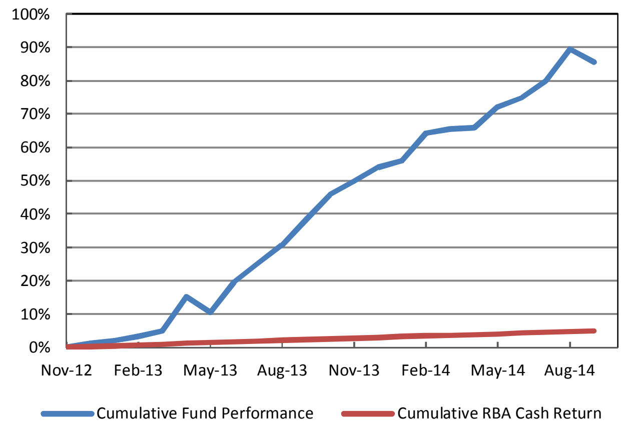
# Auscap Long Short Australian Equities Fund Newsletter – October 2014

## Welcome

Welcome to the Auscap newsletter, an opportunity for us to report the performance of the Auscap Long Short Australian Equities Fund (ìFundî) to current and prospective investors. In each publication we will also discuss a subject that we have found interesting in our research and analysis of the market. We hope that you enjoy reading these snippets and encourage any feedback. In this edition we take a look at the growth in production and consumption of steel in China in the context of global supply and demand.

## Fund Performance

The Fund returned ï2.09% net of fees during September 2014. This compares with the benchmark return of 0.21% and the All Ordinaries Accumulation Index return of ï5.26%. Average gross capital employed by the Fund was 148.9% long and 29.6% short. Average net exposure over the month was +119.3%. At the end of the month the Fund had 33 long positions and 12 short positions. The Fundís biggest stock exposures at month end were spread across the consumer discretionary, financials and materials sectors.




## Fund Returns

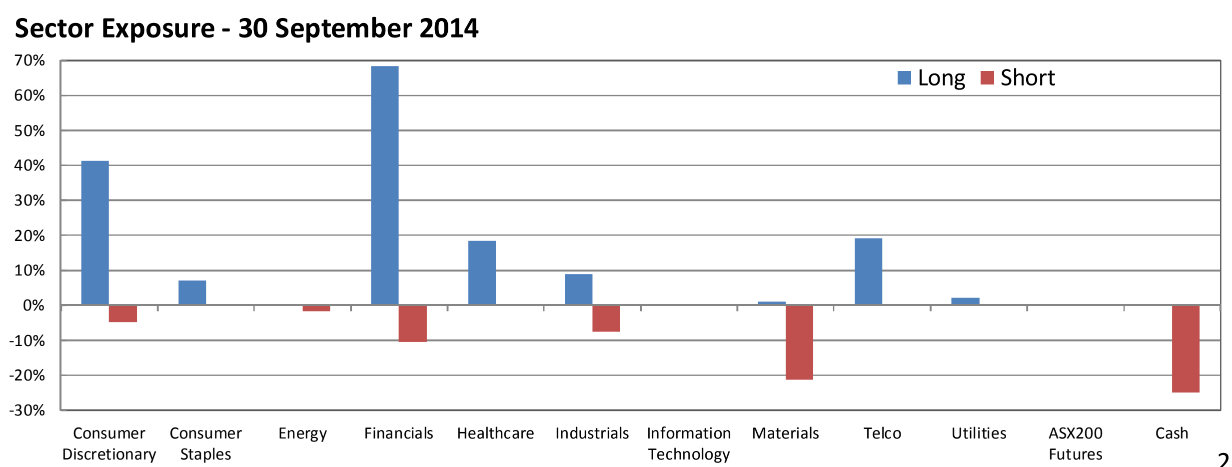
| Period | Auscap | Benchmark |
|---|---|---|
| September 2014 | ï 2.09% | 0.21% |
| Financial Year to date | 6.08% | 0.63% |
| Calendar Year to date | 20.46% | 1.89% |
| Since inception | 85.41% | 4.97% |

