From our **Fund Manager's Desk**

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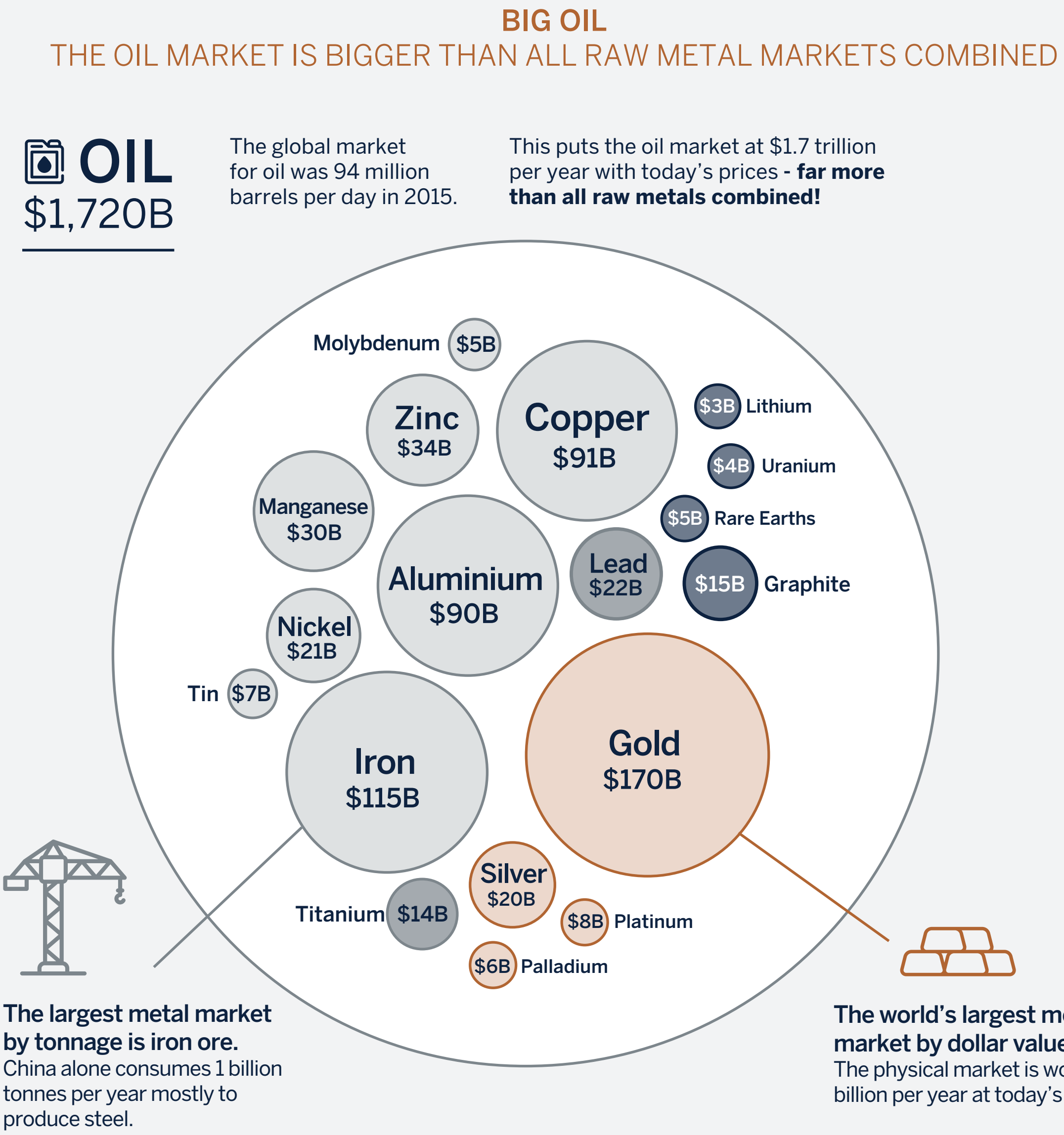
Anglo American & BHP

Our quarterly reports regularly explore the investment rationale of one of the companies we own in the Melville Douglas Equity funds and across client portfolios, to articulate what we find compelling. This time, we have chosen to discuss the significance of copper and its anticipated benefits for Anglo American and BHP.

Copper's critical moment: The strategic moves of Anglo American and BHP amid impending supply shortages

