Auscap Newsletter

Auscap Long Short Australian Equities Fund

APRIL 2022

AUSCAP ASSET MANAGEMENT LIMITED

An Electric Future

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In Auscap's September 2019 newsletter titled "Dealing with Volatility", we ran through our investment thesis on Mineral Resources, a company that we had been following since its 2006 IPO. At that point the share price was $14.15. As at the time of publication of this newsletter, the MinRes share price is over $60. Does this mean MinRes is fully valued? This newsletter runs through our views on how MinRes has transformed itself from the company we discussed in 2019 and why we continue to see significant upside.

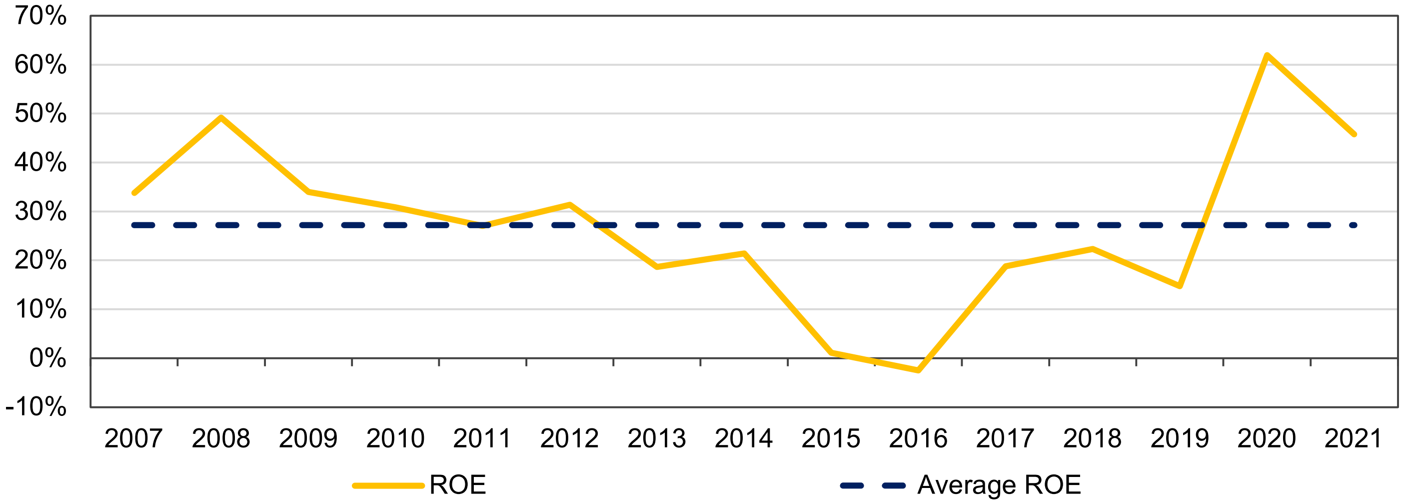
Business overview

We think MinRes is best thought of as four largely complementary businesses:

- **Mining services**: a leading mining services provider with capabilities across crushing, processing, open-pit mining, supply chain and port operations. MinRes is the world's largest crushing contractor.
- **Lithium**: the world's fifth largest owner of lithium assets, with a focus on Australian hard rock lithium deposits. MinRes' key assets are:
    - Wodgina: one of the largest known hard-rock lithium deposits in the world. A joint venture ("JV") with Albermarle, a leading global lithium producer. MinRes currently owns 40% of the JV but this will shortly increase to 50% under a restructure;
    - Mt Marion: a 50% owned hard-rock lithium JV with Jiangxi Ganfeng ("Ganfeng"), China's largest lithium compounds producer; and
    - Kemerton: a 40% JV stake with Albermarle in a new WA-based lithium hydroxide facility. MinRes is also progressing further international hydroxide opportunities with Albermarle.
- **Iron ore**: Australia's fifth largest iron ore producer. Current portfolio of WA assets includes Iron Valley, Koolyanobbing, Kumina and Wonmunna.
- **Emerging businesses and strategic investments**: MinRes is constantly investing in complementary projects, initiatives and emerging technologies. These have historically included iron ore, lithium, gas, rail and carbon fibre truck trays.

