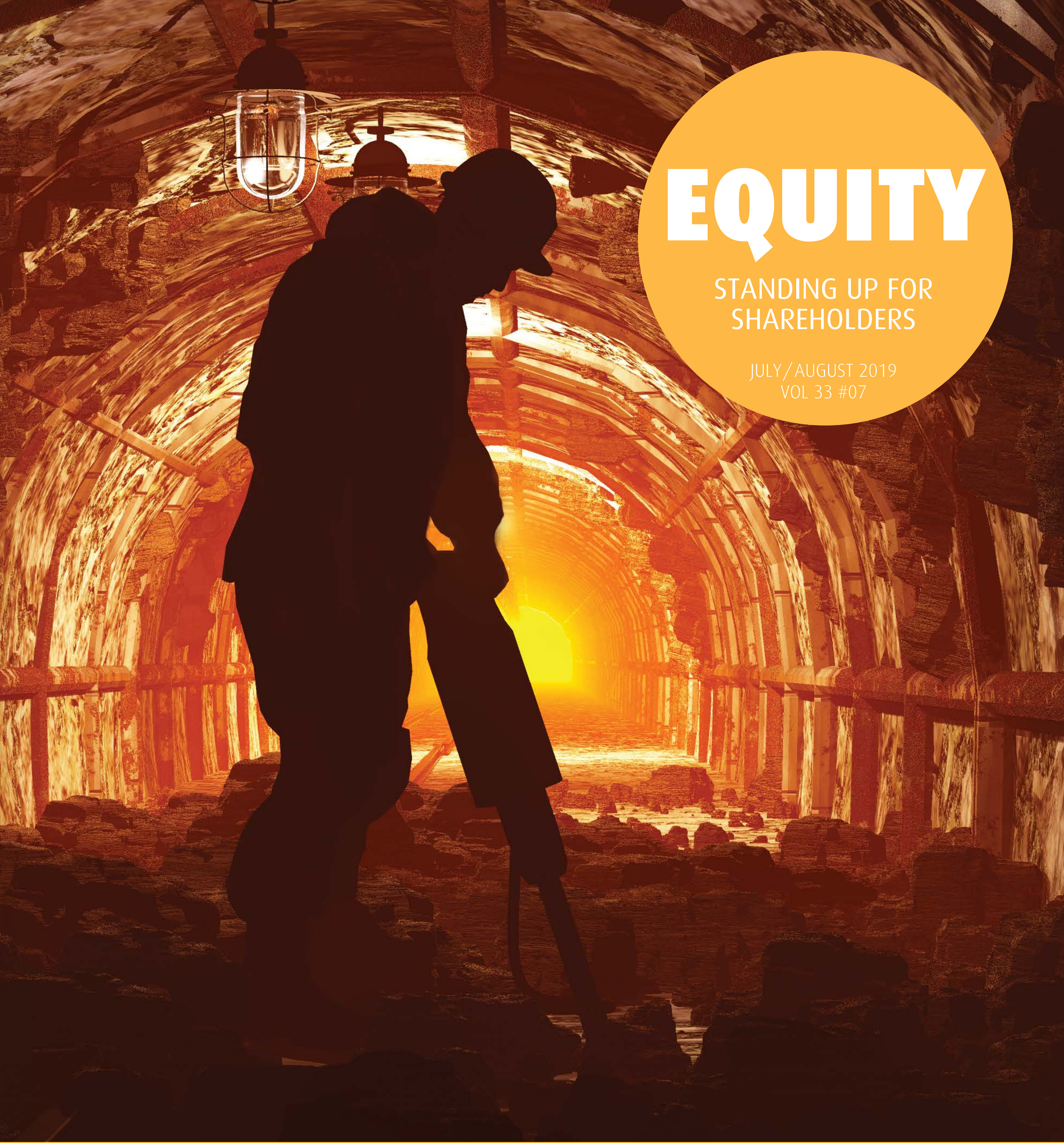

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Diversified miners: 5 themes for the next decade

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Diversified miners: 5 themes for the next decade

By Andy Forster Senior Investment Officer, Argo Investments Limited

Resources companies make up more than 15% of the ASX's total market capitalisation and commonly form part of a diversified domestic equity portfolio. The outlook for these businesses, particularly the large diversified miners, is therefore of great interest to many Australian investors. As we approach the end of this decade, it is timely to reflect on the prevailing conditions influencing the sector's recent performance and look ahead to the outlook for the next ten years.

