Global Resources

Quarterly Review and Outlook

As at September 2016

Key Highlights

- Global resources equities were mixed in the September quarter. Industrial metals continued to benefit from robust demand following Chinese stimulus earlier in the year. Coking coal performed strongly due to Chinese government enforced supply restraint. Energy companies lagged their mining peers as oil prices declined.
- The First State Global Resources Fund increased in value during the September quarter, driven primarily by our exposure to large diversified metals and mining producers, which benefited from rising coal, zinc and nickel prices.

The First State Global Resources Fund 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.

Market Review

Global resources equity markets were mixed in the September quarter. Mining equities and commodity prices generally increased. Demand and hence prices for most base metals and bulk commodities continue to be supported by Chinese stimulus measures. Emerging supply constraint, particularly in zinc and coking coal, have also been supportive of commodity prices. Gold and silver traded in a tight range reflecting uncertainty over central bank policy. Energy producers underperformed miners as oil prices declined during the quarter.

Strategy Performance and Positioning

The strategy rose by 6.4% in SGD terms, while its benchmark increased by 6.8%.

The strategy diversified metals and mining holdings show as the largest contributors to performance. Global miners such as BHP Billiton, Glencore, Rio Tinto and South32 have aggressively reduced operating costs and capital expenditure plans. Those with high debt are selling assets and raising capital to strengthen their balance sheets for the current lower price environment. Reduced output by major producers together with government policies to curb excess capacity has tightened the coking coal, nickel and zinc markets. Glencore and South32 are most leveraged to this commodity mix and their share prices appreciated over the quarter. Holdings in both stocks were increased. We prefer these names to Rio Tinto and BHP. We have concerns around the ongoing investigation into the Samarco tailings dam incident in Brazil which will likely be an overhang on BHP's stock. Rio Tinto is highly exposed to iron ore and faces some strategic uncertainty with the arrival of a new CEO.

Gold stocks were strong performers in 1H 16, but gave-back some of these gains as the gold price declined over the quarter. Goldcorp and Franco-Nevada were among the largest detractors. Goldcorp is currently undergoing structural and cultural changes as the company focuses on the execution of its turnaround strategy. The recent appointment of Mr David Garofalo as CEO gives the company the opportunity to re-set expectations with conservative production guidance and a focus on Net Asset Value per share. Goldcorp has a relatively low cost profile, reasonable balance sheet and no backlog of deferred sustaining capital. It has invested through the cycle and has commissioned two new mines in the last twelve months – Cerro Negro in Argentina and Éléonore in Canada. It recently completed the purchase of Kaminak Gold for US$520m in Canada's Yukon Territory. Goldcorp's biggest challenge may be its Peñasquito mine in Mexico which, following some high-grading of production in 2015, is now undergoing a shift to lower grades and different recovery methods. Should Goldcorp manage this transition successfully, it should go some way to restoring the markets faith in this company.

Franco-Nevada continues to perform well operationally. It announced record ounces and revenues in its latest quarterly update, supported by the addition of two major streams located in Peru – Antamina and Antapaccay. Franco recently acquired the gold/silver stream on the Antapaccay mine from Glencore for US$500m. We consider Franco-Nevada to be one of the industry's highest quality precious metals royalty companies with strong long term growth potential. Franco's solid balance sheet provides flexibility for acquisitions or increased dividends. 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-Nevada's lower risk business model should continue to be very attractive to investors.

Although stocks are selected using bottom up fundamental analysis, the fund is committed to diversification by sector and geography. The charts below show on next page the sector diversification of the strategy as at 30 September 2016. Its largest exposures are to diversified metals and mining companies, energy companies, precious metals companies (gold, silver, palladium and platinum), and base metals companies (principally copper, zinc and nickel producers). The subsequent chart shows the sector contributions to fund performance over the period.

The charts show on this page 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 small and 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, such as Exxon Mobil and Chevron.

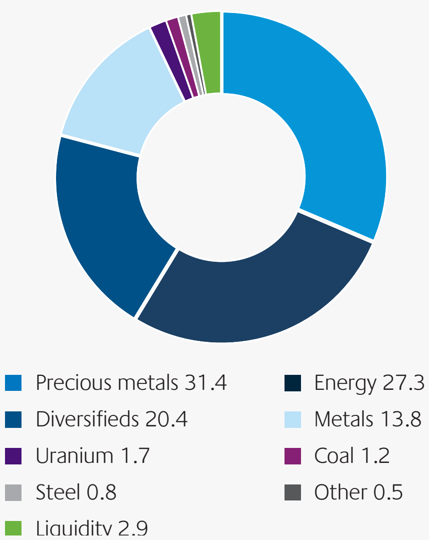
The Fund's geographic allocations result from balancing two factors. The first factor is portfolio diversification. We are conscious of the fact that diversification is one of the most important tools for ensuring portfolio risk and return is optimised. The second factor is political risk. Mining and 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 fund is diversified by geography, but with a tilt towards lower risk jurisdictions like Canada, Australia, and the US.

