

FUNDAMENTAL VIEW ON METAL MARKETS - Part II



Debt and High Grading to Push up Metal Commodities

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As a follow up to my resource industry and market review of December 9, 2008 'Fundamental View on Metal Markets' let's review a synopsis of that letter before proceeding to how corporate debt and high grading is affecting the supply of metal commodities today.

In the supply and demand equation, focusing on supply is the basis for a rebound in metal commodities thereby positively affecting explorers, developers and operating companies that survive the current blood bath.

I pointed out in my earlier letter that gold would lead the way in for all commodities to rebound. As we have seen, gold is now over \$935./oz. up from \$750./oz. in November 2008 resulting in some gold stocks rebounding between 100% to 300% in a three month period.

We see wide swings in the price of copper (\pm \$.20) as the metal looks for a reason to go higher. Manganese flake at \$1.05/lb. in November 2008 is currently at \$1.35/lb. (Ryan's Notes), nickel vacillating \pm \$1.25/lb., zinc, lead and crude oil appear to have found a bottom near their November lows. We should start to see a strengthening of metal commodity prices in the next few weeks as the prices once more head north.

As we review the past year it is important to note that a great many companies actually achieved new highs in June 2008, particularly a number of resource stocks reached historic highs. However, July saw stocks begin a rapid slide toward the cliff. Metal commodities avoided an obvious downturn until October, sustaining levels four months longer than traditional equities.

The reasons were apparent as the recession in North America and Western Europe deepened. China cut power by 50% for six months creating stockpiles of metals and the panic of the worthless debt instruments pounded all markets simultaneously, the perfect storm for a complete rout of shareholder value and savings. Currently, the U.S., Western Europe, China and several other countries are on build-out programs with plans to replace aging infrastructure budgeting trillions of dollars to create jobs and wealth within their own boundaries.

I agree that this will work over the next 3-4 years, although the printing of new money to accomplish this will eventually have a devastating effect on all economies throughout the world. One of the obvious beneficiaries of this will be commodities, especially metals as the steel mills once again run at full capacity lifting the prices of coal, iron, manganese and specialty metals like molybdenum, tungsten, magnesium, cobalt and niobium. Copper, lead, zinc and nickel demand will also increase concurrently.

The surviving miners, developers and explorers will once more see an appetite for their shares and financings will again be available. You are already seeing 'bought deals' for up to 100's of millions of dollars. The recipients are profitable companies, mostly in precious metals with money in the bank, low cost operations and advanced gold/silver resources looking to expand. This tells us there is a lot of money on the sidelines which will eventually invest in traditional risky development and exploration.

Currently, stockpiles of all metal continue to climb. I believe the effect of the shut-downs in the production of all metals (especially nickel and zinc) has not yet impacted the current situation. A lot of our shut-down metal producers will not be reinstated. Stockpiles will disappear as rapidly as they built up.

This leads into my analysis of rebounding commodity demand and how the effect of debt and past high grading of mines disrupts the supply. One question which begs to be answered is how so many mines cannot make a profit or are operating at a loss while the price of their metals is still substantially higher than the prices in 2002? Also, how does a company's debt effect production?

Let's look at the debt first. Over the past five years debt financing was favored by companies and shareholders alike, it created less dilution and made a lot of sense in the market environment we were in. Debt could be repaid in 2 - 5 years at 60% or 70% of the current price at the time. Majors, juniors and developers embraced the debt scenario. Investment firms created facilities to accommodate the expanding trend. Debt made sense and the availability of debt outweighed equity financing.

I myself as 'a key executive' was also engaged in helping to facilitate a large bridge financing for a company I founded. That bridge eventually turned from an asset to a liability. The inability to repay the existing debt has shut down production and forced bankruptcy onto several producers and development companies **disrupting future and current supply.**

Acquisitions by major and mid-tier companies were paid for by the creation of debt. These acquisitions, which could have been financed by the acquired target company's production and cash flow, have been negatively affected. The focus is realigning on repaying or paying the interest on debt. Companies are being forced to sell off parts of their operations (usually some of the 'crown jewels') to meet interest and debt repayment. Companies with large debt loads will lose their positions in the pecking order. Some companies with smaller debt loads have not had their capitalization as seriously affected negatively and will be able to complete equity financings to pay down at least their short-term commitments.

This disrupts the supply as any mine operating at a loss will go on care and maintenance as it is paramount that cash flow goes to service debt and cannot be reduced by even marginal losers. **A lot more shutdowns are apparent - negatively impacting the supply of metal commodities.**

Prior high grading of existing brown field operations has also accelerated the closing of mines. It made a lot of sense to re-engineer your mining plan to take advantage of the prevailing high prices and to telescope your operation to get the best grades. No one expected the metal prices to collapse as rapidly as they have. A lot of mines are now relying on lower grades and higher strip ratios at much lower prices. Fewer pounds per tonne equates to higher costs per pound. These mines are now considered high cost producers and are or will be shut down.