## Fund Exposure

| September 2014 Average | % NAV | Positions |
|---|---|---|
| Gross Long | 148.9% | 34 |
| Gross Short | 29.6% | 8 |
| Gross Total | 167.5% | 42 |
| Net / Beta Adjusted Net | 119.3% | 75.7% |

## Fund Monthly Returns

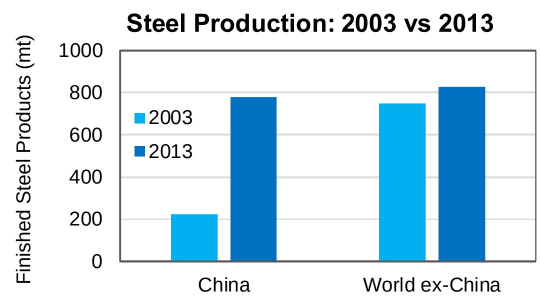
| Year | Jul % | Aug % | Sep % | Oct % | Nov % | Dec % | Jan % | Feb % | Mar % | Apr % | May % | Jun % | YTD |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| FY13 | | | | | | 1.35 | 0.74 | 1.23 | 1.46 | 9.83 | ï 4.05 | 8.32 | 19.72 |
| FY14 | 4.70 | 4.28 | 5.84 | 5.46 | 2.86 | 2.57 | 1.32 | 5.32 | 0.70 | 0.29 | 3.82 | 1.48 | 46.01 |
| FY15 | 2.95 | 5.24 | ï 2.09 | | | | | | | | | | 6.08 |



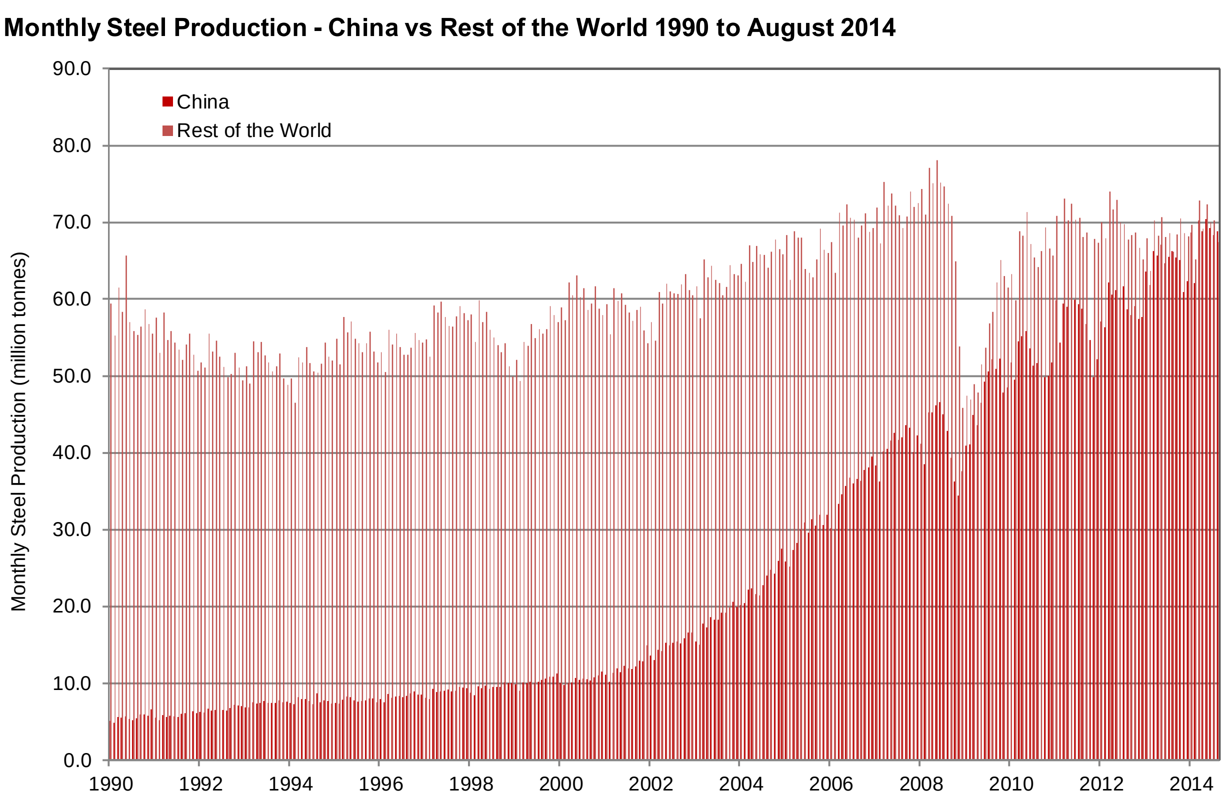
## Global Steel Supply & Demand: Putting China In Context

