Australian Resources Investing

Key factors driving the Resources Sector

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Managing Director

Zurich Geneva
29th Nov – 1st Dec 2011
Presentation Outline

• Breakaway Investment Group Overview
• Relationships in Australian Resources
• Economic backdrop
• Seasonal variations
• BHP/RIO outlook
• A comment on Intensity of Use Charts
• A golden story
• Summary
Breakaway Investment Group
AFSL 290093

What we do…

- LimeStreet Capital – managed funds (LSC Australian Resources Hi-Alpha Fund)
- Breakaway Research – commissioned research (+25 companies and growing)
- Breakaway Corporate Advisory – project partial or total divestment, IPOs and independent expert’s reports
- Stock Resource – independent newsletter research
- Breakaway Private Equity – a new private equity fund focused on pre-IPO or direct project investments
LimeStreet Capital manages the LSC Australian Resources Hi-Alpha Fund

LSC Australian Resources Hi-Alpha Fund Performance

Note: ASX 300 Resources Index includes BHP Billiton and Rio Tinto and presented for comparison only. All indices set to 1.0 as at 30 June, 2008.
LimeStreet Capital manages the LSC Australian Resources Hi-Alpha Fund

<table>
<thead>
<tr>
<th>LSC Australian Resources Hi-Alpha Fund</th>
<th>Inception Date</th>
<th>12 Month performance to 31 October 2011</th>
<th>2 Year annualised performance to 31 October 2011</th>
<th>3 Year annualised performance to 31 October 2011</th>
<th>Annualised performance from Inception to 31 October 2011</th>
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<tbody>
<tr>
<td>Total Net Return</td>
<td>30-Jun-08</td>
<td>-7.3%</td>
<td>14.3%</td>
<td>29.1%</td>
<td>0.03%</td>
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<td>Resource focused indices</td>
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<tr>
<td>ASX Accumulation Small Cap Resources</td>
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<td>-12.8%</td>
<td>6.1%</td>
<td>24.1%</td>
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<td>Index (benchmark)</td>
<td>30-Jun-08</td>
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<tr>
<td>ASX Accumulation 300 Resources Index</td>
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<td>-9.6%</td>
<td>2.2%</td>
<td>11.4%</td>
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<tr>
<td>ASX Accumulation 100 Resources Index</td>
<td></td>
<td>-9.1%</td>
<td>1.7%</td>
<td>10.2%</td>
<td>-0.05%</td>
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<td>30-Jun-08</td>
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<td>General market indices</td>
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<td>ASX Accumulation 200 Index</td>
<td></td>
<td>-3.7%</td>
<td>0.4%</td>
<td>6.9%</td>
<td>-0.01%</td>
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<td>30-Jun-08</td>
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<tr>
<td>ASX AllOrdinaries Index</td>
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<td>-7.9%</td>
<td>-3.1%</td>
<td>3.1%</td>
<td>-0.04%</td>
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<td>30-Jun-08</td>
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<td>Dow Jones Industrial Average*</td>
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<td>0.4%</td>
<td>2.6%</td>
<td>-6.7%</td>
<td>-0.01%</td>
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<td>30-Jun-08</td>
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<td>Commodities</td>
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<td>Gold (spot)*</td>
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<td>17.8%</td>
<td>18.4%</td>
<td>14.5%</td>
<td>0.11%</td>
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<td>30-Jun-08</td>
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<tr>
<td>LMEX (LME base metal index)*</td>
<td></td>
<td>-12.6%</td>
<td>0.2%</td>
<td>0.7%</td>
<td>-0.05%</td>
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<td>30-Jun-08</td>
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*DJIA, Gold (spot) and LMEX index are converted to A$ at month end AUD/USD exchange rates. Data sourced from Bloomberg.

Total Net Returns is the Fund Return after the deduction of ongoing fees and expenses and assumes the reinvestment of all distributions. Past performance is not indicative of future performance.

Inception date of the Fund was 30 June 2008.
Why are we interested in resources (mining & energy)?
Returns in the Resource Sector – can be impressive!

Stage 2 ran too hard too fast given the world economic backdrop? We believe a turnaround from here will offer reasonable returns but these can be higher depending on what part of the sector you are investing in, and of course it is about timing!
And recalling the longer term picture

- China has stated that it still wants to relocate 270m people to cities by 2020!
- 400m in India do not have electricity and 420m live in ‘multi-dimension’ poverty
- Other BRIC and non-BRIC growth e.g. BHP is now referring to growth in Indonesia!

