Global Resources

Quarterly Review and Outlook

As at March 2016

Key Highlights

- Global resources equities rallied due to seasonal demand, Chinese policy stimulus, and diminished expectations for the pace of US interest rate hikes. This weighed on the US dollar, propelling metals prices off their most recent lows. Major supply disruptions and OPEC headlines about a potential production freeze, supported oil prices.
- The First State Global Resources strategy increased in value during the March quarter, driven primarily by our exposure to gold producers, which benefited from the rising gold price on increased demand for the precious metal as a store of value.

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?

Source: First State Investments images.

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

Quality companies + growth
= superior returns with lower risk

Market Review

Global resources equity markets rallied strongly in Q1 16, boosted by seasonal demand, Chinese policy stimulus and improving property sector activities. This pushed the iron ore price up by 23.4% to US$53.75/t. The US Federal Reserve's intention to slow the pace of future interest rate rises resulted in a weaker US dollar. The Brent crude oil price rose by 6.2% to US$39.60/bbl, supported by major supply disruptions in Iraq and Nigeria and OPEC headlines. Spot gold prices lifted by 16.1% to US$1,232.71/oz, the largest quarterly increase since 1986, as negative interest rate policies in Europe and Japan boosted the appeal of gold.

Strategy Performance and Positioning

The strategy returned 15.5% (net of fees, gross of tax in USD terms) in the March quarter. The strategy's gold holdings show as the largest contributors, reflecting the rising spot gold price, in particular. Investments that fall into this category include **Franco-Nevada and Goldcorp**.

Precious metals royalty company **Franco-Nevada** reported stronger-than-expected Q4 15 earnings results, with earnings growing by 22% (QoQ) largely as a result of initial contributions received from the Antamina mine in Peru. The company acquired the Antamina silver stream from Teck Resources in October 2015.

Beyond the quarter, Franco's growth profile remains solid. The company reported 2016 guidance including Gold Equivalent Ounces (GEO) growth of around 20%. It also provided an outlook for 40% growth from 2015 levels by 2020. We like this company for its strong purchasing power and free cash flow generation. In a sector with stretched balance sheets we believe royalty opportunities will continue to arise at attractive prices. Franco recently announced that it will acquire a gold/silver stream on the Antapaccay mine in Peru from Glencore for US$500m.

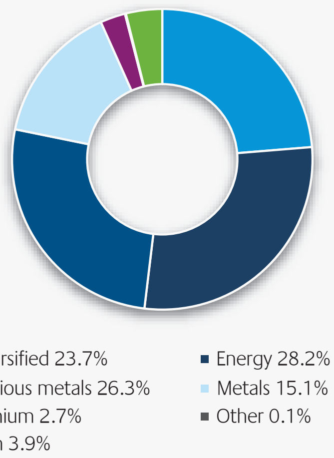
Goldcorp is a senior Canadian-listed gold producer whose key world class operating assets include Peñasquito (Mexico), Pueblo Viejo (Dominican Republic), Red Lake (Canada), Cerro Negro (Argentina) and Éléonore (Canada). 2015 was a record year for production, however this was largely because of higher than average gold grades at Peñasquito. Overall operational performance was disappointing and a number of mines missed their targets. The Cochenour project was downgraded to exploration status and previously forecast production was removed from 2016 guidance. Goldcorp has invested through the cycle, and has brought two new projects into production in the last two years. Despite this, production is forecast to fall 10-20% in 2016 and then remain flat in 2017 and 2018.

The recent appointment of Mr David Garofalo as CEO gives the company the opportunity to re-set expectations with conservative guidance and focus on NAV per share. We believe operating costs will improve as the new mines ramp up towards full production rates and the company cuts overheads. It has already announced a senior management restructure significantly reducing middle management and moving to a decentralised mine operating model.

After an aggressive market sell-off following its Q4 15 result, we added to the strategy's holding in **Memorial Resource Development**. The lower-than-expected earnings numbers reflected weaker realised gas prices, higher cash costs and higher depreciation, depletion and amortisation expenses. This disappointing result followed a downside surprise around its more conservative drilling plan for 2016, impacting production. We continue to favour Memorial Resource Development for exposure to gas. In our view, company management has made the prudent decision to live within cash flow and build up a backlog of uncompleted wells to provide flexibility once commodity prices improve.

