Resources industry facing 'upside risk' challenge

Taking a wait-and-see approach during a challenging operating environment may be tempting, but the resources industry must now act to seize the enormous medium- and long-term opportunities on offer, writes author of the AMMA Resource Industry Market Outlook Tristan Menalda.

Here's the good news: with an abundance of world-class resource deposits, untapped exploration potential and strong long-term fundamentals, the Australian resources sector currently has its highest ever levels of upside risk – that is, despite challenges in the immediate operating environment, our industry's medium- to long-term prospects are promising.

With more than $220 billion worth of major tier-one greenfield and expansion resource projects currently stalled in the pre-construction pipeline, however, and with existing operations ageing, Australia must now actively develop its significant growth potential.

Tristan Menalda, Senior Industry Policy Adviser, AMMA

Without efforts to increase exploration levels, identify new projects, and transition projects currently under consideration to the approval and construction phase, the resources industry could prematurely and unnecessarily come to a halt.

This will have a detrimental impact on jobs, investment and royalties, with serious implications for procurement sectors as well as for the creation of necessary end products.

The upside is, that if we can tip the scales to a point where medium- to long-term investment attractiveness exceeds current investment risk, Australia could capitalise on proven and probable future gains generated by ongoing development of the nation's many resource deposits.

Commodity prices a mixed bag

The first quarter of 2016 saw a slight overall market correction, albeit sporadic and turbulent in nature.

In a standout performance, the iron ore price rose 27.72 per cent to $54.18 as at 31 March 2016. This is largely attributable to mill restocking as well as optimism coming from China's growth forecasts.

While most minerals and metallurgical commodities saw an uplift in prices, oil and gas did not. There are a number of reasons for this, including an excess of oil flooding an already oversaturated market, and a number of mega LNG projects becoming operational.

While the Reserve Bank of Australia (RBA) puts most commodity prices back in the black in 2016, the World Bank, Office of the Chief Economist and Economist Intelligence Unit expect double-digit falls across all major Australian traded commodities. Most significantly, expectations for iron ore have been written down $14.23 to an averaged 2016 forecast price of $41.65.

The 2016 outlook value of Australia's key resource exports was also recently further downgraded by $5.5 billion to $160 billion.

It is possible, however, that some assumptions have moved from being overly opportunistic to overly conservative. For example, if China

achieves its revised five-year growth target of 6.3 per cent and is joined by growth in the United States, Latin American, German and Japanese economies above 2.6 per cent, -0.3 per cent, 1.7 per cent and 1.0 per cent respectively, it is likely that current forecast Australian resource export volumes and values may be understated.

Exploration the ticket to growth

Exploration spend is a leading indicator of the future success and prosperity of the industry and the nation in general.

On the bright side, in 2015, exploration spend was higher year-on-year for gold and mineral sands. There also appears to be some buoyancy in lesser-known commodities such as rare earths – including lithium, which will likely be a key commodity in the future, noting its application in battery storage, renewable energies and electric vehicles, to name a few.

Across some of our biggest exports, however, the picture isn't as pretty. In the ABS's original terms, onshore petroleum exploration fell by 63 per cent (or $272.5 million to $158.9 million) over 2015, and offshore petroleum exploration fell by 55.2 per cent (or $398.6 million to $323.1 million).

Mineral exploration expenditure fell by 17 per cent (or $77 million) in the past calendar year, marking Australia's fourth consecutive year of falls – now down 63 per cent (or $650.4 million) compared to four years ago.

Today, exploration spend is trending 32.2 per cent lower than the 10-year quarterly average. This is going to have significant long-term repercussions for Australia in terms of job losses, royalties and taxes, and in terms of both living standards and what we can achieve as a community in the years ahead.

It is now vitally important that falling exploration spend is tackled head-on at both state and national levels, and that we look to innovative measures such as taxation reform, positive government investment and lifting moratoriums on energy sources of the future – such as nuclear – to stimulate exploration activity.

Investor confidence remains subdued

While there are various events and developments that impact upon market sentiment, a leading short-term metric to assess volatility and confidence is expected capital resource expenditure.

In the first quarter of 2016, expected capital expenditure fell by 5.6 per cent (or $3.4 billion to $56.8 billion), just above the original 2016 estimate of $53.8 billion. Disturbingly, moving forward into 2017, capital resource expenditure is forecast to decline to five-year lows of $34.4 billion.

Even though there are signs of resource recovery and some optimism for capital expenditure, measured falls in expenditure intentions show that resource companies foresee challenging times ahead.

Notwithstanding that they may be, in part, a product of short-term fluctuations, the renewal of productive capacity also threatens to have long-term negative structural consequences for the Australian industry, and for productivity and competitiveness globally.

Inaction on capital resource expenditure will likely create a situation in which ageing capital assets decrease multi-factor productivity and production levels that will ultimately negatively impact on company profitability levels.

Although confidence is lower than desired, in times of volatility lie some of the greatest opportunities. For companies with the financial means or projects that can be expanded or constructed in time to ride the current wave of commodity price cycles, this may be a very advantageous time to invest.

Overall, the Australian resources industry has significant growth potential; however, we need to increase our critically low exploration levels, identify new resource projects, and transition a greater number of projects into construction and production if we are to keep a tight grip on our status as a global resources powerhouse over the long term.

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