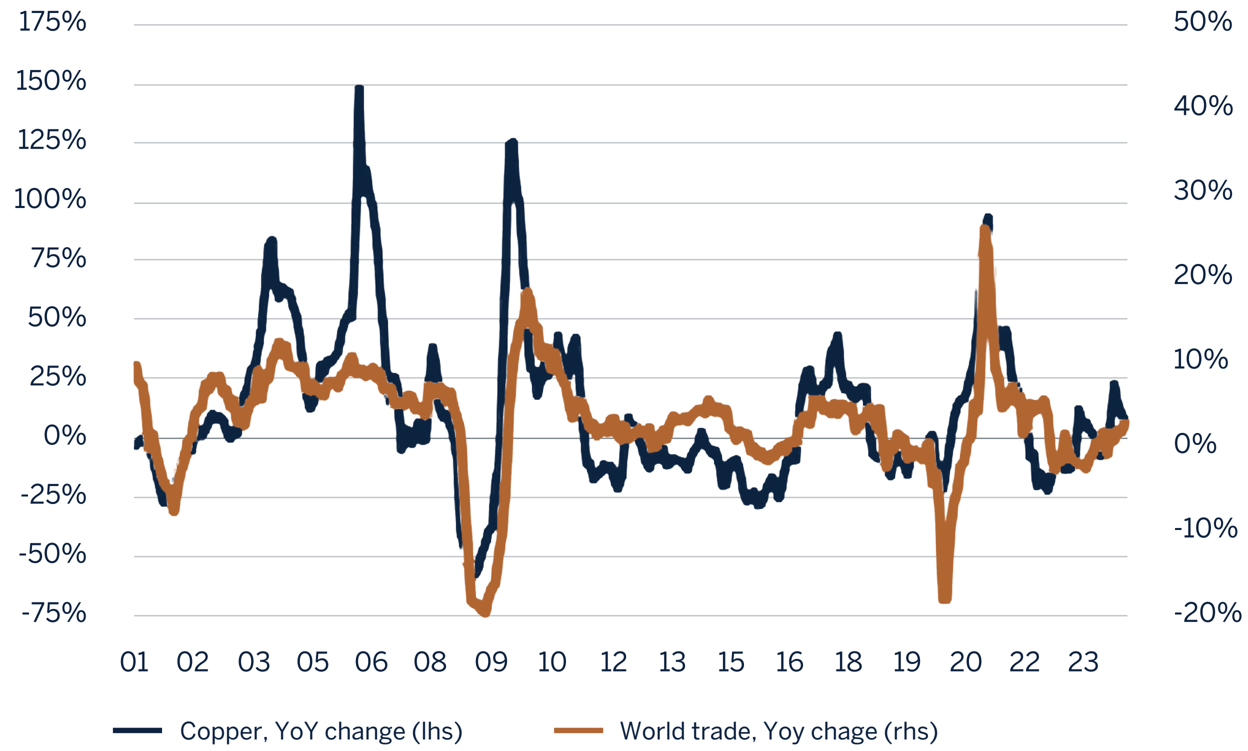
Will copper become the new oil?



Source: Infomine, EIA, World Gold Council, Johnson Matthey, Cameco, Benchmark Minerals

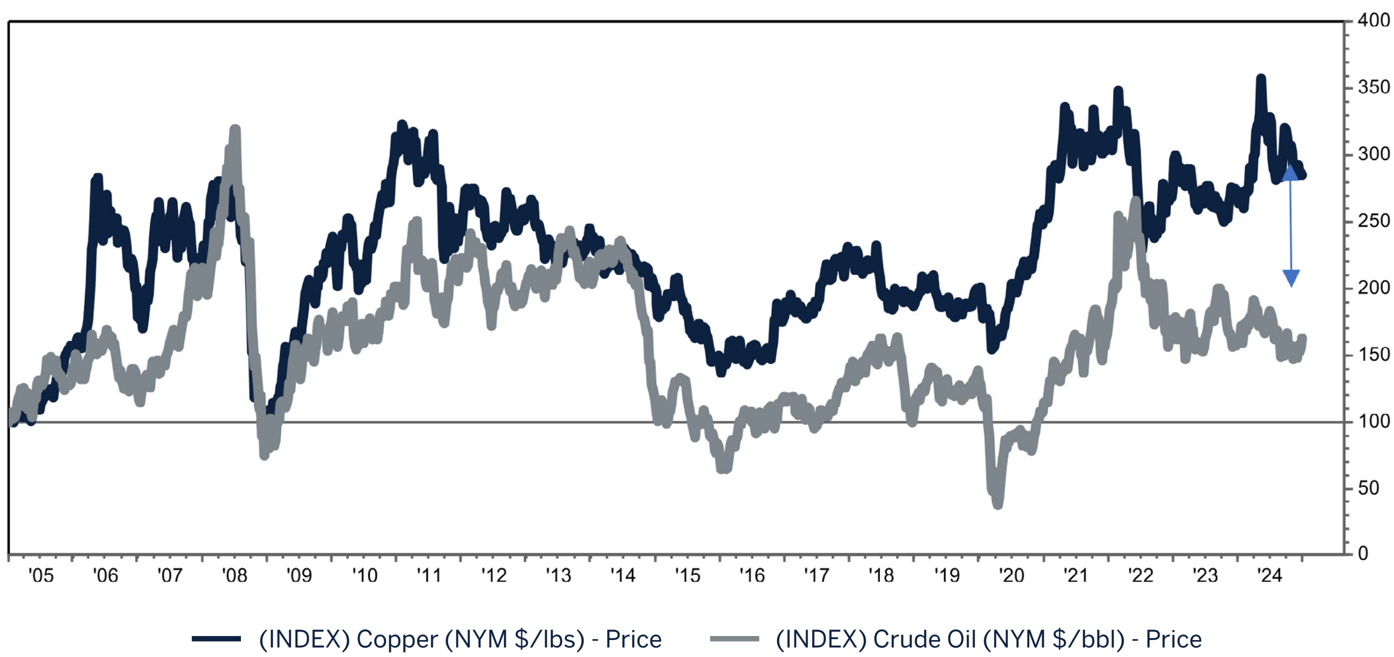
For decades, the oil market has surpassed the combined dollar value of all raw metal markets. Accounting for over three percent of the global economy, oil is not only a critical energy source but also integral to economic stability. Its applications span plastic production, chemicals, clothing, motor gasoline, distillate fuel oil, hydrocarbon gas liquids, jet fuel, and aviation gasoline. These activities generate billions in transactions worldwide, with many countries relying heavily on oil for national income. Consequently, oil has historically served as a reliable indicator of economic strength and weakness.