Market Outlook

Despite a mixed outlook for commodity prices there are still attractive investment opportunities in the metals and mining sector because we expect to see a wide dispersion in returns among industries and companies. We maintain a well-diversified portfolio representing as many commodities as possible, where we can find good quality companies or exciting growth opportunities.

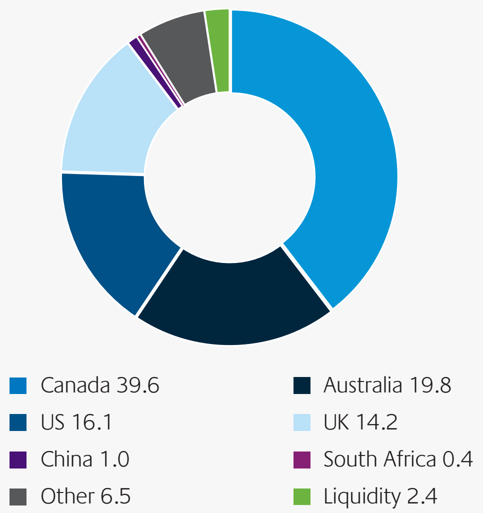
A sustained low interest rate environment has been supportive for precious metals over base metals and bulks. Zinc and nickel remain our preferred commodities due to expectations for an undersupplied market. Supply-side reform and the exit of loss-making capacity have also helped reduce China's coal output. Upside in steel appears capped by China's maturing materials-intensive growth cycle.

Sector Diversification (%)



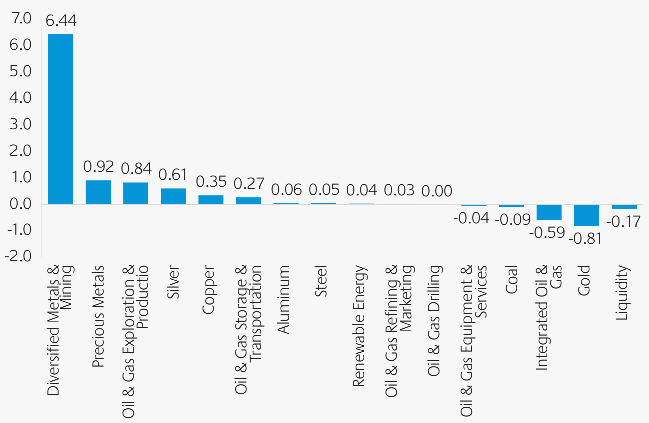
Source: First State Investments as at 30 September 2016.

Country Diversification (%)



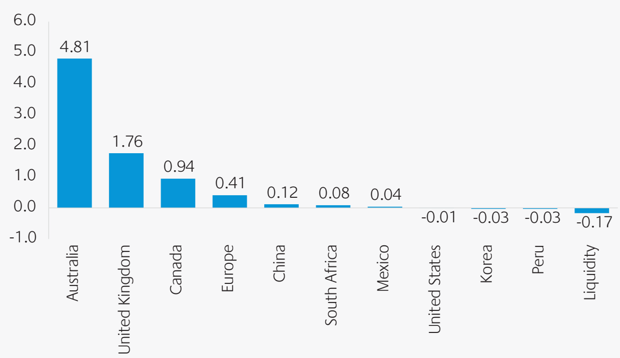
Source: First State Investments as at 30 September 2016.

Sector Contribution (%)



Source: First State Investments as at 30 September 2016.

Country Contribution (%)



Source: First State Investments as at 30 September 2016.

Increased US unconventional oil and gas production, combined with the removal of sanctions on Iran has resulted in additional oil supply, reducing price tension. In the absence of any major geopolitical disruption in the Middle East or Russia causing concern over security of supply, we think energy prices are likely to remain around current levels for several years.

At this point in the cyclical recovery, large cap miners and energy producers need to continue to demonstrate capital discipline and to maximise free cash flow. Amongst the mid-cap and intermediate producers, high asset quality, low costs and balance sheet strength are qualities that we emphasise. Smaller companies are inherently higher risk, and small positions can make a meaningful impact upon the fund. Catalysts such as exploration success, permitting and development, as well as operational turnarounds are considered amongst the acorns in the portfolio.