Adjusting for COVID-19 in valuations

Cost of Equity addendum: Commodities Focus

Insights as at 30 April 2020

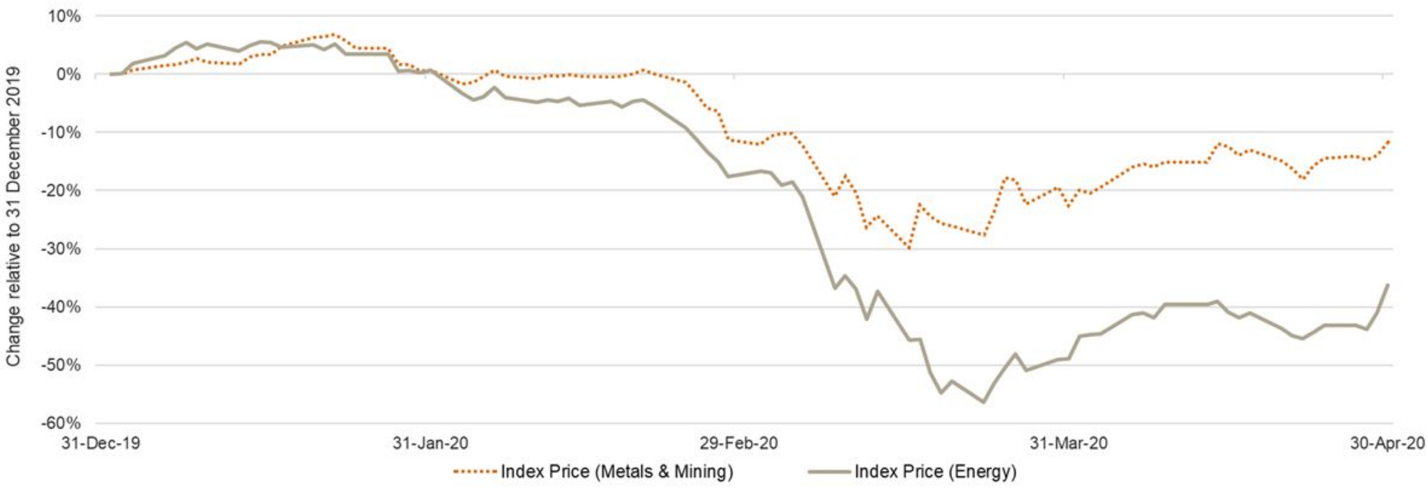
The insights in this paper are based on analysis of the Australian market and reflect the views of the PwC Australia firm. These insights may not be applicable in other territories given differences in local market practice and is predominantly focused on observations of Australian companies and financial exchanges.

In our previous Cost of Equity update, http://bit.ly/COVID19valuations, (published 6 May 2020) we presented our updated analysis on how the impact of COVID-19 could be factored into valuations. By necessity this paper presented analysis on a sector by sector basis and this addendum seeks to provide insight on the impact of COVID-19 on the assessment of the cost of equity used to support the values of projects and companies which are exposed to specific commodities - oil, coal, base metals (copper and nickel focus), iron ore and gold.

A high-level view of the impact on share prices

Global stock markets began a correction around the weekend of 22/23 February as the world started to come to terms with COVID-19 as a global rather than a regional issue.

Figure 1: Change in [the ASX 200 Energy and Metals and Mining indices]



Source: S&P CapitalIQ

As shown above, prima facie, COVID-19 has had a significant impact on both the energy and metals and mining sectors, with the prices of many commodities falling significantly (notably oil, coal and base metals), however the price of iron ore has remained relatively stable and gold prices have increased.

Risks to commodity prices over the near-term are seen as being mixed, and whilst the duration and intensity of COVID-19 is still a major source of uncertainty, many other factors are impacting future price expectations and the near-term impact on earnings of companies operating in specific commodities.

