Thursday 16 October 2014
The Australian Financial Review | www.afr.com AFR

Ric Spooner, of CMC Markets, says predictions call for iron ore to average out somewhere between $US80 and $US100 a tonne.

Flat commodities may be investors' chance

Resources

Alexandra Cain

The drop in the iron ore, oil and coal prices has spooked the local market, prompting a selloff of local resources businesses. While the outlook for these commodities remains subdued, this could prompt buying opportunities if shares whose prices are affected by movements in commodity prices continue to fall.

Ric Spooner, chief market analyst at CMC Markets, explains iron ore prices are suffering from rising supply and slowing demand.

"It's been a long time coming but we have passed the inflection point where supply capacity exceeds demand. In these circumstances it can be very difficult to forecast where prices will bottom. Theoretically, high cost producers should cease loss-making operations, bringing the market back into balance. But this sort of process often takes longer than many expect, meaning prices can drop well below consensus forecasts," he says.

Spooner says the same dynamic was evident as iron ore prices rose. "Supply capacity took longer to come on board than forecast and prices stayed stronger for longer than the consensus view."

He says most predictions call for iron ore to average out somewhere between $US80 and $US100 a tonne over coming years with prices forecast to recover from current lows in November or December this year, as inventories are restocked.

"However, the risk to these forecasts is to the downside with the potential for China's demand growth to soften as a property oversupply is worked through."

David Bassanese, ETF provider BetaShares' chief economist, agrees rising supply and softer demand from China for local iron ore has caused a slump in prices.

"Iron ore prices have already fallen faster and further than many anticipated, largely due to a reticence by high cost producers – as in China – to cut back capacity.

"My outlook is for prices to stabilise around current levels as inefficient producers eventually exit the market and China's economy stabilises."

One business with a vested interest in, and first-hand knowledge of, the factors driving the iron ore price is **Carpentaria Exploration**, a small listed iron ore producer. Managing director **Quentin Hill** recently attended the China Iron and Steel Association's conference in Dalian, giving him insight into what's driving the price of this commodity.

"At the CISA conference in Dalian, it was clear that China's focus on reducing pollution is being treated seriously by steel mills, with stringent standards expected to be introduced next year. This is putting significant pressure on the steel industry in China," said Hill.

"Steel mills will be looking to improve efficiency and reduce emissions and this will lead to increased demand for high grade, low impurities products that meet these needs. There is no doubt there is a short term oversupply, but the medium and long term fundamentals are good, especially for higher grade products."

> **Theoretically, high-cost producers should cease loss making operations, bringing the market back into balance.**
> Ric Spooner, CMC Markets

Another commodity whose prices have come under pressure recently is oil. Spooner explains oil prices have also been driven lower by an underlying supply/demand overhang.

"This has been prompted by a rising US dollar and the fact that geopolitical risk premium has been stripped out of markets. The US shale oil phenomenon has had a major impact on this market over the medium term," he says. American shale oil rigs have flooded the market with supply in recent years.

According to Spooner, growth in demand for oil is unlikely to outstrip supply capacity in the near future. He says this could prompt further falls in the oil price. But there are also mitigating factors that affect the outlook for oil.

"A couple of contingencies need to be kept in mind with oil. The first is the ever-present risk of a major loss of supply capacity from the Middle East or Russia. The second is the OPEC cartel's role as a swing producer. These factors are likely to create a base for Brent Oil around $US90. But the geopolitical situation carries the risk of significant price spikes occurring out of the blue."

The Organisation of Petroleum Exporting Countries pursues a policy that encourages oil-producing countries to co-ordinate the price of oil, to stabilise prices in this market.

Bassanese agrees oil prices tend to spike at times due to tensions in the Middle East. Nevertheless, he says the outlook for oil is for prices to remain relatively subdued. "This is due to ample global capacity, rising US non-conventional supply and only moderate global economic growth."

As for coal, Dan Morgan, UBS commodities analyst, says high quality metallurgical coal appears to have a flattish price outlook until North American mine closures tighten the trade.

"Expect a lift in 2015 back to$ US130 to $US140 a tonne from supply rebalancing and modest demand growth."

He says the price for thermal coal has bottomed out at about $US60 a tonne. "We could see prices lift from October 1 from disruption to Indonesia's trade from government moves to enforce a new export licence regime. The November-December seasonal restock may also support prices. Expect spot prices to return to $US70 to $US75 a tonne in early 2015."

So how will the price movements in the various commodities affect the major Australian mining securities?

Bassanese says further declines in commodity prices – long expected by markets – are likely. Although, like Spooner, he says the recent declines have been quicker and deeper than anticipated: "That said, local producers remain among the most diversified and lowest cost producers in the world and should hold up well in the inevitable industry shake-out. Rising volumes and a renewed down-trend in the Australian dollar will also support profits. The current backdrop, however, is not one in which we should expect mining sector share prices to rise strongly; they are likely to continue trading within their current ranges."

