October 2017 — Over the Horizon Market Commentary by David Offer

The Australian share market defied the historical trend of October being a negative month and instead posted strong returns. The All Ordinaries Index closed up 4% at 6,003 points, a significant milestone given it has been more than 9 years since our share market last traded above 6,000. The positive momentum continued in November, with our market up a further 1% at the time of writing.

Resource shares have contributed strongly to the current share market strength. It is hard to imagine that less than two years ago in January 2016 our share market was trading under 5,000 points, largely under the weight of resource share selling. Many vocal share market experts were predicting the end of China's strong economic growth and thus, the end of Australia's resource era. At that time, the share market was telling them they were right, with significant share market falls incurred by major resource companies as commodity prices fell. Less than two years later, with China not collapsing but instead continuing to economically power ahead, commodity prices have at least partially rebounded. The resulting subsequent turnaround of some of our major resource shares is summarised below.

Company	Jan 2016 Low	Prior 5yr High	% Fall	Current Price	% Recovery
BHP	$14.06	$36.04	(61%)	$27.91	98%
RIO Tinto	$36.53	$71.30	(49%)	$72.93	100%
Fortescue	$1.44	$4.66	(69%)	$4.79	233%
Woodside	$24.94	$40.32	(38%)	$31.20	25%
Origin	$3.44	$15.06	(77%)	$8.25	140%
Alumina	$0.97	$2.10	(54%)	$2.26	133%

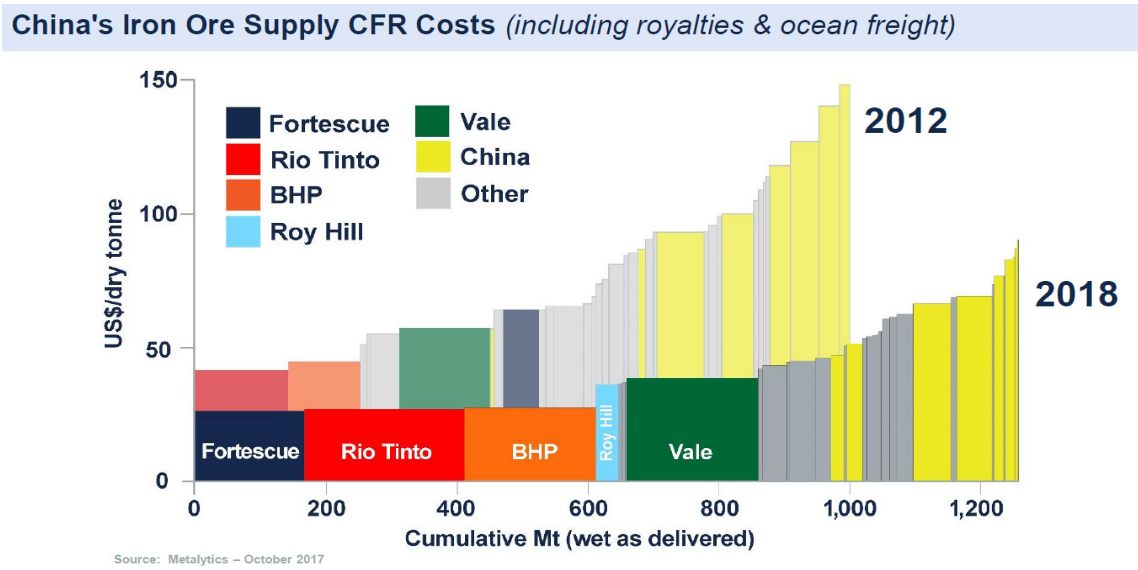
While part of the recovery can be explained by strength in commodity prices, a significant component of our resource sector turnaround can also be attributed to significant industry wide cost savings as mining companies took the opportunity presented in the downturn to reset wages at lower levels, downsize their workforce, improve best practice and embrace automation. As is often the way, economic or industry downturns allow the opportunity for businesses to reset to ultimately prosper in the longer term and our mining companies have taken advantage of this period to strengthen their businesses. Cash flow generation is arguably the strongest measure of corporate health and it is hard to identify an industry presently generating stronger cash flow than our mining sector.

By adding to resource shares while they were down, we are now presented with the opportunity to lock in significant profits on these shares even though they are yet to recover in full to their former highs. Ultimately, we do need to remember that resource shares will remain cyclical. It is inevitable that there will be future bumps in the investment road ahead that market experts will be keen to highlight after the fact. As such, we are content to take some profits where overweight or the opportunity presents.

