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Best Ideas 2021 Preview: Commodity Company With Attractive Model

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With central banks printing unprecedented amounts of money, rapidly increasing global debts and fiscal deficits and strong pent-up consumer demand, many investors are looking for ways to hedge their portfolio against inflation. While gold is the widest known hedge against inflation (or more precise negative and decreasing real interest rates), some commodity companies appear suitable as well.

In addition, many commodity companies trade at historically low valuations and generate decent free cash flows at current commodity prices. After the last commodity price and cycle peak in 2011, many companies slashed exploration spending and CAPEX for the rest of the decade, with COVID-19 further delaying CAPEX decisions. As a consequence, it will take years for any significant supply increase even if commodity prices go up a lot due to infrastructure spending, fiscal and monetary policies.

Anglo Pacific Group is a commodity royalty company: They help finance e.g., a copper mine, and in return receive a royalty (e.g., 2.5%) on the revenue of the mine as long as the mine produces copper. Any increase in production or extension of mine life due to exploration success in the mine area is a free option. There are very few publicly listed royalty companies outside precious metals and oil & gas, and competition from banks for mine financing is decreasing due to ESG mandates excluding companies with a high CO2 footprint like miners.

Several banks in Switzerland – a major commodity trading and financing hub – have recently announced that they will reduce or close their commodity financing business. Raising equity is also difficult for miners as many large ETF providers have ESG mandates effectively excluding miners. This reduction in competition enables APF to achieve better financial terms in future royalty deals. Since 2014 the average annual yield on royalty deals was at least 10% while remaining mine life was typically 15-25 years.

The most important commodities for the company are iron ore, coking coal, copper, nickel, thermal coal, and uranium. Coking coal royalties contributed 62% to revenue in H1 2020. Within 4-6 years the operator of the coking coal mine will move outside the area APF has a royalty on, so the revenue from coking coal royalties will go to zero by then. (Revenues will return several years later when the operator is again moving into the royalty area.) However, in addition to eight producing royalties the company has a portfolio of seven royalties in the pipeline (e.g., mines currently in development) and management is optimistic that it can replace lost revenue from coking coal.

Most commodity prices reached a low point in spring-summer 2020. Copper, iron ore, nickel and uranium prices are currently significantly above the level of January 1, 2020 while the picture is less clear for Australian export prices for coal due to a Chinese ban on Australian coal imports since November 2020. This ban has led to reduced export volumes and lower

prices as Australian miners scrambled to find customers in other countries.

By mid-December there were reports about surging thermal coal prices and some electricity rationing in China as non-Australian suppliers struggle to fill the gap short-term. Coking coal prices in China also increased significantly although there are no reports on shortages yet. If the ban stays in place during 2021 the most likely outcome is a re-arranging of the global seaborne coal supply chain where Australian miners ship to non-Chinese customers while others reroute their shipments to China. The adjustment might take several months but it is unlikely that Australian miners will suffer a long-term negative impact as total global demand for coal does not change due to the ban.

If commodity prices average levels of 2019 in 2021 the company trades at a free cash flow yield above 20% or an EV/EBIT below 6x. From a sum of the parts perspective, the company owns stakes in two listed companies which are worth almost 40% of enterprise value. Therefore, the company appears undervalued even without further significant commodity price increases.

The company is facing the following *major risks*:

- A prolonged double dip recession could depress commodity prices for years if demand drops more than supply.
- APF might not be able to completely replace the royalty revenue from coking coal until the mining activity moves out of its royalty area in 4-6 years.
- The thermal coal royalty (8% of revenue in H1 2020) could be impaired long-term due to climate change policies and a remaining mine life of more than 20 years.
- Institutional investors might sell the stock due to ESG mandates and depress the share price.

The main *reasons to go long* with APF are the following:

- The company is a very good inflation hedge due to upside exposure to commodity prices while having almost no input cost inflation. (In 2019 the company had revenue of more than 50 Mio. GBP with just 11 employees and an EBIT margin of 80%.)
- There is almost no bankruptcy risk as APF is free cash flow positive even at low commodity prices.
- The business model is becoming more attractive as financing options for miners are increasingly constrained due to ESG. Less competition from banks and institutional investors leads to better royalty terms for APF.
- The CEO has a good capital allocation track record since joining the company in 2013. Previously, he co-founded a UK-based value fund and advised on investments for 12 years.
- The CEO owns 2.6% of the company – bought, not received via stock options. CEO and board members have acquired shares during 2020 in the open market.