Global resources

Q&A

November 2011

Dr Joanne Warner
Head of Global Resources

- Joined First State Investments in August 1997 and became the Head of Global Resources in June 2010.
- Has more than 15 years' experience as a specialist Global Resources portfolio manager and analyst.
- Won the Outstanding Achievement Award for Mining Funds Management at the annual Mines and Money Conference, sponsored by the Mining Journal in London in November 2007.
- Holds a Bachelor of Applied Science (Applied Chemistry) from the University of Technology, Sydney, where she won the University Medal.

Q1: What are the major influences on commodity prices?

A1: Commodity prices are being affected by investor sentiment amid concerns of a slowdown in the major economies of the world. It's worth reiterating that the majority of raw material consumption, and nearly all of the demand growth, during the last five years has been from the emerging market economies. Generally speaking, these emerging market economies have better balance sheets than those in the OECD. The demand from emerging markets, primarily from China, has supported strong commodity prices in the last few years, despite the majority of OECD economies experiencing lacklustre growth.

Ongoing Chinese demand was indicated in the twelfth 'Five Year Plan' announced late last year, for infrastructure and social housing to support ongoing urbanisation and modernisation. The rate of year-on-year economic growth in China is likely to reduce over time, however the magnitude of demand is much greater than five or ten years ago. As a result, it remains challenging for resources companies to increase supply to keep up with the incremental tonnages. To date, the majority of additional supply has been met from expansions of existing operations, as this is the most cost-effective way to increase production relatively quickly.

In the longer term, unless resources companies believe that strong commodity prices can be sustained for five to ten years, they will be reluctant to invest in large new projects that can underpin the next generation of resource production. The growing risks of capital cost over-runs, labour inflation, and political and fiscal instability are all disincentives towards investing in large new projects that would generate a seven to ten year payback period. As all mines and oil fields have a finite life, these new developments will be required to sustain global demand in the long term.

Q2: Why is there a disconnect between equity prices and commodity prices?

A2: The recent market correction has seen share prices drop significantly, while commodity prices and forecasts have remained strong. Fundamentals remain favourable and company valuations are attractive, but risk premia has evaporated. The market has become fixated on a bank default in Europe, which investors fear will have global contagion effect, leading to a global recession. This has contributed to the significant de-rating the sector has experienced.

Mining company valuations are attractive, but there is not enough of a catalyst for investors because the macro headwinds are too onerous for valuations and fundamentals to overcome. Major miners, such as BHP Billiton, Rio Tinto and Vale are generating a lot of cash, their balance sheets are in good shape and they are attractively priced, but markets aren't willing to pay because of a lack of confidence in equity markets.

The recent reporting period went as expected and the results confirm the strong cash generating ability of these companies, as demonstrated by BHP Billiton, which reported Australia's largest-ever corporate annual profit of almost A$22 billion. Costs may be rising at an operational and capex level, but this is already priced in when we look at the earnings of these companies. However when you look at the price to earnings ratios and EBITDA numbers, we are almost at the level of the trough back in 2008.

Q3: What steps have you taken in response to market conditions?

A3: It was important to stress test the companies we invest in. We assumed long-term commodity prices from 2012, while maintaining forecast capital expenditure spend and dividend payments. We wanted to test whether companies could meet their financial obligations in an environment of declining commodity prices. The scenario analysis showed that, on the whole, company balance sheets would remain in good shape and companies would be able to meet their interest payment obligations. Companies were helped by reduced gearing levels, which on average are roughly half the level that they were during 2008.

We then went one step further and dropped volumes to see what would happen to balance sheets. Again, most companies looked strong and remained profitable, even at lower commodity price assumptions.

Q4: What are the key factors affecting confidence?

A4: Cash flows are strong, balance sheets are in good order, buybacks are being announced, dividends are rising, but this still isn't enough to restore investor confidence in the sector.

One of the key issues affecting investor confidence is dysfunctional political leadership globally. Strong leadership on issues such as the euro zone debt crisis and the US debt ceiling extension, has been lacking. Indecision and the inability to resolve these fundamental issues sends a negative signal to investors. Companies are pulling back on capital expenditure while they wait for governments to focus on the issues in hand. This drives down investor and consumer confidence, which creates a vicious circle, driving down company values.

There is no confidence in equity markets at the moment. Investors are taking a wait-and-see approach because, given the volatility of the markets and investor uncertainty, there is no telling whether a stock today is going to be cheaper tomorrow. Our stock turnover has decreased by around 30% – 35% from this time last year, and we are moving our portfolios as defensively as we can within the sector.

Merger and acquisition activity might be the catalyst that gets attention focused back on the sector once confidence returns to cash-rich companies. We have already seen a number of small acquisitions recently, such as Rio Tinto and Mitsubishi Development acquiring Coal & Allied, and Peabody Energy and ArcelorMittal taking over Macarthur Coal, but we need more significant transactions to re-establish confidence in the sector. However I don't think this will happen in any time soon.

Q5: What is the outlook for commodities?

A5: In the latest market correction, many commodity prices, including iron ore and copper, held up well. The outlook for iron ore remains positive. Exports from India have declined due to an export ban revolving around environmental issues and illegal mining, while China is producing 50 million tonnes more steel than it was just a year ago.

When you compare iron ore consensus numbers to the spot prices, the consensus figure actually resides below the spot price, which suggest there's earning upgrades to come through for companies that are producing iron ore such as Vale, Rio and BHP. The copper price is also keeping up well as demand remains strong and inventories are tight.

For iron ore, copper and other commodities, it is important to note that China is the price setter; not the US or Europe. China purchases roughly half of world's iron ore, and about 40% of its copper and coal, so the current focus on a recession in the US or Europe doesn't apply to the key demand drivers for these commodities. While the US and Europe remain significant, they are becoming ever less so, especially as emerging economies increasingly trade with each other.