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Hallgarten & Company

Portfolio Strategy

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Beyond Zero

Finding Survivors Amongst the Ruins of LatAm Mining

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LatAm Mining in 2009
It's all M&A

- ✘ The picture for mining companies worldwide is grim. Miners in LatAm fare little better than those elsewhere. However prices have bottomed for most metals and gold has made a substantial rebound with uranium also having consolidated earlier than others and regained lost ground.
- ✘ Gold has rebounded but it is not "business as usual" for gold miners and misery for others. Investors remain wary of the "hidden hand" that has moved gold and the dollar in recent months. Moreover the landscape has changed for good. The fat dumb hedge funds that funded so many "ask no questions" PIPEs (you know who you are..) are now gone (so not reading this anyway..). Money is too tight to mention and just being a gold miner does not mean the spigots are open again.
- + Politically, the commodity price plunge has been a wake-up call for Bolivia and Ecuador. The latter realized that it could not depend solely on oil revenues, while Bolivia's pungent rhetoric has been watered down as Morales raced to help miners (to preserve jobs) rather than hinder. Argentina was left bemused that its high export taxes may have killed the goose that laid the golden egg.
- + Currencies in the region have moved to the advantage of miners with local costs dropping strongly in dollar terms. The retreat has been strongest in Brazil and the benefit has been weakest in Argentina and Mexico.
- + The fall in oil prices has helped lower operating costs. The biggest beneficiary has been Chile where an energy crisis hampered operations of many miners in early 2008. The least benefited country is Brazil where the energy retreat's positives were heavily diluted by the currency plunge.
- + The next wave is M&A and corporate actions. The playing field is too crowded and the money is too thin to go around even the worthy players let alone the marginal projects and amateur management teams. Those that have will consume those that have not.. Harvesting this new trend wikll be the best way to make money in mining stocks in LatAm at least in the first half of 2009.

The Shape of the Boom Gone By

Recent months have given us pause to look back over the last few years of commodity boom and its attendant effect upon the mining industry.

We have been over the reasons that commodities rose so many times that this discussion is rather a dead letter. More interesting is to wonder what flaws were built into the mining industry "this time around".

One of the beauties of the current moment is that miners if they are going bust are doing so merely by running out of cash rather than being heavily debt burdened. The vast bulk of the hundreds of juniors listed on the main exchanges have little or no debt. This creates a situation in which they do not have any built-in poison pill that would scare away a cashed-up buyer of an interesting but cash-poor miner. In other booms this was not the case. Many of the medium-sized mines that have come into operation also have little or no debt because the capital markets in recent years made it so easy to bring a mine to production via a constant stream of mini-financings. These brutalized existing shareholders but they seemed to take it like frogs in the slowly boiling water. The managements were largely on board with this strategy as it avoided the debt buildups of previous booms AND they, as the board incumbents, could always issue themselves more shares (at least in the Canadian and US-listed entities) and keep their skin in the game at virtually no cost to themselves.

Horses for Courses

We meet often with managements and we have tried to synthesise the impression we have received and analyse why the managements do what they do. It has struck us that the Bre-X scandal, back in the dark days of the 1990s, might explain the structure of the mining industry today, or at least the nature of the Canadian industry. We go to so many meetings now where the CEOs are either geologists or mine engineers. Twenty years ago, the crusty old prospector staggered into some office on Bay Street clutching a registered claim and some samples, he was spun around a few times, given some options and a pouch of tobacco and sent back into the woods. The financial spinmeisters then picked up the deal. They owned it, they filled the board, they floated it on the market and they milked it. This is the way it had been for 150 years before then. They needed the requisite technical people but they were seldom allowed to see light of day with the investors, except on carefully orchestrated field trips.

The Bre-X scandal turned the tables on this regime in Canada, but not elsewhere. Thus we have seen the rise of the geologists (and engineers) in the latest mining boom. This has coloured the shape of the Canadian industry, as we noted in our rather controversial note of the first half of 2008. The geologists love to go fossicking about. They love to drill. They love core samples. They do not like anything vaguely like production or building a mine. They like to find it and then hope that someone will buy it off them to do the dirty work of mine building. Very few that we have seen (out of a universe of hundreds) have pulled off this trick but investors of a certain kind thought it was plausible.

