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EXPLORATION and MINING in SOUTH AMERICA

THE BIG DISCONNECT

Mining record profits vs stock market performance

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The uncertainty disconnect in mining – a long-term view

by Sandy Chim, CEO, Century Iron Mines Inc.

As the global economy has been buffeted by unexpected and unprecedented events – the international financial crisis and the European debt crisis – it has become a truism to say that the only certainty in the global economy is uncertainty.

However, in the mining sector, this sentiment of uncertainty is misleading. PwC reports that the top 40 mining companies posted record profits of $133 billion in 2011, up 21% over the previous year. And yet, these companies, a good proxy for the sector worldwide, faced a 25% drop in market capitalization while achieving record profits. Why this disconnect between economic performance in such an uncertain global economy and investor confidence?

In the past, the mining sector has tracked global economic trends, with commodity markets and prices falling when the global economy was down. However, over the last few years, governments of major countries have injected hundreds of billions of dollars into stimulus programs. This has uncoupled the mining sector's performance from the current economic volatility.

After the great recession of 2008, these massive government programs caused a relatively sharp rebound in the price of base metals such as iron, copper, lead and zinc. In fact, iron and copper prices actually peaked after the international financial crisis. These base metals are the commodities that China buys, largely from global markets.

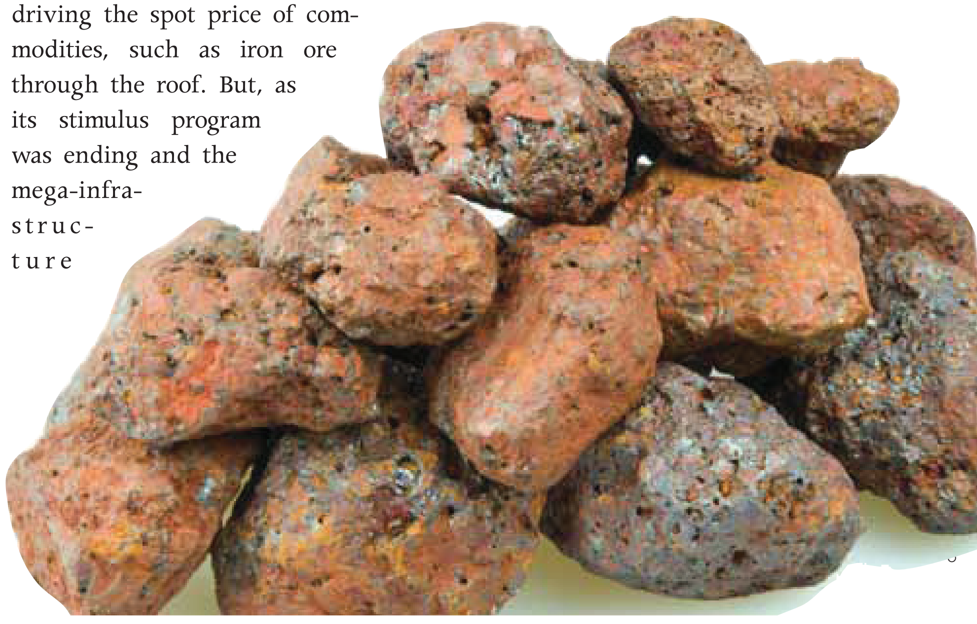
The spot price of iron ore, for example, is heavily influenced by China's growing dependence on imported seaborne iron; its giant economy is currently absorbing 70% of the entire global seaborne supply, as China produces 46% of total global steel. To be sure, given the crucial role of steel in the creation of infrastructure, the impact of China's stimulus programs on iron is much greater than on other metals. Furthermore, China's current Five-Year Plan targets 50% of imports to come from Chinese-owned mines elsewhere in the world.

It is quite clear that China is the primary factor that sustained and advanced the mineral commodity market over these crisis years. PwC analyzed the revenue and EBIT mix of the top five diversified mining companies comparing the pre-crisis year, 2007, with 2011. The firm found that the outstanding performance of the base metals commodity market, to date, explains the record profits of the top 40 mining companies. Iron and copper alone contributed more than 80% of EBIT and close to 60% of revenue. China's contribution to these profits is substantial and ongoing. Do we want to put a number on this?

At the outset of the international financial crisis, China introduced a $600-billion stimulus program of massive infrastructure building. The program not only rekindled the growth momentum of the Chinese economy, it sustained the global mining sector and created new demand, driving the spot price of commodities, such as iron ore through the roof. But, as its stimulus program was ending and the mega-infrastructure projects were being completed, China inevitably lost speed and momentum. Without support from an export market recovery, Chinese growth slowed. Now, here we are, back to volatility in the financial and commodity markets, on a crisis scale.

This has triggered fear in markets across the board, driving trends in real time and breeding more uncertainty—a self-fulfilling prophecy. Whether or not institutions see the real cause of the uncertainty, they are captive to this dynamic. If they resist, the market will punish them. When the market wants to see buybacks or dividends, institutions have to respond, or face a flood of redemptions and selling that could take them down.

This is why the total market capitalization of the same top 40 mining companies actually came down by 25%, despite their record profits. And the gap between profit and market capitalization is widening, reflecting market sentiment and fear. Tom Albanese, CEO of Rio Tinto, recently captured this imperfection of the global financial system: "Each of you in this room wants more money back. You want



buybacks, you want dividends, and you want special dividends. You don't want us spending as much money. We recognize that…But what that means…(is) there is going to be less supply coming in."

