

## Feature

### SA platinum industry – a shimmer of hope for investors

Today's Angle will be a cursory discussion about the platinum industry; it is not a detailed analysis and is instead at this stage, some thoughts and general comments.

For us, assessing value involves various steps in a lengthy investment process – as you know, our investment process delves into Moats, Management and Margin of Safety. Before ascribing a moat to a business, it is important to really understand the industry in which it operates.

Three rudimentary or basic triggers sparked my interest in platinum stocks of late. The first is simply the prices at which the SA listed companies are presently trading at. The second is more meaningful, it is about the rating at which these stocks trade against their histories. The third is industry dynamics which is inseparable from the first two triggers and taken collectively, underpins my current thoughts that an opportunity might be opening up, on a longer term basis, in these counters. The key assumption in this thesis is that specific long-term industry dynamics are still in place in the SA platinum sector.

#### **The share prices of platinum companies:**

Purely on price, excluding important valuation metrics, current share prices are deeply reflective of woeful past periods. Lonmin is presently at levels last seen during the crash of 2008, before that, its shares traded at these levels in 2000 and then again in 2003. Its current share price of about 9000c represents 15% of the values reached in the middle of 2007. Impala and Amplats hardly look significantly better!

To some extent, one can understand why platinum stock share prices are not at the heady heights being enjoyed by various other locally listed commodity counters – the likes of Kumba and Exxaro being the most obvious. Although platinum has enjoyed tailwinds from the emerging market boom this past decade, it has not been at the epicentre of developments like base metals and energy. Over ten years, copper has gained in price by 420%; coal by 300% and iron ore a staggering 900%. Against this, the platinum price has risen 160% – not quite as meteoric as the others but certainly not shabby.

#### **The valuations of platinum companies:**

Valuations seem compelling. Looking at the shareholder equity to share prices of each of the domestic listed platinum companies, they are at 15 year lows. Amplats on this measure has been insanely expensive at times, its share price trading as high as 12 times its book value; it is currently at 2 times. For Impala, the same gyrations and cyclicity in its P/B is visible spanning many years. In 2007, Implats traded at 7 times, it is now 1.6 times. Lonmin reached a P/B of 10 in 2007; it now trades at less than its book value.

It should be noted that lower shareholder returns in the last few years have driven these de-ratings and one is not oblivious to this important point. Current industry dynamics are terrible and there a few wise brains about that feel that 'this time is different', that there are irreversible problems within the platinum sector. Adding credence to this argument is weak demand caused by a global slowdown, government stoppages due to poor safety concerns affecting production and strong unionization preventing the mothballing or closure of uneconomic mines. Against this, these are cyclical companies and a case can be made that typical cyclicity is being misconstrued as a permanent change in the

industry playing field.

**Industry dynamics:**

*Platinum a concentrated market dominated by SA producers:*

South African platinum producers have a greater chance of affecting the price of the metal than is the case with our producers of other commodities because we control supply to the market. Comparing platinum to other commodities illustrates this. In the global iron ore market, SA represents 5% of production; we are the world's 7th largest producer. China, the largest supplier, produces 16 times more than we do; Australia, number 2 in the world, provides 7 times more supply to world markets than SA.

South Africa's position in the coal market is not dissimilar to that of iron ore. We are the 5th largest coal supplier in the world representing 8.6% of the market. Placing our size in perspective, our production is 12.5 times smaller than number 1 producer, China and less than one third of the USA's, the second largest global supplier. In copper, we don't make the list of top 12 producers in the world! Clearly, in these commodities, South Africa has little or no impact on the price traded on international markets.

In platinum the picture is totally different. The total supply of platinum in 2011 represented 7705 ounces, SA supply accounting for 63% of this. Excluding auto catalyst recycling and looking merely at new supply to the market, our mines make-up 75% of total world production. Behind auto catalyst recycling, the Russians, producing 835 ounces are the other large producer.

*Demand growth sluggish but inter-sector contra-cycles create a relatively defensive market:*

Auto catalyst average demand the past five years has been 2600 ounces, so 2011's off-take of 3235 ounces was at reasonable levels. That said, pre financial crisis demand was 4145 ounces and most analyst forecasts in the years ahead, exceed these levels. Auto catalyst demand represents about 45% and jewellery about 25% of the market in a 'normal year'. According to my estimates, industrial demand, where I exclude jewellery and investment buying (ETF's), account for about 70% of the platinum demand. So the real issue with demand at present is that it is sluggish. Although current usage is 17% higher than 2009 levels, it is still 4% lower than in 2007. The market has effectively gone nowhere!

That said, looking at the individual demand segments within the total platinum market, when prices collapse, as was the case in 2009 (the platinum price averaged \$1205 in 2009 versus \$1576 in 2008), jewellery demand kicks in and offsets some lost demand from auto catalysts. Between 2008 and 2009, jewellery demand rose 60% or 840 ounces whilst auto catalyst demand fell 1475 ounces or 40%. Total demand over that period in the industry fell by 15% and thus to some extent, one notices that different demand segments create a slightly defensive demand picture for this precious metal. Were it not for the long lead times to shut down production, it is not improbable that the metal's price would have fallen by less in 2009 – supply shrunk by 6.3% in 2008 and 3% in 2009.

*Cash negative production:*

Looking at the current platinum price against ever rising costs, which include government safety demands and labour union pressures, it is approximated that about 40% of platinum production in South Africa is losing money on a cash

basis. This is leading to casualties, with certain mines being mothballed or closed – Marikana, PSA, Everest and Crocodile River. Other mines are being assessed for a similar fate but sticky unions and calls for nationalization from certain ANC quarters have slowed this process.

Whilst political forces are in place to sustain uneconomic production, given time, mines will not maintain this. Inevitably, production will be cut and if we simply look at the demand/supply balance in 2011, a further 6% reduction in supply would have placed the market into equilibrium. It is worth noting however, that supply would have been higher in SA had certain unexpected production problems not occurred in 2011, so we do need more permanent supply reductions. I must acknowledge at this juncture that supply reductions could take a very long time and so the thought that this market could enter equilibrium overnight, is by no means accurate. It will be a long journey.

An Angle demands brevity and hence the need to conclude this discussion – much more should and could have been said for and against this investment idea. That said, I hope I illuminated the unique industry dynamics at play here and provided some proof that South African output can be controlled which would have the affect of influencing the price of platinum and in so doing, improve the profitability of the industry.

I'll be surprised if this isn't a rewarding but really bumpy ride for investors and before we actively purchase any of these companies for our clients, PSG Asset Management will be undertaking much more detailed research than this cursory look.

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