Opinion

FROM THE CAPITAL

Orocobre makes claim on equity portfolios

Argentina lithium project puts junior on a path to tap high-growth market

John Robertson

Orocobre has the makings of an equity portfolio mainstay, an attribute few mining companies possess. To realise its potential, the company must show it has what it takes to penetrate specialist markets.

Orocobre announced at the start of February that it had completed the commissioning phase of its Olaroz lithium plant in Argentina and was set to ramp up commercial production.

The company was listed on the Australian Securities Exchange in late 2007, with several mineral prospects in Argentina including the Olaroz lithium brine prospect in Jujuy province. Drill testing at Olaroz began in September 2008 and since then the project has remained the company's primary focus.

Along the way, Orocobre acquired a portfolio of borax assets from Rio Tinto. Acquisition of the 50-year-old Borax Argentina business in August 2012 complemented the Olaroz development pushing the company further along the specialty chemicals path. The move uniquely positioned the company as both a start-up and a longstanding business, with connections into some of the specialist market segments it sought to penetrate.

A link with trading house Toyota Tsusho Corporation has proven pivotal to successful development. A 75/25 joint venture dating from 2010 underpinned the financing of the project, with some US$192 million of the total US$229 million development cost sourced from Japanese institutions with its help.

Not everything has run smoothly. Government approvals were less speedy than the company had budgeted. Construction has also taken longer. A scheduled production start in early 2014 is nearly a year late.

The market has generally given Orocobre the benefit of the doubt when things have not gone to plan. Its investment return has been within the top 5% of returns among ASX-listed resources companies, while the plant was being built during 2013 and 2014. The S&P/ASX 200 returned 27%, the S&P 500 increased 44%, while the Orocobre share price rose 90%.

Now, Orocobre plans to produce 17,500t/y of battery-grade lithium carbonate at a cost of US$2,000/t. It expects to receive a price in the range of US$5,000-7,000/t, a potentially strong margin that will be needed to validate a market value of A$387 million (US$300 million).

Olaroz in northwest Argentina has a large salt-lake hosted brine resource able to support a long project life

Realising its marketing aims would imply a pre-tax cash return on an investment of 11-12% and a price to sales ratio of 3.5 based on the lower end of its sales price target. A prospective return of this size for a company yet to make its first sale suggests considerable success has already been embedded in the share price.

The current 10.2% cash yield based on Apple Inc 2014 operations puts the Orocobre pricing in some context. The Apple Inc market value is also 3.5 times 2014 sales. DuPont, The Dow Chemical Company and Albemarle Corporation are all well established in the sector Orocobre is entering and trading at multiples of 1-2 times 2014 sales.

At the currently anticipated production rate, Orocobre has a resource big enough to continue producing for 40 years. In October, it identified an additional exploration target that would allow an even longer operating life or a considerably larger output.

The long life potential of the Olaroz project offers investors the unusual chance to buy a resources company with enduring growth. Most often, companies in the sector will quickly ramp up production and, once at capacity, rely on commodity prices for subsequent earnings uplift. With mine lives frequently under 10 years, investors quickly confront a deteriorating value proposition.

Recent comments from Orocobre directors have raised expectations of a rapid increase in initial sales followed by a growth rate at least in line with market expansion.

The ideal for an investor is steady ongoing growth in sales that markets are prepared to capitalise and embed in current market prices. Orocobre is in a position to fulfil this investment ideal. The current 33,000t/y lithium market is growing rapidly, with the potential to double in size over the next seven or eight years.

The extent to which future value can accrue will hinge on the evolution of the lithium market and adaptation of related battery technologies, especially in transportation applications. The company's value will also reflect the attitude of potential customers to diversifying sources of supply. With the advantage of already being in production, Orocobre should be able to react more quickly to expansion opportunities than new developments, many of which are technically more difficult and require scarce and expensive funding.

Pricing is a risk with which investors will have to contend. Orocobre has flagged an ability to sustain high margins into the future. There are circumstances in which this could happen, but commodity markets typically erode high margins. Averting margin compression among lower-cost producers usually depends on higher-cost producers retaining a sufficiently large market share. Recent experiences in the iron ore and oil sectors bear out the tendency for prices to fall as new production at the lower end of the cost curve is available to fulfil rising demand.

Offsetting these considerations to some extent is the specialised nature of lithium product streams and the priority attaching to meeting individual end-use specifications. This can lead to more customised price settings than are typically found in commodity markets. Orocobre will be relying on this to sustain its anticipated margins.

Margin retention could act as a constraint on how rapidly Orocobre can expand its output and the company will have to balance these competing forces to maximise its investment potential.

Investors will watch the Orocobre sales results closely from quarter to quarter in much the same way they watch Apple or Du Pont. Depending on how the sales process is managed, this could be a source of indefinite market volatility, as it is for any other company whose ongoing investment return depends on continually rising revenue. This is especially the case for companies engaged in technology-driven market sectors in which underlying investment propositions rely heavily on industry or consumer take-up of new products. ▼

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