The mining engineers on the other hand, suffer the geologists but frequently tag-team on the boards. Some of the mining engineers have developed a curious mindset, which consists of indulging themselves by building a mine and then praying nightly that they can sell it off before it gets to production. They all hope to emulate the models of Peru Copper, Global Copper and Northern Peru Copper. This is somewhat like “having one’s mine and building it too”. Unfortunately its also a game of chicken that requires a constant dripfeed of money to get to the last turn when the mine is actually sold-off. The geologists can suspend drilling at any point to conserve cash, such an option does not exist for a mine that is 70% built. Thus far in the mining “meltdown” we have seen less than a handful of such half-completed projects change hands.

What of the “Sharks” of yore?

Investors in Canada may have felt safer that financial types were out of the picture, but were they? We notice a disconnect. They loved to hear that Sprott or Endeavour or Rob McEwan were on the register and gave the stocks thus favoured an almighty boost. At its peak Rob McEwan’s vehicle US Gold had a market cap of nigh US$1billion but more recently has traded around $90mn. In reality, an “unknown” junior with prospects like those of US Gold would have had a $150mn market cap at best and would be languishing at cash value or even less, say $15mn in today’s environment if it wasn’t for the auspicious financial mover and shaker on board.

Frankly we think that having a financial guy at the wheel in the current environment gives much more comfort than having some technical whiz (or not so much of a whiz) agonizing over how he will fund the drilling of his next hole. The latter is far more inclined to maintain the drilling campaign to get to the pot at the end of the rainbow (the near mythic trade buyer) by having brutally dilutive placings.

The absence of financial whizzes from the scene over recent years also helps to explain the dearth of M&A action. A financial whiz sees M&A and corporate actions as the key to growth while a geologist sees growth only in drill results and proving up the world's biggest deposits. We have reeled at meetings where some geo has just stated that he has 8 million ozs of silver in measured and indicated and he wants another 7 millions oz. They look at us blankly when we ask "then what?".. when obviously we should have realized that after 15 million ozs then you look to get to 20 mn ozs. Only a geo can love so many intangible onces. He can stroke them with his drill, but will they ever see light of day!?!

While a geo looks around now and sees death and destruction, a financial whiz (maybe not the current breed but at least those in the "olden days") would see opportunity. Great properties going for a song and managements (run by geos) that are largely clueless in the face of the enormities about them.. Like taking candy from babies!

Harvesting the whirlwind

We shall officially declare 2009 the year of M&A in LatAm. Those who accept this might be winners and snatch some juicy assets or they might be taken over and salvage some value. Those who reject the notion will find themselves devoured, probably when they least expect it or face the ignominy of delisting when their last cash dribbles out the door on a last-gasp drilling effort.

Thus the task in 2009, or at least the first half thereof, will be to identify targets, decide who the predator will be and then conjure what the terms will be and whether they will suit a equity holder. This might indicate it would be better to position a portfolio in the aggressors rather than the targets, or at least mix and match between the eaters and the eaten.

LatAm M&A charts for the second half of 2008

Fresnillo – MAG Silver (takeover by Fresnillo)
Amerigo Resources – Los Andes (increasing stake in Los Andes from 6% to 14%)
Capstone – Sherwood (merger)
Central Sun – Linear Metals (merger)
Kinross – Aurelian (takeover by Kinross)
Benton Resources - Coro Mining ($3mn private placing taken by Benton)
Hochschild – Lake Shore Gold (increase in stake to 40%)
Hochschild – Mariana Resources ($1.5mn placement to former by Mariana)
Hochschild – Gold Resource Corp ($5mn placement)
Fortuna Silver– Continuum (takeover by Fortuna)
Cardero - Nanjinzhao Group (sale of Pampa de Pongo iron ore deposit fro $200mn plus)
Admiralty Resources - (sale of Rincon Lithium project to Charge Resources for AUD$36mn)
Inmet – Petaquilla Copper (takeover by Inmet)
Rusoro - Gold Reserve (takeover bid by Rusoro)
Vale – Cementos Argos (purchase of all Argos' Colombian export coal assets for $300mn)

Room with a view

We find it hard to project what might happen when one doesn't have a view on the underlying commodities, why they rose and why they fell and what might be their stimuli on the second go around. Our key thesis is the degradation of money, most notably the dollar. This reflects well onto gold, some reflected sheen onto silver and a distant Pluto-like glimmer on the basic commodities.

