

Global Resources

Quarterly Review and Outlook

As at December 2015

Key Highlights

- The First State Global Resources strategy declined in value during the December quarter.
- Global mining and metals benchmark returns were negative, amid continuing overcapacity in commodity markets. The fall-out from the Volkswagen diesel emissions scandal weighed on platinum companies, in particular. Global energy index returns also declined, as the oil supply glut worsened.
- Defensive oil super major companies, Chevron and Exxon Mobil, were among the strongest contributors to the strategy's absolute performance over the quarter. Conversely, the strategy's exposure to Anglo-Australian miner BHP Billiton negatively impacted returns. The company had a difficult quarter due to the Samarco tailings dam tragedy in Brazil, and declining oil and iron ore prices, in particular.

The First State Global Resources strategy is actively managed using a fundamental, bottom-up stock selection process. We invest in high quality resources companies with world class assets, low production costs, reliable management teams, strong balance sheets and a path towards organic earnings growth.

What makes a good resource company?



- World-class assets
- Organic EPS growth
- Strong management
- Low-cost producers
- Strong financials

Quality companies + growth
= superior returns with lower risk

Market Review

Global resources equity markets remained volatile during Q4 2015. Slowing economic growth and structural reforms in China continued to depress commodity prices (i.e. iron ore -22.6%). In response, the People's Bank of China announced further policy stimulus measures, which supported economic activity data at year-end. Elsewhere, the US Federal Reserve raised the Fed funds target rate range by 0.25% to 0.25%-0.50%, the first increase since June 2006. The European Central Bank cut its deposit rate by 0.10% to -0.3% and announced a 6-month extension to its QE programme. The Euromoney Global Mining Total Return Index decreased by 9.5%, led lower by platinum companies amid the fall-out from the Volkswagen diesel emissions scandal. The metal is used in automotive catalytic converters, particularly in diesel engines. The MSCI All Country World Energy Index declined by 0.5%, pulled down by the draught in the Brent crude oil price (-22.9%), due to oversupply.

Strategy Performance and Portfolio Positioning

The strategy returned -1.6% (net of fees, gross of tax in USD terms) in the December quarter. Generally, the strategy's largest metals and mining holdings show as the largest detractors, reflecting the falling market. Investments that fall into this category include **BHP Billiton** and **Rio Tinto**.

BHP Billiton's share price has been under pressure due to a combination of the fall-out from the tragic Brazilian Samarco tailings dam breach, declining commodity prices (especially oil and iron ore) and reduced earnings, amid acute pressure from investors to abandon its progressive dividend policy. BHP reports its financial results on 23 February. Management recently reiterated that its progressive dividend policy is subject to the group retaining a 'solid A' credit rating. Therefore, BHP's balance sheet strength remains a priority, not the dividend policy, and will likely be revisited at its interim results. With this in mind, we have begun increasing the strategy's holding in BHP. A rebasing of the dividend could effectively re-set BHP's investment case, providing potential share price upside.

Despite announcing a solid Q3 2015 financial update with no material change in earnings, Rio Tinto declined over the December quarter. Production in key divisions was broadly in-line with market expectations, and substantial cash flow is still being generated. The company expects to achieve US\$300m

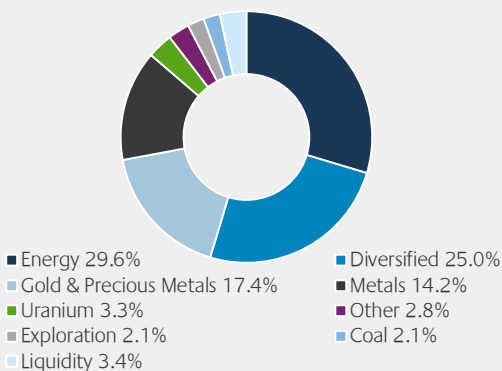
in opex savings at its aluminium unit Alcan by the end of 2016 amid a Chinese supply glut. Management also revealed additional capex and opex cuts, lowering 2015 and 2016 group capex guidance to US\$5bn (from US\$5.5bn and US\$6.0bn respectively), allaying market concerns over a potential dividend cut. Rio also announced that it's much anticipated US\$4.4bn project financing facility for the development of the Oyu Tolgoi mine (JV with Turquoise Hill) has been signed. The facility is one of the last major milestones before the development of the underground copper block cave project in Mongolia.

Defensive and safe haven oil majors, **Exxon Mobil** and **Chevron**, were strong performers over the quarter in the declining energy price environment. Both companies released their Q3 15 earnings results, which were viewed favourably by most market participants. Exxon beat consensus largely on better Refining and Marketing, and Chemicals earnings, while retaining its 2015 capex guidance and production growth targets. We reduced our position in Exxon after a strong period of relative performance. Chevron also released a solid earnings report. Its capex reductions are large and well ahead of consensus which points to the possibility of free cash flow neutrality prior to 2017. Project execution remains crucial to delivering the free cash flow inflection and resetting the dividend growth story.

