RAB Special Situations Company Limited

Key Facts
AIM quoted
Ticker: RSS.L

Company Information

Shares in issue:	63,987,761*
Denomination:	GBP
Admission date:	31 May 2005
Year end:	31 December

**Voting shares in issue as at 31/12/15, excludes shares held in treasury*

Share Price (as at 31/12/15)
8.50 p

Manager
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Investment Commentary

On the back of poor sector performance, and one adverse legal ruling (Oxus Gold) the RAB Special Situations Company (the "Company") returned -32% during the fourth quarter of 2015. RAB Special Situations (Master) Fund Limited (the "Fund") returned -30.8% in Q3.

Despite this there were brighter spots with the top contributing positions for the quarter being Trevali Mining, Victoria Gold and Bahamas Petroleum.

Trevali Mining ended the fourth quarter strongly following a flurry of positive announcements. Commissioning of the Caribou mine continued through the quarter with steady month-over-month improvements in all core areas. The company also took measures to enhance their balance sheet in Q4 by reaching an agreement with their lenders to extend and expand their debt facility. With the demonstrated strong support of their lenders and their strategic partner Glencore, we believe Trevali remains in good condition to take advantage of improving zinc fundamentals.

Victoria Gold had a particularly strong quarter as the company announced they had received the final permit required to develop their flagship Eagle project into a working mine, after two years of work for the company.

(Continued overleaf)

Portfolio Breakdown

Top 5 Holdings		Gross Assets (%)
1	Falkland Oil & Gas	18.8
2	Royal Nickel	13.2
3	Victoria Gold Corp	9.2
4	Trevali Mining	7.8
5	Brasoil do Brasil Mem. Int.	3.3
	Top 5 holdings represent	**52.3**

Sector Split

	Sector	(%)
1	Oil & Gas	31.9
2	Ind. Base Metals	23.1
3	Gold & P. Metal	18.6
4	Biotech	3.4
5	Coal/Uranium	3.1
6	Real Estate	2.0
7	Consumer	1.1
8	Clean Technology / Energy	0.7
9	Other	0.4
		84.3

Country Split

	Sector	(%)
1	Canada	39.9
2	UK	33.2
3	USA	6.9
4	Australia/Far East	3.2
5	Europe	1.1
		84.3

Listing Split

	Sector	(%)
1	Listed	70.4
2	Unlisted	13.9
		84.3

While Bahamas Petroleum has suffered along with its peers as the appetite for frontier exploration has diminished, its share price performed strongly into year-end due to progress on the legislative framework being put in place in-country. The company announced that the House of Assembly had passed the Petroleum Bill which will regulate hydrocarbon exploration and, in management's view, provide "the assurance required to attract the considerable investment necessary to develop the potentially huge, and therefore significant economic resources present in Bahamian waters." The Bill will now move to the Senate, but looking forward, the company will continue with its efforts to secure a farm-in to its acreage with a view to drilling an exploration well.

On the negative side, the holdings that contributed mostly to the negative performance of the Fund were Oxus Gold, Falkland Oil and Gas and Royal Nickel.

Oxus Gold announced in December that trading in their shares would be suspended pending clarification of the company's future financial position following an adverse decision by the Arbitral Tribunal in relation to the expropriation of assets by the Government of Uzbekistan. As a result of the decision of the Tribunal, a material uncertainty now exists in relation to the company's ability to continue as a going concern. We understand Oxus Gold is currently in the process of analysing the Arbitral Tribunal's decision with its legal advisers with a view to considering whether there is any further opportunity for legal recourse against the Uzbek government. In the absence of any knowledge of the outcome of this process; nor whether any further funding for the company will be made available; and given its known liabilities and suspension from trading, we consider the equity in the company is worthless and valued the position at year end accordingly.

On October 29th Falkland Oil and Gas announced that their Humpback well had encountered oil and gas but that these discoveries were considered to be in non-commercial quantities. Clearly this was a very disappointing outcome. The operator of the well, Noble, explained that "full well assessment and the integration of drilling results into the Company's geologic models is ongoing to determine remaining exploration potential in the Southern Area License. The geologic play including Humpback was only one of a number of prospect play types in the Southern Area License." Unfortunately this disappointment was compounded by the fact that, due to a number of issues, the cost of the well had significantly overrun leaving FOGL with a balance sheet that was stretched further than anticipated. However, less than a month later the company announced a proposal to merge with one of its partners in the North Falklands, Rockhopper Exploration plc, the group which discovered and appraised the Sea Lion field. We were supportive of this transaction for a number of reasons, primary among them was a view that, in these challenging markets, the consolidation of groups like these offer savings in terms of G&A expenditure, strengthening of balance sheets and, via the aggregation of interests in jointly held licences, will hopefully facilitate securing a farm-out arrangement with a third party.