THE COPPER CONNECTION:
A BAROMETER FOR GLOBAL TRADE AND ECONOMIC HEALTH



Source: Bloomberg, BofA Global Research

Beyond oil, copper serves as a key indicator of economic health due to its vast application utility. Copper is essential in manufacturing cars, powering phones and computers, and in various electrical appliances for homes and industries. Its widespread use makes it integral to the global economy, with its price closely linked to overall economic performance and global trade flows.



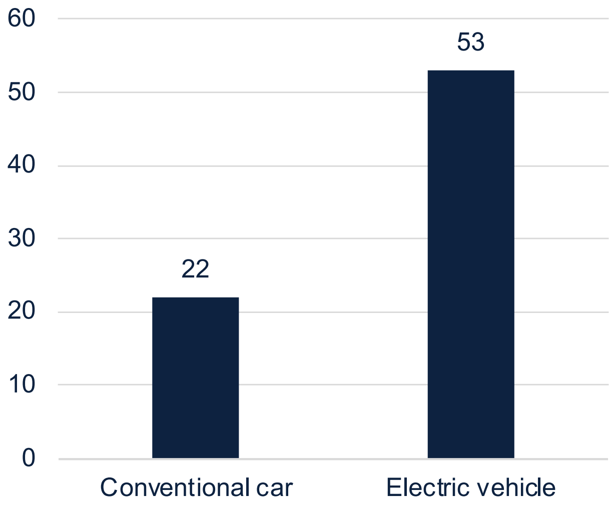
Source: FactSet

Both copper and oil prices are influenced by similar macroeconomic factors, hence over the last two decades they have tended to move in tandem. However, in recent years the market has witnessed a significant decoupling between the two commodities prices, primarily driven by increasing copper demand, supply constraints and escalating geopolitical tensions. This divergence suggests a strategic shift in investment focus, favouring copper over oil as the latter's demand is expected to peak in the coming decades. This is in juxtaposition to copper whose demand appears to be on an upward trajectory. As long-term investors, we find comfort in preferring copper over oil, as its robust prospects provide us with a margin of safety.

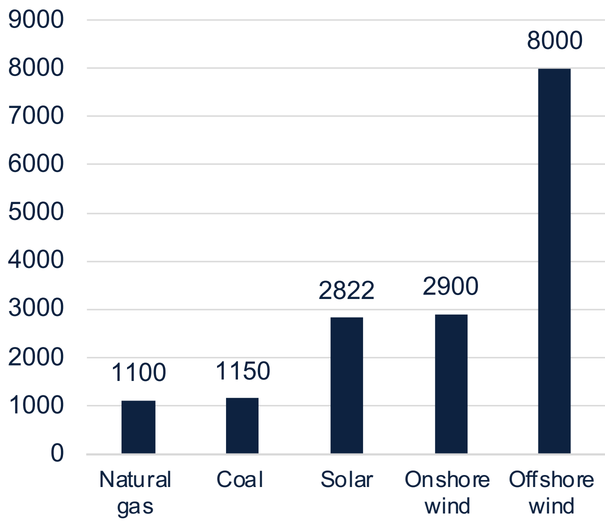
This raises an important question: What else has contributed to this significant dislocation? We believe it comes down to a few key factors:

01 / Copper is the cornerstone of the green evolution

KG OF COPPER USED PER VEHICLE



KG OF COPPER USED PER MEGAWATT (MW)



Source: International Energy Agency (IEA)

