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Nickel Mines gets lucky

Nickel Mines has had a double dose of good luck as it pushes ambitiously to become the world's largest listed pure play nickel stock.

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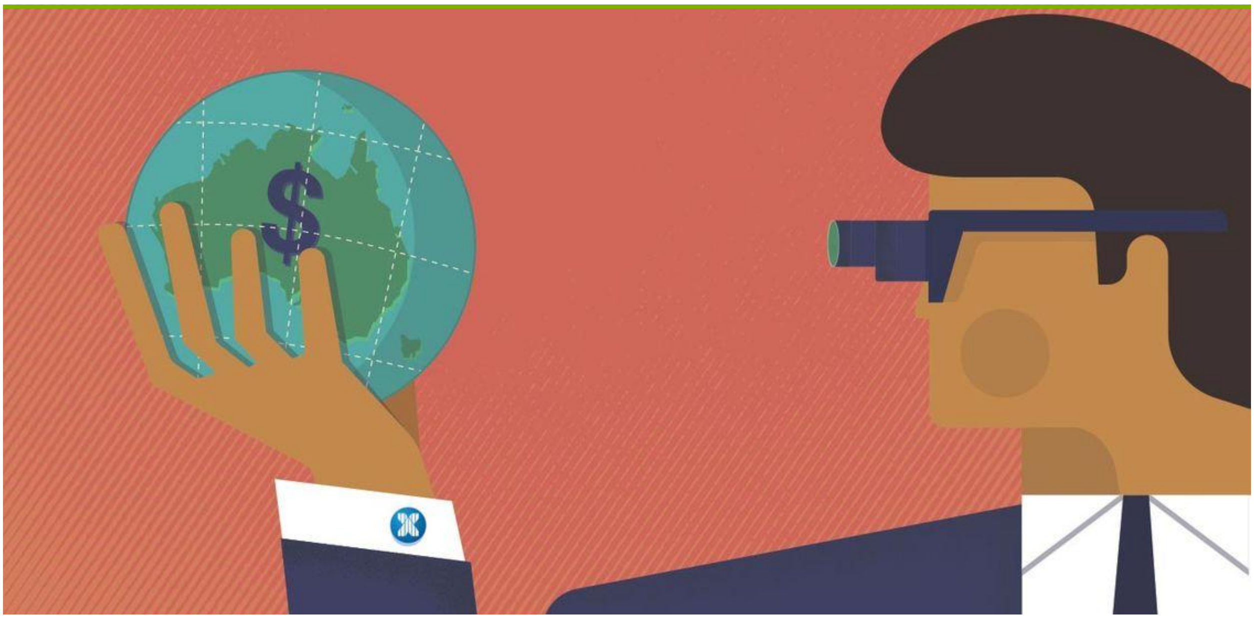

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The founders of Nickel Mines - former directors of Bolnisi Gold, taken over by Coeur d'Alene Mines in 2007 - listed the company on the ASX as recently as August 2018 after spending a decade and failing twice to enter the global nickel trade.

Deposits in the Solomon Islands were the first stop. The 2008 financial crisis, combined with land access problems, forced a rethink there. A search for a new project eventually took the group to Indonesia where it acquired an 80% interest in the Hengjaya lateritic nickel resource in Sulawesi with the intention of mining and shipping ore.

The Indonesian gambit faced a potentially fatal roadblock when the Djakarta government first moved to prohibit exports of unprocessed mineral products in 2014, within a year of the mine's start.

The company's luck turned dramatically in its favour when Tsingshan Holdings, the world's largest stainless-steel producer, set up nearby. Prompted in part by the Indonesian government export ban, the Chinese steel manufacturer is spending US$5 billion on an industrial park, including stainless steel production capacity, just 20km from the Hengjaya site.

The Tsingshan venture gives Nickel Mines a convenient market for its 30 years of resource but also opened the door for a deeper commercial relationship. The Tsingshan link is transforming Nickel Mines from yet another company struggling to find a viable project to an internationally substantial metal producer.

In deals with Tsingshan, Nickel Mines spent US$120 million to acquire a 60% interest in two rotary kiln electric furnace (RKEF) lines with capacity to produce 16,000 tonnes of nickel in nickel pig iron. Nickel Mines has an option to increase its interest to 80% for an additional US$60 million. The company has a parallel deal for an 80% interest in another two lines for US$231.4 million.

The second piece of luck for Nickel Mines has been a surging nickel price that, if sustained, would allow its share in the RKEF lines to spit out annual cash flows approaching US$250 million. Tsingshan, it turns out, has generously gifted the company future cash flows and a potential billion dollar-plus market capitalisation on the cheap.

> **Reliance on commodity prices for investment returns tends to erode performance differences and blur the need for stock choice**

Actual financial outcomes and the eventual investment returns from Nickel Mines remain at the mercy of nickel prices. For decades, nickel prices have displayed a more volatile profile than the prices of other base metals. Nickel Mines has both suffered and benefitted from the tendency for prices to gyrate quickly between boom and bust.

The nickel market risk profile should mean that investors always pay more for a zinc or copper producer than a nickel miner, everything else being the same. Similarly, a higher discount rate would be warranted in valuing the cash flows of a nickel-exposed company than a producer of another commodity. Such analytical niceties are rarely recognised.

Speaking to investors in Melbourne recently, Nickel Mines chief executive Justin Werner sought to reposition the company away from the nickel hyper-volatility, which has tainted companies in the past. Werner insisted that Nickel Mines "is not a mining story".

According to Werner, Nickel Mines produces the most profitable nickel units in the world. To emphasise its investment prospects, Werner drew attention to several broker 'Buy' recommendations with 12-month price targets sitting around A$1 (US68c) per share, based on anticipated cash flows. Since speaking, the share price has risen as high as A73c.

One of the brokers to which Werner referred, and the lead manager in the company's 2018 IPO, had placed a A95c a share price target on the company in July. In fact, that broker had categorised the company as 'Speculative' and not, strictly speaking, a 'Buy'. A stock in the former category, the broker says, "may not be suitable for retail clients", a warning omitted from Werner's presentation to an audience, which included retail investors.

To adequately compensate for risk, a stock in the speculative category must be able to demonstrate a return of over 30%, according to the broker's recommendation glossary, suggesting an imminent need to downgrade the current recommendation or favourably re-evaluate the project economics.

As it turns out, in the past week, the broker did issue a new report. It not only upped the share price target to A$1.24 but also removed the 'Speculative' designation. Is Nickel Mines worth 30% more than in July? Not really. All but A5c of the target price upgrade has come from an unexplained change in the valuation methodology.

The cash flow valuations underpinning these price targets all use a lowly 12% discount rate. Low discount rates are a helpful artifice with which to conjure attractive short-term price targets but downplaying the near-term risks comes home to roost. Analysts cannot up the valuation in response to lowered risks, as a company progresses its plans, if they have not taken account of the risk profile in the first instance.

As the valuation gap closes, a company like Nickel Mines will depend more heavily on commodity price movements rather than valuation for an acceptable investment return.

Reliance on commodity prices for investment returns tends to erode performance differences and blur the need for stock choice. The correlation between nickel price moves and price changes for nickel miners Western Areas and Independence Group, for example, have not been significantly different over the past seven years.

Over the brief history of Nickel Mines so far, there has been little difference in its responsiveness to metal price movements and the leverage to metal price changes of the two longer-established nickel miners.

However much Werner might prefer to have discarded the nickel-price connotations usually associated with miners, he needs as much leverage to the price as he can get to match others in the market and avoid having to rely on analytical sleight of hand to bolster performance.

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