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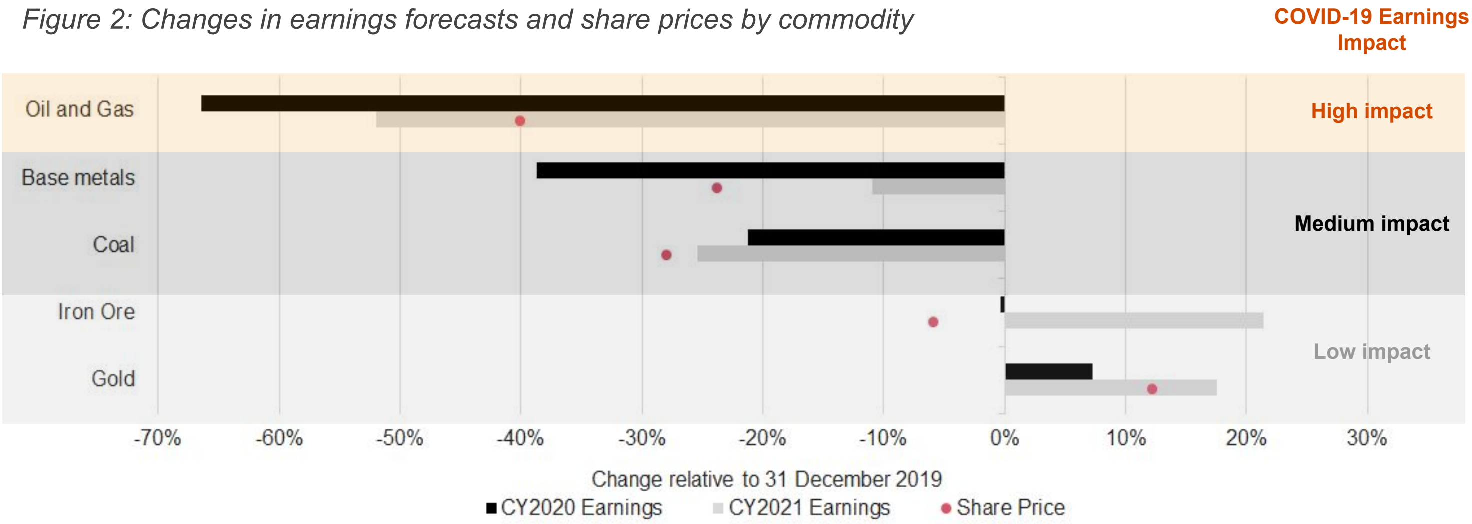
Dissecting the data - by commodity

Aside from complications in getting people to site and supply chain disruptions, producing mining companies have experienced minimal operational issues directly as a result of COVID-19. However, commodity prices have moved (some significantly) and the share prices of companies in the sector have reacted to both movements in spot and forecast commodity prices as well as to general market uncertainty (and share market volatility) due to COVID-19.

We have broken the resources data out by sub-sector to provide information as to how share prices have changed together with some indication of the level of earnings adjustments that have been forecast to date and what this implies about the potential and implied change in the cost of equity. We have also considered the impact on both share prices and earnings due to movements in commodity prices.

Figure 2: Changes in earnings forecasts and share prices by commodity



Source: S&P CapitalIQ; PwC Analysis

Low Impact: The iron ore sector has experienced limited downside whilst gold producers have experienced recent positive share price movements (albeit with increased volatility). We note that our dataset for iron ore is mixed and is influenced by BHP (which also has significant oil, coal and copper exposure) and Rio (which also has significant copper and aluminum exposure).

Medium Impact: The share prices of entities that primarily operate in the base metals and coal sectors have decreased significantly, broadly reflecting significant decreases to spot and near-term commodity price forecasts as reflected in the downgrading of near-term earnings forecasts. We expect there to be revisions to forecast CY2020 earnings of base metals producers as current forecasts appear to be overstated relative to compared to commodity prices.

High Impact: The oil and gas sector has been heavily impacted by COVID-19 and over supply issues. This requires particular caution because forecast CY2021 earnings have been revised significantly lower (c.50%) and the recovery of oil prices (and associated earnings) is anticipated to extend beyond CY2021.

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Figure 3: Changes in commodity price forecasts

		Spot price			Nominal 2021			Nominal 2024		
	Units	31 Dec 2019	30 Apr 2020	Change in Spot Price	31 Dec 2019	30 Apr 2020	Change in Nominal 2021 Price	31 Dec 2019	30 Apr 2020	Change in Nominal LT Price
Brent Oil	US$/bbl	66	25	(62%)	64	46	(28%)	67	58	(13%)
WTI Oil	US$/bbl	61	19	(69%)	59	42	(29%)	62	53	(13%)
Nickel	US$/t	13,950	12,124	(13%)	16,047	14,420	(10%)	16,433	15,960	(3%)
Copper	US$/t	6,149	5,160	(16%)	6,301	5,867	(7%)	6,965	6,658	(4%)
Aluminium	US$/t	1,781	1,459	(18%)	1,865	1,733	(7%)	2,095	1,998	(5%)
Coking Coal	US$/t	129	101	(22%)	157	153	(2%)	153	149	(3%)
Thermal Coal	US$/t	65	49	(24%)	69	69	0%	76	74	(2%)
Iron Ore	US$/t	86	82	(5%)	61	64	5%	56	54	(4%)
Gold	US$/oz	1,523	1,716	13%	1,489	1,653	11%	1,434	1,503	5%

Source: S&P CapitalIQ; PwC Analysis

Oil: The COVID-19 outbreak has significantly reduced oil demand in 2020 and, together with the Russia/OPEC supply conflict, the market expects a surplus to remain throughout 2020. A rebound in petroleum products from industrial sectors such as aviation, heavy duty road transportation and petrochemical production is expected to underpin upward growth in demand for crude oil. However, the question remains as to over what time period this will occur, and we note that oil prices remain highly susceptible to swings due to global economic uncertainty.

