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What's next for Metals?

WS Amati Strategic Metals Fund
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Georges Lequime, Co-Fund Manager of the WS Amati Strategic Metals Fund, examines the current backdrop and future opportunities within the metals sector.

Metals markets - where are we now?

It has been a very volatile period for investors in the metals sector over the past few years. Demand for metals completely dried up during the Covid period 2019 to 2020. We then had unprecedented monetary stimulus to recover from the economic damage caused by the Covid lockdown. Coupled with the release of household savings built up during Covid, this resulted in a huge surge in buying of goods and services, which of course, led to high inflation numbers.

This came at a time when policymakers were pushing zero carbon policies and infrastructure spending. All of these activities are metals intensive. So it came as no surprise that we saw commodity prices like copper recover from $2.10/lb in 2020 to $4.78/lb in 2021, and now back down to around $3.60/lb. Nickel went from below $5.50/lb to over $22/lb in 2022 and now back to below $9/lb. Lithium, the key metal for EV and static batteries, raced up from below $5,000/t to over $85,000/t in late 2022 and has now come all the way back to below $20,000/t.

Looking across many metals right now, we can see huge supply deficits looming over the next few years – even factoring in a rather pessimistic demand outlook. The volatility in metals prices and high inflation in recent years simply delayed investment decisions in added capacity to the metal markets, which implies higher for longer prices over the next 10 years or so as supply races to catch up with demand. We have seen a snapshot of what is to come in the uranium market in recent months.

Of course, the most aggressive rate hike cycle in history – up to 11 rate hikes now in just over a year – is muddying the picture. The dollar is very strong which dampens demand for metals in non-US dollar denominated regions since metals are usually quoted in US dollars. And there is this fear that the Fed has gone too far and that we will see a severe pullback in global economic activity over the coming months. This is what is making investors wary of the metals market for now.

If you look through the noise and the short-term uncertainty, the looming supply deficits have not gone away. At some point in time, investors will look at this sector and say that the valuations are far too attractive to ignore even if we factor in a global slowdown.

Given that we are beholden to short-term monetary policy decisions, it is very difficult to say when the inflection point is going to be, but investors who have a focus of more than one or two months should be handsomely rewarded over the next 3-5 years if they continue to accumulate shares in good companies on weakness.

Selecting portfolio companies

The three key criteria are asset quality, people and the balance sheet. Overlaying these criteria are ESG considerations and location of the assets. The balance sheet is becoming increasingly important when we look at companies to invest in. Capital markets have not been kind to mining companies in recent years and many companies have to resort to alternative funding for completion of even the best projects.

In recent months, we have repositioned the Fund to as to avoid companies that require short-term funding. Liquidity is also a major concern for us when looking at companies to invest in.

We have screened close to 200 hundred companies over the past 2 years and really settled on around 40 companies. With regards to developers, we have around 20 in the Fund right now. In all cases, we have had multiple meetings with management, developed detailed financial models on the company and, in nearly all the cases, we have gone out to conduct a site visit. We obtain invaluable information from a site visit, especially with regards to the people on the ground who are expected to deliver the project according to plan. Developing a mining project can be very tricky indeed, with very few projects that have a record of being delivered on time and on budget.

For example, last year, we visited G Mining Venture's Tocantinzinho gold development project in Northern Brazil. What encouraged us to invest in the company was the fact that the team building the mine – the Gignac family out of Quebec – have got an enviable track record of developing great mines in South America.

Before Covid, we were fortunate enough to see the development of Lundin Gold's Fruta del Norte mine in Ecuador, which the Gignac family built for the Lundin Group. It is one of the most successful gold mines in the world today with the share price trading at a significant premium to NAV. G Mining was trading at 0.2x NAV at the time and it has performed well over the past year, but is still trading around 0.3-0.4x NAV. As the project nears completion in mid 2024 and if they deliver on time and on budget, the shares should trade closer to NAV and possibly even at a premium, as the company focusses on the exciting exploration potential in the area.

The long term opportunity. Why hold this Fund?

This Fund is positioned for the recapitalization of the metals industry over the next 5-10 years. The industry has seen severe underinvestment over the past 10-20 years and a serious catch up in developing and finding new projects is required. This sector can be very tricky to invest in given the legacy of failed development projects. But the inverse is true and investors can be greatly rewarded for the timing of investing in good projects in a growth cycle.

