Perpetua INVESTMENT MANAGERS

COMMODITIES – NOW WHAT?

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2016 finally marked the turning point for many commodities (and the companies that produce them). After multi-year price declines based on overcapacity on the supply side and/or a reduction in demand expectations, many commodities launched a spectacular recovery in 2016, with Iron Ore up 86%, Thermal Coal up 68% and Brent Crude up 46% year to date.

Not all industrial metals have reacted in the same way with Copper up 18% year to date and the precious metals (Gold and Platinum) up 5% and 2% respectively.

Looking back over the last 3 years, only thermal coal and Chinese steel (HRC) are near their starting prices, so what has happened and what can we expect from here?

Figure 1: 3 year commodity prices

Source: Inet

The first question to ask is what drove the significant declines in certain commodities and their subsequent recoveries.

- The second question is what this means for the future prices of those commodities.
- Finally we need to ask what this could mean for the prices of the commodity companies that produce those commodities relative to expectations about the pricing of those commodities.

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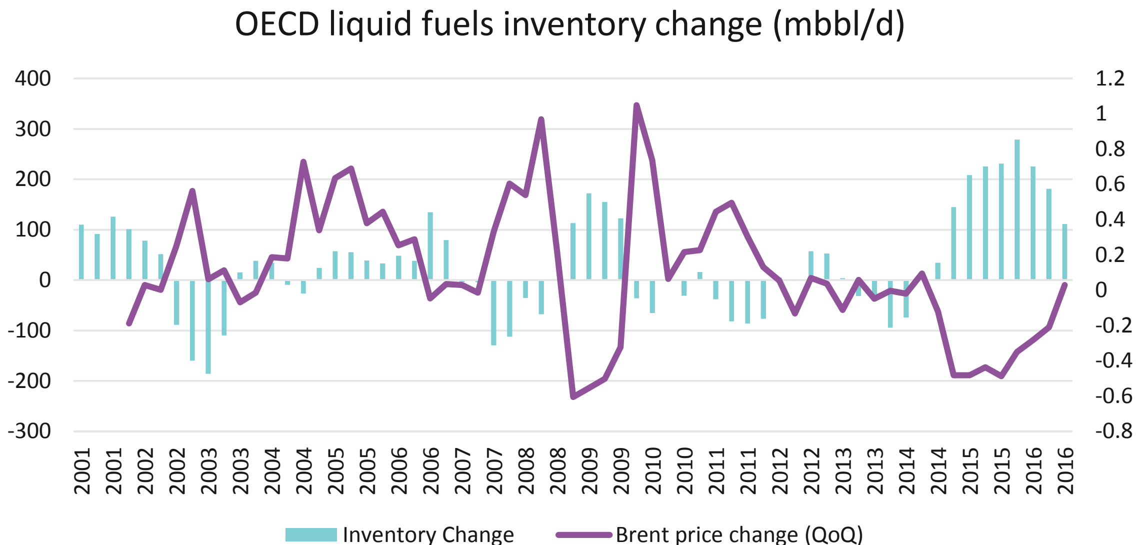
INVESTMENT COMMENTARY (continued)

What drove the significant declines in oil and its subsequent recovery?

Figure 2: OECD Liquid fuels inventory change



Source: IEA and Inet

Using crude oil as an example, the world had become used to prices of around $100 per barrel and expected them to persist for at least a couple of years (as per the forward curve at the time). Supply and demand were fairly well balanced, with only minor changes in inventories. Then the US started to aggressively ramp up Shale Oil production, Organization of the Petroleum Exporting Countries (OPEC) failed to come to the rescue and cut production to balance the market and inventory levels started to rise as production outpaced demand. This resulted in both the spot and forward prices of oil falling, and Brent crude bottomed at under $30/bbl in January 2016.

Since then the market has been moving closer towards a balanced supply/demand state, with major market sources (IEA, EIA and OPEC) expecting the market to be in balance by mid-2017. As such the oil price has recovered to levels of around $55 at the time of writing this report. This is a long way from the $100 where it came from but yet up significantly from the bottom.

So what does this mean for the future price of oil?

There are many things we do not know when it comes to predicting the future prices of commodities but there are a few useful data points that help us form a view of the distribution of possible outcomes.

- We would expect the long-term pricing for a commodity to reflect the marginal cost of production if the market is in balance.
- We know US shale has introduced a significant new supply that is profitable (at least for a while) in the $50-$60 range and currently this is probably the marginal producer of oil.
- We know that oil has significant decline rates (around 5% per annum) and shale has particularly fast decline rates (20+% per annum) meaning new supply would need to be brought online relatively quickly to replace existing supply and this would need to be at similar costs to keep the cost curve static.
- We know producers typically focus on the “sweet spots” when times are tough, leaving the higher cost areas for better times.
- We do not currently know of any major oil finds or technologies that would displace large portions of the current cost curve resulting in a significantly lower marginal cost of production.
- We do not expect any major changes in the demand growth for oil in the next few years, although acknowledge the long-term threat of electric vehicles, driverless cars and car pooling in the future.
- This information makes us comfortable with current prices, with the balance of probability being that prices are high in the medium term, rather than lower.

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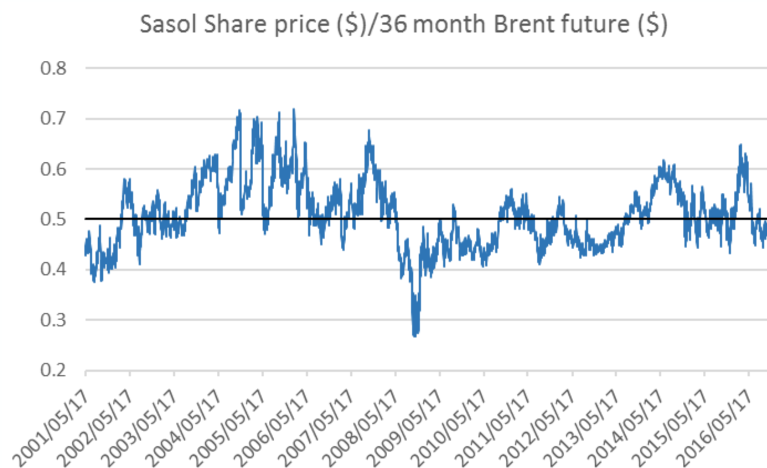
INVESTMENT COMMENTARY (continued)

What does this mean for Sasol relative to what is priced in?

Single commodity companies typically exhibit strong correlations to the price of the underlying commodity they produce. This is primarily due to the fact that the price of the underlying commodity is what drives the earnings and cash flows of that company. The share price or market value of that company is at best an approximation of the discounted future cash flows of that company and at worst a multiple of the next years estimated earnings.

Figure 3: Sasol share price relative to 36 month Brent future in US Dollars



Source: Bloomberg

Bearing this in mind one can look at the relationship between the share price and the price of the underlying commodity and get an idea whether the market is pricing the company directly off the current price of the commodity or if it is expressing a strong view about the future direction of either the commodity price or the company fundamentals. As we currently stand, the relationship is very close to its long-term median and as such one can conclude the market is pricing Sasol off the current oil price outlook.

At Perpetua we focus on detailed bottom-up, company specific research and as such an analysis like the one presented above does not form the basis of our investment decisions. It does however help us understand the landscape in which companies are operating.

We currently hold Sasol in our clients' portfolios and have added to this positon during 2016.

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