Copper exploration values uncertain

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"Explorers such as Xanadu make a mistake even hinting at the development option"

Xanadu Mines chief executive Andrew Stewart describes a copper market peppered with unsustainable imbalances and pricing incongruities as he grapples with ways to extract value.

He describes Xanadu's Kharmagtai copper district in Mongolia as home to one of the outstanding copper finds on the planet, comparable to Rio Tinto's Oyu Tolgoi in location, geological characteristics and, potentially, size.

A scoping study released last month suggested a possible 20 million tonne annual openpit mining rate to tap a 468.9Mt indicated and inferred copper porphyry resource containing 0.31% copper. The resource also holds 2.8 million ounces of gold. About 51% of the currently estimated resource could be extracted economically, according to the study.

In recent presentations to investors, Stewart has emphasised the potential for ongoing growth in resource size and for numerous opportunities to enhance the Kharmagtai economics.

As it stands, an initial capital outlay of US$484 million plus working capital in the lead-up would be needed by Xanadu to kick start development. The company has referred to high margins and a rapid payback without formally disclosing any valuations.

In talking to investors in Melbourne, Stewart used the backdrop of an anticipated 10Mt per annum global copper production shortfall by 2027 as a way to excite interest. Below-average rates of new discovery in recent years and ongoing growth in demand for metal are likely to precipitate "the looming copper supply crunch", according to Stewart.

Some understandably sceptical investors with longer memories will recall previous forecasts of copper shortages. Those threats of a world running out of the metal proved nothing more than deeply flawed thinking. Markets helped avert the danger.

This time will be different, many in the industry will assert. Extended project gestation periods add plausibility to the argument that tighter supply constraints will prevail.

True or not, massive annual disparities between production and demand cannot exist in real life. Usage will not exceed supplies. This is a rock-solid law backed by economics and the physical sciences, not conjecture.

Graphical portrayals of large-scale market imbalances are no more than useful rhetorical artifices to excite investors' expectations of an impending price explosion. Unfortunately, analysts contributing to the artwork are failing to address how demand and supply will be brought into balance, as they conspire themselves to excite interest in their sector.

Underpinning the threatening market imbalance foreshowed by Stewart is an assumed 1.8% annual growth in metal demand. Although the mooted rate of increase is lower than the 3.2% rate over the past 10 years estimated by the International Copper Study Group (ICSG), global GDP growth potential has also fallen with no signs of it being restored to its historical pace.

The ICSG usage data clearly show a rising incidence of historically slow growth over the past five years and, adjusted for cyclical conditions, a correspondingly higher chance of sub-1% outcomes in the years ahead. Such an out-of-consensus possibility simply highlights the range of ways in which markets can unexpectedly re-establish balance.

Despite the supposedly impressive outlook for the copper market, Stewart said he does not intend to develop a mine. Even in the event of Xanadu overcoming the technical, logistical and regulatory challenges accompanying a development commitment, trying to raise around 14 times its current A$50 million (US34.4 million) market value to get development underway could pose an insurmountable obstacle.

Xanadu directors are looking for a transaction that adequately compensates the company for its exploration efforts. They are hoping disparities in the current pricing of copper exploration efforts can work in their favour.

Stewart told investors the costs of copper discovery in recent years have jumped to US7c per pound or higher. Xanadu's own costs have so far averaged just US2c/lb. The market value of the company is equivalent to US1c/lb.

Stewart is counting on a well-capitalised benefactor preferring to pay up to US7c/lb in a one-off transaction rather than spend the same amount in the field over several years without the certainty of what Xanadu can already offer. It is a tempting but hardly watertight proposition.

Discovery costs are not independent of the amounts spent. Apparently expensive exploration is partly the product of a cut back in spending amid weakening cyclical conditions. Within declining overall exploration budgets until as recently as 2017, money was also diverted from copper to other metals.

More dollars being directed at copper exploration, as they are, should enhance the incidence of discovery and, in raising the chance of larger-than-average finds, lower the cost of resource definition.

Contrary to the Xanadu interpretation, the market is also saying copper exploration will be cheaper in the future.

In any event, public markets will probably remain reluctant to base the price of exploration assets on costs of discovery. More often than not, companies do not want to stop at that point. They want to develop a mine, then bulk up the resource and possibly look elsewhere for other projects. Unsurprisingly, this changes the risk and return profiles for the worse.

Even Xanadu is somewhat biased in this direction. A scoping study that speaks of future cash flows and development capital invites investors to think about the investment impact of lengthy project gestations, repeated shareholder dilutions, changes in cyclical conditions and jurisdictional risks.

Being years away from a start and needing to spend some US$500 million before revenue begins to flow could easily imply a value today closer to US2c/lb of current resource than US7c/lb.

Perhaps explorers such as Xanadu make a mistake even hinting at the development option. They might be better off making clear from the outset that they have no intention of building a mine.

Investors will feel less compelled to adopt values consistent with problematic developments many years away, in the absence of grandiose plans for a globally large mine.

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