We believe that MinRes is one of the highest quality mining and mining services companies on the ASX, and that it has a track record of consistently executing on significant growth ambitions. EBITDA has grown from $24m at IPO in 2006 to $1.9bn in FY21. Impressively, this was achieved with an average return on equity since listing of 27% and high cash generation. MinRes' mining services division has long-life contracts, a high-quality client list and is forecast to grow at 15-20% per annum over the next five years. MinRes' lithium assets are high quality, long-life, jurisdictionally advantaged and have JV partners that are the global leaders in lithium hydroxide production. The company's largest shareholder is Chris Ellison, its Founder and CEO, who owns 11.8% of the business (~$1.4bn).

Mineral Resources Return on Equity (%)



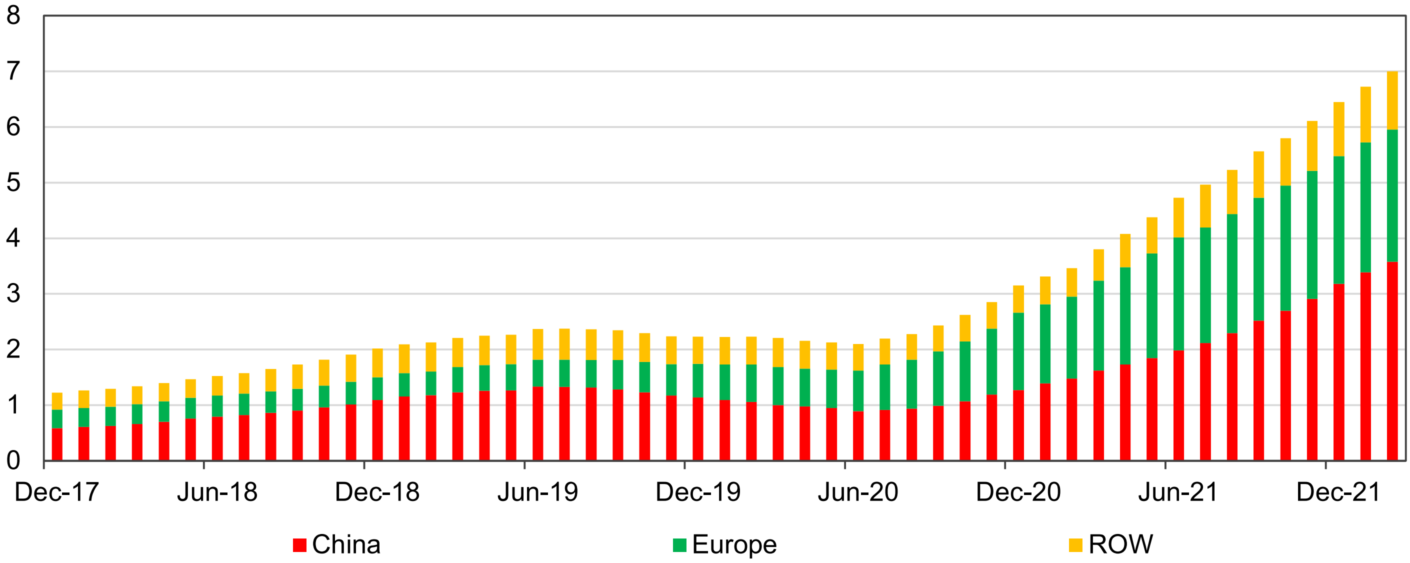
Source: Company disclosures, Auscap

Lithium

Whilst we see opportunity in all parts of MinRes, we think the largest transformation since 2019 has been to the lithium business. Based on transactional evidence for stakes in Wodgina and Mt Marion in 2019, MinRes' lithium business was worth $2.3bn (~$12 per share) at that time – not far off MinRes' then $14.15 share price. Today, our view is that MinRes' lithium business is worth more than the current MinRes market capitalisation, even with a MinRes share price above $60. This is due to acceleration within the lithium demand outlook, changes in MinRes' ability to capture downstream value and promising executional developments.