Favourable conditions

The large Australian diversified miners, such as BHP and Rio Tinto, are set to end the decade in a strong position, due largely to record iron ore prices. In recent months, iron ore prices have been supported by supply disruptions following the tragic Brumadinho dam collapse in Brazil in January. The diversified miners are in a strong balance sheet position due to record levels of operating cashflow and divestments of non-core assets. With their portfolios trimmed, these companies are now positioning their businesses to meet the future needs of the global economy. Demand for Australian commodities, particularly iron ore from WA's Pilbara region, is significantly underpinned by the strength of the Chinese economy which has been fuelled by various stimulus measures, including massive expenditure on infrastructure projects and property development.

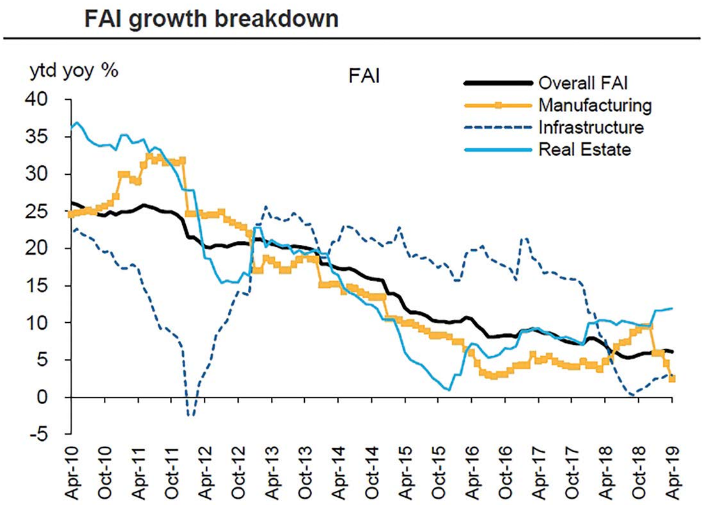
The decade ahead

Looking ahead to the next decade brings into sharp focus the changing nature of the world's economy and the forces shaping it. In assessing investment opportunities, it is critical for investors to consider the trends that will influence the future operating environment for Australia's diversified miners. In our view, key factors to consider include:

1. Chinese economy in transition

The fortunes of Australia's miners are inherently tied to the strength of the Chinese economy. In recent years, increased infrastructure spending and other stimulus measures by China's governing Communist Party have had positive flow-on effects for Australian commodities prices, most notably iron ore. The outlook for commodities is largely contingent on China's economy, which is transitioning from an emerging market economy to a developed economy. This process includes moving away from a fixed asset investment economy to a more consumption-based economy, which will reduce China's consumption of bulk commodities and in turn, apply downward pressure on bulk commodity prices over the longer term.

Chart 1 Chinese fixed asset investment growth breakdown



Source: CEIC, Macquarie Macro Strategy, May 2019

In the more immediate term however, China's ambitious 'One Belt One Road' initiative to build an extensive network of transport and communications infrastructure will underpin demand for bulk commodities and potentially extend the current resources cycle.

As China transitions to a developed economy, the greater demand for commodities will increasingly come from rapidly industrialising nations, such as India and various African and Asian countries. US tariffs have the potential to accelerate this demand diversification as production is pushed out of China to its neighbours, such as Vietnam and Indonesia.

