

## The high cost of hubris

Orocobre investors have remained remarkably supportive despite foregoing profits amounting to hundreds of millions of dollars from production delays. The company is another illustration of how resources firms are more likely to zigzag to success than head in a straight line.

John Robertson\* | 23 Mar 2017 | 6:39 | Opinion



*Orocobre's consistent misjudgments at its Olaroz operation should be a warning sign for investors*

In July 2012, the company had said it would be producing in the first quarter of 2014. Production actually started in 2016 with just over 8,500 tonnes of lithium carbonate. It now expects a little over 14,000t in 2017 on the way to reaching the nameplate production rate of 17,500t per annum for the first time in 2018.

The profit foregone from delays and higher than anticipated costs could be as much as US\$240 million.

In February, the emerging lithium producer proudly described its flagship Olaroz project as "strongly profitable" despite having to pull back guidance on its near-term production yet again.

At one level, Orocobre could be characterised as one of only a tiny handful of successful new entrants to the mining industry.

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Starting with little meaningful background, the company has created a complex lithium brine development processing circuit in Argentina. For that, those associated with the company deserve considerable praise.

The company has built what could be a very profitable, strategically well positioned long-life asset. On paper, it could justify holding down a long-term position in a portfolio of investments along with the likes of BHP Billiton and Rio Tinto.

Hand-in-hand with this considerable achievement, though, has come disappointment.

Orocobre's success depends on an unusual combination of sophisticated processing and having to wait for nature to invisibly take its course. Unlike a hard-rock miner, Orocobre engineers cannot see tonnes being moved. Therein lies the source of its latest problem.

Orocobre had been relying on a complex Excel spreadsheet model to calculate inventory accumulation in evaporative ponds from which to forecast its production.

Within the bowels of its 20 megabyte model lurked every analyst's nightmare. An incorrectly specified formula calculating evaporation rates left the company with less saleable product than it had expected.

Model stress testing, which might prevent accidents like, this relies on having people with operational experience recognise potential discrepancies between what models say will happen and what is feasible.

Speaking just on two years ago, as he was trying to promote his own hard-rock lithium mining project, the chief executive of Pilbara Minerals was urging investors to eschew an investment in Orocobre in favour of his company for this very reason.

Neil Biddle foreshadowed how complex processes led by inexperienced managers would prevent the company meeting its targets as he derisively dismissed the possibility of Orocobre's success with a jaunty "I wish them luck".

Of course, a competitor would say that, but sympathy for Orocobre's predicament is limited by the company's own strenuous denials of the development risks along the way.

The company had always claimed that the production process was straightforward, doing business in Argentina was trouble free, operating personnel were in abundant supply, adequate supervision of an Argentine project from Brisbane was possible and that the lithium market would remain strong.

The strength of the lithium market has persisted but the company has frequently floundered as it has tried to overcome other evident obstacles to success.

The company's latest quarterly activities report disclosing a commitment to raise the frequency with which management in Argentina meets directors and executives from Brisbane to just twice a year hints at inadequate oversight.

After five years of promise again punctuated by disappointment, disenchanted investors have stripped A\$398 million (US\$305 million) from the market value of the company since late January.

Despite the renewed selling pressure, the current market value of A\$615 million is 55 times annualised 2016 second-half EBIT.

A great deal of future success is embedded in the company's share price. Even if it was hitting its production target, the company would already be trading on the same multiple investors are applying to Rio Tinto, for example, based on its operating results in the second half of 2016.

Orocobre has announced expansion plans. It intends to double capacity in Argentina and build a lithium hydroxide plant in Japan with its current joint venture partners.

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*"An already pricey Orocobre now has to keep hitting its targets, drawing on all of what it has learned in the past five years"*

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Together, these investments will incur expenditures of up to US\$220 million, of which Orocobre plans to make up US\$43.3 million to supplement available debt funding and partner contributions.

The company has yet to clarify satisfactorily whether these sums will also be adequate to cover expanding working capital needs it had earlier underestimated as it ramped up stage one.

Lengthy brine pond gestation periods have resulted in the accumulation of a 40,300t lithium carbonate inventory with a notional market value of around US\$400 million at the end of December. The joint venture's balance sheet assets include inventories valued at US\$36 million.

Assuming the company smoothly achieves its latest set of operational goals and lithium carbonate prices do not change, an annual operating income in the vicinity of US\$170-180 million is possible.

Based on how other companies are valued, a market capitalisation of around A\$1.175 billion by 2021 is feasible by which time there should be a track record of successfully meeting production and sales targets.

Such an outcome would imply an annualised four-year investment return of 17%. Nothing less should be acceptable. Hundreds of other companies in the sector have the potential to do better.

An already pricey Orocobre now has to keep hitting its targets, drawing on all of what it has learned in the past five years.

A more impressive track record is needed to underpin what should be a minimum acceptable investment outcome given the nature of the industry and the company track record.