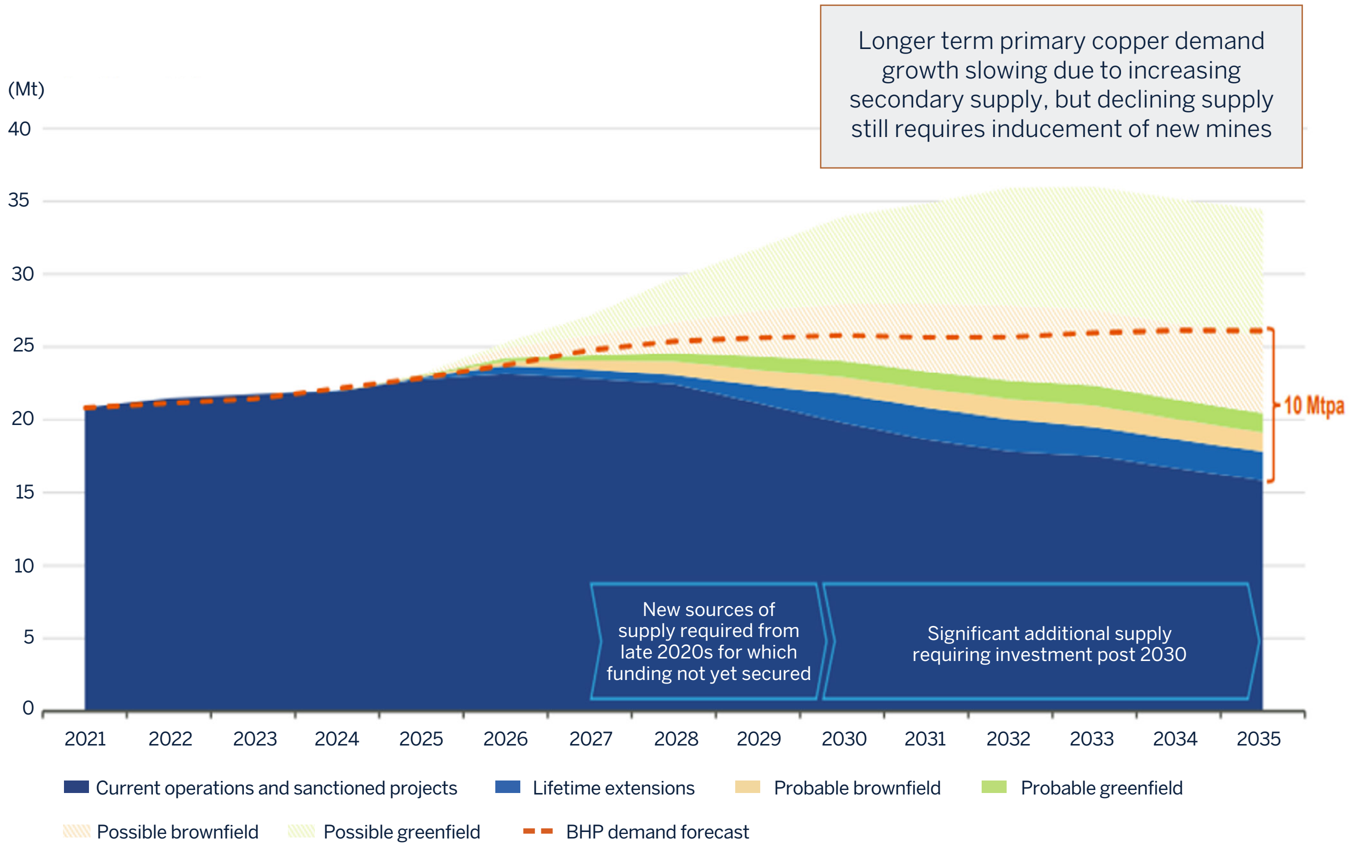
Copper plays a crucial role in the electrical grid, electric vehicles (EVs), and AI data centres. Beyond its integration in these sectors, copper is also vital in defence, transport, and construction. The EV market has seen substantial growth, driven by government subsidies and the decarbonization trend, particularly in China. A continuation of this trend is expected to reduce oil demand whilst increasing copper consumption in the world largest commodity consuming nation. Notably, EVs use more than double the amount of copper compared to internal combustion vehicles. As penetration rates increase overtime, higher copper demand may contribute towards elevated copper prices while suppressing oil demand and prices, further widening the performance gap between the two commodities.

The global economy is witnessing increased electrification in line with Conference of Parties (COP) goals and countries' net-zero ambitions, which is expected to significantly boost copper demand and widen the supply deficit. In contrast, we foresee no major near term demand catalyst for oil as China continues to show slower economic growth, requiring government intervention in the form of stimulus to stablise the economy.

At the United Nations COP28 climate summit in 2023, 118 governments pledged to triple global renewable energy capacity by 2030, aiming to reduce reliance on fossil fuels. This shift positions copper as a key transmission metal essential for decarbonizing manufacturing and infrastructure. The growth of renewable energy and EV adoption is projected to continue, positively impacting copper demand which the market projects to grow by approximately 70% through to 2050. In conjunction to this, copper demand will be supported by factors such as population growth, urbanization, industrialization and improving living standards.