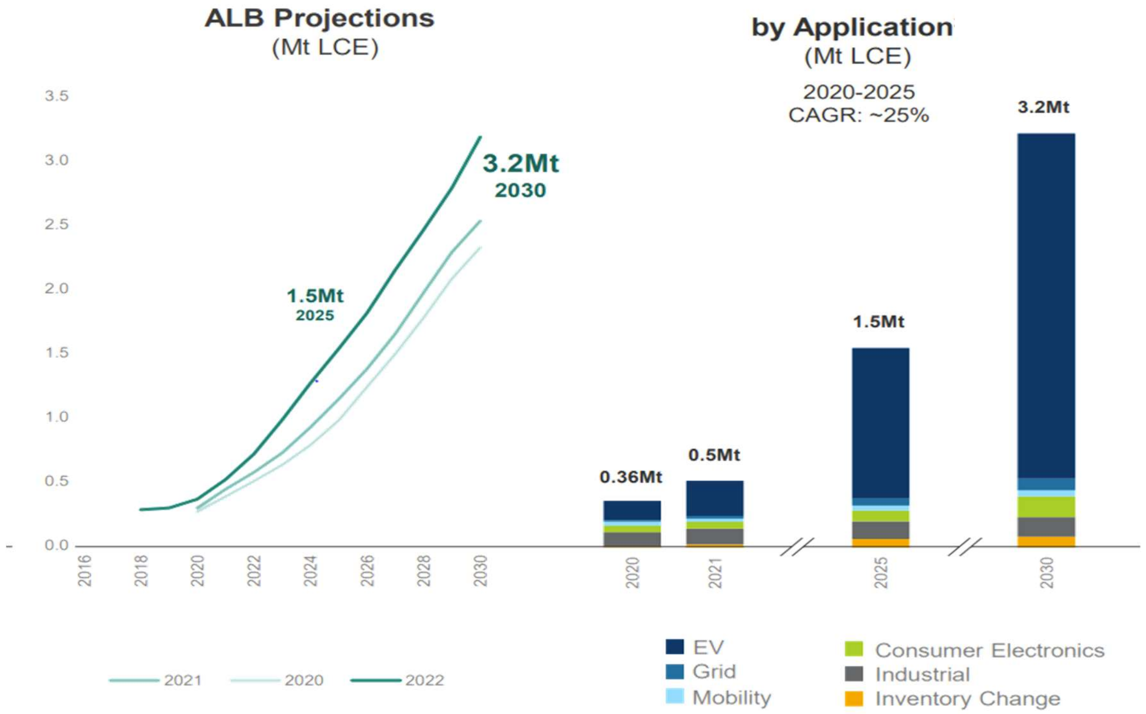
The combination of government electric vehicle ("EV") policies, global decarbonisation commitments and automotive original equipment manufacturer ("OEM") EV transitional commitments are causing a surge in demand for lithium, the key component of lithium-ion batteries. The UK has banned the sale of new internal combustion engines ("ICE") by 2030, the EU is looking at a similar ban in 2035, the US is targeting 50% EV sales by 2030 and China has made various ambitious environmental commitments. In response, automotive OEMs have reengineered their supply chains and are increasingly committing to completely phasing out the manufacturing of ICE vehicles, with manufacturers such as Mercedes (Daimler), Honda, GM, Volvo and Jaguar Land Rover committing to not sell ICE vehicles by 2040.