Copper & nickel: The near-term forecast prices for key base metals copper and nickel have decreased materially but are expected to largely recover over the near to medium-term. Resource depletion, declining grades, increased input costs and a lack of high–quality development opportunities are also anticipated to drive up copper prices to a level required to induce necessary supply in the medium-term.

Coal: The thermal and coking coal markets have both been negatively impacted recently, not necessarily due to the impacts of COVID-19. Energy coal prices have been on a downward trend and demand had weakened somewhat due to the low gas price environment. In the long term, energy coal is expected to lose competitiveness on a new-build basis, however, coal power is expected to remain competitive in India and other highly populated, low income emerging markets for some time. The demand for coking coal was weak outside of China in 2019 (despite policy uncertainty), which led to a decline in metallurgical coal prices, however the anticipated increased government spending globally on infrastructure projects (and demand for steel) is seen as positive for the medium–term outlook for metallurgical coal.

Iron Ore: Although there appears to be some price volatility resulting from the COVID-19 outbreak, the main factor supporting strong near-term price expectations is the uncertainty of seaborne supply (principally out of Brazil).

Gold: A flight to safety has supported near-term gold prices which has been reflected in the share prices of gold producers and it is widely expected that financial and geopolitical uncertainty, combined with low interest rates, will likely continue to support the near to medium-term investment in gold.

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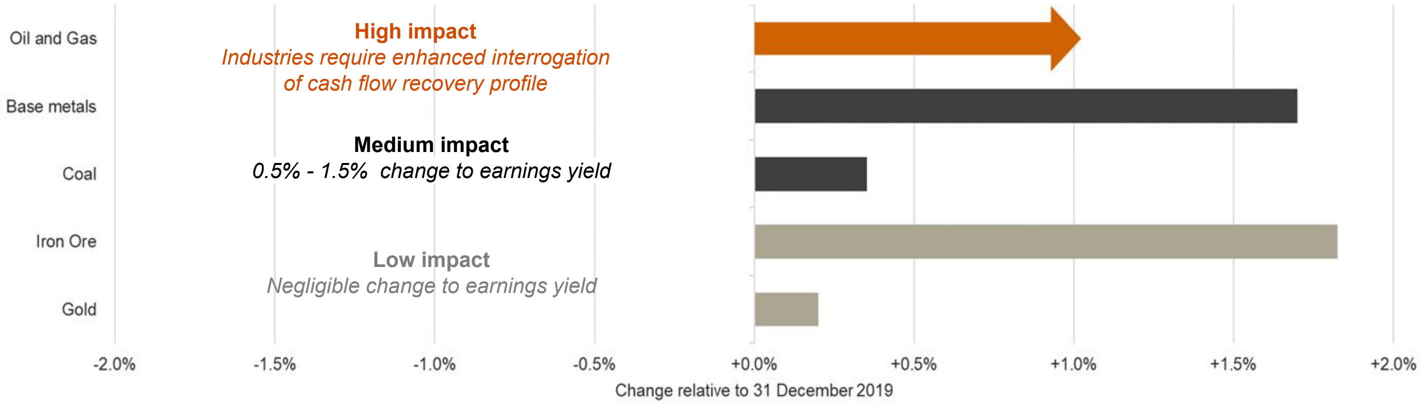
Figure 4: Changes in earnings yield by commodity



Source: S&P CapitalIQ; PwC Analysis

Conclusions: Although any COVID-19 adjustment to the cost of equity will be subjective and dependent on specific company or project exposures and impacts, at a high level we consider the following:

Oil and Gas: As this sector is expected to have a prolonged recovery period, with reduced earnings extending beyond CY2021, to appropriately assess any necessary adjustments to the cost of equity, key assumptions underpinning longer term cash flow forecasts requires additional scrutiny and analysis should be undertaken to assess the potential value impacts under differing future demand / supply (price) scenarios.

Base metals and coal: The analysis indicates base metals may require a larger COVID-19 related cost of equity adjustment, but we note that forecast prices of copper and nickel are both anticipated to broadly recover to pre-COVID-19 levels over the next few years. Regarding coal, the analysis in this paper implies that the recent share price movements of coal stocks are broadly reflective of changes in earnings forecasts so only a modest increase in cost of equity may be appropriate.

Iron ore and gold: Given the minimal (or positive) impacts of COVID-19 on the iron ore and gold sectors, we consider that any associated potential changes to the cost of equity to be minimal.

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