02 / Copper output growth is muted, and the supply outlook looks bleak

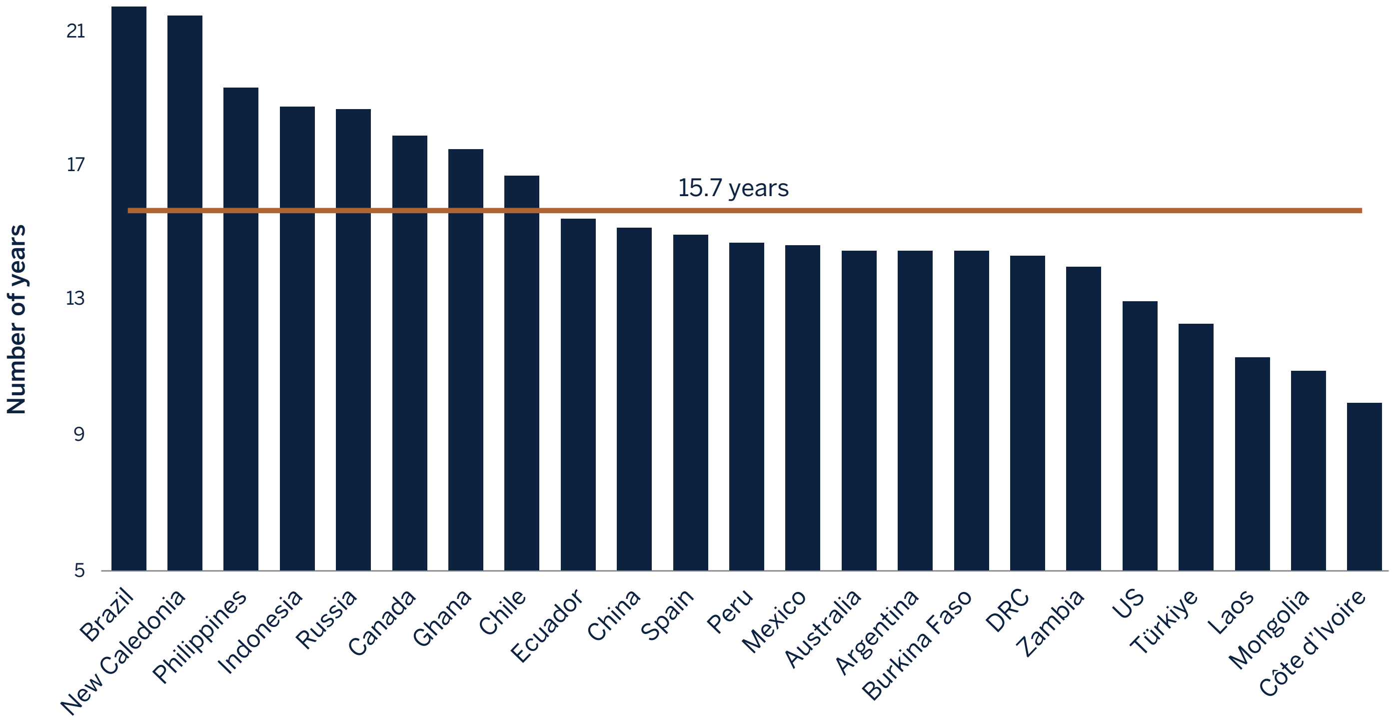
PRIMARY COPPER SUPPLY AND DEMAND



Source: BHP

The investment case for copper is compelling. Producers have underinvested in the capital expenditure needed to meet rising demand, which is expected to result in significant supply shortfalls in the coming years. Factors such as a lack of new discoveries, environmental concerns, resource nationalization, and geopolitical risks further constrain supply. We expect these bullish supply dynamics to drive copper prices higher amid this looming deficit as shown in the graph above.

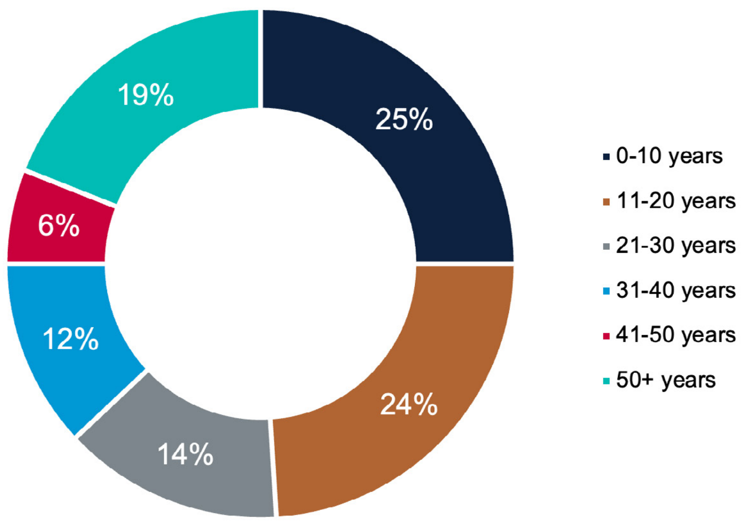
03 / The copper conundrum: Time required to build a mine



Source: S&P Global

The incoming supply constraints for miners present a trade-off between investing in high-risk greenfield projects or paying a premium for existing brownfield mines. With dwindling copper reserves and new mines taking close to two decades to develop, there is an urgent race to meet rising demand. This situation may lead to bidding wars for prime copper projects, driving prices higher over time.