We were also pleased to see 2016 start well from an operational point of view, with the announcement of the successful result of the Isobel/Elaine well. All five of the targeted fan systems were oil bearing and no gas was encountered. The company highlighted that "whilst the data acquired is still to be fully evaluated and integrated, the initial view of the Company is that the Isobel/Elaine complex is likely to contain commercially viable quantities of recoverable oil." As Rockhopper mentioned in a recent presentation, the North Falkland Basin is now "a step closer to realising Billion Barrel Potential." The rig will move to drill the Chatham prospect (in which Rockhopper hold 40% and estimate a Pmean resource of 51mmbbls) before being transferred to Noble Energy who will use it to drill Rhea. Encouragingly it has also been announced that the pre-FEED work completed to date on Sea Lion has led to significant improvements in the overall economics. Phase 1a resources to be commercialised have been increased from 160mmbbls to 220mmbbls, peak production went from 60k bpd to 85k bpd and the field life increased from 15 to 20 years. Set against pre-first oil capex remaining at $1.8bn, this represents a cost reduction of 30% on a per barrel basis. As such, the newsflow will continue through 2016 from the Falklands as Premier and Rockhopper progress through the FEED process and the drilling campaign continues.

The share price of Royal Nickel disappointed over the quarter as the nickel price crashed causing more cautious market sentiment towards nickel equities. The management continues to advance the project towards development with permitting completed and only financing outstanding before mine construction can commence.

The oversupply cycle goes on and on

Commodities saw their worst losses in 2015 since the 2008 financial crisis, with the Bloomberg World Mining Index falling -35.3% over the period. Nearly a decade of overinvestment in production, supported by high prices and demand growth in Emerging Economies, gave way to a vicious cycle of price deterioration and cost deflation as global supplies soared and demand expectations were tempered on the back of a China led Emerging Markets slow-down. Precipitous price declines in the petroleum complex acted as a catalyst, but the sell-off was broad based with every sector from metals, to bulks to agriculture seeing sharp losses in 2015.

Compared with the previous year, base metal prices were down -24.4% on average (LMEX Index) in 2015 with molybdenum (-42.8%) and nickel (-41.8%, at a 12-year low) demonstrating the most significant declines. Copper, the primary revenue driver for the base metal sector, was down -26.1% as moderating global GDP growth and the continued slowdown of the Chinese economy continued to weigh on all commodities throughout the year. Even gold languished at multi-year lows, down -10.6%, unable to attract buyers despite bouts of intense stock market volatility, geopolitical shocks, counterintuitive bond market behaviour, unusually fluid and unpredictable asset class correlations and changing views about central bank policies. Steep appreciation in the US dollar further weighed on dollar-denominated commodity prices amidst the bearish fundamental environment.

Many commodity markets were beginning to tighten in the latter half of the year though as the impact of lower prices started to filter through in the production side. For oil and gas, sharp declines in US rig counts should begin to make meaningful impacts on production growth. Meanwhile, mining supply cuts could support a rebound for some metals. A slower pace of US dollar appreciation should also give the complex some breathing room in 2016.

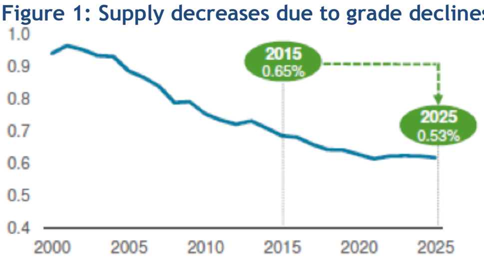
Outlook remains cloudy with occasional sunny spells

2015 witnessed a much sharper slowdown in China's commodity demand than was generally expected. Combined with ongoing supply growth – the result of 30-year high in capital investment over 2009-13 – it has led to commodity prices falling materially in 2015, and the mining sector underperforming for an unprecedented fifth consecutive year, making it the worst period for the sector since at least 1966.

Copper and iron ore supply responses helped reduce but not eliminate potential surpluses, while some commodities, like aluminium and nickel, have actually seen increases to supply estimates. As such, iron ore and aluminium are forecast to remain in surplus until at least 2018. This implies prices at or around marginal cost levels for the time being. The exceptions to this are zinc and nickel, where fundamentals or price levels look attractive, but getting meaningful equity exposure is difficult. For this reason we still hold Royal Nickel.