At one time mines could afford to stockpile a portion of their concentrate production while waiting for commodity prices to increase. The exact opposite is now in effect with all production required for debt repayment. The majority of base metals, specialty metal, iron and coal producers are being dictated to by servicing debt load. The same scenario is effecting the mid-tier and small oil and gas producers.

A lot of metal supply has disappeared with more shutdowns and cut-backs occurring on a daily basis (see my expanded list of NA companies with operations on care and maintenance at www.reacompanies.com/list).

The following is a snapshot comparison of some of the commodity price losses in the past 8 months:

Commodity	Jun-08	Nov-08	Feb 12/09	Diff. %
Gold	\$950/oz	\$750/oz	\$948/oz	-%
Copper	\$3.80/lb	\$1.36/lb	\$1.52/lb	-60%
Aluminum	\$1.40/lb	\$0.65/lb	\$0.61/lb	-57%
Nickel	\$11.00/lb	\$3.95/lb	\$4.61/lb	-58%
Zinc	\$0.87/lb	\$0.47/lb	\$0.50/lb	-43%
Lead	\$0.85/lb	\$0.41/lb	\$0.51/lb	-40%
Molybdenum	\$32.00/lb	\$8.75/lb	\$9.15/lb	-72%
Manganese Flake	\$2.00/lb	\$1.05lb	\$1.35/lb	-33%
Cobalt	\$51.00/lb	\$16.00/lb	\$16.25/lb	-69%
Crude Oil	\$145/brl	\$41/brl	\$33.50/brl	-76%

Mining shutdowns due to commodity price weakness is not something new. My experience has been that these shutdowns occurred sporadically over several years. (Some of the old mines that were shut down a decade ago are currently back operating.) There is an unprecedented number of shutdowns over a few months. *You only have to stand back and visualize that all of this lost production was required to meet demand in early 2008.* I will reiterate my reasons for metal commodity prices to exceed their historical highs in the next cycle:

1. The BRIC countries infra-structure expansions will continue to create demand for all metals.
2. New infrastructure expansion and replacement amounting to about \$2 trillion in several countries will absorb more metal commodities than previously.
3. Debt repayment now dictates mining policy resulting in more shutdowns.
4. Government stockpiling of all metal will accelerate especially in China which holds trillions of U.S. dollars.
5. Stockpiling of strategic metals by governments as economic uncertainty creates worldwide tensions.
6. Reluctance by the mining and development companies to finance expansions and new development. After the last go around the emphasis will be top reserve cash after debt repayment.
7. New projects have a long development period from feasibility to production (3 - 5 years) that does not include paybacks. To be successful in new production you will have to hit two cycles in this bull as there will be other pullbacks along the way. As always, timing is everything. You don't want to be too soon or too late. At least

half of the new mines on the drawing board have been indefinitely sidelined.

8. The supply side of the equation for metals has been set back at least 5 years.
9. Future investment for new mines will come by a combination of joint ventures, cash reserves and new equity. It will be a while yet before this happens.

These are several reasons to be investing in producing, exploration and development companies at this time. Gold stocks are already lofting, the bargains will be found in the gold explorers and under-valued metal companies. They are not that far behind. Again due diligence on these companies is paramount in your investment strategy.

Let's recap the events that are rapidly developing in our industry:

1. Financings are picking up, especially bought deals for companies having cash and low cost operations, and those companies having developing resources in gold/seller.
2. Mergers and acquisitions are picking up steam, in some cases bidding wars are beginning to develop.
3. Shares of companies that are shutting down unprofitable mines or reducing large commitments and obligations are actually going up.
4. Cashed up mid-tier and major producers gearing up for acquisitions of companies having production and/or large resources of gold and silver.
5. Chinese companies buying up cash strapped resource companies or parts of large companies (as an example Rio/Chinalco the Chinalco investment of \$19.5 billion).
6. Advanced gold company shares are breaking 6 -7 month highs.
7. Majors continue to shut down or reduce production of iron, coal, manganese, zinc, nickel and copper.
8. Smelter rates going up while reducing capacity in some cases.
9. Mines in all categories continue to shut down worldwide. The list I have made is the tip of the iceberg and only entails TSX & TSX.V mining companies.

The upshot is investors and funds are once again investing in mining operations, development and exploration. It is conceivable that this investment will soon start bargain hunting in gold exploration and the battered base metals, coal, oil and specialty metal companies. As with gold the window of opportunity is currently wide open for bargain hunters and, also as in gold, it will rapidly close.

As you follow events in the media the emphasis is on how the mining industry is reeling from bankruptcy, layoffs, strikes and negative cash flows. This has created one of the best buying opportunities I have seen in my 45 years in the mining industry.

In conclusion, from time to time, I'll be updating this article, and if you'd like to receive those updates, please send an email to: lwreaugh@rdminerals.ca.

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