However, the game has changed – these countries are seeking security of supply and this should be included in investment considerations
Recent performance in the regional markets and broader Australian market
Recent markets have been largely tracking Wall Street with China less so. Recent influence has been Europe on the US and then to our regional markets.
Relative market performance on 6 monthly intervals (US$, indexed)

If the US and China are moving higher, the Australian market does well!
Relative market performance on 6 monthly intervals (US$, indexed) – Australian Resources

And even more so with Australian resources!
Indeed, ASX 200 Index more closely tracks DJIA movements when the exchange rate influence is ignored.
Australian Market
Australian market composition

Australian Market
S&P/ASX 200 Index
($1,136bn)

Resources includes Materials and Energy and comprise 33.5% of the market ($381.7bn)

Materials 25%
Consumer Staples 8%
Energy 7%
Industrials 7%
Consumer Discretionary 4%
Health 0%
Telecommunication Services 3%
Utilities 1%
Information Technology 1%
Financials 40%
So how has the Australian resource market performed?

Resources are volatile but this largely drives the Australian market.
Australian Resource Sector Driver
Base metal and gold have different drivers

Base metal prices (and World economic growth) has a strong influence on Australian resources.
A similar relationship with Wall Street and base metal prices
Gold has been less of an influence on the Australian resource sector.
Recent unsustainable gold price rally on the back of Standard & Poor’s downgrade.
Returning to the exchange rate – strong correlation with base metal prices – until recently

The AUS/USD ~ 1.00 while base metal prices have fallen
ASX 300 Resources Index and A$/US$ exchange rate

The resource sector has followed base metal prices while the higher A$/US$ may reflect other influences (yields, economic strength).
Global Economy

Three main market influencing pillars: the US, European Union and China

- US – improving
- EU – a mess
- China – scope for policy shift with easing inflation
China inflation – has been the biggest impediment

Premier Wen Jiabao recently said that he “cannot relax” due to high prices in China that have led to steep rises in the cost of food, vowing to step up the fight against inflation.

However, it is likely to have peaked:
- Falling exports (particularly to Europe)
- Falling commodity prices
- Falling property prices

source: TradingEconomics.com; China Economic Information Net
Chinese Soft Landing

- GDP grew at a healthy at 9.1% y-o-y for the September quarter
- Household debt is low
- Property prices are falling but selected impact
- Banks can recover losses by underpaying depositors! (The Economist)
- Controlled economy – lending will take place! (e.g. recent buying of banks shares by the government)
- Government economic management has been good to-date and strong incentive to avoid social unrest!
China’s scope to ease policies?

- China manufacturing slumped to 32 month low signalling probably contraction in factory activity. The HSBC “flash” purchasing managers index fell to 48%, down from 51 in October.
- 5 interest rate rises and 9 increases in the bank reserve requirement ratio over the past year
- Inflation peaked in July at 6.5% followed by 6.2% in August, 6.1% in September and then 5.5% in October. Expectations are that it will continue to fall fast then previously expected

- Premier Wen Jiabao has now said the government stands ready to ‘fine tune’ policy when ‘appropriate’. This fine tuning has already been evident in the relaxation of bank lending rules to small and medium-sized companies and raising of tax thresholds (which will boost small businesses).

A significant influence on the Australian resource sector is if China starts loosen monetary or fiscal policies… ...and perceptions are that its growth remains intact
Iron Ore & China

The 12th 5-year plan for iron and steel industry (released on 7th November 2011) outlined the following:

- China Iron and Steel Association (CISA) has called for China to source at least 40% of iron ore from its overseas assets by 2015 from a present level of about 15% (Seeking to add 100Mt of offshore iron ore production)
- China produced 627Mt in 2010 and targeted to produce 700Mt in 2011. China’s annual steel demand is expected to peak at between 770Mt and 820Mt pa between 2015 and 2020.
- The Government is moving steel production centres to coastal regions to in south east China to reduce logistic costs. (e.g. Zhanjiang in Guangdong province and Fangcheng port in the Guangxi Zhuang autonomous region)

Suggests:
- Iron ore demand remains robust
- China will be funding new iron ore projects
Europe – Observations from down under!

- Current policy – appears to suggest a wave of Sovereign defaults and bank failures.
- Resolution requires common Euro bond (debt mutualisation), ECB backing and focus on growth.
- Outside exporting focused Germany, domestic demand required for growth.
- Conspiracy theory – Germany/France holds out for demands before relenting! (Additional pressure from rising recent German bond yields)

Signs of a resolution important to resources

- Chinese exports - EU was China’s biggest export market, buying US$265.3b in Chinese products in the first three-quarters of this year.
- Global market uncertainty and volatility
US – a slow grind!

Housing & Unemployment
US Housing

In the doldrums and provides a restraint to consumer spending....

- Houses expected to fall 2.5% in 2011 and rise by 1.1% each year through 2015.
- Housed prices peaked in 2006 based on Case-Shiller 10-city Index.
- One in five Americans owe more than their home is worth.
- Banks hold nearly 500,000 homes on their books but more than 4 million more are in some stage of foreclosure or seriously delinquent after missing 3 or more payments.
- Bank owned foreclosures have sidelined new construction, the traditional employment engine of a downturn.
- Some encouragement to banks to write down loan balances.
- Anecdotally, many people had stopped believing home improvements would increase the value of their property.
- Consumer spending has been the main driver of the US economy.