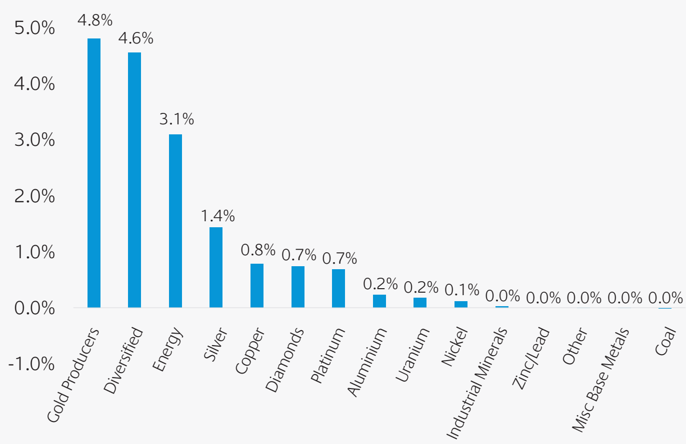
Although stocks are selected using bottom up fundamental analysis, the strategy is committed to diversification by sector and geography. The charts below show the **sector diversification** of the strategy as at 31 March 2016. Its largest exposures are to diversified metals and mining companies, energy 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 March 2016.

Sector contribution

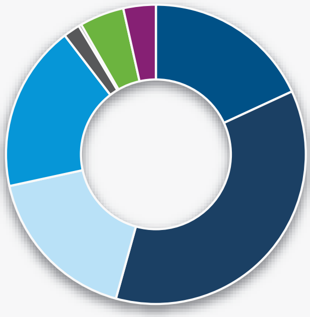


Source: First State Investments as at 31 March 2016.

The following charts show the geographic diversification and contributions to strategy performance over the quarter. The geography is 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. The exposure to Australia is mainly comprised of large diversified mining companies, **BHP Billiton** and **Rio Tinto**. This is followed by the US which largely reflects the strategy's holdings in a number of energy companies.

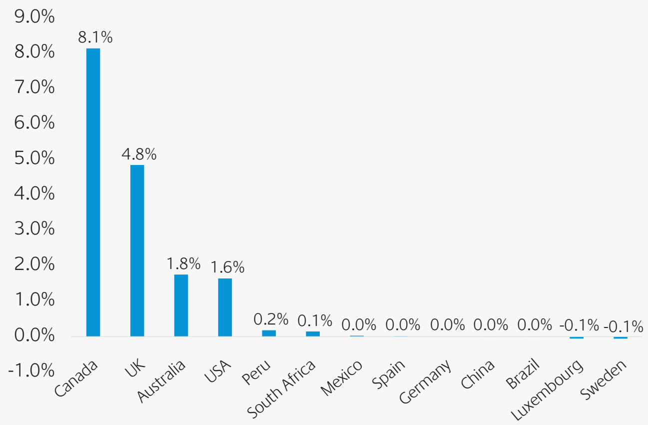
The strategy's geographic allocations result from balancing two factors. The first factor is portfolio diversification. We are conscious of the fact that diversification is one of the most important tools for ensuring portfolio risk and return is optimised. The second factor is political risk. Mining 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, and the US.

Country Diversification



Source: First State Investments as at 31 March 2016.

Country Contribution



Source: First State Investments as at 31 March 2016.

Market Outlook

Global resources is a cyclical sector. An extended period of high prices provided both the incentive and funding for new projects and expansions. In some sectors, the timing of this new supply has coincided with a reduction in demand from China. As a result, commodity prices have been pushed lower, weighing upon investor sentiment. After five years of commodity price declines, more than half the industry is struggling to generate free cash flow.

Companies are being forced to respond aggressively; cutting costs, jobs and high cost production. Later cycle, consumer-oriented commodities such as base metals, precious metals, diamonds and oil have the best potential for price recovery in the medium term. Bulk commodities like iron ore, coal and steel are likely to remain in over-supply for longer. Company valuations appear attractive, but risks abound. Meanwhile, many companies are moving to defend their balance sheets by cutting costs, capex and dividends. Those most at risk are being forced to consider selling assets and royalties, as well as raising capital.

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 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. In absolute terms, we expect the strategy to perform well when sentiment towards the sector improves.