However, in a scenario of total degradation of the dollar one might see basic materials as a store of value for the emerging countries that don't have as many of these resources as they would like. Before we are dismissed as being of the *tinfoil hat* brigade we would note the cryptic announcements from two Chinese provinces in November (and repeated by Yunnan just last week) that they might stockpile base metals and then a large supportive order for aluminium that the Chinese initiated in recent weeks. Frankly if the Chinese are not prepared to use their massive reserves to pump-prime their own economy (something we suspect they will be forced to do eventually) then stashing some of the forex reserve in dirt cheap basic commodities makes imminently more sense than throwing good money after bad in the T-bill market. If the Chinese are smart (and that is not a given) then they should already be undertaking this process. Though as some have noted they would prefer to buy the mine that buy the output. At least that way they could keep the product stashed underground. However, governments in Africa and Latin America being what they are the old adage of a “bird in the hand being better than one in the bush” holds for the strategic stockpile approach over the “stash it in the ground” school of thought. The Chinese in recent years have been stashing their own metal in the ground and paying up for other’s product precisely for this security of supply issue.

Our view on trading ranges for the metals of relevance in 2009 are:

- Gold - $800-$970
- Silver $9.50-$13.50
- Copper $1.45-$2.60
- Zinc $0.50 -$0.95
- Nickel $5.15 - $6.70
- Moly $10-$17

The players and those in play

The universe of companies that might come into play is very large. We decided here to take a cross-sample of those we know best from the armoury and defensive standpoint.

Mirabela Nickel (MNB.to)

This Brazilian nickel miner may seem a strange choice for anybody’s stocks to keep an eye on in 2009. However, amongst nickel miners it is the one with best financing prospects and a collection of good hedging and off-take agreements that might make it the sole addition to new nickel capacity over the next three years as virtually everything else has gone into a mothballed state. The interesting thing which fits in with our thesis on M&A is that it has two strategic parties circling, namely Norilsk and Votorantim. Frankly we suspect the latter is in better condition to make a move on Mirabela while its value remains severely depleted. Norilsk is better positioned but also currently gripped by the crisis that is buffeting the Russian economy and markets. Provided its bank syndicate can come up with the money to finish building the mine and facilities then Mirabela should be able to come into production in mid-2009 with one third or more of its output hedged at good prices, any improvement in nickel (such as the jump seen last week) would go towards enhancing the profitability of the unhedged production.

The story here is not a complicated one. Essentially some big predator will take out Mirabela as probably the best of the new crop of up-and-coming nickel plays. The closer it gets to production the more attractive its resource will look to someone wanting a foothold in nickel or Brazilian nickel in particular..

Timmins Gold (TMM.v)

Production may be a bridge too far for Timmins or may be within spitting distance. That is the nub of the issue. The company's San Francisco mine is largely built and could be production before March. The company bought itself a mine with most of the infrastructure for 100,000 ozs per annum so extra investment was a mere fraction of what it would have been in a scratchbuilt operation. However will the financing crunch trip them at the last hurdle? Certainly Timmins is no aggressor but it definitely it looks like it could be party to a transaction. We can think of several gold miners or gold miner wannabes that have the money to get Timmins production rolling. With cash operating costs of $412 per oz (and falling due to oil prices) the margin is very safe in anything short of a greater gold meltdown than we saw through the machinations of September through to November of 2008.

Timmins Gold, for a predator, is a situation where they put their money in the slot machine pull the handle and then after a long pregnant pause the cash starts rushing out. This may be a much more protracted process though if the company has to scrabble around to get the stray pennies from under the slot machines to feed into itself.