Source: MacroMarkets
At least US house prices are stabilising….

US house prices are bouncing around 2004 levels.
US subdued but positive

- Recent downgrading of September quarter growth (GDP lowered from 2.5% to 2%) reflecting significant inventory drawdown
- Restocking now likely to occur, particularly during rising holiday season demand
- Recent data indicates the economy is slowly adding jobs and rate of layoffs is slowing
- December quarter GDP growth could be 3% pa

Increasing confidence that the US is on a recovery path....
At least the stock market has been relatively strong...

Historical periods of high unemployment have corresponded to a weaker stock market. The current stronger market is supportive of a modestly falling unemployment rate.
So we need:

* Euro uncertainty to go (top priority!)
* US – continue growth trajectory (likely)
* China – demonstrate soft landing and maintain modest growth (we believe likely)

Then Australian resources will flourish!

Now to seasonal trends…
Seasonal trends...supported by commodities

Only 3 years out of the last 11 years had declining markets over this period
On average, there is a 10% gain from September to March
Seasonal trends...Australian Resources

Only 2 years of the last 11 years had declining markets over this period.
On average, there is a 10% gain from September to March.
Seasonal trends...supported by gold

Over the past 11 years, there has only been one year when the gold price was lower at the end of March in comparison to early September. The gold price was US$1826/oz on the 1 September 2011.

Average 13% price increase
The outlook for BHP Billiton and Rio Tinto
...the resource leaders
BHP Billiton lacks earnings growth

No obvious share price drivers (unlike recent earnings growth)
BHP Billiton lacks dividend support...

If the share price remains constant, the yield will increase to 3.5% pa by 2014

Source: Bloomberg

BHP Billiton Dividend and Yield (actual & forecasts)

- Dividend (US$ share)
- Dividend Yield

Source: Bloomberg
This chart suggests that with the recent share price fall, the market assumes BHP’s earnings will fall by 30% from consensus … is this reasonable?
Similarly on a cash flow basis – the current share price assumes a 30% fall in cash flow forecasts.
Similarly, the Rio share price now appears to factor in a 35% reduction in earnings.
Earnings sensitivities

For earnings to fall 30%, commodity price have to fall (including offsetting forex movement):

BHP Billiton 24%
Rio Tinto 42%

Sensitivities based on BHP & RIO data

Commodity prices have fallen by 15% - 20%, hence the market has probably overshot on the downside

But remember the earnings profiles of these companies are changing! – little earnings growth going forward
Commodity Prices

Substantially off recent highs….

**Iron ore contracts prices** > US$170/t (now $140/t, sales at US$120/t)

**Thermal coal spot prices** – US$120/t (appears to be holding, US$126.50 set by Xstrata for 1 Oct)

**Met Coal** – US$310/t – now US$280/t with view towards US$240/t

**Copper** – was around US$4.10/lb, now US$3.46/lb
Implications for the overall Resource Sector

Broad sector investment may not be the answer!
Last topics:
The famed ‘intensity of use’ charts
A golden story!
Steel Consumption Trends

Looks like a strong outlook?
Consider the historical consumption in the US and Germany.
Electricity Consumption

This does have a believable trend!
A Golden Story!

In 2007 the Chinese started accumulating significant gold reserves (in part as a replacement to investing in US treasuries)

In October 2009 the Chinese received a shipment of gold. A significant proportion of this gold turned out to be fake – tungsten bars covered in gold and it was discovered after drilling 4 bars for assay.

The bars had serial numbers for tracking, originated in the US and had been stored in Fort Knox for years. There were reportedly between 5,600 to 5,700 bars, weighing 400 oz. each, ($3.6b at current prices)

Rumour is that 15 years ago during the Clinton Administration between 1.3 and 1.5 million 400 oz tungsten blanks were allegedly manufactured by a very high-end, sophisticated refiner in the USA.

Remember recent unusual requests? …

- In August 2011, Venezuelan President Hugo Chavez requesting the return of Venezuelan gold back to Venezuela
- In June 2011 – US Senator Ron Paul requested gold audit
Australian Resources - Summary

- Economic growth (as reflected in base metal prices) is a major driver for Australian resources sector
- Outlook is relatively positive if Euro zone can sort itself out. (US and China appear ok)
- Seasonal trends suggest attractive returns over new few months
- Large diversified stocks such as BHP and RIO are lacking significant earnings growth but may experience a modest bounce
- Mid tier companies are more attractive (particularly with projects/commodities that may attract Chinese/Indian/Japanese/Korean funding)
And to investing?

- Target large, long life mines in companies that have leverage to project growth
- Gold – producers and emerging developers that can capitalise on high gold prices
- Other favoured commodities –
  - Thermal coal and premium coking
  - Copper (on M&A basis)
- And lastly:
  - Be active! – do not assume that the diversified and balanced portfolio will make you money!
Lastly, BPs prediction of India’s oil shortfall

India – it is happening but not as fast as we all would like!
Thank-you...

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