The strategy's other top performers were generally 'acorns' (small cap companies) or 'saplings' (mid-cap companies) which had individual catalysts that resulted in price appreciation. For example, shares in Canadian diamond exploration and development company, **Lucara Diamond Corp.**, surged after the company unveiled an incredible 1,111 carat Type II high quality diamond, the second largest gem ever discovered.

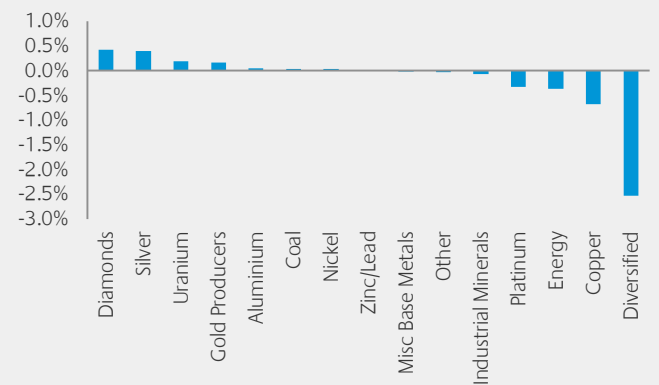
Although stocks are selected using bottom up fundamental analysis, the strategy is committed to diversification by sector and geography. The charts below show the sector diversification of the strategy as at 31 December 2015. Its largest exposures are to diversified metals and mining companies, energy companies, precious metals companies (gold, silver and PGMs), and base metals companies (principally copper and nickel producers). The subsequent chart shows the sector contributions to strategy performance over the period.

Sector Diversification



Source: First State Investments as at 31 December 2015.

Sector Contribution

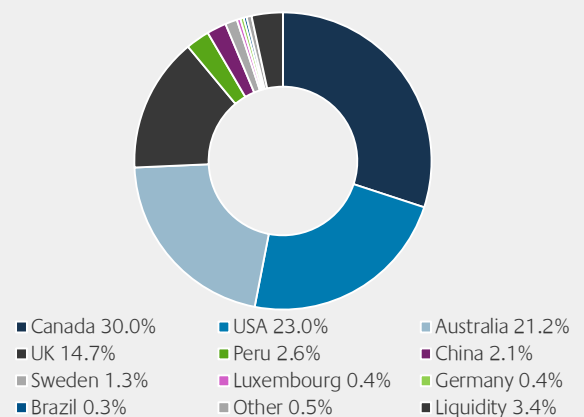


Source: First State Investments as at 31 December 2015.

The following charts show the strategy's **geographic diversification** and the **geographic contributions** to performance over the quarter. The geographical allocations are based on the stock's country of listing, not the domicile of the underlying assets. The largest exposure is to Canada and is generally constituted of mid-cap precious metals and base metals companies. This is followed by Australia which largely reflects the strategy's holdings in **BHP Billiton and Rio Tinto** alongside some smaller positions in **South32, Alumina, Oil Search, Independence Group, and Western Areas**.

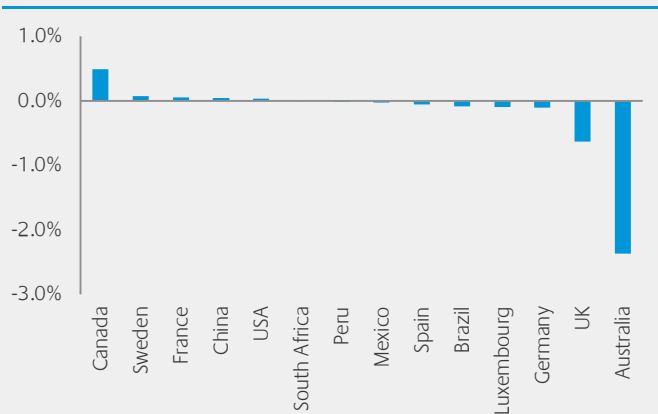
The strategy's geographic allocations result from balancing two factors. The first factor is portfolio diversification. We are conscious of the fact that diversification is one of the most important tools for ensuring portfolio risk and return is optimised. The second factor is political risk. Mining and energy projects require significant capital investments and once the capital has been spent, the project is immobile. Countries with superior track records of stable fiscal, labour and social environments are much lower risk domiciles for these immobile assets. Hence, the strategy is diversified by geography, but with a tilt towards lower risk jurisdictions like Canada, Australia, UK and the US.

Country Diversification



Source: First State Investments as at 31 December 2015.

Country Contribution



Source: First State Investments as at 31 December 2015.