2. Repositioning for a low-carbon world

In a bid to reduce greenhouse emissions, many nations are moving away from fossil fuels, and towards low-carbon and renewable energy sources. At its recent Strategy Briefing, mining giant BHP noted that the decarbonisation of the world's energy industry is occurring at a faster rate than its executives had previously anticipated. This trend has a range of implications for the resources sector, with demand for commodities to be shaped by the world's changing energy mix, particularly the growth of renewables usage.

The electrification of the transport sector is seen as a key component of decarbonising the global economy with some analysts predicting that up to 30% of all car sales will be electric, or hybrid-electric, by 2025. Reductions in battery costs, increased government subsidies, the availability of charging infrastructure, and regulatory restrictions on internal combustion engine vehicles will all be key to the mass adoption of electric cars.

For commodities, there are winners and losers from this trend. Production of millions of batteries for electric vehicles and stationary energy storage will be a boon for metals such as lithium, cobalt, graphite and nickel. However, it must be noted that there is much uncertainty surrounding the ultimate chemistry of these batteries as technology constantly changes and improves.

The future demand for copper is also set to grow, given its various applications in the generation of renewable energy, including in the manufacture of wind turbines. Demand for low and zero emissions energy also has the potential to support the development of newer energy sources and markets, such as hydrogen energy.

A carbon constrained global economy would see demand for coal, oil and gas decline. This may not necessarily put downward pressure on prices. For example, the current outlook for the oil price remains positive as supply is declining faster than demand due to a lack of investment.

3. The circular economy

A greater focus by consumers and policymakers on environmental harm caused by waste and consumption underpins the global trend towards a more circular economy. Through the redesign of supply chains, a circular economy sees less reliance on raw materials and favours reusable and recycled materials. Facing increased regulatory and social pressure, manufacturers must now consider the environmental impact of a product over its entire lifecycle, including sourcing raw and recycled materials, and how it is disposed of or re-used. This trend has negative implications across most commodities and has the potential to alter existing value chains.

4. Changing cost dynamics

A range of factors are creating increased cost pressures for the big miners, including declining ore grades. They also face greater capital expenses, with recent mine site disasters highlighting that sustaining capital expenditure costs for some assets have been artificially low. However, technological improvements are helping to offset steepening cost curves, with the use of automation and big data to optimise operations helping to reduce input costs.

5. China/US relations

The most pressing issue for the resources sector, and indeed the broader global economy, is the protracted trade dispute between the US and China which has the potential to adversely impact China's economic health and stability, as well as trade flows and foreign investment. A trade war could lead to reduced demand for Australian commodities from manufacturers in China, Australia's largest trading partner. Any impact on demand from infrastructure and real estate investment is likely to be limited due to anticipated government intervention. However, trade restrictions between the US and China may in fact increase demand for some Australian commodities, such as rare earths.

The right commodity mix

Recognising these themes and their impact on the future of the global economy, diversified mining companies are repositioning their portfolios to maximise future shareholder returns. The biggest challenge they currently confront is a mature asset base which is heavily weighted to commodity markets that are close to peaking in demand but remain very profitable. Some diversified miners have divested thermal coal assets (wholly or partly) in favour of commodities they anticipate will be in greater demand as the global economy decarbonises.

In our view, these future growth opportunities will initially deliver lower returns as the market structure and investment required for these newer commodities are less favourable than in established markets such as iron ore. A poor history of capital allocation, including multi-billion dollar write-downs of overpriced acquisitions made at the top of the cycle, may leave some market participants sceptical about the ability of these companies to allocate their capital prudently.

Outlook

Diversified mining companies and their shareholders must consider the longer-term forces shaping the global economy. Investors need to remember that commodities are inherently cyclical and current profitability must be balanced against expectations that bulk commodity prices (especially iron ore) will return to longer-term averages. Heading into the next decade, the operating environment is undoubtedly becoming more challenging, as the conditions that have bolstered revenues start to recede and impact earnings and dividends. Increasingly, local diversified miners will derive revenues from a different mix of commodities.

However, we expect these companies will continue to benefit from long-life, low cost assets which are well-positioned to endure variable conditions. The most successful companies will identify emerging trends and technologies and leverage these opportunities. E