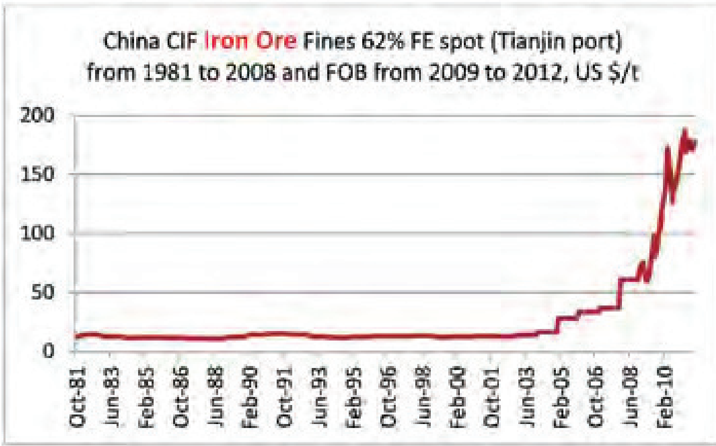
Short-term volatility, driven by market sentiment and fear, does more damage than the underlying economic trends. The demand for money back, instead of letting successful mining companies invest as they see fit, distorts long-term capital allocation. To compound the problem, mining companies are freezing capital expenditures around the world. This substantial scaling back of capital expenditure, driven by the fear of uncertainty, will certainly create a huge slowdown in future supply—again, a self-fulfilling prophecy.

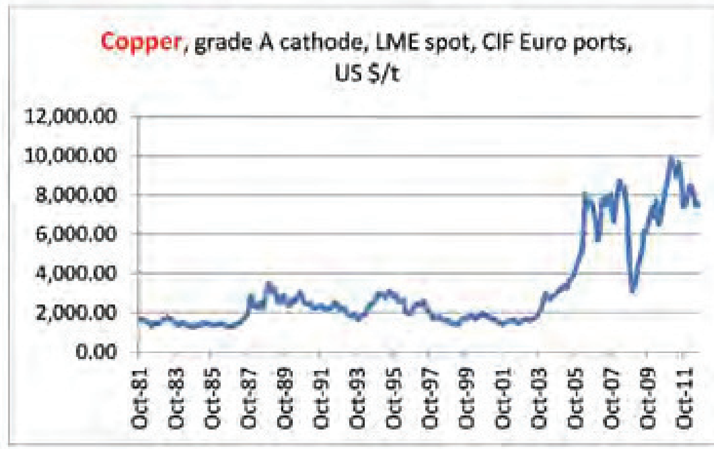
In this kind of market, what the investment community wants is no longer based on rational or desirable capital allocation. Unfortunately, this means that short-term market sentiment is replacing the thoughtful consideration of long-term benefits and the long-term success of companies.

When we look beyond the market volatility and apparent uncertainty at the underlying fundamentals, we can see that China, the world's growth engine, is actually running in fourth gear, on a very stable path. China's 10-14% growth over the last decade made it the world's number two economy. Its slower pace of growth, which the consensus projects at 6-8%, is still very significant and outstanding growth, by any measure. The world has never seen an expanding \$6-trillion economy, and even a reduced rate of growth to 7.5% in 2012 represents huge absolute numbers of increased demand in the still-developing Chinese economy.

The relevant question now is whether the driving engine of the global economy

30-Year Base Metal Price Trend





can sustain growth at the market consensus of 6-8%. To answer this, we have to look at what propelled China from the back of the pack to become the second-largest economy in the world.

When we evaluate a country's development and potential, we often look at it in silos to form an opinion: its business environment, its political system and its demographical characteristics, for example. It is also useful to integrate this evaluation, and look at China's overall experience, its combined strengths and weaknesses to see if its growth can continue. Despite China's problems and imperfections, there can be little dispute that it has done an amazing job of developing a country of its size and scale in such a short time.

The past performance of China's economic development is a fair indication of its ability to manage itself well. Setting aside political considerations, it is fair to say that China has selected competent top managers and leaders over the last three decades and four generations, compared to other successful advanced economies. Leaders with a decade-long tenure are able to provide stable management, policy-making and implementation, all of which are key to the long-term development of any country or organization.

To bolster China's underlying growth story, India is coming on stream rapidly, and many other developing countries are also following in similar progression. While half the world (traditional industrialized countries) is slowing down, dipping into slightly negative growth (-0.49%) in 2012, India is producing 5.71% more steel and is rapidly expanding a robustly growing middle class. Over the next 10 years, developing countries outside of China will contribute one-third of global growth, more than half of China's growth over the same period. And even though its growth is slowing, China will still contribute 58% of growth in absolute tonnage. The rest of the world will return to modest growth, leaving China, India and the developing countries in the driver's seat.

With long-term certainty about the growth engine of the world, we can be more certain about the long-term development of the global economy. The short-term restraint on capital allocation currently restricting the development of new mines will result in a global supply shortage when the world economy recovers. Therefore, the mining sector and those with a long-term view of the supply-demand dynamic will benefit over time. ■