There are many amazing statistics borne from China's phenomenal growth story over the last few decades, perhaps none more than those surrounding China's growth in the production and consumption of steel. And certainly for Australia's economy, there are few more important statistics. Iron ore and coal are the basic ingredients required to produce steel, and the growth in domestic production of these inputs has been a very significant contributor to the Australian economy. In 2013 the export of iron ore and coal constituted 8.4% of Australian Gross Domestic Product (GDP), compared to 3.4% in 2000. Given the significant direct and indirect employment associated with these export industries, any change in steel demand in China is likely to have a material impact on the domestic economy.

China's growing demand for steel over the last decade has been remarkable. Global production of steel has grown by just over 65% from 2003 to 2013, from 972mtpa to 1606mtpa. Of this 634mtpa increase, China's increase in production has accounted for 555mtpa, or 87.5% of the increase. China has produced more steel in the last twelve months than the US has produced in the last 9 years, despite having an economy that is currently just over half the size in GDP terms.



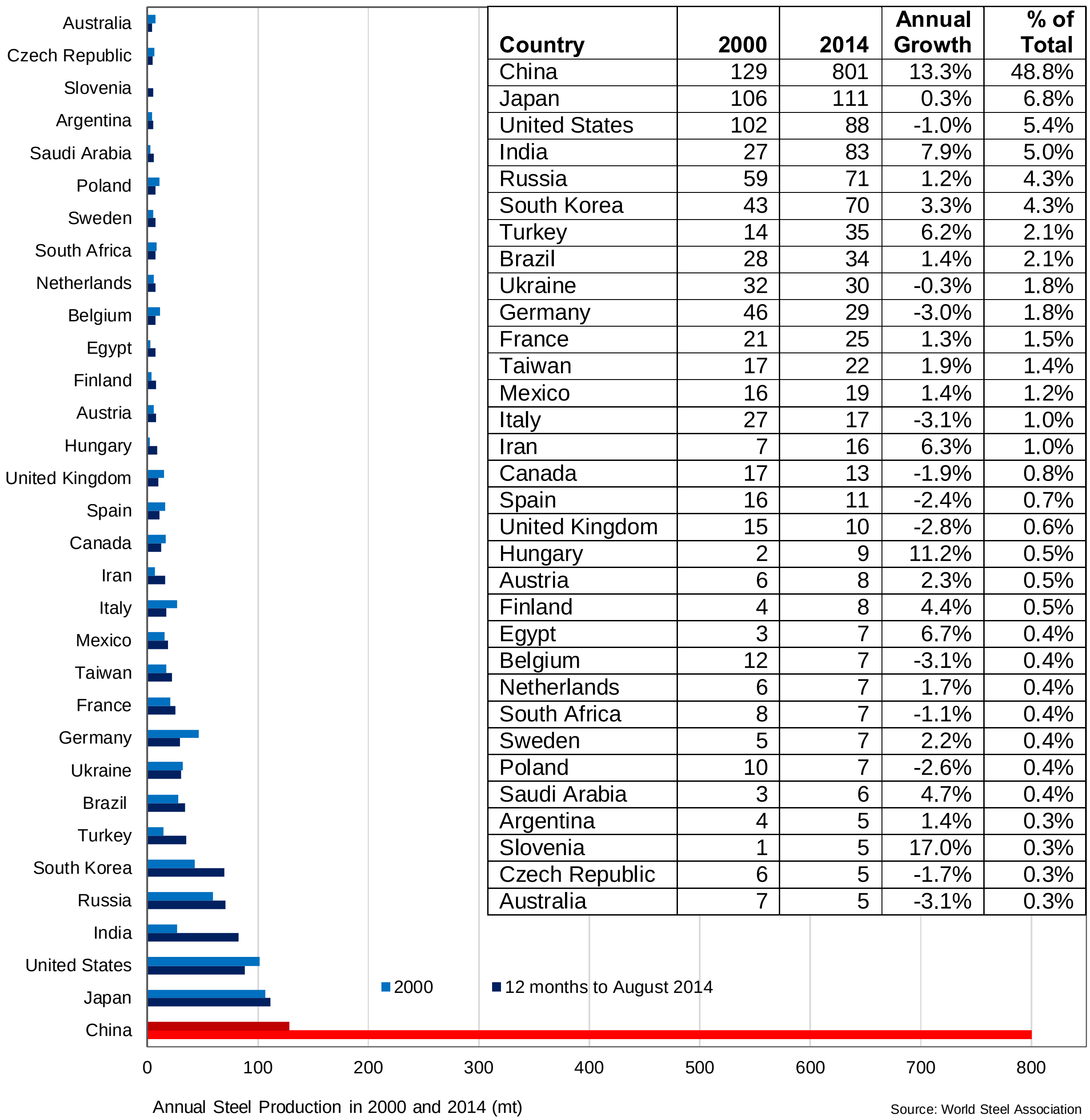

Quite remarkably, this increase in Chinese production is primarily being driven by China's equally incredible growth in consumption of steel and steel products. Global consumption of finished steel products has increased 68% from 880mt in 2003 to 1481mt in 2013. In this period China's consumption has gone from 240mt to over 700mt. In other words, of the 601mt increase in global consumption, China has been responsible for 460mt or 67.6% of the increase.




Source: World Steel Association

China has moved from a large consumer of resources to, we would suggest, the only material driver for where prices are likely to go in the medium term due to the fact that their production and consumption is disproportionately large. The fact that China, which according to the World Bank contains approximately 19.0% of the world's population and was responsible for circa 12.3% of global GDP in 2013, currently produces almost 50% of global output of steel annually is given context when its production is compared to the next largest producers.

