International Equity Spotlight

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Fundamentals of Iron Ore Remain Robust

Over the last few years, there has been much debate over the future growth rate of China, when it will shift from an investment led to consumption led economy and how that will impact its demand for natural resources. As consensus opinion has oscillated between optimistic and cautious on growth in China, the periods of negative sentiment have weighed on natural resources, and in particular on the equities of iron ore producers. However, while sentiment can be fickle and disproportionately impacted by media headlines, the fundamentals of the iron ore industry have remained robust. Due to the strength of the demand for seaborne iron ore, coupled with the positioning of WHV International Equity strategy's iron ore miners, BHP Billiton, Rio Tinto and Vale, we believe that our iron ore investments will produce attractive returns over our three to five year investment time horizon.

Iron Ore Pricing Range Bound in 2013

If the face of dramatic headlines suggesting that China's growth spurt is over, one might expect the price of iron ore to collapse. Instead, for most of 2013, the price has been relatively range-bound between $120 and $140 per ton. In what has been a challenging year for the commodity complex, iron ore is one of the few natural resources which has remained above its marginal cost of production. This is because, contrary to perception, demand for seaborne iron ore has remained strong while a shifting supply picture has reinforced price strength.

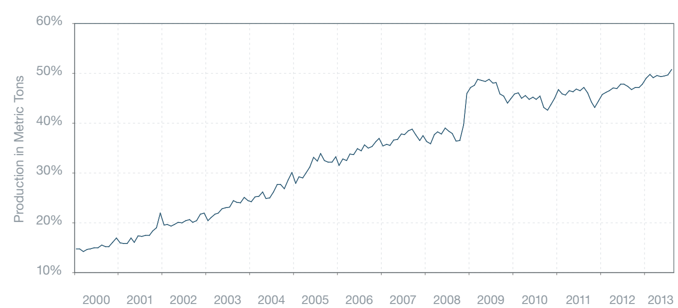
Iron Ore Spot Prices 2009-2013

Source: The Steel Index Ltd.

Iron Ore Demand Tied to Global Steel Market

Demand for iron ore is driven by steel demand. Therefore in order to understand the iron ore market, one must first consider the global steel market. Global steel production is approximately 1.55 billion tons per year. China alone currently accounts for nearly half of this production, which is particularly impressive given that China accounted for only 15% of global steel production in 2000. In the intervening 12 years, Chinese steel production has grown at a steady clip, accounting for nearly all of the growth in steel production globally. This production growth has been fueled by steel demand for everything from railways to new apartment buildings as the country has industrialized and urbanized. This process continues apace.

China's Steel Production as a Percent of World Steel Production



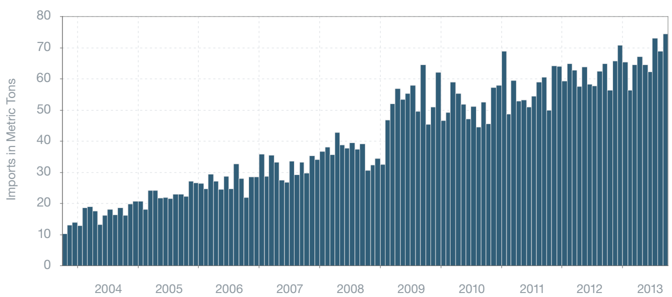
Source: World Steel Association

Even as headlines conjure fears of a China hard landing, the reality on the ground suggests a robust economy. Indicators of steel demand such as industrial production and fixed asset investment—which encompasses real estate, manufacturing and infrastructure investment—are strong. As a result, Chinese steel production has defied the expectations of China bears and has continued to grow into record territory in 2013.

China Drives Demand for Iron Ore and Steel

At current rates of steel production, China needs about 1 billion tons of iron ore each year to keep its steel production machine moving. China can supply enough iron ore to meet about one third of its needs. The country has large reserves of iron ore; however, the quality of its ore is low and it is expensive to mine. China's domestic supply is some of the highest cost iron ore in the world. As the marginal ton, Chinese iron ore essentially sets a floor for the price of iron ore because prices theoretically cannot fall below the cost of the marginal production for sustained periods without rational production being shut in, driving supply down and, ultimately, prices up in order to incentivize the return of the closed production.

China's Iron Ore Imports (Millions of Metric Tons)



Source: China Customs

"Big Three" Dominate Global Iron Ore Market

For the majority of its iron ore needs, China turns to the globally traded seaborne iron ore market. China's demand for this high quality product has been strong as steel production grows and domestic ore grades continue to fall. The global seaborne iron ore market is dominated by BHP Billiton, Rio Tinto and Vale, core holdings in the WHV International Equity strategy. Their product comes primarily from Australia and Brazil, countries which are home to some of the largest high quality iron ore reserves in the world. Together these companies supply over two thirds of the seaborne market. Because of their scale and low cost, high quality reserves, the big three producers of iron ore sit at the very bottom of the global iron ore cost curve with all in costs ranging from $50-$70 per ton. At 2013 prices, the big three miners make significant margins. Even if prices were to fall to the marginal cost of production, estimated to be $100-$120 per ton, the big three miners would still reap significant profits. At the same time, recent prices have been too low to incentivize the planning of new production because of the massive multi-billion dollar investments necessary to develop new iron ore resources.

While it has been difficult for new entrants to obtain funding for new iron ore projects, BHP, Rio Tinto and Vale are each on the cusp of bringing significant new supply online. Some fear that this new supply will result in a glut of iron ore, but we do not expect this to be the case. The new supply will not be enough to displace Chinese production, so the price floor will remain high even as China imports an increasing percentage of iron ore to meet growing demand. This new supply, however, may keep a ceiling on iron ore prices. Thus the big three's production increases will be critical as they will allow BHP, Rio Tinto and Vale to grow profits even in a tempered price environment.

Although the big three miners are spending significant capital to bring their new production online, these projects are occurring under the stewardship of management teams which are tasked with reigning in capital spending and ensuring that all capital spent goes to projects with maximum projected returns. This stands in stark contrast to the attitude of previous management teams who, in headier days early in the last decade, had mandates to grow production with less of an emphasis on cost control. Today's management teams must focus not only on growth, but also on returning cash to shareholders, whether through stock buybacks or dividends. We believe this combined emphasis on reasonably priced growth and shareholder returns gives us further comfort in our iron ore holdings.

Conclusion

Conventional wisdom says one should invest in what China buys and avoid anything that China can produce on its own. Iron ore, one of the favored natural resources in the WHV International Equity strategy, provides an illustration of why this has worked. To fuel its continued growth, China has a seemingly insatiable demand for the high quality product of the big three iron ore miners. The companies, BHP Billiton, Rio Tinto and Vale, are focused on meeting this demand while growing profits through a combination of declining costs and increasing volumes. Both the demand and supply trends may be subject to interruptions. However, we believe that the stage is set for compelling long term returns on the WHV International Equity iron ore investments.