Copper, given its standing as a barometer for economic activity, tends to wilt at any sign of a slowdown, particularly in China's housing market. Nevertheless, copper still looks more secure than other commodities given its supply remains constrained. With copper grades falling, meaning more earth must be shovelled to produce the same amount of metal, falling prices could make lower-grade mines or projects uneconomic.

Figure 1: Supply decreases due to grade declines (copperhead grade all mines)[1]

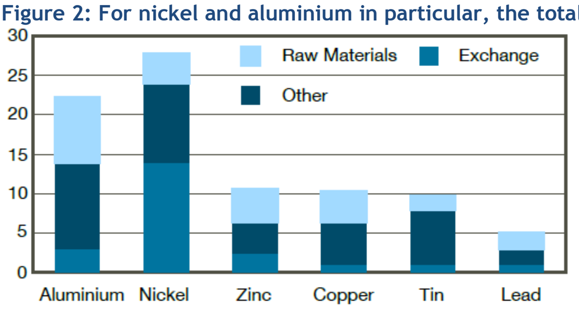


We do think 2016 will see a steady acceleration of the supply cuts in the commodities sector. However, we do not expect to see any material impact of these cuts in the short term. In past cycles we would have seen more producers going out of business completely, but the availability of cheap capital in the current financial environment has buffered against this. Still, this is just one of the reasons producers are reluctant to cut operational capacity and will seek ever more inventive ways to keep operations going when basic economics suggest they shouldn't be.

Given producers naturally don't want to cut, removal of excess capacity from markets has to be driven by extraneous factors and in this case the financial markets may hold the key. Credit markets are already providing a very negative feedback loop to commodities, and low oil prices are making this even more pertinent. Any refinancing process becomes both more difficult and more expensive in this environment, and without financial market backing many leveraged assets will be forced into bankruptcy, from where some will not re-emerge, at least in the short term.

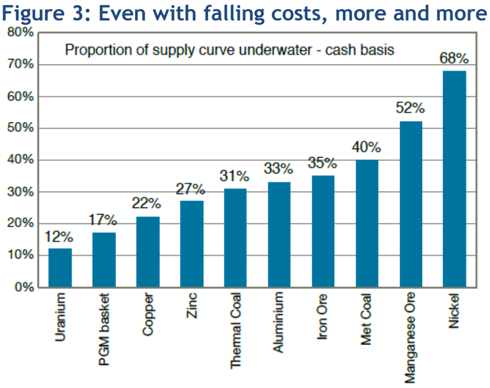
With supply now gradually starting to adjust we are looking at markets which could end up in supply deficit in 2016. Deficits themselves only matter, however, when inventory is low – this is when individual metal prices can outperform. We expect inventories to be a differentiator in performance throughout 2016 and perhaps through to the end of the decade, as markets strive for normality. This is also why we prefer zinc among base metals, as inventory through the raw material and refined metal chain continues to look set to drop at a reasonable pace. In contrast, aluminium and nickel inventories remain well above normal, acting as a buffer to price upside.

Figure 2: For nickel and aluminium in particular, the total inventory overhang remains high[2]



Should commodity prices stay at the levels they are now, many producing assets are not viable concerns. Given the level of overcapacity in many markets, many of these assets simply do not need to produce in the foreseeable future.

Figure 3: Even with falling costs, more and more supply is loss-making following recent price moves[3]



[1] Source: Wood Mackenzie as at 31 December 2015.Percentage copper weighted by ore processed.
[2] Source: LME, CRU, SHFE, Macquarie Research as at Jan 2016.
[3] Source: Wood Mackenzie, Macquarie Research as at Jan 2016.

Whatever happens, supply cuts in themselves are generally a reaction to current market conditions, and it is rare to see "too much" supply cut – they may stabilise cycles, but they rarely lead sustained recoveries if demand doesn't play ball.

Unfortunately, the prospect for an upside demand-shock looks limited with Purchasing Managers Indices in China and the US in contraction territory. Aside from the structural transition away from fixed asset investment intensive growth in China, we worry about deteriorating demographics and a multi-year slowdown in property investment – we note that floor space per capita in China is already the highest in any Emerging Economy and among the top 10 of all countries globally. The recent pressure from the weakening of the currency does not help either, not only making imports that much more expensive but also assisting the competitiveness of domestic production. China is the world's biggest producer of coal, aluminium, gold, zinc and steel, and it is the third biggest global producer of copper and iron ore.

While the above points to further near term difficulties, for those with longer term horizons, we are starting to see the capital raises, dividend cuts and, crucially, capacity withdrawals, which are a necessary prerequisite for a cyclical turning point, as is an increase in M&A activity. Unfortunately they do not in themselves signify a bottoming of the market which may well be yet to come.

Philip Richards and Team

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