**Largest Steel Producing Countries: 2000 v 2014**



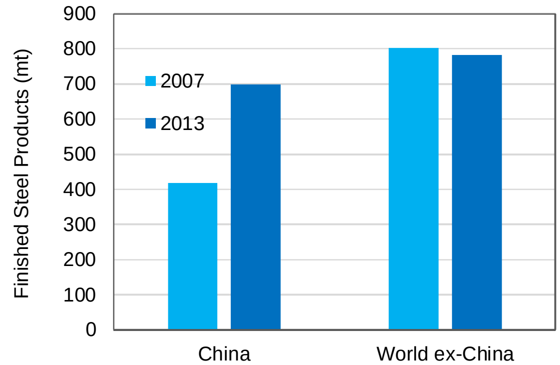

| Country | 2000 | 2014 | Annual Growth | % of Total |
|---|---|---|---|---|
| China | 129 | 801 | 13.3% | 48.8% |
| Japan | 106 | 111 | 0.3% | 6.8% |
| United States | 102 | 88 | -1.0% | 5.4% |
| India | 27 | 83 | 7.9% | 5.0% |
| Russia | 59 | 71 | 1.2% | 4.3% |
| South Korea | 43 | 70 | 3.3% | 4.3% |
| Turkey | 14 | 35 | 6.2% | 2.1% |
| Brazil | 28 | 34 | 1.4% | 2.1% |
| Ukraine | 32 | 30 | -0.3% | 1.8% |
| Germany | 46 | 29 | -3.0% | 1.8% |
| France | 21 | 25 | 1.3% | 1.5% |
| Taiwan | 17 | 22 | 1.9% | 1.4% |
| Mexico | 16 | 19 | 1.4% | 1.2% |
| Italy | 27 | 17 | -3.1% | 1.0% |
| Iran | 7 | 16 | 6.3% | 1.0% |
| Canada | 17 | 13 | -1.9% | 0.8% |
| Spain | 16 | 11 | -2.4% | 0.7% |
| United Kingdom | 15 | 10 | -2.8% | 0.6% |
| Hungary | 2 | 9 | 11.2% | 0.5% |