Global Plug-In Vehicle Sales (millions) - Rolling 12 Month Data



Source: insideevs.com, Auscap

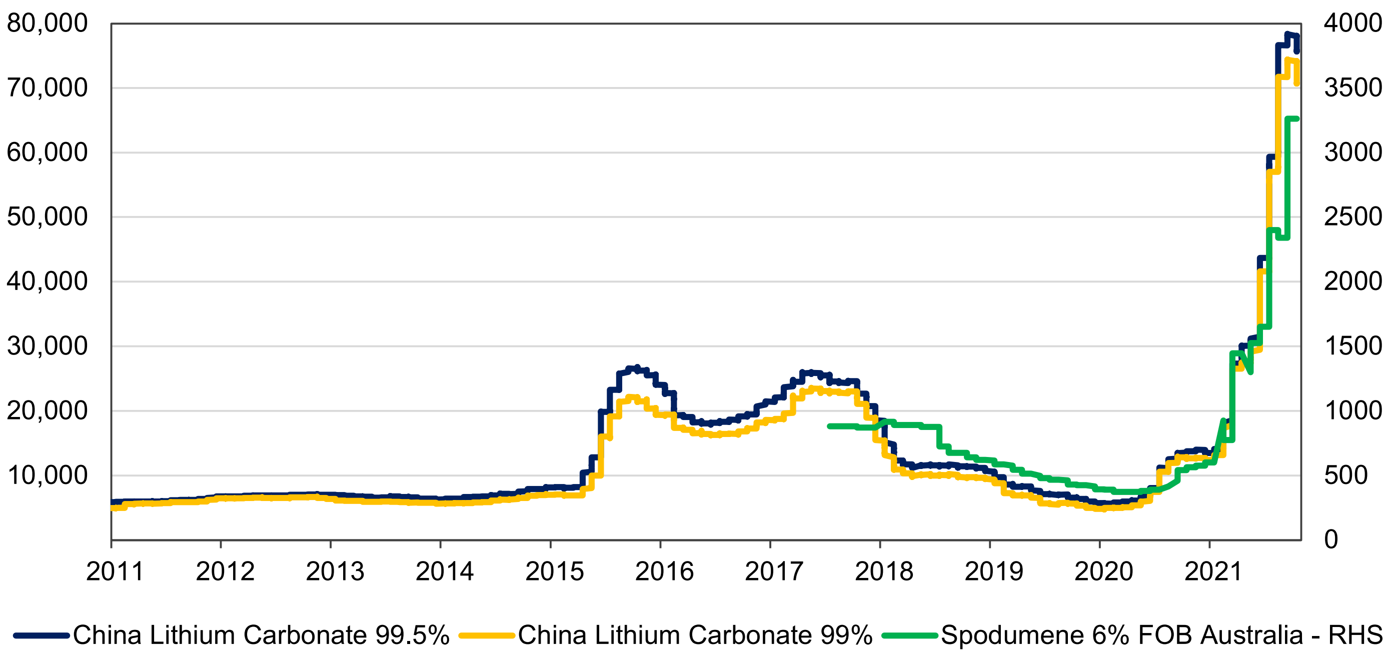
Global demand for lithium was approximately 0.3Mt in 2020. Albermarle expects demand to grow to 3.2Mt by 2030, and Albermarle's industry demand forecasts have generally needed to be revised higher in recent years.



Source: Albermarle

For lithium producers to come close to meeting such high demand in an environment of supply chain pressures and inflation, we think a high incentive price is required. After a false start in 2015, lithium prices are now surging to record highs. We expect the lithium price to remain volatile in the near-term, but we remain positive on its longer-term outlook.

Lithium Price (USD)



Source: Bloomberg, Auscap

In addition to a very strong lithium market, we think MinRes has transformed its ability to capture the economic value of its lithium assets, which we believe the market has underappreciated. Spodumene is the lithium product produced from Australia's hard rock mines. This product is not directly useable in batteries and is typically converted to lithium hydroxide as a transitional step. The effective revenue split of lithium hydroxide typically accrues roughly equally between the spodumene miner and the hydroxide converter, with both parts of the value chain offering very attractive economics. MinRes is focused on capturing this additional part of the downstream value chain and has leveraged its ownership of high-quality lithium assets into JV partnerships with Albermarle and Ganfeng, who MinRes considers "*probably the two best hydroxide operators in the world*", with the partnerships meaning that MinRes is increasingly participating in downstream lithium economics. For example, MinRes' JV with Albermarle has been structured to provide MinRes with exposure to 40% of the JV's hydroxide conversion economics at the flagship Kemerton conversion plant. Whilst Kemerton is an encouraging first step, MinRes and Albermarle are also currently finalising terms of an agreement to pursue further global hydroxide conversion opportunities for Wodgina's spodumene, which could eventually overtake Kemerton in scale. In addition, MinRes' agreement with Ganfeng has recently been restructured to provide MinRes with part of the conversion upside through a tolling arrangement.

