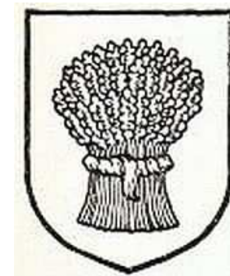
Wednesday, June 3, 2015



HALLGARTEN & COMPANY

Coverage Update

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MFC Industrial Ltd (NYSE: MIL)
Strategy: Long

Key Metrics			
Price (USD)	$ 4.36		
12-Month Target Price (USD)	$ 6.30		
Upside to Target	44%		
12mth hi-low USD	$ 3.61 - 8.20		
Market Cap (USD mn)	$ 275.3		
Shares Outstanding (mns)	63.1		
Dividend Yield	5.5%		
	FY14	**FY15e**	**FY16e**
Consensus EPS		n/a	n/a
Hallgarten EPS		$0.70	$0.90
Actual EPS	$0.01		
P/E	326.8	6.2	4.8

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MFC Industrial

Trading at Its Cash Value

- + Management changeover is now complete with new team steering the company away from some past mistakes
- + Many of the natural gas assets have been put on the sales block
- + The plan to distribute around $100mn to shareholders in a capital return is admirable
- + Peace has broken out with the largest shareholder being given representation
- + The plan to "do a bank deal" to create a sort of trade bank is a good one and we suspect this will be the purchase of a bank in Central Europe
- + Company has a massive cash-pile amounting to over $300mn, greater than its current market capitalisation
- × Sprawling "global supply-chain" business is relatively low margin as March quarter results show
- × Company has resisted (or slipped up) entering the metals trading business in a whole-hearted way

A Trading House by Any Other name….

MFC Industrial currently styles itself as a global commodities supply chain company however the eclectic nature of its assets would cause us to question this self-designation. It bases this categorization on its activities "sourcing and delivering commodities and materials to clients, with a special expertise on the financing and risk management aspects of their businesses". It is active in a range of basic materials and resources, including iron ore, bauxite, manganese ore, cobalt, base metals, magnesium, steel, zinc alloys, aluminum, coal, silicon and ferrous alloys – as well as plastics and wood products.

The company itself is cagey about its trading operations and when the question went out to our collaborators in the trading community about MFC, the universal response was "Who?". There is a difference between low-key and insignificant and MFC seems to be on the wrong side of that divide at least as far as metals trading is concerned.

The other transaction that the company would point to in justifying the supply-chain moniker was carried out in late 2011 and represented the purchase of a firm with a Latin American slant that is involved in distribution of products out of South America into Mexico (if we interpreted the public information correctly). Once again, this was an asset no-one had heard of in the broader world. While it was styled as a bolt-on to the existing assets (i.e. the trading activities) the new vibe became "global supply-chain logistics".

Until last year the company, under previous management, looked like it was purely opportunistic and investors could wake up tomorrow and find supply-chain management gone and some new exotic line

of business taking centre-stage. The recent shift of power towards a group led by Wall Street veteran, Peter Kellogg, bodes more profit-oriented management and a tightening of the corporate focus.

Some Background

The company was previously known as Terra Nova until late September 2011 when it changed its name to the current bland incarnation (generating confusion with two other major financial firms of similar name). The company is nothing if not mobile. Few companies show the enthusiasm for making and remaking itself morphing and dividing itself in various ways in an attempt to “make value for shareholders”. The now-displaced team at MFC Industrial had a 25-year record of cycling through undervalued or troubled assets, seizing at turnaround opportunities and initiating what it claims are low-risk restructurings of problem operations. Again it claims that it has rewarded its shareholders with spinout, dividends, returns of capital and other distributions, producing a compound annual return of 20.4% over the last ten years. The last one of these deals was the Compton transaction in the energy sector, of which more anon.

Trading Operations

At the time of our last note, the main focus of the company was its trading operations. The table below shows its main product lines:

METALS	PLASTICS	TIMBER PRODUCTS
iron ore	polystyrene	wood pellets
manganese-ore	high density polyethylene	saw logs
cobalt	linear low density	round logs
base metals	polyethylene	sawn timber
magnesium	low density polyethylene	plywood
steel products	polyethylene	medium density
zinc alloys	terephthalate	fiberboard
aluminum foils	polypropylene	
aluminum sheets	polyvinyl chloride	
ferrous alloys		
silicon metals		

Trading is a notoriously opaque world and most players have preferred to play in the twilight zone of private ownership instead of the public markets. MFC Industrial has found itself comfortable in this space and it is no surprise as it has often appeared to be a private investing club operating in the public arena. Thus for trading to rise to become its main activity, did not involve a major culture change. However with Glencore now representing the gold standard of disclosure on metals trading (we have long been able to have a window into softs via ADM and Bunge), the level of information on the mix of products in MFC’s operations could be much better.

From information gleaned elsewhere and snippets in the company’s conference calls we were able to say that the main areas of focus were iron ore and ferro-alloys and plastics. In the former it is a well-known player, though in plastics we suspect it is far from being a household name in what is a lot more

diffuse sector than the metals space. Both businesses had a strong Mittel-Europa orientation.

The mooted DCM transaction would have significantly changed the firm's balance towards metals if it had been consummated with a further strengthening of status in the iron-steel complex-related metals, with a quantum leap in its chromite activities. However the consolation prize transaction that did eventually come to pass was much more humdrum and gave the company geographical spread but scarcely any more heft in the key metals space.

