector.

We won't speculate on potential returns, but would argue each of these companies is better positioned now versus before the respective mergers were announced.

There are obviously many more details here, but I use these examples to demonstrate a very serious issue in the mining space today: if one thing has become clear, it is that metals and mining developers that are "one trick ponies" are dead. The sooner management teams realize this, the better off their companies and their shareholders will be. We would argue that in the current market environment, the traditional lifelines for mining companies – equity (or, God forbid, debt) funding or joint ventures do not offer the opportunity for optimal long-term returns based on the potential dilution.

While M&A can create winners and losers, the need to combine businesses to emerge as a more flexible and sustainable entity is entirely preferable to the alternative – a stagnant share price, or worse – just ask Molycorp (MCPIQ:OTCBB). The current M&A wave we observe today paradoxically should be welcomed by investors as it sows the seeds for a leaner and more resilient mining development space going forward.

To be clear, while I think the next three to five years will be challenging for most mining companies across the value chain, the M&A that we will continue to see should be welcomed by investors and management teams. While I don't think you'll see many traditional take outs at a significant premia, a merger of equals like the examples above positions these companies eventually for a larger suitor once more clarity returns to the metals markets and the global economy returns to a more normal pace of growth.

Until then, our strategy for miners remains in place: focus on metals whose demand is growing well above global GDP and those companies who are low cost potential producers with the ability to leverage technology to drive returns.

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