Go beyond gloss to sound out IPOs

Raisings

Alexandra Cain

There is a slew of companies due to list on the Australian bourse before the year is out, across sectors including technology, biotechnology, healthcare and mining exploration.

While their prospectuses are replete with reasons explaining why they make good investment propositions, prospective shareholders need to make an independent assessment about the likelihood they will actually deliver on forecasts set out in their offer documents.

S.T. Wong, joint-chief investment officer of Australian equities manager Prime Value Asset Management says the assessment process for an initial public offering can be more qualitative than quantitative at the outset.

"The quality of management is important. As a professional fund manager, we get the opportunity to meet with and question management during the IPO process, which helps us form a view as to their quality and ability to execute on the stated business strategy. Naturally, there can be a strong judgment element in this assessment, particularly where we don't have previous knowledge of a management team or key individuals," he explains.

Wong pays particular attention to the past experience and track record of both management and the board. "This can involve various avenues of channel-checking to ensure we have a well-informed view of their capabilities. This will lead to insights to how the business has been run and help assess if the company's business plans post-IPO are credible and achievable."

Once you have developed a view on the business's management and its ability to deliver on promises outlined in the prospectus, the next step is to determine whether revenue and profit forecasts stack up.

David Poppenbeek, head of Australian equities, K2 Asset Management explains potential investors in IPOs need to think about their investment in terms of, "do I want to own this business?" and "am I paying a fair price?"

"Understanding the financial outlook of the business is important in determining the pricing of an IPO. Assess the outlook for revenue, profit and margins, as well as the price-to-earnings multiple on current and future earnings."

Poppenbeek says an important consideration is the structure of the industry in which the business operates. He suggests analysing the growth outlook for the sector, barriers to entry, potential competition, the regulatory environment and pricing power.

"There are always warning signs that need to be identified and those can often be found in understanding why an IPO is being undertaken. Are the existing shareholders selling or cashing out for sound or purely opportunistic reasons? Is the IPO raising equity for solid expansion plans that will deliver future growth? Understanding the vendors' motivation for selling can often highlight opportunities or raise suspicions and concerns."

The earning potential of the business is also something **Paul Sweeney**, a transactions partner with McGrathNicol says investors need to examine. "It's essential to understand the assumptions behind forecast earnings growth, and assess whether you believe that growth is realistic, based on the company's current performance and market conditions," he says.

Sweeney says an additional area of focus should be the level of expenditure and investment in the business, remembering that from the outside it can be difficult to distinguish between genuine cost reductions and a business that's starved of cash.

"The old adage that cash is king remains as important as ever. Understanding how earnings translate into cash flows allows you to understand how the company will fund debt repayments and dividends."

Delving deeper into the numbers, **David Lane**, director of Pitcher Partners Wealth Management says "it's important to consider a company's compound annual growth rate, EBIT margins, revenue growth rates and debt levels."

Another important consideration, says **Mark Draper**, a private client adviser with financial advice business GEM Capital, is whether you're investing for the long-term, or just to take advantage of a potential stag profit if values rise after listing.

"If your only interest is a short-term stag and you would not want to own the business long term, then I would suggest walking away. Questions to ask yourself to determine whether a business is an attractive long-term proposition include whether the business is a market leader and the amount of recurring earnings the business makes," says Draper.

"But my bottom line when it comes to IPOs and retail investors is buyer beware. Medibank Private could be an exception; typically businesses sold by governments have made attractive investments," he argues.

But there can also be advantages in buying shares in companies that are moving from being privately to publicly held. **Peter Horsfield**, founder of financial planning business SMART Advice, reminds investors that there's no stamp duty or brokerage fees to pay when buying shares through a prospectus. Buying into IPOs can also help investors to diversify their portfolio. In addition, investing in a company as an employee might mean you can buy the shares at a discount to the issue price, or use share options to increase your future salary.

> **Understanding the vendors' motivation for selling can often highlight opportunities or raise suspicions and concerns.**
> David Poppenbeek, K2 Asset Management

But he warns investors that if the IPO is for a well-know company, then the listing price is generally fully valued. So don't expect the value of your investment to immediately rise once the shares list. He also says it can be hard for retail investors to get access to an offer if only limited shares are available.

"Investors should also be aware that sometimes forecasts are inflated to attract shareholders. This can be hard to assess if there's limited historical financial information available about the business, which can increase investment risks."

Horsfields urges IPO investors to look for historical success. "If it's a well known business at least you have a better chance of understanding its performance before investing.

"The idea is to research the value of assets the business owns, and its current income and expenses, rather than focus too much on forecast income. If you can, visit their office and ask to interview directors and staff. And don't gamble what you cannot afford to lose."

SPEB 004