Leith Wheeler
INVESTMENT COUNSEL LTD.

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INVESTMENT OUTLOOK

MATERIAL VALUES

It is a common belief amongst value investors that the basic materials sector* is "uninvestable". Commodity price volatility, high upfront capital intensity and the lengthy mining life cycle are commonly used to justify under-investment or absence from the sector entirely. The above criticisms don't come without a degree of justification, but not all opportunities are created equal. We would like to provide a framework and explain how Leith Wheeler applies its bottom-up value approach to select what we believe are best-in-class investment opportunities in the materials space.

"...own quality businesses that are trading at prices that understate their future prospects."

Value Approach

Amidst the 2008/09 global recession, in this same letter to investors, Bill Wheeler judiciously reaffirmed Leith Wheeler's investment approach - "to build diversified portfolios comprised of strong companies that can weather economic storms, that are acquired at sensible prices and that give our clients exposure to long term economic growth." Our process requires us to be different from the market and own quality businesses that are trading at prices which understate their future prospects. Certain companies and entire industries can fall out of favour with investors in times of turmoil. It is times like this which can create significant opportunities – where we can buy businesses at a substantial discount to their intrinsic value.

Valuing Materials Companies

Commodity prices are core drivers to the valuation process of materials companies. While we are not in the business of speculating on the spot price movement of commodities, we do take a view on their long-term direction. A fundamental view of the underlying supply/demand characteristics of each particular commodity is critical. Through this understanding, we can interpret what the market is pricing/mispricing, estimate when prices can revert to the long-term cost of production and if there are structural changes

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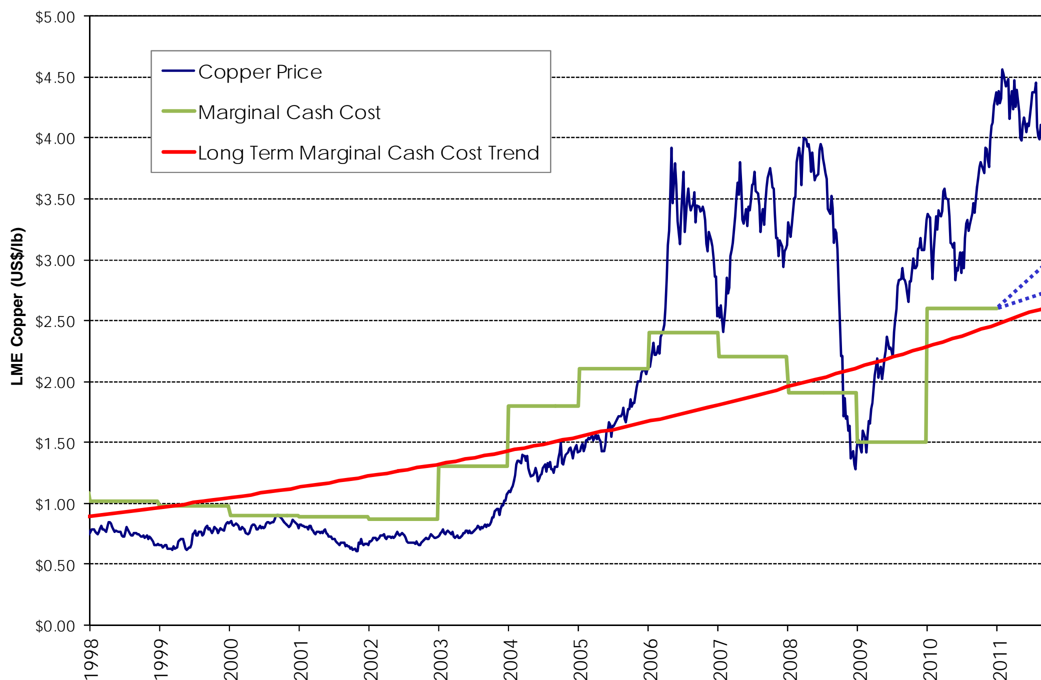
*Basic materials sector includes; base metals, precious metals, bulk commodities, agricultural and forest products.

which can alter the long-term pricing outlook. The figure below demonstrates that while spot prices periodically diverge from their marginal cash cost of production, they ultimately revert to their longer-term marginal cost trend. As such, we use a combination of industry estimates and in-house modeling to derive representative cost curves for each major commodity to observe how they could change over time.



Source: Bloomberg, CIBC and Leith Wheeler estimates

The volatility in commodities markets can present the long-term value investor with significant opportunities when markets decline, detaching themselves from fundamentals. If prices remain depressed for too long, it hampers production capacity expansion and inevitably prices rebound to a level that will incentivize incremental capacity additions. In these instances, equity investments can become cheap as the broader markets value companies on depressed spot prices.

The "cyclicality" of the materials space and propensity for materials companies to have a mix of both cash flow generating assets, as well as prospective, pre-production opportunities, lends itself to a dynamic investment approach. Profitability or return on equity (ROE) is core to the materials valuation process. Typically, Leith Wheeler investments will exhibit higher ROE's than the market or show a capacity to grow returns to above market levels. We employ a range of additional metrics when evaluating materials companies which include, but are not limited to:

- **Earning based metrics (P/E)** can be useful in times of positive earnings, but ignore the value of longer-term development projects.
- **Cashflows (P/CF, P/FCF)** can be useful when there is a short-term absence of earnings, but require positive cash flows and can disproportionately penalize companies which are in the "building" phase vs. those in decline.
- **Net asset value calculations (P/NAV)** tend to be more comprehensive in capturing the value of future cash flow generating assets, but are also highly sensitive to user inputs (ie. discount rates).

