Formerly Appian Asset Management

Monthly Monitor | August 2022

Commodities - is cyclical weakness masking a structural opportunity?

Commodities were the hot topic at the start of this year as investors viewed them as a hedge against inflation.

As the year has progressed, the market has started to price in an economic slowdown and the prices of commodities and the companies that produce them have come down in line with this. We believe this cyclical weakness is masking a structural opportunity and the conditions are in place for commodity stocks to shine over the long term.

Well-placed in the capital cycle

The capital cycle is a simple concept. Low levels of supply in a sector leads to strong pricing for incumbent companies. The high margins lead to over-investment and new competitors entering the sector.

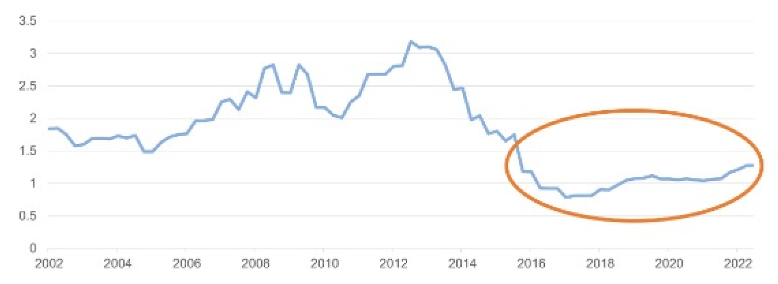
Margins and profitability are soon compressed as excess supply overwhelms demand. With profitability reduced, consolidation occurs, and investment is reduced. This under-investment ensures the seeds for the next recovery are planted.

Today, we are just coming out of a long period of under-investment in the mining space illustrated by the chart below.

This is the best possible background and despite commodity prices being elevated versus pre-Covid levels, we are seeing very little additional supply being added.

We are in the sweet spot of the capital cycle.

European mining sector CapEx/Depreciation



Source: Bloomberg, August 2022

The current supply 'sweet spot' is likely to be sustained for a longer period than normal for several reasons.

Firstly, the previous cycle has left investors scarred. The current attractive price environment is not enough to make investors push for expansions. Value destructive investments with capital overruns and delayed deliveries in the late 2000s/early 2010s have led to investors imposing strict capital discipline on management teams.

Secondly, investors have started to view the miners as dividend paying stocks, particularly UK pensions funds. Therefore, investors are imposing capital discipline on management teams.

Thirdly, increased ESG requirements are being imposed on companies by investors. This means projects require more planning and extended lead times.

Finally, there is a shortage of large projects in lower risk jurisdictions with amenable governments.

Structural demand growth

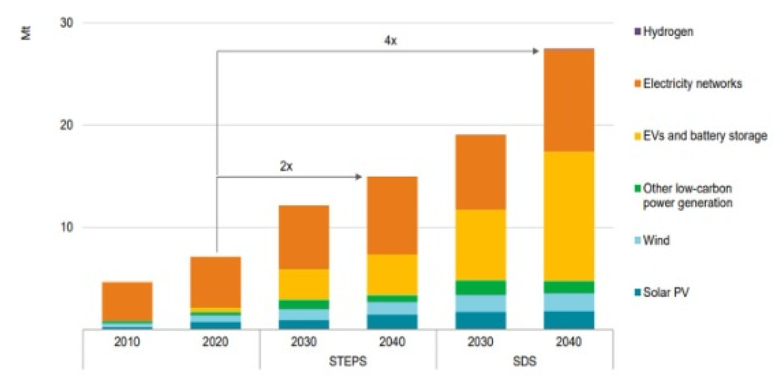
Demand tailwinds alone are not enough to sustain commodity bull markets. However, structurally growing demand combined with the supply 'sweet spot' is likely to be a powerful force.

The demand outlook has become increasingly rosy over the last number of years.

Historically, such high demand increases in commodities have been fuelled by a new major economy or region beginning to industrialise. However, this time it is not a country driving demand, it is predominantly the energy transition (grid network upgrades, solar power, wind power and electric vehicles).

If we are to come close to the targets set by governments, the demand for minerals will take off over the next few years and be sustained into the second half of the century.

Total mineral demand for clean energy technologies by scenario



Source: International Energy Agency (IEA), March 2022

Conservative estimates put the demand for renewables, Grid and xEV's (CAGR) of copper, nickel, and aluminium from 2022 to 2023 at 15%, 22% and 14.5% respectively.

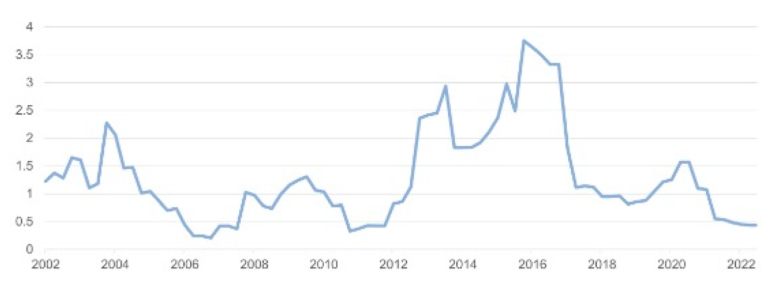
Urbanisation is a further demand driver - essential infrastructure and electrical wiring are needed as populations migrate towards cities.