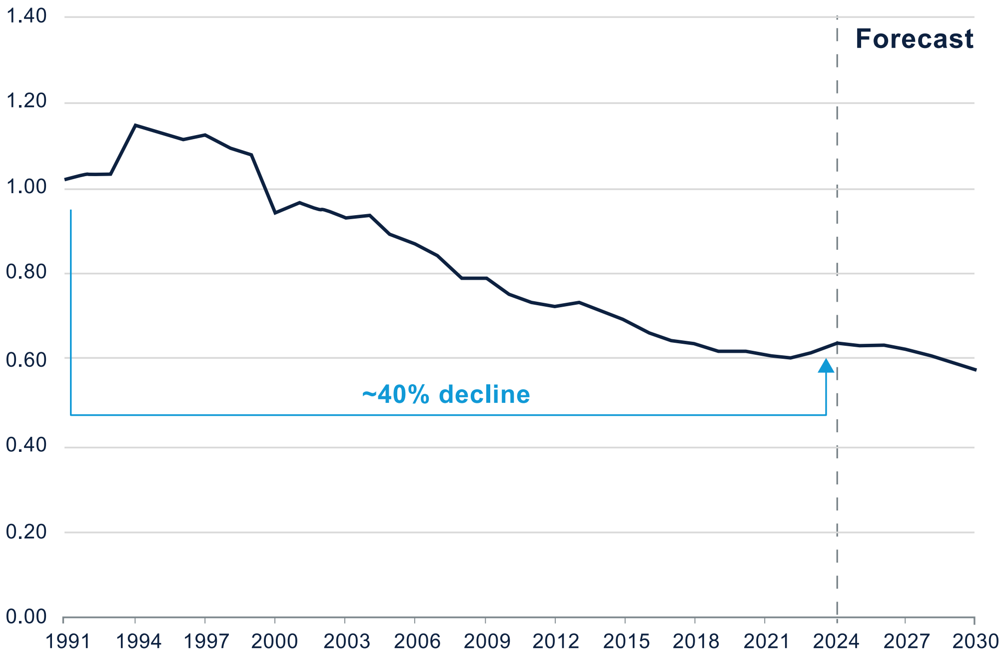
MORE THAN HALF OF MINES OPERATING ARE >20 YEARS OLD



Source: BHP

Over the past decade, major copper discoveries have proved to be scarce. Majority of the world's copper mines are old, facing reserve declines, geological challenges, and regulatory hurdles. As future supply remains constrained, the copper market is likely to enter a prolonged period of deficits further supporting our view of rising copper prices overtime.

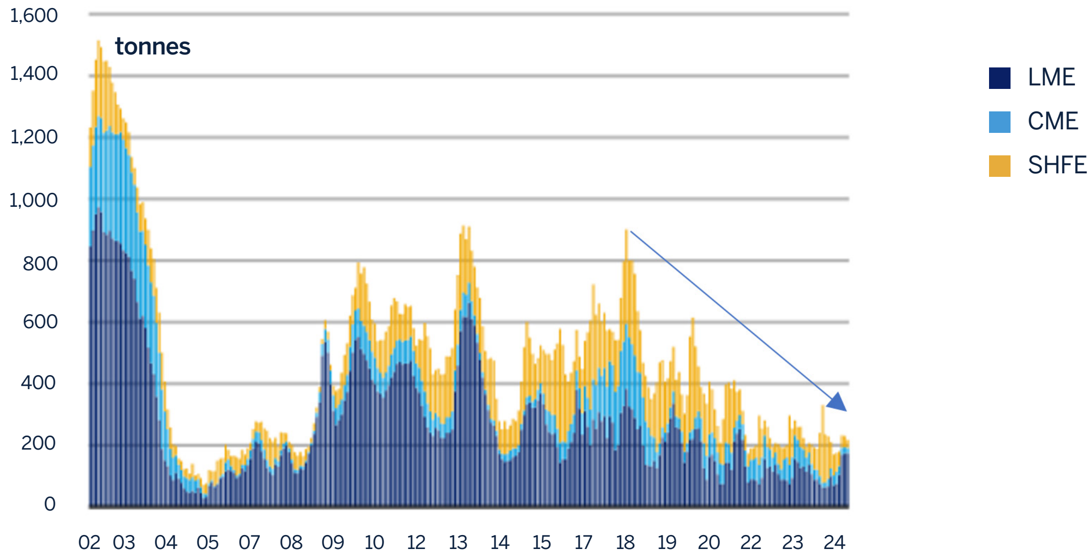
04 / Grade decline has been a consistent long-term trend



Source: BHP

The extraction of high-grade, near-surface copper deposits have largely been completed, making it increasingly difficult to find readily available copper projects, raising the costs for extraction. Subsequently, producers will require higher copper prices to offset the increasing cost of production, which reinforces our view that the supply dynamics will be supportive of copper prices going forward.