The San Francisco project and the portfolio of other prospects the company has would take a one-trick pony producer with cash that gets Timmins in its sights into a more sophisticated league altogether.

Capital Gold (CGC.TO)

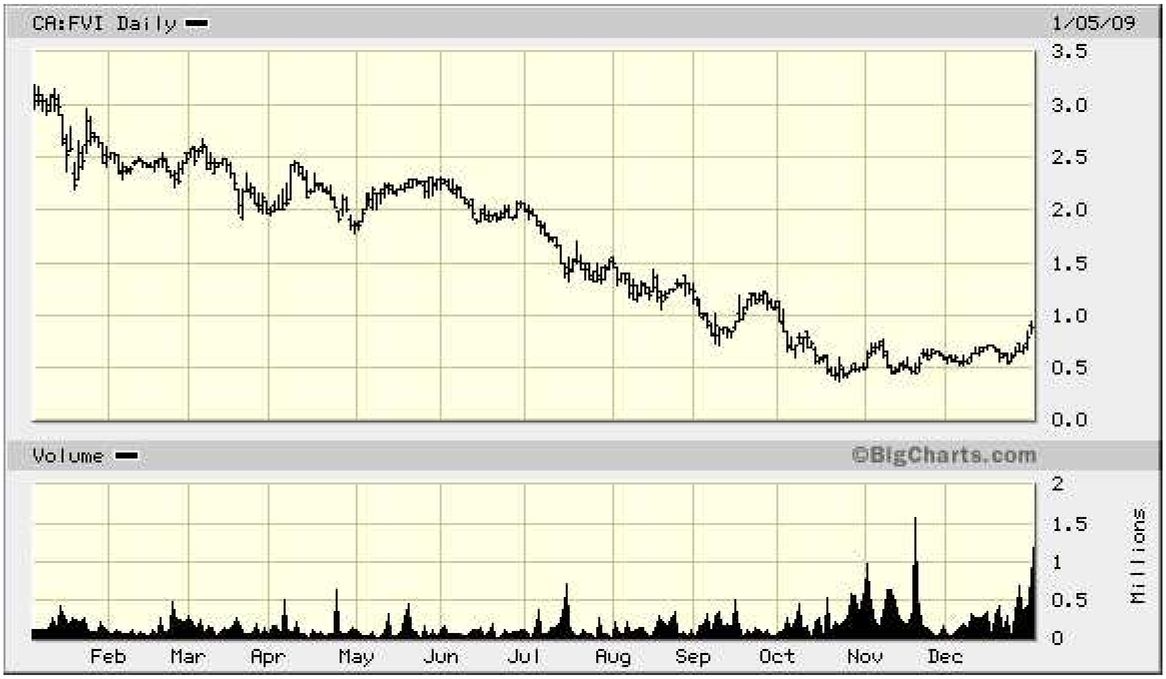
This company should be licking its chops at the opportunities available but instead is in blushing bride mode. Management that cannot grasp the nettle thus becomes management on the way out. If the cash pile and cashflow from its El Chanate mine can't be turned into a deal at this point in the cycle it is not caution at work it is lack of gumption. Capital Gold is takeover fodder at this point.

That is a great pity as no company with cash and a good mine should be eaten except by a top carnivore. Instead Capital Gold looks like it could be taken down by any old hyena and count itself happy for the privilege. Being a gold miner the company is well positioned now that gold is in a most respectable price range. Margins are great and unlike six months ago fuel prices in the cost component are way down and costs in dollar terms are lower due to the travails of the Mexican peso. It seems somewhat perverse that with gold off a mere 12% from its fleeting high that Capital Gold should be off 50% from its best price despite the obvious cost-side benefits the company has gained on other fronts. Any news of aggression by Capital Gold would be good news.. Now is it's moment to strike.