Strong financial position, allowing cyclical storms to be weathered

Mining companies have significant levels of operating leverage. Combining operating leverage with financial leverage has historically proven disastrous for cyclical companies.

The mining sector has cleaned up its balance sheet over the last decade. The financial position is very strong and even a sustained cyclical downturn would be unlikely to affect the financial position of the major commodity producers.

Sector net debt to EBITDA



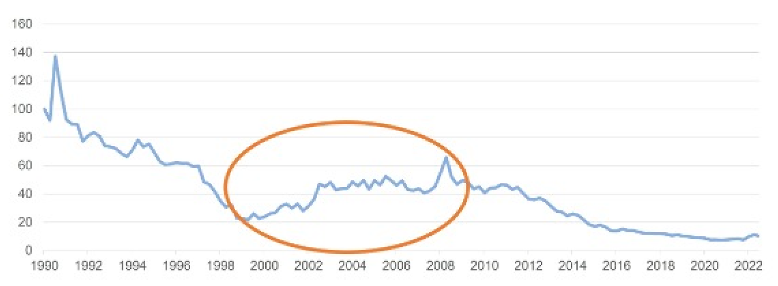
Source: Bloomberg, August 2022

Low valuations on an absolute and relative basis

Commodities are very cheap versus broad equity markets.

The previous commodity boom from 2000 to 2008 saw the ratio of commodity prices to the broad index treble.

Commodities to S&P 500 ratio

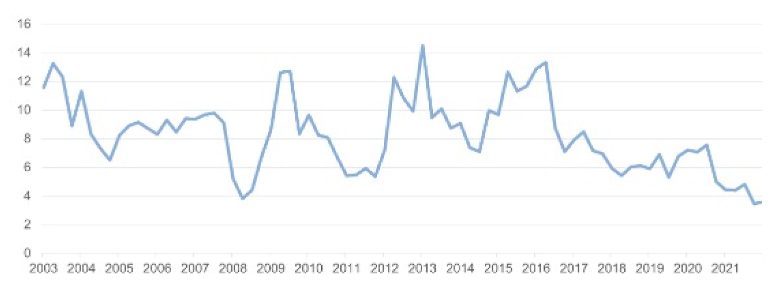


Source: Bloomberg, August 2022

The absolute valuation levels are also significantly below historical averages.

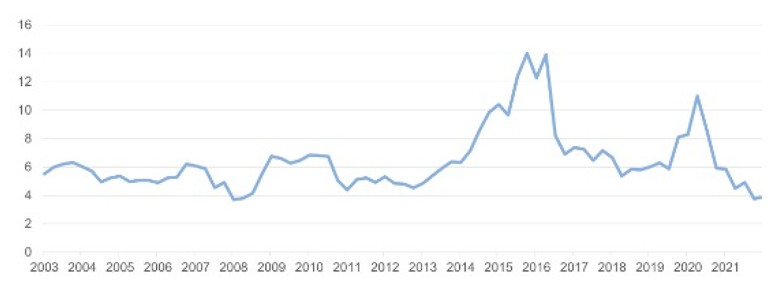
Earnings may be elevated but even normalising earnings down to historic margin levels gives us very attractive valuation opportunities.

European mining EV/EBITDA



Source: Bloomberg, August 2022

European energy EV/EBITDA



Source: Bloomberg, August 2022

Investment opportunity

We believe that the stocks we hold in the commodity spaces will emerge from a cyclical downturn in a better position than their peers. We think that they will be the ones that can take advantage of the huge structural opportunities that the constrained supply/strong demand environment will bring.

Their strong balance sheets mean that they can deal with a sustained negative pricing environment if it occurs. Their high dividend yields provide investors with generous levels of income, so we are essentially paid to wait through any weakness.

Name	Sector	FCF Yield	EV/EBITDA	Dividend Yield	Net Debt to EBITDA	Net Debt to Equity
Antofagasta plc	Materials	6.69	5.20	9.40	0.15	-4.90
BHP Group Ltd	Materials	15.00	3.70	10.73	-0.02	-1.66
Rio Tinto plc	Materials	15.86	3.51	11.68	-0.01	-4.77
BP plc	Energy	19.74	10.05	3.92	2.07	42.54
Shell plc	Energy	16.14	3.53	3.40	0.66	29.73
Eni S.p.A	Energy	24.63	2.01	7.30	0.47	41.48
ConocoPhillips	Energy	11.42	4.20	2.90	0.30	33.31

Source: Bloomberg, August 2022

Please visit our website for further information. The latest views and insights from the team can be found here.

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