

Market View - Mining

January 2008

Following a strong performance last year, the mining sector looks set to stay on track in 2008. A potential merger between two of the sector's largest companies, as well as trends of rising prices and strong demand for many commodities, mean mining remains a bright spot within the equity market.

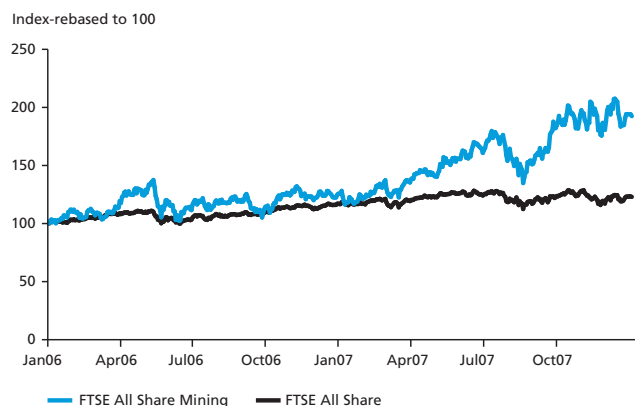
Continuing global tightness in supplies and growing demand are providing the healthy backdrop for mining companies. Last year, weakness in the dollar, rising demand from Asian countries and weak growth in supply all supported the firm run by mining stocks, which saw a total return of 53% over 2007, compared to the FTSE All-Share's 5%.

Reasons for optimism

There are several key factors that will drive the mining sector's valuations in the next 12 months. The first relates to prospects for a merger between BHP and Rio, which could trigger a general sector re-rating if it does go ahead. The sector is also likely to benefit from a realisation that any US slowdown will not affect the dynamics between supply and demand, notably in base metals and particularly copper. We expect the Asian region easily to take up excess supplies. Further positive momentum will come from a recasting of expectations for Indian demand, which we think will be higher than previously expected, and finally, from continuing cost inflation.

The companies that will benefit most from these factors are those with long mine lives, high quality assets and low unit costs of production. This equates to larger players in the industry such as BHP/Rio, Anglo's, Vedanta and Xstrata. Companies with poorer quality assets, high unit costs of production and short mine lives, such as Lonmin and Kazakhmys, may miss out.

Mining stocks v. stock market (2006/07)



Source: Datastream

Consolidation is on the cards

Whatever the result of the possible mega-merger between BHP and Rio, some consolidation is inevitable given the amount of excess cash currently lying on company balance sheets. Companies might also look to join forces because of problems in getting access to new ore bodies, cost inflation and the effect of globalisation of the world economy.

The pooling of resources should, in theory, improve sector prospects given the greater global pricing power larger companies would have, although much rests on management's ability to implement change effectively to realise cost savings in any post merger structure and then prove to the market that they can grow organically without the need for further M&A.

Commodities

Prospects for different commodities produced by mining companies are mixed. Gold, coal and iron-ore have all been star performers in the current environment. Bulk commodities will continue to do well, particularly Australian coal, and iron-ore producers, which supply China. Gold is expected to remain strong but this is very dependent on continued weakness in the dollar and continuing concern about the fall-out from the sub-prime crisis.

Base metals will recover but will remain volatile as worries over the US economy will persist. Aluminium, nickel and zinc should be avoided given the poorer supply/demand dynamics. Demand for autocatalysts in the US means that platinum will benefit but palladium will not. Uranium's price will be depressed because there are abundant new supplies coming on stream in 2008.

Among other commodities, diamonds are worth looking at particularly in the high quality end market. So far, diamond company plays have been side tracking the rest of the market but this could change this year with strong prices being forecast and demand from emerging countries remaining high. Diamonds, like gold, offer a safe haven to preserve value in uncertain times.

Outlook – strong demand, tight supplies, prices stay high

Since China and India's demand is almost 100% domestic driven it is currently decoupled from the US. There is no sign that demand from these two countries is slowing down and if anything it will increase in 2008. Commodity forecasts would suffer if there were a slowdown in the Chinese economy but this would have to be significant enough to cut GDP growth by 3 to 4 percentage points.

Since commodities are priced in dollars, companies have benefitted from the recent dollar weakness, and so far, the net effect has been to boost their revenue. As commodity prices have risen, this has also led to strengthening of local currencies and in some cases increased unit costs of production. The net effect of this is generally more positive on the revenue line. Most companies have fully incorporated this inflation into their cost plans, with larger companies able to bargain for key production items like tyres in bulk, or fuel oil through fixed contracts with suppliers, offsetting the effects of higher production costs. Again this drives the need to consolidate and harness economies of scale, improve production capability and reduce unit costs of production.

In the long run high prices will provide an inducement for companies to access new mines and increase supplies and this will eventually help lower prices. However, since the mining sector requires a higher level of capital employed compared to the oil industry, with projects typically having a shorter life and longer payback time, mining can be less attractive from a pure economic value standpoint and this is one reason why it is harder for prices to achieve lower long term levels. Companies which have strong balance sheets and access to capital are in a better position to finance large mining projects, however the recent sub-prime crisis has affected smaller mining companies' ability to access debt and forge new exploration projects. Again this helps to sustain higher prices, through a lack of new supplies.

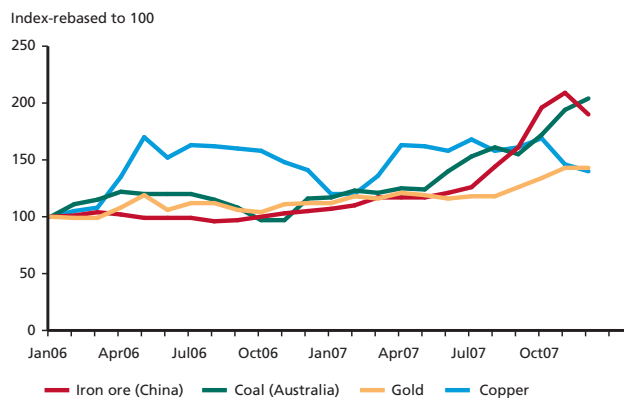
Currently China and India are the key drivers behind the mining sector's fortunes. As they move from being developing economies to being fully developed, energy intensity will fall, and with this, the demand for commodities. This process is a long one, however, and will not affect mines' prospects in the medium term.

One factor that may have an impact is that industry is making significant strides to develop composite materials that have better material characteristics than traditional alloys. This is already being applied in the aerospace industry. Developments in alternatives to natural resources will reduce demand for metals as well as create greater fuel efficiency in the future.

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Commodity Price Trends (2006/07)



Source: Citigroup

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