THE ALTERNATIVE VIEW

By Hugh Dive

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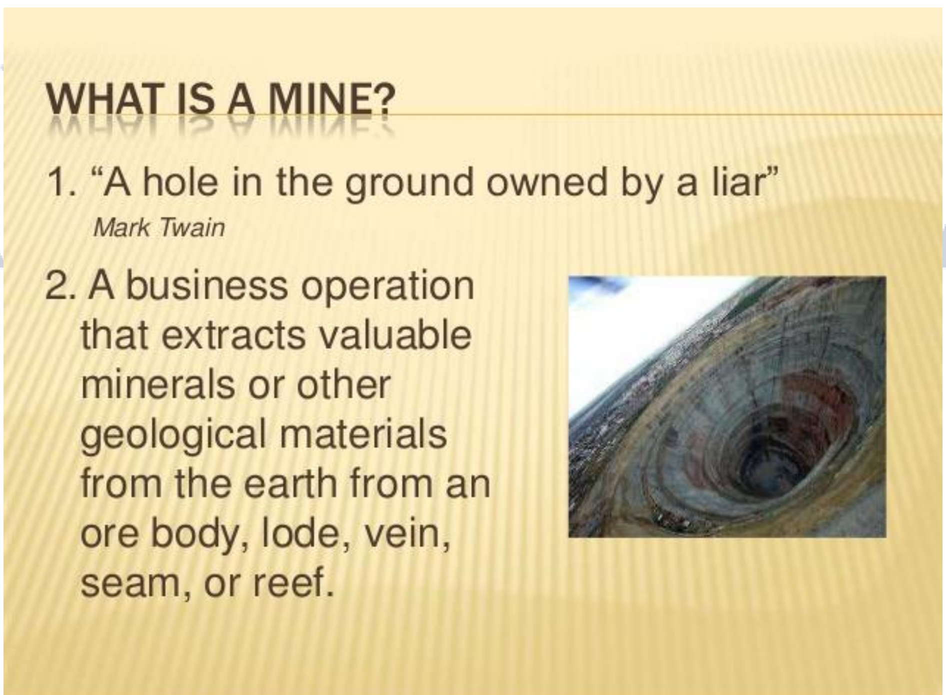
What to do with Resources

On Monday a broker in the UK put out a research note on Swiss-based Glencore suggesting that equity in the company could be worthless thanks to its US$50 billion debt burden. Shares in the company which runs over 150 mining, oil production and agricultural assets and employs about 180,000 people fell by 29%, caused BHP and Rio Tinto to fall 6.7% and 4.6% respectively on Tuesday and contributed to wiping A$50 billion off the market capitalisation of the ASX.

Like all fund managers we follow the resources sector closely, as it is the biggest sector in the ASX after the banks and spend a large amount of time testing our assumptions. Indeed over the last year, we have travelled to both the hot and dusty mines of the Pilbara and to the Dickensian dark satanic steel mills of North and Western China. In the press there has been much written about the end of the mining boom, and whilst we see that the boom days are over where marginal mines were making supernormal profits, we don't see that the wholesale dumping of mining stocks is the right move for investors especially at current prices.



Source: Palisade Capital

Resources on the ASX

In pure numbers metals and mining make up the largest sector on the ASX with 602 mining companies currently listed on the ASX. If you exclude the "zombie" companies with market capitalisations less than $20 million, the number only reduces to 157 and from this set a mere 16 mining companies listed on the ASX are profitable and pay dividends. Surprisingly even at the end of the China-led mining boom there remains A$30.7 billion of market capitalisation tied up in small unprofitable mining companies.

In any boom there is a transfer of wealth from investors to stock (mining or tech) promoters, stock brokers and service providers (lawyers, bankers and accountants), as hundreds of new companies are spawned. Typically the easiest companies to float are those that either have a project or are exploring for the hot mineral *du jour*. When I was a chemicals analyst at an international investment bank, I fielded many calls about junior phosphate plays as this was the hot commodity in 2010. Whilst phosphate was a sexy story in 2010, the common theme was very low phosphate ore grades which equate to high processing costs to and wildly optimistic estimates of what it would cost to build the necessary infrastructure in the highest cost construction market in the world. For example Legend International (LGDI) estimated that the costs of building their required plant (600ktpa sulphuric acid plant, 300ktpa phosphoric acid plant, 600ktpa MAP/DAP plant as well as corresponding utilities) would be only $600M when the true figure would have been around $1.5 billion, a pretty big ask for a company with $25M in cash and burning through it at a fast rate. In 2011 this had a market cap of $200M and a range of positive broker reports (Current mkt cap $5M share price 0.01).

