

How to Value Mining and Oil Stocks



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Overview

- Examine commodities as an asset class.
- Understand why commodities are important in the global economy.
- Valuation issues for oil, mining, and other commodity stocks.

A Gigantic Financial Convulsion over Three Decades

- Two decades of declining securities prices and one decade of rising securities prices.
- Examples:
 - Crash of 1929.
 - Nifty Fifty of the early 1970s.
 - Three commodities crashes in 1980s.
 - Japanese stock market crash of the 1980s.
 - NASDAQ decline in 2000 (still continues).
- All “new economy” based.
- Our investment profession suffers greatly after each decline.

What Characterizes a Triple Water Fall?

- During the decades of a Triple Water Fall, the best and worst performing stocks in the first five years are the best and worst performers in the second five years of each decade.
- Why? Because in a Triple Water Fall the “inverse asset class” from the crash outperforms on a secular basis.

Major Reason for the Boom in Commodities

Rising affluence in China and India as 25 million people per year move to the middle class and increase their demand for metals and energy.

Coxe's Investment Maxims

1. Watch the “Obesity Index”—how many Wall Street analysts are following the stocks? The more analyst coverage, the less opportunity.
2. The greatest investment opportunities for an asset class come when “those who know it best, love it least because they have been disappointed most.”

Examples:

- Trends in insider trading statistics.
- Recent forecasts of oil prices by analysts and governmental organizations in the OECD.

Think Globally But Invest Locally

- Third-world consumption drives the global economy.
- Consumption patterns in India and China are heavily commodity oriented.
- Increased per capita income in China and India goes to purchase:
 - Dwellings with indoor plumbing, electricity and basic appliances.
 - Cars.
- Result: Increased demand for metals and Energy.

How Should Mining and Oil Stocks be Valued?

- Problem with the P/E-based valuation used by Wall Street:
 - Bearish forecasts of commodity prices were too low.
- How should they be valued?
 - By the value of the reserves in the ground.
 - missing in most analyst research reports today.

Valuation Example

Company B (see attached research report pages 12–13)

Canadian Integrated Oil and Gas Company

- Market cap over 50 billion.
- Virtually all its earnings come from Alberta oil sands.
- 50 years of reserves.
- Stock is trading at twice P/E ratio as the rest of the group.

Need to value the company the way a big oil company would value a strategic acquisition.

Valuation Example

Company A (see attached research report pages 12–13)

Leading U.S. Gas Producer

- Reserve Life Index (RLI) fell dramatically for the gas producers in the 1990s.
- U.S. gas companies had failed to replenish gas production.
- Company A acquired a Canadian company with proven large reserves of deep gas.
- Company A improved its RLI to a level substantially higher than before the acquisition.

Valuation Example

Company C (see attached research report pages 12–13)

Major Mining Company

- Highly overlooked sector; “Diversified Metals” are only .17% of the S&P 500 Index—why bother?
- The group stands between 1 billion people in China and their purchase of a modern dwelling.
- Company C has no debt and a large cash position.
- Analysts worry about the price of copper in short term, keeping the stock prices low.
- But Company C has reserves in politically stable areas—Arizona and Chile
- Company C is unhedged so will directly benefit.

Commodities Cycle Splits

- Avoid Wall Street lore that says “buy metals stocks when P/Es are high and sell them when P/Es are low because the metal prices are about to plummet” (this worked when demand came only from OECD countries).
- Now we have two cycles:
 1. Short cycle—still OECD based.
 2. Long cycle—based on demand from China and India that will last for decades.

Refiners

Why have more refineries not been built?

- Industry had poor returns historically.
- Political problems brought on by the environmentalists who don't want additional refinery capacity.
- Those companies that have the assets (refineries) and are equipped to handle heavy crude will generate significant cash flow.

Why Reserves are So Important

- Not just to satisfy demand from China and India.
- But also to supply the production we're losing from existing fields.

Investing in Commodities

- Is all about understanding the economy of the world we live in.
- Be positioned in industries that have pricing power and rising demand.
- Next recession, when commodity prices fall, major consolidation will occur in the industry. Big companies will buy smaller companies because they have the cash and their Reserve Life Indexes are declining.

What Is the Downside Risk?

- In a global recession commodity stocks will get hurt.
- Political risks globally:
 - “Excess Profit Tax” being considered in the United States
 - If it can happen in the United States it can happen anywhere.

Question:

How do you value these companies if we are unsure we are getting proper accounting for the actual reserves?

Question:

What price point do you use to discount or value the gas and oil?

Question:

Will the Chinese buy our oil? Will their demand be so large that they will box us out? Will they buy our reserves?

Question:

Where were the oil companies?