| Austria | 6 | 8 | 2.3% | 0.5% |
| Finland | 4 | 8 | 4.4% | 0.5% |
| Egypt | 3 | 7 | 6.7% | 0.4% |
| Belgium | 12 | 7 | -3.1% | 0.4% |
| Netherlands | 6 | 7 | 1.7% | 0.4% |
| South Africa | 8 | 7 | -1.1% | 0.4% |
| Sweden | 5 | 7 | 2.2% | 0.4% |
| Poland | 10 | 7 | -2.6% | 0.4% |
| Saudi Arabia | 3 | 6 | 4.7% | 0.4% |
| Argentina | 4 | 5 | 1.4% | 0.3% |
| Slovenia | 1 | 5 | 17.0% | 0.3% |
| Czech Republic | 6 | 5 | -1.7% | 0.3% |
| Australia | 7 | 5 | -3.1% | 0.3% |

Source: World Steel Association

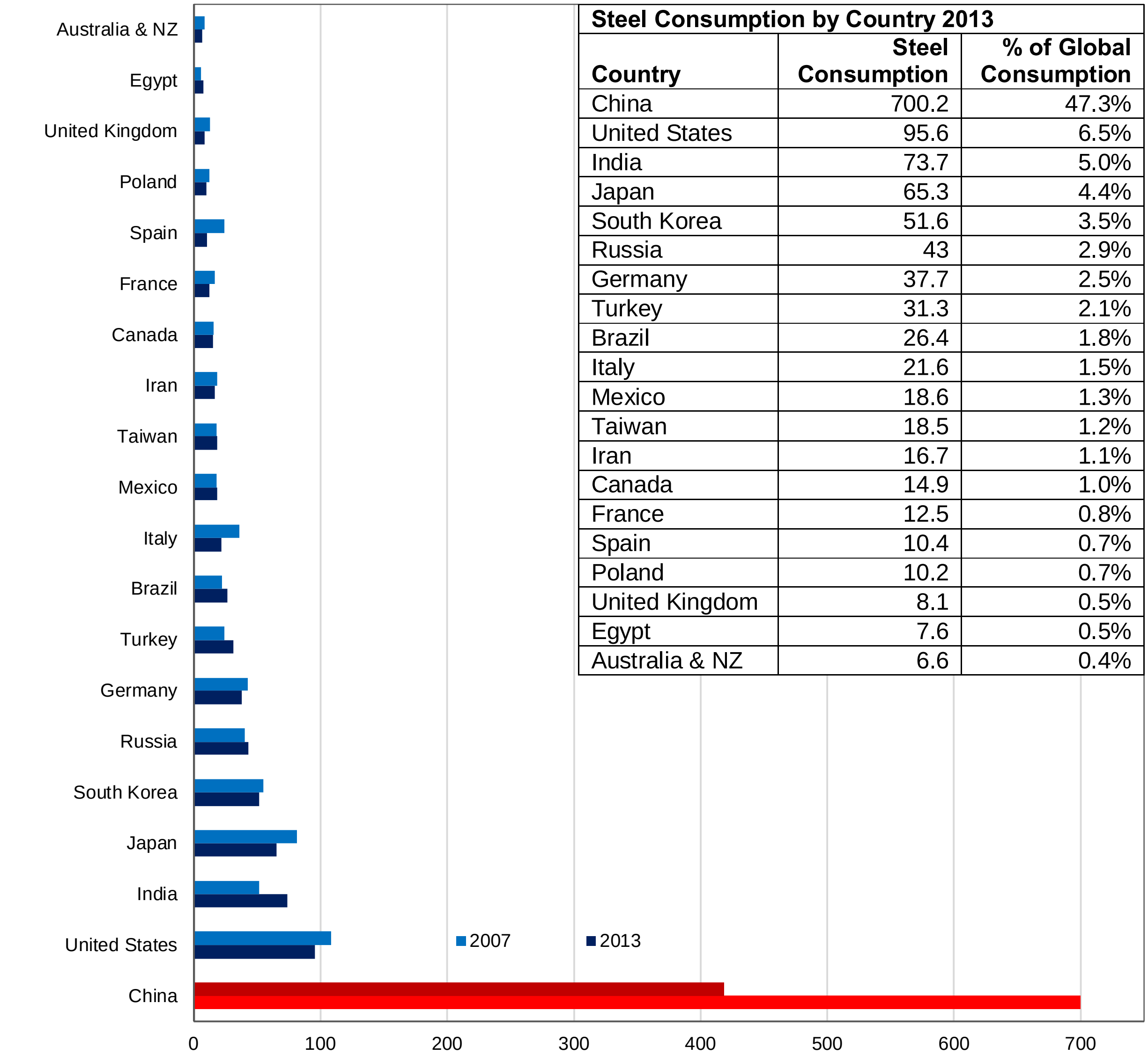
It is worth noting that a nation by nation analysis reveals patterns of rising *and* falling steel production over time. Of the current 32 largest steel producing countries, 12 produce *less* steel in 2014 than they did in 2000. This largely seems driven by domestic demand and consumption.