05 / Copper inventory levels are at multi-year lows



Source: Bloomberg, BofA Global Research

*Note LME – London Metals Exchange, CME – Chicago Metals Exchange and SHFE – Shanghai Futures Exchange.

Copper inventory levels have fallen significantly since 2018, as strong demand has resulted in the reduction of above ground stocks. Therefore, any material disruptions to primary mine supply may be a positive catalyst for copper prices, alongside these low inventory levels relative to history.

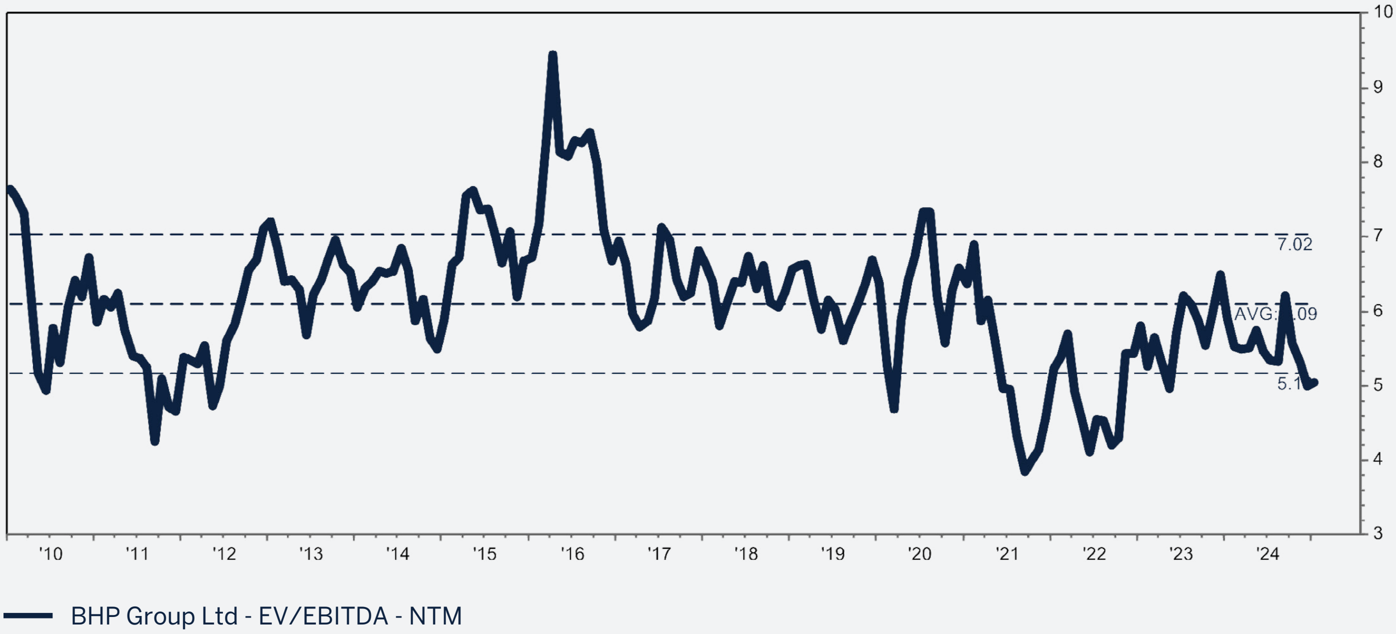
How are we playing the copper theme?

We currently own both BHP and Anglo American (AGL) in client portfolios.

Why BHP?

BHP has been transitioning away from fossil fuels and towards future-facing commodities like copper over the past few years. This shift has been driven by copper's growth prospects, reducing stranded asset risk, and striving to provide long-term value for shareholders. Concurrently, the concerns about the sustainability of oil demand in contrast to that of copper has propelled BHP's strategic pivot.

BHP's outlook for copper is evident in its multiple attempts to acquire AGL, aimed at enhancing its market leadership and positioning in the green metals. BHP viewed AGL's portfolio of South American copper assets as highly desirable, allowing the potential for significant synergies with its existing operations. In our view, BHP's interest in AGL's portfolio marks the beginning of a decade-long trend where miners will compete for high quality tier one copper projects. Regardless of the potential outcome with AGL, we expect BHP to remain acquisitive as it seeks to expand its copper portfolio, as was reflected by the recent bolt on acquisition of Filo Corp.



Source: FactSet

Besides BHP's solid copper strategy, the company also looks attractive from a valuation perspective as it is currently trading one standard deviation below its 15-year EV/EBITDA average multiple. These are undemanding levels relative to its history which provide investors with a significant margin of safety.

The balance sheet is in a healthy position with a net debt/EBITDA of 0.28x, which gives the Group optionality to pursue its copper growth strategy. BHP's competitive cost positioning, driven by its efficient operations, enables the company to maintain strong cash flows. This financial stability supports BHP's ability to pay dividends, which we expect to yield around 5% over the next few years.

Why AGL?

AGL is undergoing a business restructuring, which upon completion will focus on high grade copper and iron ore. The company's organic growth optionality for copper is unique amongst global diversified miners and the simplification of their business will provide investors with greater exposure to the metal.