Fortuna Silver (FVI.v)

A stock we have long admired despite its silver focus. The company has been one of the first to show its teeth by launching an opportunistic move upon Continuum Resources that was the minority partner in its Mexican project (and which also owned a "donut" of concessions around the project). The company is cashed up and despite the silver woes it is still cashflow positive from its Caylloma mine. Its cash pile varies but when we wrote on the company last in late November it had around C$41mn on hand. It has its positives and negatives. It smartly had hedged its zinc sales, but only through to early 2009, however on the plus side gold is going to be a more important part of the mix from Caylloma going forward. Additionally, a copper circuit is adding extra by-product credits despite the depressed price of the latter. In our best (yet conservative) case scenario the company could be making 10 cts per share in 2009 and has only just managed to struggle above 70 cts in its share price.

We would not expect great aggression form this company but a combination with another metals company, where base or precious, would not surprise us. We would suggest that gold might be a worthy addition and doubt that anything would be done outside of Peru or Mexico. Vena Resources, another company we like, would be a cheap bolt-on for around $16mn.



Minera Andes (MAI.to)

This is a stock that should have been fought over before now, but it shows how clueless the larger mining industry has been (and how exceptionally inertly those in close proximity to the company have behaved). The company has developed a most unfortunate poison pill in the form of the 30% stake that the McEwan interests hold. Neither do they move forward (which might excite some bargain hunters to follow them) nor will they get out of the way and let someone else make a bid for the company. The McEwan interests are so far underwater that it is unlikely they will accept offers in the realms of reality.

So Minera Andes is like a bride who has arrived at the church and no groom is in sight, but neither is she allowed to leave the building to search for a new partner. The latest twist of the screw is that Hochschild the partners in the San Jose project in Argentina have decided to do a capital raising and Andes must stump up their share at a particularly tight moment. The company is too juicy a morsel to let slip away. Its eschewing of Hochschild's offer of $250mn plus for its half of San Jose earlier in 2008 abrogates all rights that management has remain in their seats. In a year full of dumb decisions, that one exceeded all others.

In mid-December the company announced that, following a meeting of the shareholders of Minera Santa Cruz, S.A., the shareholders of MSC (51% by Hochschild and 49% by MAI) can expect to receive a cash call of US$23 million to finance further expansion and development of the San José project.

MAI's share of the cash call is approximately US$11.3mn, payable by mid-February 2009. Failure by MAI to pay this amount (the company only has $3.3mn in the kitty at this time) could result in a dilution of MAI's interest in the San Jose mine below 49%. MAI says it is investigating its options, however, we would note it also has a tranche of financing ($7.5mn) due to Macquarie Bank falling due in February.

Hochschild seem to be acting in an excessively predatory manner at this point as this request for additional funding is being made notwithstanding previous assurances from them that additional cash calls would not be required. With the mill and plant operating and Phase I of the initial expansion completed one would have expected that further plant expansion costs were going to be paid from cash flow. This may backfire if it forces Minera Andes into the arms of another. Money may be tight but this company is one of the biggest bargains around.

Ironically, the best party to jump on Minera Andes is probably Xstrata, the partner in the fabulous Los Andes copper discovery in the province of San Juan. They would have the credibility to challenge Hochschild and could make life difficult for the Peruvians should it come to a stare-down between the two. The amount of money involved would be minimal. In light of the existing cashflow at San Jose, the financial merits of doing a deal at Xstrata would be self-evident. The big doubt is whether MAI can play one party off another and snatch some sort of victory from the jaws of defeat.

Hochschild (HOC.l)

This London-listed, Peruvian-owned and managed company has been on a wild ride from clearly over-valued to patently undervalued in the space of a year. It has also done some dumb moves that have cost it a lot of its $540mn cashpile that it collected in its IPO. As we noted above it has Minera Andes in its orbit or would like to. In fact it offered around $250mn, only slightly over six months ago, to the hapless MAI to acquire the minority position in San Jose. Now its trying t o nickel and dime them to death. In retrospect Hochschild was dumb to have offered so much and MAI were dumber not to have accepted. The story of Hochschild’s recent misadventures is related in a full note on Hochschild that we shall be putting out within the next two weeks. In the short term it is enough to say that the company has switched from paying too much for poor quality companies (Lake Shore Gold) to paying too little for its targets. Alas, the targets are now dangling the “Bite Me” signs as soon as they see Hochschild’s fin in the waters.