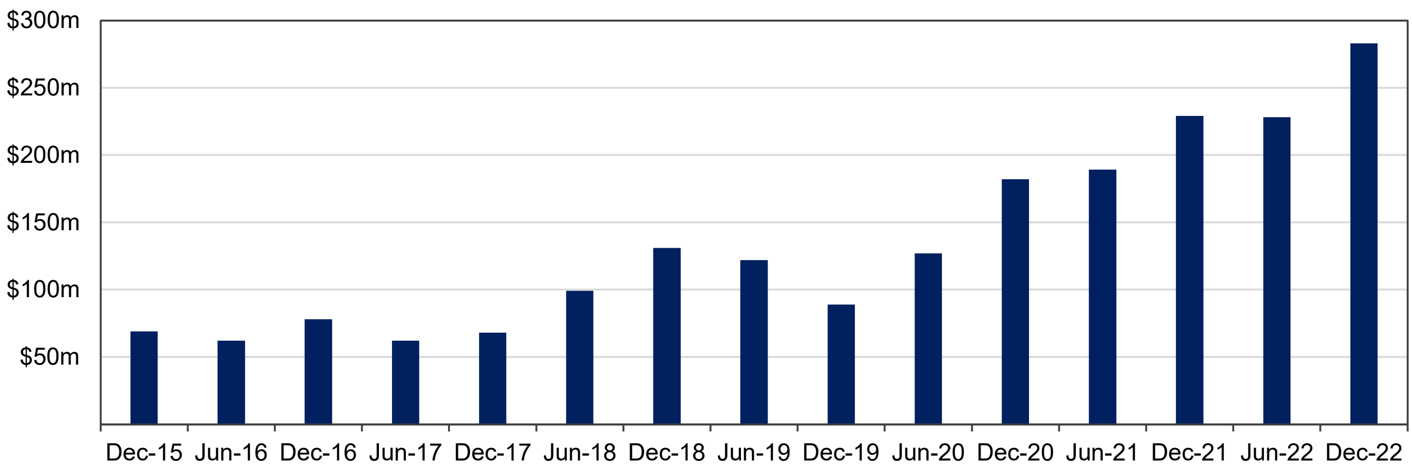
The execution of MinRes' lithium mining operations also appears to have been progressing well. In February, Chris Ellison said that MinRes "*probably has the most clear and certain path of any of the lithium producers I know of to get to where we want*". This month, MinRes announced that it was increasing production in response to "*unprecedented global customer demand*". Wodgina's near term lithium production was brought forward to May 2022 from Q3 2022 and Mt Marion's production capacity will be expanded to 600,000 tonnes per annum (6% grade equivalent). In an environment of cost inflation, uncertain borders and supply chain pressures, we see such positive announcements as highly encouraging.

The combination of current lithium prices with an increased share of upstream economics has, in our view, completely transformed the value of MinRes' lithium business. By 2025, we expect MinRes' current assets to be producing approximately 800k tonnes (6% equivalent) of lithium spodumene on a proportional basis, with further participation in the hydroxide conversion margin for most, if not all, of this output. Whilst MinRes has not provided detailed longer-term lithium forecasts, even if current lithium prices fall by 50% from current spot levels we estimate that by 2025 the company could earn over $3bn in EBITDA from lithium alone. For context, the lithium business contributed negative $5m to MinRes' record EBITDA number of $1,901m in FY21.

Mining Services

Mining Services is at the heart of MinRes' business and is its most stable earnings stream. Whilst there will always be some year-to-year volatility as individual projects ramp up and down, we see a clear long term trend of strong volume and EBITDA growth. Excluding project construction earnings, the "annuity-style" EBITDA has achieved a 22% CAGR since 2015. MinRes has announced that it has "locked in" growth over the next 5 years of 15-20%, driven by growth with Tier 1 clients of 10-15% over the next 3 years and the ramp up of MinRes' JVs across lithium and iron ore. This implies a more than doubling of the business in the coming years.

Mining Services Ex-Construction EBITDA ($m)