Steel consumption has also been a growth story revolving around China. In 2013 China was responsible for over 47% of the world's consumption of finished steel products. This is up from 34% in 2007. During this period China's consumption of finished steel products has grown over 67%. This is in stark contrast to the rest of the world, which in 2013 consumed 2.6% ***less*** finished steel products than in 2007. Of the 30 countries on which the World Steel Association reported individual country data, 20 consumed less steel finished products in 2013 than they did in 2007, including the United States, Japan, South Korea and Germany.

**Steel Consumption: 2007 vs 2013**




**Steel Consumption by Country 2007 vs 2013**




**Steel Consumption by Country 2013**

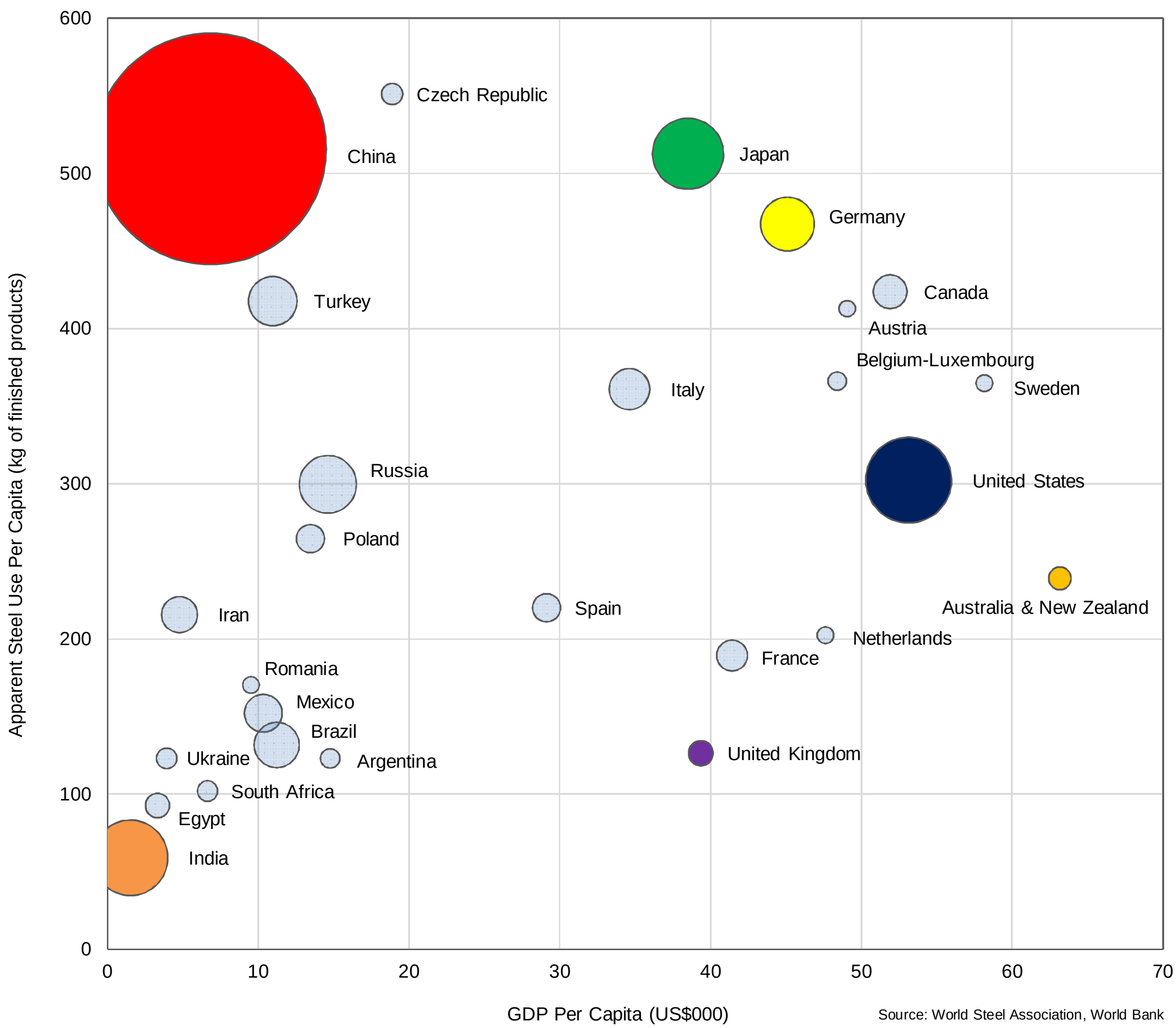
| Country | Steel Consumption | % of Global Consumption |
|---|---|---|
| China | 700.2 | 47.3% |
| United States | 95.6 | 6.5% |
| India | 73.7 | 5.0% |
| Japan | 65.3 | 4.4% |
| South Korea | 51.6 | 3.5% |
| Russia | 43 | 2.9% |
| Germany | 37.7 | 2.5% |
| Turkey | 31.3 | 2.1% |
| Brazil | 26.4 | 1.8% |
| Italy | 21.6 | 1.5% |
| Mexico | 18.6 | 1.3% |
| Taiwan | 18.5 | 1.2% |
| Iran | 16.7 | 1.1% |
| Canada | 14.9 | 1.0% |
| France | 12.5 | 0.8% |
| Spain | 10.4 | 0.7% |
| Poland | 10.2 | 0.7% |
| United Kingdom | 8.1 | 0.5% |
| Egypt | 7.6 | 0.5% |
| Australia & NZ | 6.6 | 0.4% |

Apparent Steel Use in 2007 and 2013 (finished steel products in mt)

Source: World Steel Association

China's rapid industrialisation program has placed it well above the global mean for per capita consumption of steel, which is especially noteworthy given the fact that GDP per capita is less than USD 7,000 per annum. In fact, they currently appear to be consuming more steel on a per person basis than many of the big steel consuming manufacturing-based economies such as Japan and Germany. To some degree we would expect there to be a relationship between GDP per capita and steel consumption, as plotted on the chart below for different countries. Increasing GDP typically leads to affordability of larger homes, offices, equipment, cars and disposable household items, all of which can lead to an increase in the demand for steel. It would appear that China's current consumption of steel is well above a line of best fit, if one could be drawn. China's steel demand appears to be driven primarily by investment in infrastructure and property. Given current income levels within China, should it continue to grow its steel consumption on a per capita basis it would be worth understanding the sustainability and marginal utility of the steel intensive investments being undertaken.