I strongly suspect that for these unprofitable mining companies, the best chance that shareholders have of seeing a return is if their mining hopeful is used by sexy IT or a biotech company as a shell for a backdoor listing on the ASX. Like a stolen Subaru WRX the ASX-listed shells of tech companies from the late 1990s were rebirthed as mining companies in the mid 2000s and some are likely to turn up as fin-tech companies in the next few years.

A recent example of this was the South Australian copper-gold-uranium explorer ***Interment Resources*** which was reinvented as Silicon Valley-based on-line recruiter ***1-Page*** and investors have seen the price rise from $0.30 to $4.68 in the last 12 months! Whilst this was very profitable for some Newcastle-based investors in our funds, it is a very unlikely outcome for virtually all investors in small mining stocks.

Key Factors that we look for in Resources Companies.

- **Prefer the Big Diversified Miners**: The Aurora Dividend Investment Trust prefers to hold our mining exposure in the large diversified miners (***Rio Tinto*** and ***BHP***), rather than the single commodity stocks such as Newcrest, Fortescue or Alumina. We view that through the cycle their diversification by geography and commodity type will give investors fewer headaches than the higher risk pure plays. These companies are well-managed, low cost commodity producers with un-hedged reserves in the ground, predominately located in politically secure areas of the world.
- **Own Producers rather than Explorers**: When investing in junior miners, often one of the best things to do is to sell out before they start producing, as this is when the glorious blue sky is interrupted by the harsh reality of construction cost blowouts or miscalculations as to the mine's ore grades or levels of impurities become apparent. Further as we happen to prefer actual dividends now to promises, we prefer to own companies producing now rather than those still building major projects or prospecting. In the hydrocarbons space, our focus on owning companies producing oil and gas like ***Woodside Petroleum***; rather than those constructing projects such as ***Origin Energy*** or ***Oil Search*** has added value over the past year and has resulted in greater dividends for our investors. The dramatic fall in the oil price over the past 12 months highlights the desirability for current cash flows over potentially higher returns in an uncertain future. Cash in hand put Woodside in the position to pay off debt, reward shareholders and buy assets off motivated sellers, whereas Origin Energy's shareholders are now facing a dilutive $2.5 billion capital raising done at a 73% discount to where the company's share price was one year ago. See Four Sins of Cashed up Companies
- **Low Cost Volume Wins**. Whilst higher cost iron ore miners like Mount Gibson and Fortescue may give the investor the greatest upside exposure to recovering markets, they also give the strong possibility that they won't survive a prolonged downturn. Every mining boom is littered with the financial wreckage of companies that either had higher costs or were late to the party in bringing on their projects. In August both BHP and RIO have reported solid production lifts and production costs per tonne of iron ore of US$16 and US$15 respectively. Significant volume from these large low cost producers will have pushed down prices and will force high cost operators both domestically and in China to cut production and abandon new projects.
- **Key Commodities we look fo**r. At this stage in the resources cycle, investors have to be aware of the market conditions for the various commodities. It is no longer 2006, when China had an insatiable appetite for most commodities. At a mineral level we prefer oil, coking coal and iron ore to aluminium, thermal coal, gold and base metals, primarily due to the superior market structure and limited Chinese domestic supply. In the case of iron ore the price appears to have stabilized around the mid US$50/t as most of the supply surge has been absorbed and marginal high cost producers have cut production. Further the majors have regained control of market.

Our View

We currently see that BHP and Rio Tinto are attractively valued on fully franked dividend yields of 7.8% and 6.8% respectively. Whilst there has been much debate around the sustainability of the dividends for these companies, our recent meetings with the management teams post the results in August gave us comfort as to both the determination of the management teams to maintain these dividends and the ability of the companies to fund them. For example BHP in 2016 is expected to generate over US$7 billion in free cash flow (after taxes and capital expenditure) which is US$500 million more than the cash flow required to pay a dividend of A$1.75.

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- **Aurora Absolute Return Fund (ASX code: ABW)**
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