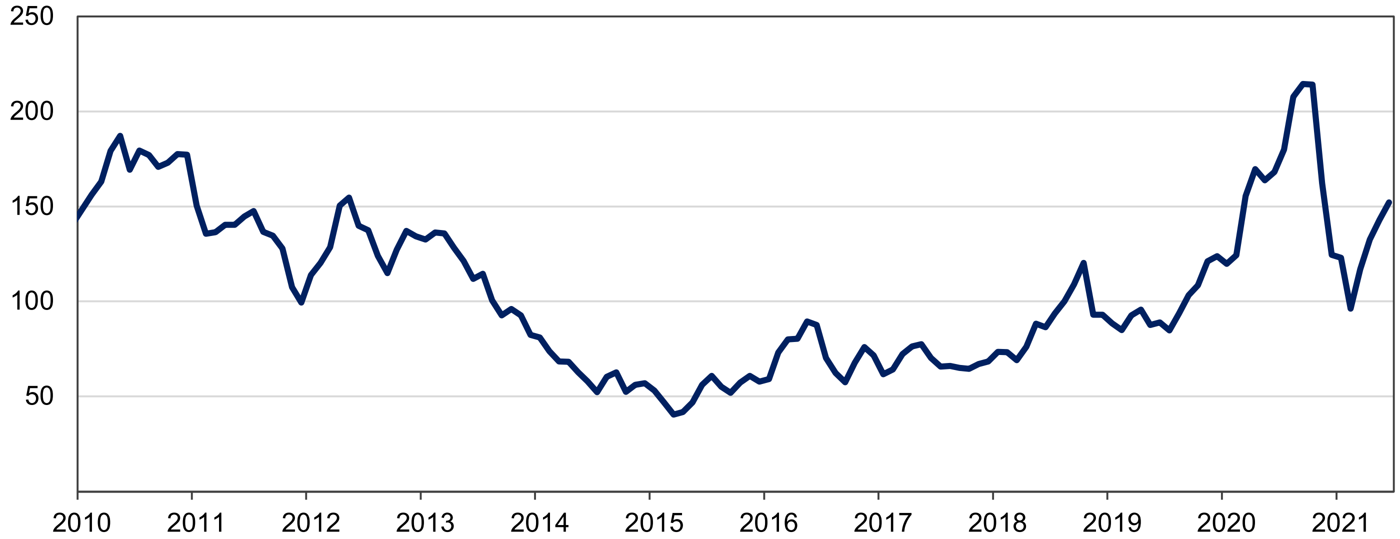


Source: Company disclosures, Auscap

Iron Ore

In 2019, MinRes had two key operating iron ore mines: Iron Valley (Pilbara) and Koolyanobbing (Yilgarn). This division was small, low-grade and had a limited mine life, albeit with the potential to be very profitable if iron ore prices spike higher. Iron ore prices were elevated in 2020, causing this business to become highly profitable. Unfortunately, in recent months, cost pressures, a declining iron ore price and provisional price adjustments in late 2021 have caused the business to swing from a significant profit in FY2021 to a loss in the six months to 31 December 2021. However, many of these headwinds have since reversed, which we think will provide a short-term benefit.

Iron Ore Price (US$)



Source: indexmundi, Auscap

In our view, the longer-term transformation of the iron ore division that appears to be occurring is more important than its short-term earnings. MinRes has recently secured access to the in-demand Port Hedland Berth 3 (“South West Creek”) alongside Gina Rinehart’s Roy Hill and Hancock Prospecting businesses. In addition, MinRes owns multiple iron ore deposits within 300 kilometres of the Port of Ashburton in the Pilbara region. MinRes’ “Ashburton Hub” infrastructure project will allow MIN to monetise these often ’stranded’ deposits. The result is that over the coming years, we expect MinRes to transform its iron ore business into a low-cost sustainable iron ore business with a 50 million tonne run rate and a mine life of more than 30 years.

	FY22	Medium Term
Projects	Utah Point & Yilgarn	Ashburton & South West Creek
Production	8-8.5 mtpa & 10.5-11 mtpa	30 mpta & 20 mtpa
Costs	$80-104/t	$40-60/t

Emerging businesses and strategic investments

MinRes has a track record of developing new projects, innovative technologies and making early-stage investments in emerging business that are complementary to MinRes’ operations. We often reflect on how some of MinRes’ most lucrative businesses started as a single dot point on a presentation slide. These have included a lucrative shareholding in Pilbara Minerals and most of MinRes’ current lithium and iron ore businesses. MinRes’ gas business is the latest new business to emerge from an early-stage acquisition and joint development. While it is early days, it appears as though gas could become an important and valuable business for MinRes going forward, with benefits to emissions, energy security and profitability.

Conclusion

Equity market participants and research analysts tend to focus heavily on multiples of near-term earnings. Whilst this is often a reasonable approach, we believe that with MinRes it has led to the market underappreciating the transformations that have been occurring within each part of its business. In recent years MinRes has exceeded even our bullish outlook from September 2019. Based on what has already been announced by MinRes, we think its transformation over the next 3 years will again exceed the market's expectations. We look forward to continuing to be supportive and enthusiastic long-term shareholders.

Auscap Long Short Australian Equities Fund

Fund Performance*

Period	Auscap	All Ords
March 2022	4.9%	6.9%
Financial Year To Date	8.9%	6.3%
Since Inception	343.4%	151.4%
Annualised Returns	17.3%	10.4%

Fund Exposures

March 2022 Average	% NAV	Positions
Gross Long	100%	38
Gross Short	0%	0
Gross Total	100%	38
Net / Beta Adjusted Net	100%	117%

Portfolio Commentary

The Fund returned 4.9% net of fees during March 2022. This compares with the All Ordinaries Accumulation Index return of 6.9%. The Fund's largest exposures over the month were spread across the consumer discretionary, communication services, real estate, materials and financials sectors.