**Steel Use vs Income Per Capita**

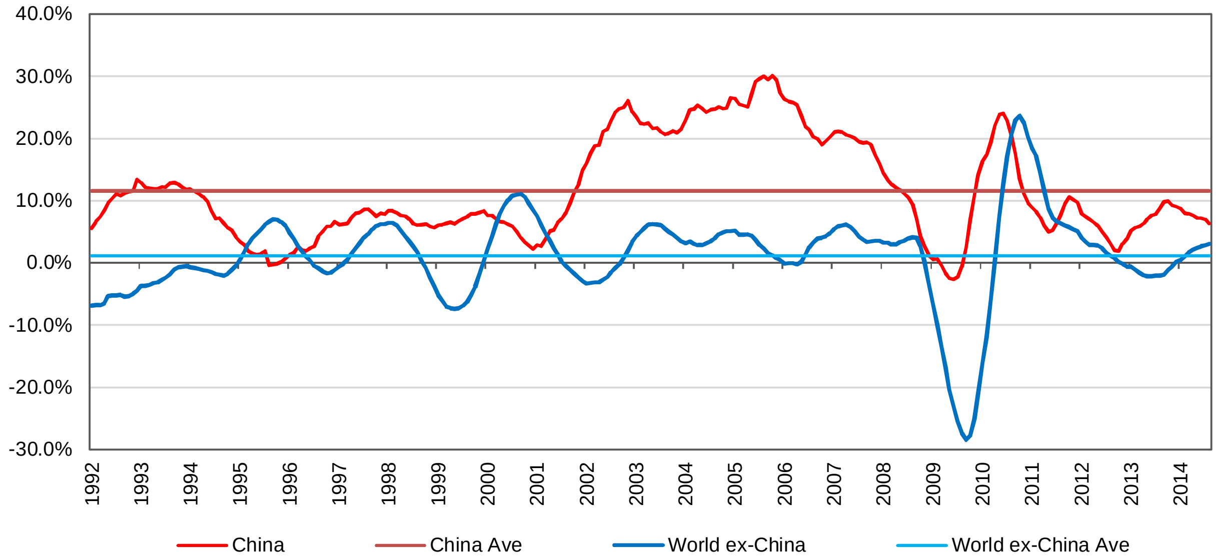



Source: World Steel Association, World Bank

We note that South Korea (GDP US$26kpp, Steel Use 1,027kgpp) and Taiwan (GDP US$20kpp, Steel Use 792kgpp) are not shown on the chart above although they are both globally significant steel consumers. These two countries have the highest per capital consumption of steel, albeit with populations that are significantly smaller than China's.

Chinese steel production growth has averaged 11.6% pa over the last 15 years, compared to 1.2% for the rest of the world. This growth currently appears to be slowing, with steel production in China increasing 6.3% yoy to the end of August 2014. We suggest that any material change in steel production and consumption growth from this point could have significant implications for the consumption of input commodities.

**Steel Production Rolling Year on Year Growth: 1992-2014**




The combination of slowing growth in Chinese steel production and a material increase in the supply of the input commodities, iron ore and coal, is having a significant impact on the prices at which these commodities trade. This issue has been most likely exacerbated recently by the seasonal weakness that is experienced around September and October, during which China celebrates National Day Golden Week. The potentially more significant question from an Australian perspective is what happens to commodity prices over the medium term should Chinese demand for steel actually start declining. Given the significance of Chinese consumption and the regularity with which major economies have experienced negative growth in steel demand for prolonged periods, we believe it is one worth contemplating.

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**Auscap Asset Management**

ACN 158 929 143 AFSL 428014
Lvl 24, 9 Castlereagh St, Sydney

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

**Service Providers**

Prime Brokerage: Citi Global Markets
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