



Selling picks and shovels to miners

During the 19th century Victorian gold rush a few lucky miners struck it rich and made their fortune. However, the really great fortunes were accumulated by canny merchants supplying the daily needs of miners. These were the publicans, grocers and traders of ordinary goods.

This phenomenon is sometimes referred to as “selling picks and shovels to gold miners”. It has occurred in every great minerals industry boom, and it is alive and well in Australia today.



In Issue 2 of The Good Dirt, we considered the forces that are driving up operating costs and the scale of investment capital for new projects. These forces are primarily the geology and geography of new deposits, plus the supply scarcity of people and services. The mining industry must earn a margin beyond this structurally growing cost base, hence the rapid growth of commodity prices.

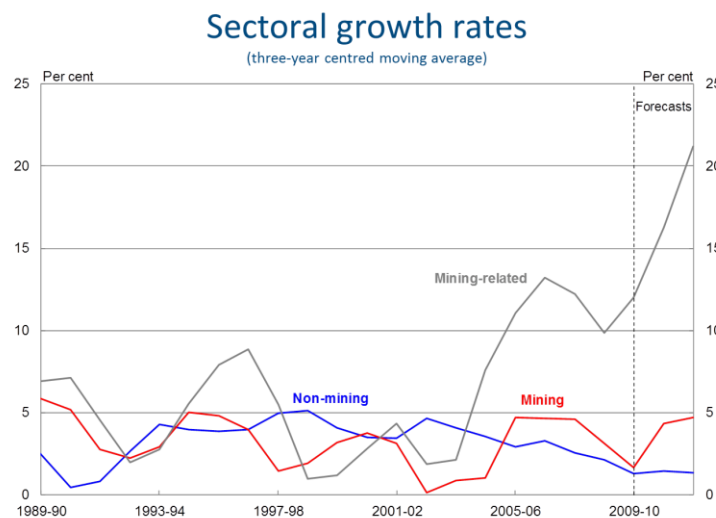
But one man’s cost structure is another man’s revenue base. The Mining and Oil & Gas service sector is quietly reaping the biggest boom in its revenue base, ever. It is even greater than during 2006-08, since this time around we also have massive investment in LNG projects.



The Good Dirt

Industry insights brought to you by the Ferrier Hodgson mining team

Australian Treasury economist David Gruen recently presented the graph below that depicts forecast sectoral growth rates, which sets expectations for mining-related services booming off the chart.



The data is often presented as “Non-mining” and “Mining & mining related”, with mining speeding ahead in Australia’s two speed economy. This aggregation disguises what is so apparent in the Treasury graph. It is “Mining-related” construction, manufacturing and services that are really booming. Recent sector growth rates of 10-15% are forecast to exceed 20% in 2011-12.

In this boom it is not picks and shovels being sold to miners. These nuggets come from a diverse range of goods and services provided by fly-in/fly-out airlines, catering and cleaning, mobile camps, consulting engineers, construction and maintenance workshops, heavy mining equipment hire and drilling services. It is a very long list.

Do all boats rise with this king tide of unprecedented growth in demand for mining (and Oil & Gas) related services? No, and we have already seen winners and losers in the mining services sectors.

Fortunes are of course being made by some players. However, the prospect of massive revenue growth also accelerates the pace at which poorly managed firms can become financially distressed.



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What attributes appear to be common amongst the companies going to ruin in a boom?

- Win projects much larger than any prior contracts – going for growth.
- Poor tendering discipline and weak ability to cost their own services.
- Miss contract milestones and in dispute with their clients.
- Management who trumpet the contract wins but are much quieter at earnings revisions.
- Use debt to underpin growth rather than re-investment of cash flow – a sign of success.
- A series of earnings revisions and a weak share price.

Seek out the canny merchants who quietly exhibit the opposite traits to those listed above.