Question: So what do we use and when? Answer: Common sense. We apply the valuation method or combination of methods that gives the best measure of the value of a business, so we can determine what we would reasonably pay to own the whole business.

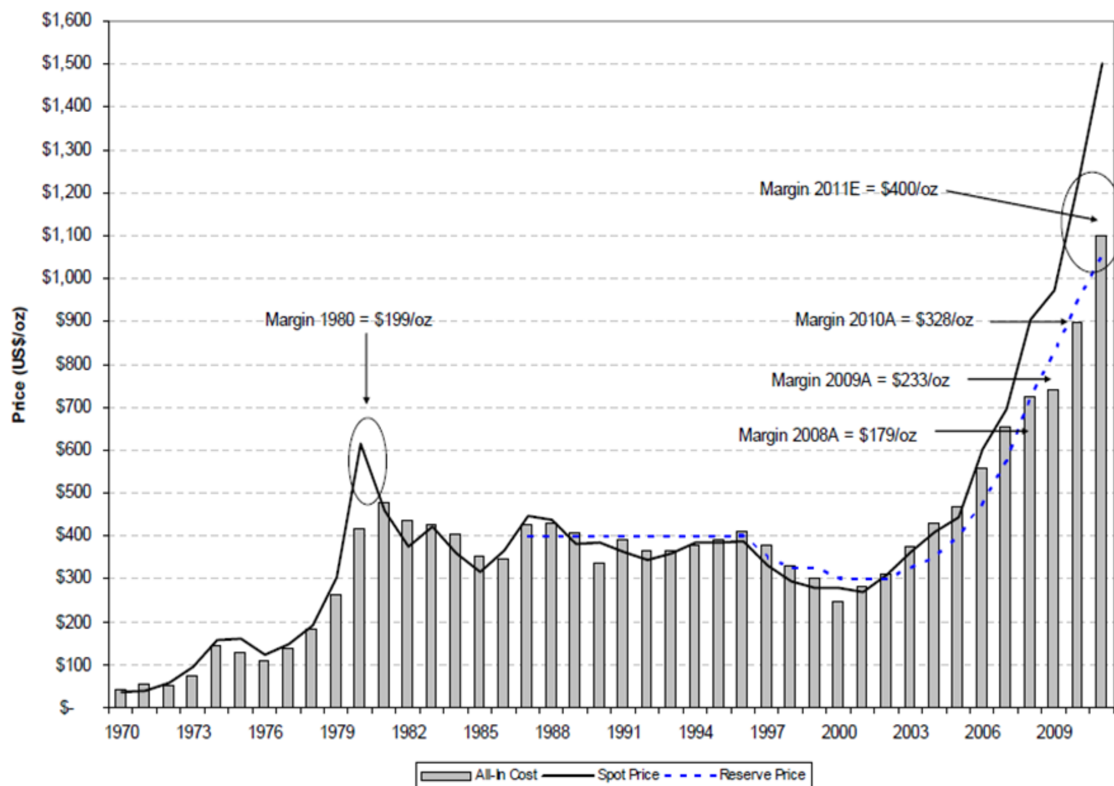
Value Traps

Is a company cheap for a reason? During a broad market downturn, the risk of getting trapped in a stock whose price keeps declining may be higher in the materials sector, as underlying commodity prices tend to deteriorate much quicker than respective equity fundamentals. As a result, it is important to focus on normalized long-term pricing when evaluating materials opportunities and in our work we assume, similar to the energy sector, that prices may remain elevated/ depressed temporarily, but ultimately revert to the long-term cost of production.

What About Golds?

Within the materials sector, gold companies present their own unique valuation challenges. Is gold a safe-haven de facto currency, or an industrial commodity? Is it appropriate to use a lower discount rate of 3-5%, versus 8-12% for a base metals company? Why would we buy a business that trades at a significant premium to its underlying net asset value (2-3x NAV in some cases)? At Leith Wheeler, we evaluate each investment opportunity as if we are "buying the whole business". To pay multiples of underlying asset value implies we are overpaying for the business – clearly an unattractive proposition. When investing, we treat gold companies in a similar fashion to our other materials companies, applying discount rates appropriate to operational, technical, geographic, and political risk levels. This may limit our opportunities, but we stick to our core belief that performance can only be added by being different from the market and more selective. The chart below illustrates the historical stereotype that gold companies have "never made money". In recent years, one can see an improvement in operating margins, which may present new investment opportunities in the future.

All-In Costs vs. Gold Spot Price



Source: Bloomberg; company reports; Scotia Capital estimates.

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Out of Favour Opportunities

The basic materials sector, like many others, provides a variety of in- and out-of-favour investment opportunities at any given point in the economic cycle. For example, amidst a relatively benign first quarter for Canadian materials related equities, Japan faced the Fukushima earthquake and subsequent nuclear disaster, which sent uranium equities plummeting, down as much as 40% in the following week. The long-term implications of this disaster remain unknown. Initial reactions from several countries to reduce global reliance on nuclear power have fueled investor fears and uranium-related equities haven't recovered (some are now near their 2008 lows). It has clearly become an unloved space and at the same time, a potential investment opportunity. Despite the near-term pessimism, uranium is an obvious long-term solution for the world's growing need for efficient, clean fuel sources and energy security concerns.

Summary

Our investment process in materials is not a departure from Leith Wheeler's traditional bottom-up value approach. We buy strong, profitable businesses at sensible prices. The path to understanding the underlying value may vary, but centers around our core criteria of profitability and attractive 3-year return potential. The above is by no means an exhaustive list of the criteria we consider. Strength of management, return on invested capital and operational history are always key factors in our decision to own a business.

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