Maybe this is a company that performs best on the management front when it has limited funds and a recession exists in its industry. Clearly money burnt a hole in its pocket and strategic thinking was the baby thrown out with the bathwater. Ideally this company should merge with another company of size to reorient its focus away from silver-dependence however the chief negative at Hochschild is that it is a Latin company and as such has a family in the foreground rather than the background and dilution is a no-go zone for Latin families. That may give comfort to some shareholders but its also precludes the company (now that the cash pile is largely blown away) from doing much more than nibbling at small targets (which may have great prospects).

A stock to watch : Amerigo Resources (ARG.to)

Despite being one of the walking wounded from the copper price collapse we suspect that this company with its canny and focused management will be one to come out on top. However, this is dependent upon a rally in copper before it is too late. If copper gets back above $2 per lb then Amerigo should be empowered to do more than just mark time as it currently does.

The company only has a market capitalization of around $34mn at the current time. This company currently produces copper and molybdenum concentrates from tailings from Codelco's El Teniente mine. Amerigo treats all the fresh tailings from El Teniente's present production, and has the right to treat the higher-grade old tailings from a 200 million tonne abandoned tailings impoundment located near it's plant. We met with the company earlier in 2008 and at the time the company had a goal to increase annualized production to approximately 60 million pounds of copper and one million pounds of molybdenum.

Ironically energy costs were its big problem when we met and now these have gone the company's way while copper and moly have gone into a meltdown. Amerigo claims that it can reduce its cash costs before royalties to $1.20 to $1.25 per pound of copper during the course of 2009. This is down from nearly $2 when we met. It restores margins to positive territory. The company was still turning in a positive operating profit in the September quarter but this must have turned south since then.

The company has a symbiotic relation with Los Andes (LA.v) a stock we have written favorably about in the past due to the potential of its Vizcachitas project in Chile. In August Amerigo dubled its stake in Los Andes via a placement of 4 mn shares and 4 mn warrants at 50 cts each. Not such a smart deal as the shares now trade around 7.5 cts. Amerigo now has beneficial ownership of 8,015,000 common shares and 6,007,500 share purchase warrants of Los Andes, representing approximately 14.08% of Los Andes's issued and outstanding common shares (calculated to include the common shares issuable on the exercise of the 6,007,500 warrants). As a result of this Amerigo had only a touch over $4mn in cash at the end of the third quarter. However, its strong local connections means that it is one of the few Canadian miners with a Chilean bank credit line. For Los Andes (with which it shares directors) this was enough money to tide it over on a skeletal drilling schedule until the crisis passes. Frankly we think that Amerigo should just move on Los Andes and make the genesis of a larger mining group. A local listing in Chile would make sense also.

Conclusion

We have been like a voice crying in the wilderness for M&A. No one much paid attention though there were some nodding in agreement and wondering what sort of impetus would get companies to sit down and negotiate away their little fiefdoms. Our mid-year note on the subject highlighted Capstone as one of the most attractive partners around, and lo and behold a deal was done. And a splendid deal it was too.

We have spelt out that the techie/financial divide has been the problem in this space. Clearly the idea cannot come naturally to the techie crowd so it has unfortunately been gun against the head that has achieved the most movement. There are still lots of interesting assets out there in distressed companies. Waiting for them to go bust though is a mistake. Some have shown an avbility to shrink to $20,000 per month burn rates and hope to last out 20 years of drought with their remaining $400k in cash. These companies are the “undead”. Their assets aren’t auctioned off by liquidators because the companies are still alive, barely. Their ranks are growing by the day.. Maybe the lack of action by some potential predators could be attributed to an excess of supply but frankly it usually comes back to lack of gumption.

In the investment community the secret is not just how to identify bargains (that is the easy part) it is how to catalyse a transaction by poking and prodding the potential partners into a situation where consummation is doable. Activism on the investment side should be a new trend. Techie managements aren’t the only deer in the headlights, so too are excessively passive portfolio players.

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