One such opportunity has been the recent RIO Tinto off-market buyback, where investors on a zero tax rate will effectively receive $86.91 a share once franking credits are refunded and those on a 15% tax rate will receive $75.29 plus a capital loss to offset capital gains into the future. This compares favourably to the current share price of $73.02.

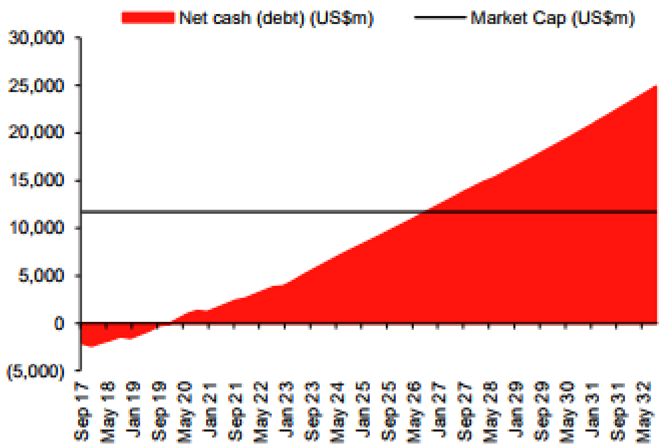
One resource share that we are presently happy to add to portfolios is Fortescue Metals Group, which is trading at $4.75 at the time of writing. Fortescue typifies much of the resource sector at this time as highlighted by Macquarie in this research report.

Fortescue has become the world's lowest cost supplier of iron ore and with RIO Tinto and BHP they dominate the supply of iron ore into China at a significantly lower cost than all other competitors, including domestic Chinese suppliers. In time, it would not be unreasonable to expect that the five companies that supply the world's sea borne iron ore ultimately squeeze out all other competitors, particularly if iron ore prices did drift back. If this eventuates, the market would develop oligopolistic characteristics that would give immense long-term pricing power to our incumbents.



In addition to reducing costs, Fortescue has focused on paying down debt. From being viewed as highly geared just 2 years ago, Fortescue is now projected to be debt free by 2020. Further, by 2026 Fortescue is projected to have generated the same amount of cash flow as the entire market value of the Company at this time – approximately $AU15 billion. This is based on a lower projected iron ore price of approximately $US55 a tonne versus the current spot price of $US62 a tonne.

Fig 6 FMG cumulative cash flow



Universally, all analysts are forecasting the iron ore price to fall and Macquarie's forecasts also reflect this. However, should the iron ore price remain at current levels then the profitability of Fortescue will be much greater than currently forecast. This would likely result in a higher dividend than the presently forecast 6% fully franked yield for the next few years.

Fig 3 FMG's multiples look attractive using a US$50/dmt realised price

	Macquarie forecasts				US$50/dmt realised price		
Y/E June	FY18e	FY19e	FY20e	Y/E June	FY18e	FY19e	FY20e
P/E	9.4x	10.8x	9.8x	P/E	7.6x	7.8x	7.6x
EV/EBITDA	4.4x	4.5x	4.0x	EV/EBITDA	3.8x	3.7x	3.4x
Dividend yield	6.0%	6.2%	6.0%	Dividend yield	7.8%	8.2%	7.8%
FCF Yield	8%	8%	15%	FCF Yield	11%	13%	18%

Source: FMG, Macquarie Research, October 2017

On conservative iron ore price assumptions, Fortescue is trading on a future Price Earnings (PE) ratio of approximately 10 times. This compares favourably to RIO Tinto which is on a projected forward PE of 15 times and BHP on a projected forward PE of 18 times. Part of the discount can perhaps be attributed to Fortescue's pure iron ore focus and that the Company's iron ore is of a lower grade than BHP and RIO Tinto. However, this is arguably more than factored into Fortescue's current share price.

While we believe Fortescue's fundamentals are sufficiently attractive to buy at current prices, with variables such as the iron ore price outside the Company's control, it is impossible to predict what the share price will do in the short term. The volatility associated with Fortescue means that investors should not over commit and to retain funds to provide scope to average down on their initial entry price should the share price subsequently fall significantly. For example, if shares were initially bought at $4.75, we would probably look to average down below $4.00. Conversely, from current levels we would probably look to sell at $6.75 and above, which if realised would generate gains of +40% plus income received from dividends for the duration of time shares were held. We view this potential return as adequate compensation for the risks associated with buying Fortescue.

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