Post the restructuring, "AGL 2.0" will be focused on optimizing assets, reducing costs, and increasing their copper production as we approach 2030, which if executed effectively, should provide value for shareholders. Managements increased focus on copper will create a more superior commodity mix which we expect to result in greater profitability through the cycle.

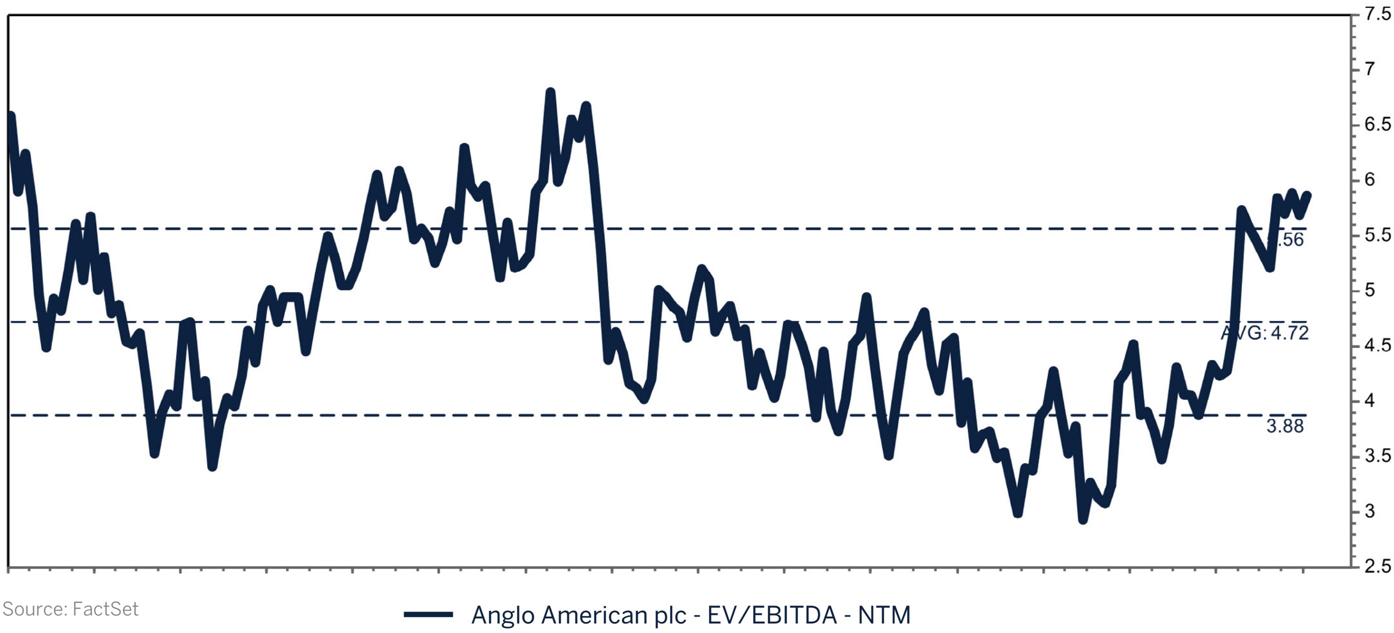
AGL'S COPPER GROWTH OPTIONALITY

+300KTPA
QUELLAVECO GREENFIELD[2]

+150KTPA
COLLAHUASI BROWNFIELD[1]

+100KTPA
SAKATTI GREENFIELD[1]

Source: Anglo American



Source: FactSet

AGL has re-rated from a valuation perspective due to successful restructuring efforts thus far. The stock is currently trading one standard deviation above its 15-year EV/EBITDA average multiple. Despite the share's current valuation, we believe the stock can still re-rate further as copper becomes a meaningful proportion of the portfolio.

AGL's balance sheet is in a solid financial standing with a net debt/EBITDA of 1.27x. The company's restructuring efforts have streamlined its operations and enhanced its focus on a superior commodity mix. This strategic shift is expected to boost profitability and cash flow, thereby supporting the Group's ability to continue generating attractive returns for shareholders.

Conclusion

The demand outlook for copper remains strong, driven by the ongoing energy transition, particularly in China. This, combined with supply challenges, suggests a higher long-term copper price which we expect to benefit producers like BHP and AGL. Meanwhile, reshoring and protectionism efforts in both the U.S. and China, are expected to diversify and de-risk supply chains, further supporting copper demand. However, near-term price fluctuations will be influenced by Chinese stimulus measures, trade disputes, and global economic growth. Over the coming decades, oil consumption is projected to peak which is in stark contrast to copper, a commodity with a pipeline of growth levers.

As long-term investors, we gravitate towards commodities with robust fundamentals and quality companies with attractive valuations. With BHP and AGL both increasing their focus on copper, we believe that they are well positioned to capitalize from the positive copper market dynamics. We are therefore comfortable owning both shares across clients' portfolios.

It's Personal.

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