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Global Resources

Goldilocks and The Four D's

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Goldilocks

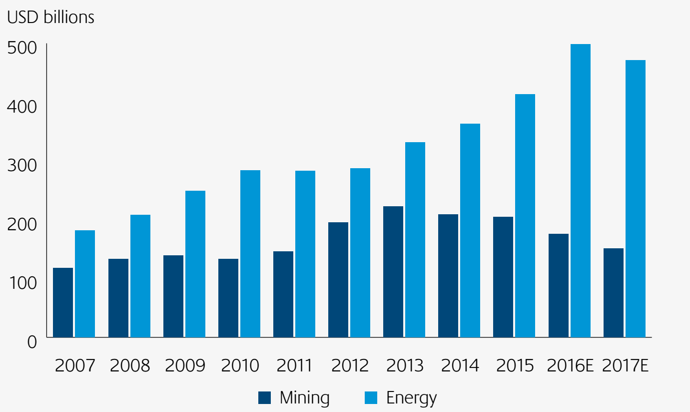
Following the worst down turn in global resources markets in more than thirty years, both mining and energy equities have rallied hard from their early 2016 lows. The last three years have been a sharp reminder of the cyclical nature of commodities markets and in this paper we address where we are in the cycle and how investors should be positioned.

Based on the famous children's fairy tale about The Three Bears, the Goldilocks principle captures the idea of having conditions that are not too 'hot', not too 'cold' but 'just right'. From a global resources perspective this neatly describes where we are in the commodities cycle. In simple terms, we believe conditions are 'just right' for shareholders to benefit from improving margins, more disciplined management and ultimately better returns. To illustrate the point, we apply a simple checklist called the Four D's: Debt, Discipline, Delivery and Distribution.

Debt

With commodity prices down sharply in recent years, balance sheets have become stretched following a period of out-sized organic and inorganic capital investment. Total debt for major mining companies peaked at US$220 billion in 2013, whilst energy company debt peaked a little later at almost half a trillion dollars (Figure 1). Management teams have been forced to reduce debt through a combination of asset sales, cost reductions and raising equity. Since oil prices peaked later in the cycle than iron ore, for instance, energy company debt is only rolling over now.

Figure 1: Total Debt

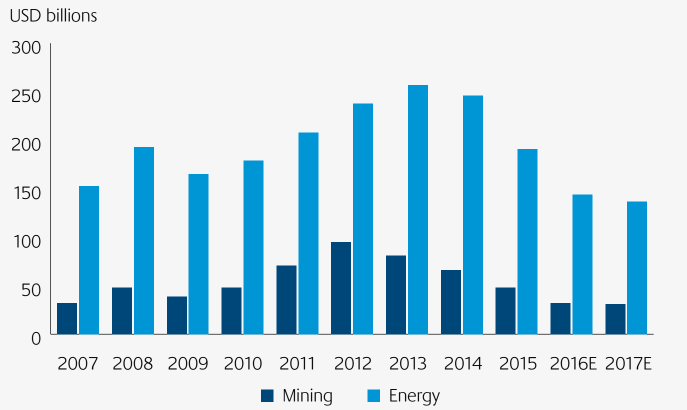


Source: Bloomberg.

Discipline

During the most recent Chinese-led commodities supercycle (2000-2011), mining and energy companies responded with increased investment in supply across the board. Whilst Chinese fiscal stimulus dampened a sharper downturn in commodities demand following the global financial crisis in 2009, supply finally started to outpace demand from 2012 across most commodities. Long lead times are required to bring in significant new supply and falling commodity prices have meant that capital flexibility has been limited for the last 4 years. Mining capex peaked in 2012 at US$90 billion, whilst global energy spend from the major oil companies topped out at US$250 billion (Figure 2). Interestingly, mining expenditure is now back at 2010 levels and likely heading lower. Energy capex is exhibiting similar trends, with investment now back to levels last seen a decade ago.

Figure 2: Organic Capex



Source: Bloomberg.

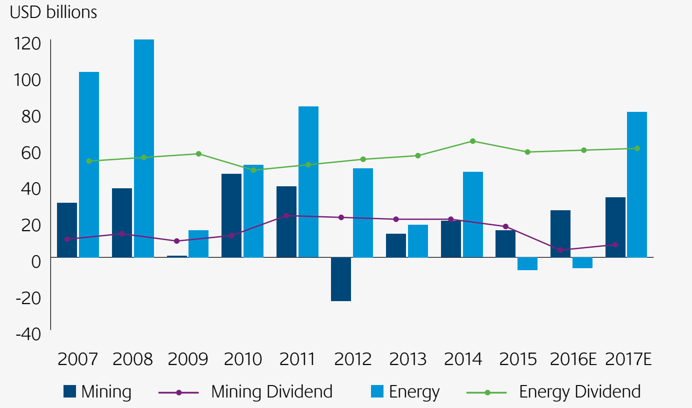
Delivery

Not surprisingly, during the boom years elevated investment and activity levels across the industry required 'all hands to the pump'. The major mining companies saw headcount almost double between 2007 and 2013 (Figure 3). But with cash flows down and balance sheet in distress, management teams across the resources space have been forced to take a hard look at efficiency – and the need to increase productivity. On this measure, the major mining and energy (Figure 3) companies have scaled back headcount by around 30% from peak levels and yet without materially impacting headline production. Doing more with less is now a central tenet for senior management teams.

Figure 3: Employees

Source: Bloomberg.

Figure 4: Organic Free Cash Flow



Source: Bloomberg.

Distributions

Taken together, the sharp reduction in debt, heightened discipline on capital allocation and clear delivery on efficiency are conspiring to sharply improve the sustainability of many of the major resources companies. In short, free cash flow is expanding rapidly from the lows witnessed in the last couple of years with most resource companies now expected to more than cover their dividends in the year ahead.

As we look ahead in to 2017, we believe that shareholders expect better and more sustainable distributions (dividend and buybacks) from the sector. Coupled with solid demand fundamentals and a more balanced commodities market the outlook for margins and returns looks as good as it has done for several years.

The Fifth D?: The Donald

But what about the risks for 2017? Geopolitics is the wildcard. The emergence of Donald Trump as the 45th President of the United States, elections in China and across Europe, Brexit and a rising tide of protectionism makes the outlook for the global economy (and thus commodities demand) somewhat murky. On the one hand, 'Trumponomics' could spur a wave of new infrastructure investment (estimated to be US$550 billion) and higher activity in the energy sector. On the other hand his proposed protectionist policies could cause wide and unknown changes in global trade flows that could be inflationary (security of supply rises) or deflationary (global demand wanes) for commodities. Uncertainty is good for gold, and we may be only one foreign policy 'Tweet' away from a higher gold price.

With such a wide range of possible outcomes for global growth and commodities demand, focusing on quality companies with strong balance sheets and high margins remains core to our investment philosophy. Whilst the Fifth D may be out of the control of the resources companies, by looking after the Four D's that are controllable we believe that the resources sector is well positioned to deal with an uncertain year ahead.