We have had a lot of noise over the past two years and investors have had to be patient. We are excited because we can accumulate shares in very good companies at very, very, attractive multiples, which is impossible to do in a bull market when all the generalists want to get exposure to this sector.

At the moment, we have investments in companies with great development projects that will see the extreme discounts to NAV unlocked as the bring the assets to fruition – or if they get taken out.

Over the past two years, which has essentially been a weak market, we have already seen seven of our investments taken out. Sadly, the premium paid for these companies were pitiful – but in many cases, management teams had very little choice to accept.

The catalysts for a turnaround.

The table on the right from Canaccord Genuity neatly illustrates what we are seeing when analyzing our own financial models.

In this report, they looked at 178 companies that they actively research in the metals sector – which covers the nine sectors that we consider for investment in the Amati Strategic Metals Fund. The valuations are based on current metal prices.

For a while now, we have been talking about a record discrepancy between the valuation of the copper companies, the senior gold and royalty companies, and the smaller cap and developers.

Not only does this chart illustrate what we are seeing and how we are positioned – that the base metal developers, the EV companies and the gold developers are just too cheap on a relative basis, but also the whole sector looks very undemanding at EV/EBITDA multiples of 1.5-4x. This is the average which includes relative expensive companies in each group. So you can see why we get excited when analyzing these companies.

We recently attended a conference in the US where we sat down with 30 companies and were surprised to find that fully funded companies with projects about to be commissioned over the next 6-9 months are trading at the same multiples as unfunded poor quality companies.

We will always be able to recognize the catalysts after the event. The normal course of events is that the interest rate cycle ends, and rates start to be cut aggressively to restimulate the economy – this is when gold and silver performs best. This is then followed by base metals 9-12 months later when the stimulus kicks in. We can see the same pattern developing again – the key will be when the Fed pivots and starts cutting rates again.

Battery metals like lithium have their own cycle overlaying the whole group. It is still an immature market due to the rapid growth in battery demand. We think lithium is very close to a bottom right now. When lithium prices stabilize again, we think that investors will come back into the stocks that look significantly oversold right now. The rapid growth in pig iron production in Indonesia and Philippines is what has driven nickel prices lower over the past year. The selloff in nickel prices also appears overdone and we could expect a bounce back even before the end of the rate hike cycle.

All-in-all, a very interesting, and challenging, time to manage a metals fund, given the volatility that we have seen in the past 2-3 years. But the coming upward cycle seems very clear… just the exact timing of the up-leg is uncertain.

Global coverage summary and average comps

Category	Stocks covered	P/NAV	23e EV/EBITDA	24e EV/EBITDA
Base metals producer	17	0.81	5.18	4.11
Base metals developer/explorer	14	0.34	-11.23	-16.50
Precious metals senior	29	0.61	5.11	3.91
Royalties/streaming	12	1.17	15.68	11.65
Precious metals junior	15	0.50	2.43	1.82
Precious metals developer/explorer	23	0.43	-12.07	3.79
EV metals	46	0.35	-8.35	-4.93
Uranium	14	0.82	-34.68	-20.17
Specialty/other	8			
Total	**178**			

Source: Company reports, Canaccord Genuity estimates

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Risk Warning

Past performance is not a reliable guide to future performance. The value of investments and the income from them may go down as well as up and you may not get back the amount originally invested. Tax rates, as well as the treatment of OEICs, could change at any time. The investments associated with this fund are concentrated in natural resources companies, which means that the fund is subect to greater risk and volatility than other funds with investments across a range of industry sectors. The fund invests in companies that have operations in developing markets and which therefore may be subject to higher volatility due to political, economic and currency instability. Shares in some of the underlying companies in the fund may be difficult to sell at a desired time and price. A dilution levy may be applied to the share price when the fund is expanding or contracting. Should you buy or sell in these circumstances it may have an adverse impact on the return from your investment.

This review does not provide you with all the facts you need to make an informed decision about investing in the fund. Before investing you should read the Prospectus, the Key Investor Document (KIID) and Supplementary Information Document (SID). The Prospectus sets out the main risks associated with the fund, the KIID shows you how costs and charges might effect your investment, and the SID details your cancellation rights. If you are in any doubt as to how to proceed you should consult an authorised financial intermediary. Fund documentation can be requested from T.Bailey or Amati and is available to download from our website.

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