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Chile Mining Sector - Australian Equities Research Trip

Our investment partner, Northcape Capital, recently returned from a research trip to Chile in December. The team visited a wide range of listed and unlisted companies across the mining sector, particularly in the copper and lithium space. The Northcape team was pleased to be travelling again as Chile had only fully eased restrictions in October 2022 after following strict COVID-19 protocols for the last few years. Here the team share their insights from the ground.

This information has been prepared by Northcape Capital, the underlying investment manager for the Warakirri Concentrated and Ethical Australian Equities funds.

Insights from Chile Mining Trip

In December 2022 the Northcape Australian Equities team travelled to Chile to visit a wide range of listed and unlisted companies across the mining sector, particularly in the copper and lithium space.

ESG was front of mind for all the mining companies we met with, who all seemed extremely conscious of maintaining their social license to operate in the country. This is because copper mining is an extremely water-intensive activity in Chile and uses half of the country's fresh water rights. About 35% of copper production in the country currently uses desalinated water but this is increasingly becoming the standard for new projects. **BHP is a leader in this area, having introduced desalination plants at its Escondida mine over 15 years ago.** Renewable sources of energy such as wind and solar are being used extensively in the mining sector. Hydrogen as an energy source is being trialled by mining companies, however there was varied conclusions on whether it will be an affordable solution at scale.

Similar to the experience in some other mining-intensive countries, the Chilean Government is looking to take a larger share of super profits from resource companies through a new proposed copper tax bill. However, unlike in Queensland, the Chilean Government has spent considerable time consulting with key stakeholders on the bill. Whilst large miners like BHP have voiced concerns around future investment in Chile, it seems unlikely it will pull out of the country given the scale of its operations there, as well as the lack of viable alternative investment options in more favourable jurisdictions.

Constructive on copper

We came away more constructive on copper after the trip as supply is expected to remain tight over the next few years due to ongoing water issues and declining ore recoveries in the country.

At the same time, copper demand is expected to see a structural increase as it is a vital component in electric vehicles (which use 4x as much copper as traditional internal combustion cars), as well as in the infrastructure required to transition to renewable energy sources. **Our exposure to BHP positions us well for this trend**.

Cautious on lithium

On the other hand, we came away more cautious on lithium prices after meeting with producers and industry experts who mentioned the biggest and most imminent risk to supply they see in the near-term is from China. Lepidolite is a form of hard-rock deposit that is abundant in China and has the potential to materially change the economics of the lithium industry.

While it costs 2-5x more to process than hard-rock Australian spodumene, Chinese companies are willing to invest at a loss in their domestic industry in order to develop security of supply. As a result, lepidolite supply has increased rapidly over the past year and is expected to increase by over 7x by the end of the decade. **High lithium prices are incentivising low-grade, high-cost deposits to come online at an increasing rate which threatens the sustainability of longer-term lithium prices, in our view.**

Adding new supply out of Chile quickly looks to be difficult due to challenges around permitting, approvals and water usage. As a result, many of the producers we met with have been working on new breakthrough technologies (such as Direct Lithium Extraction, or DLE) which allows the extraction of lithium from brine in 1-2 days versus the current 18 months. These technologies are likely at least a few years away from commercialisation, but are expected to be much higher cost, which supports the notion that prices will be higher than they have been in the past (albeit lower than current levels).

Lithium prices have finally started to correct, although by only a small amount. Meanwhile the stock prices of some of the major lithium producers have fallen by 20% over the December 2022 quarter.

Despite this, we believe the earnings downgrade cycle has further to play out in the lithium space and will dominate market action over the next few months. **Given the wide and unpredictable range of outcomes for the sector, we are steering clear for the time being**. However, at more favourable valuations, we would prefer to hold those operators producing at scale and with clear leverage to the raw material price, such as Pilbara Minerals (-18%).