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## The Accidental Environmentalist

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In anticipation of an increased focus on climate change, clean air, and environmentalism, some companies have spent years repositioning their businesses. On the other hand, other companies give the appearance of just being in the right place at the right time. It has long been noted that air quality in Chinese cities is a potential flashpoint for civil unrest. The Chinese government's emphasis on increasing air quality has been to the benefit of two companies on our Approved List, Vale S.A. and Cleveland-Cliffs, Inc.

World crude steel production grew by 30% from 2006 to 2016. In that time, China's share grew from 33.6% of the total to 49.6% of the total and stood at 53.0% in August 2018. Much of the production comes from China's Hebei province which is particularly susceptible to seasonal smog and haze. Generally, the worst pollution is during the winter heating season from November to March. Chinese authorities have been quick to mandate production cuts at steel factories when the pollutants are particularly bad.

Tangshan, a city of 7 million people in Hebei province, is the top steelmaking city in China. In June 2018, Tangshan was cited by China's Ministry of Ecology and Environment as having the worst air quality of 169 cities. In July, production curbs were mandated that affected Tangshan's steel mills. In the past, production curbs were generally blunt instruments but the government has become more sophisticated in controlling pollution. The message now being sent to steel mills is that those who can better control pollution will be allowed to produce, those who can't control pollution will be shut down.

Steel mills can partially control the amount of pollution produced by using different ingredients. In general, cheaper ingredients produce more pollution. Ore with lower iron content and finely ground ores are two of the cheaper ingredients that are often replaced by more expensive ingredients, ores with higher iron content, pellets and lump ores. Depending on the season, premiums for the expensive products in China can increase substantially. China's market position means that iron ore prices in China are the benchmarks from which global prices are derived.

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The primary suppliers of iron ore to Chinese steel mills are three Australian companies (Rio Tinto, BHP, and Fortescue) and one Brazilian company, Vale. Each of these companies has iron ore mines with different properties and can emphasize production from one mine over the other depending on market conditions. Fortescue is notable for being the low-cost producer but also having lower quality ore which commands lower prices. Vale is notable for being able to more easily produce higher-quality ore that commands premium prices. Vale is at a relative disadvantage to the three Australian companies because of the transportation cost differential between Australia to China versus Brazil to China.

Cleveland-Cliffs' sells iron ore pellets to North American steel producers under long-term supply contracts. The prices specified in the supply agreements are subject to adjustment based on Chinese prices on high-grade iron ore, prices of an Atlantic Basin pellet premium (which of course is affected by Chinese prices), domestic steel prices, freight rates, and certain narrow Producer Price Indices.

At LM Capital, we believe that identifying future beneficiaries of societal change can lead to better client performance. We realize that these beneficiaries are often not necessarily global leaders in sustainability reporting or performance. However, these companies are acutely aware of the shifting winds and we expect that it will affect their response to investor emphasis on these factors.

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