Sector Outlook

Metals & Mining sector:

- Some of the necessary conditions for a bottoming of the mining cycle are starting to emerge. On the supply-side, production is being reduced (**Glencore** and **Freeport McMoRan** for copper and zinc), mines are being shut down (coal in the US and iron ore globally), dividends are being cut (**Glencore**, **Teck**, while pressure is also mounting on **BHP Billiton**), equity is being raised, capital spending continues to be deferred, and costs remain the key focus. In 2016, we expect to see further supply cuts, asset sales, dividend cuts, write downs, bankruptcies and equity issuance in the mining sector.
- Although we think that some of the metal demand slowdown in China is structural, the cyclical weakness in the property market, weak land sales and continued anti-corruption investigations into some of the higher profile state infrastructure companies has exacerbated this slowdown. We think that there is a reasonable probability of a modest cyclical rebound in demand for 2016, supported by continuing policy stimulus measures.
- We have an ongoing preference for later cycle consumer-oriented base metals commodities (i.e. copper and zinc) that have superior long-term demand fundamentals. Recent weakness in copper prices has provided an opportunity to selectively add to high conviction positions, such as **Lundin Mining**, **Hudbay Minerals** and **Antofagasta**.
- Diamond prices have also been under pressure during 2015 due in part to an anti-corruption campaign in China which has stifled luxury goods purchases, along with reduced credit availability in the jewellery trade and a strong USD. Despite this subdued backdrop recent diamond discoveries in Tanzania (Petra) and Botswana (**Lucara**) have helped share prices. Petra has also benefited from the removal of the financing overhang on its shares, with banks agreeing to waive key covenants in early December.

- The outlook for bulk commodities (i.e. iron ore and thermal coal) remains unattractive given strong supply additions, a falling cost curve and the rotation toward a consumer-led Chinese economy. The portfolio is underweight iron ore producers and exposed only to those companies with the lowest costs, strong balance sheets, and scope to maintain already low costs (**Rio Tinto**).
- Gold continues to face macro headwinds from a strong USD, increasing US interest rates and subdued inflation outlook. This is counterbalanced by periodic bouts of risk-off demand primarily due to geo-political risks (Middle East). Given this unpredictability, we maintain a preference for gold producers with low costs and growth potential, offset by larger positions in high quality large cap companies, such as Goldcorp. We have retained our significant exposure to lower risk business models such as royalty companies, **Franco Nevada** and **Silver Wheaton**.

Energy sector:

- Our outlook for 2016 for the Energy sector is one of guarded optimism. The sharp sell-off in oil and natural gas prices in 2015 is expected to increase the pace of capex reductions, setting the stage for potentially higher oil prices in 2016. Oil has a relatively quicker natural supply response than most commodities and significant consumer orientation, leading us to favour large cap E&P and IOC companies.
- The demand-supply adjustment for oil remains incomplete, hampered by fundamental global oversupply, overflowing storage capacity and unseasonably warm Northern Hemisphere winter weather (though this appears to be abating in the US). The lifting of the 40-year old US crude oil export ban could further delay price normalisation as inventories take longer to be reduced.
- OPEC's dovish December decision largely met the market's bearish expectations and emphasises that it will adhere to its current strategy of squeezing out higher cost producers by maximising its own output. In fact, the lack of an explicit output target in OPEC's final press release is arguably more dovish than raising the target to 31.5 mmb/d excluding Indonesia as it acknowledges that members are under no production restraint whatsoever until the June 2016 meeting.
- While political risks are rising in the Persian Gulf, in the absence of any further escalation in Iran-Saudi tensions, we see global crude oil supply continuing to grow as Iran increases oil production rates by 500,000 - 1m barrels per day once sanctions are lifted.
- There are tentative signs that the M&A cycle may be starting to turn with increased activity in the energy sector in recent months, particularly in LNG assets. Any increase in M&A intensity should be seen as a lead indicator for a recovery in oil prices, though the mismatch between the price of crude oil and the value of companies are

stymieing some deals (i.e. **Apache** rebuked **Anadarko's** overtures; **Santos** has rejected an offer from Scepter; and **Canadian Oil Sands** snubbed a C\$6.6bn bid from **Suncor Energy**).

- Natural gas storage balances remain elevated courtesy of unexpectedly warm winter weather, atop of already record storage levels, both of which have acted to depress natural gas prices. However, we expect slowing production to support the rebalancing effort in 2016. The outlook for high cost US shale producers remains weak. Oil prices are close to breakeven levels for all but the most productive fields. Gas is likely to remain surplus to demand as new low cost sources, such as the Marcellus, continue to ramp-up. Competition to sell gas to power utilities is strengthening as domestic coal prices have fallen dramatically.
- Recent Canadian federal elections and Albertan provincial elections increase the risk of higher royalties and taxes for the oil industry. Alberta's NDP government announced its new plan to combat carbon emissions, with a C\$30/t carbon price applied to emissions relative to high performing facilities. We reduced our position in the oil sands sector months ago, anticipating that oil sands may be hit harder than other energy sectors, as they produce higher levels of carbon emissions.

Investment Philosophy and Process

The strategy continues to be managed by one of the sector's longest-standing natural resources teams, led by Dr Joanne Warner. The First State Investment's approach is to combine stable companies, with high-quality assets and low costs of production, with earlier stage opportunities to create the potential for sustainable returns over the course of a full cycle. We continue to look for opportunities to add to preferred names on market weakness. Overall, we expect the portfolio to perform well when sentiment towards the sector improves.

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