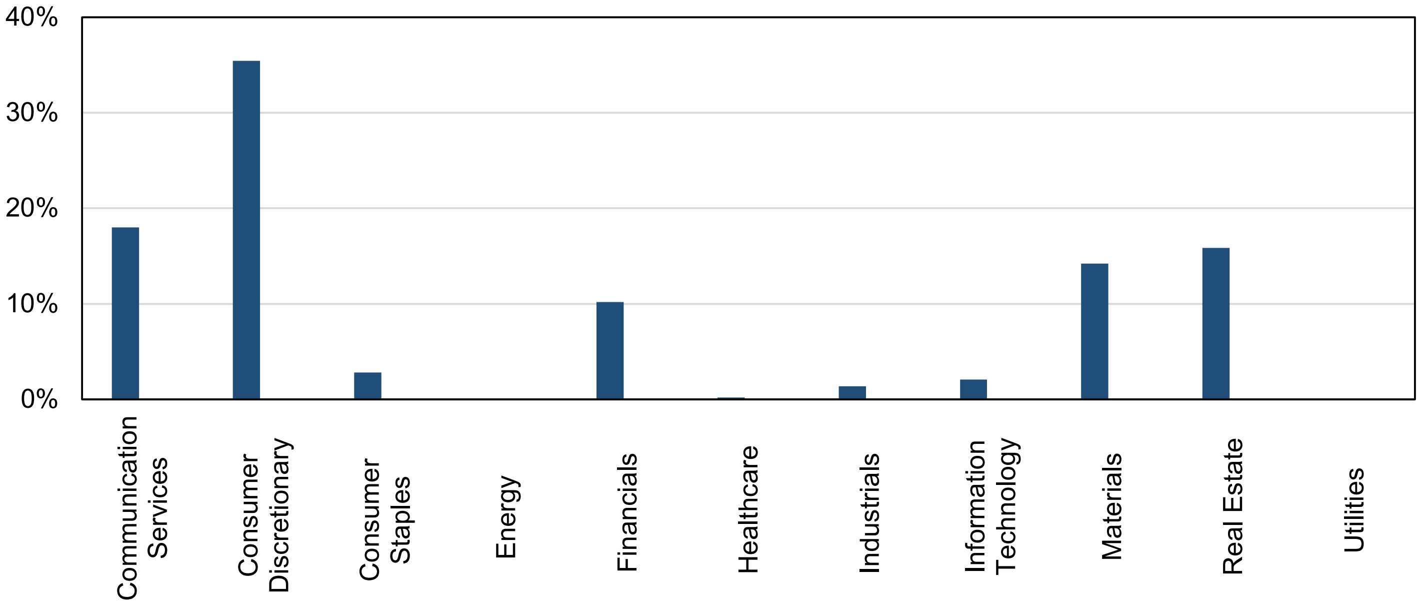
Fund Calendar Year Returns*

CY13	51.9%	CY18	(18.5%)
CY14	23.2%	CY19	18.1%
CY15	36.0%	CY20	10.6%
CY16	2.2%	CY21	43.2%
CY17	17.1%	CY22	(5.6%)

Top 20 Investments^

Adbri	MA Financial Group
ARB Corp	Macquarie Group
Blackmores	Mineral Resources
Carsales.com	Motorcycle Holdings
Charter Hall Retail REIT	News Corporation
Eagers Automotive	Nick Scali
GDI Property Group	NZME
HomeCo Daily Needs	REA Group
JB Hi-Fi	Unibail-Rodamco-Westfield
Jumbo Interactive	Wesfarmers

Sector Exposure – March 2022#



** Performance figures are calculated for the Monthly Class net of all fees and expenses and assume the reinvestment of all distributions. Note, as at 1 January 2021, the Series Class was consolidated into the Monthly Class. Past performance is not a reliable indicator of future performance.*
^ Top 20 long investments in alphabetical order as at 31 March 2022.
 # Average Sector Exposure during March 2022.

Newsletter – April 2022

Auscap Asset Management

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Auscap Asset Management Limited

ACN 158 929 143 AFSL 428014
Lvl 30, 9 Castlereagh St, Sydney

Email: info@auscapam.com
Web: www.auscapam.com

Service Providers

Prime Brokerage: Citi Global Markets
Administration: Link Fund Solutions

Tax & Audit: Ernst & Young