A large proviso must be added at this point as traditional trading model for steel raw materials (both iron ore and the alloys) is in a state of flux at the current time. What has been missed by most observers in the West is the subtle but material change in the position of Chinese raw material buyers since the commodity meltdown. In each case of the steel complex inputs, there now exists an enormous inventory, purposefully accumulated by the Chinese along their NE Ports. Their motive is to become the dog and no longer the tail in setting price (as they have successfully achieved in copper).

The Supply Chain Buy

In late November of 2012 MFC announced that it had acquired majority interests in two interlinked entities, ACC Resources Co., LP and Possehl Mexico S.A. de C.V. These were privately-owned, "fully integrated commodity supply chain" companies, specializing in industrial raw materials, chemicals and various other products. ACCR was established in 1957 and had its head office in New Jersey and a network of offices in Latin America including Argentina and Brazil, as well as a sourcing office in China. Possehl, which was established in 1986, has a network of offices, warehouses and agencies in Mexico. Both of them source commodities internationally and sell primarily in Mexico.

The logic of this acquisition was that they expanded MFC's existing network further into the North and Latin American markets. MFC claimed that the addition of these businesses would bring new product lines that "will integrate well into MFC's existing commodities business". All key managers of ACCR and Possehl will remain with the acquired companies, and both ACCR and Possehl will retain their established branding identities as well as their current business locations. Together ACCR and Possehl have approximately 100 employees.

The ACCR and Possehl businesses offered a wide variety of products with various size and packing alternatives, including raw materials for various industries such as:

- Refractories and ceramics, which include: bauxite, flint clay, magnesium oxide, alumina cements, chrome ore and other products.
- Steel and foundry, which include: ferro alloys, metals, coal, coke and other carbon products, master alloys, furnace additives & conditioners
- Talcs and plastics, which include: own brand talcs for the paint and plastics industry, seven grades of Possalc and one of Possahl, pp & pe, titanium dioxide - rutile and anatase, mica, wollastonite and calcium carbonate
- Chemical and minerals, which include: products for the detergent, cosmetic, glass, and leather treatment industries. Developing ceramic proppants, fracturing sands and baryte powder api grade for the oil and gas industry
- Food and beverages, which include: citric acid, phosphoric acid, sodium cyclamate (sweetener),

sodium bicarbonate and gum

- Animal feed integrates, which include: mineral additives for animal feeds to maintain and support healthy growth
- Other Chemicals & Minerals, which include: acid grade fluorspar, aluminium fluoride, aluminium hydroxide, barium carbonate, calcium chloride, magnesium chloride and carbon filters and felts from Japan

Quite a few of these products were new to MFC's commodities platform so the company claimed it should be able to cross-sell these into MFC’s European client base and likewise market MFC’s range into Western hemisphere markets.

MFC also claimed at the time that the sourcing center in Beijing would be a positive for the enlarged group. The intention was to expand the Chinese activities of ACCR and Possehl to not only sourcing, but also selling various products and commodities. MFC has been able to open up ACCR and Possehl towards a more global approach to sourcing looking towards Europe, India and the former Soviet Union countries in particular. These are areas where MFC will be able to assist by utilizing our established European and Indian companies.

The Norwegian Buy

One gets a bit tired of the “supply-chain” buzzword bandied about by the company’s management. A good example was a purchase in early 2014 of what was obviously an industrial company which management (at that time) chose to describe as “a vertically integrated supply-chain management company”.

In January of 2014 the company announced that it was acquiring a 100% interest in the FESIL AS Group, which has a production facility in Norway, sales companies in Germany, Luxembourg, Spain, United States, India and China, and an interest in several quartz deposits in Spain.

FESIL is headquartered in Trondheim, Norway, and is one of the leading producers of ferrosilicon, an essential alloy in the production of steel, stainless steel, and cast iron. FESIL's smelting plant is located in Mo i Rana, and produces a range of ferrosilicon products including granulated and refined qualities (high and semi-high purity), which makes up the bulk of its production. Annual capacity of the plant's two furnaces is approximately 80,000 tonnes of ferrosilicon and 23,000 tonnes of microsilica. The facility is certified according to ISO 9001 and ISO 14001 and complies with Norway's strict environmental and operational requirements.

The purchase price was approximately 500 million Norwegian Krone (approximately US$82mn). Additionally, MFC agreed to pay a royalty based on tiered ferrosilicon production at the Mo i Rana facility for two years, expected to equal approximately 2.9% of ferrosilicon revenue per annum at full production.

FESIL reported net revenues in 2012 of approximately 3.3 billion Norwegian Krone (approximately US$565mn) with its Production Segment representing just over 25% of net revenue. Approximately 60% of FESIL's ferrosilicon production is sold directly through the Sales Segment to customers, which include some of the world's leading steelworks, aluminum/iron foundries and chemical groups. The sales offices

also offer a number of complementary products including ferroalloys, metals, minerals, and specialty products. This business clearly meshed with MFC's long-held ferro-alloys interests managed out of Vienna.

More Austrian Assets

Something had clearly changed when a couple of months later the company announced another acquisition and did not mention the words "supply-chain" though ironically the asset acquired was closest to that description in its activities. It was mid-March 2014 that MFC announced that it acquired a 100% interest in F.J. Elsner & Co. GmbH, a "global commodity company" focused on steel and related products which was founded in 1864 with its head office based in Vienna. This also meshed nicely with trading activities the company already had based in the Austrian capital and the previous Norwegian buy.

Elsner's offerings include a full range of steel products including slabs, booms, billets, hot rolled steel plates, hot and cold rolled coils and sheets, reinforcing bars, galvanized material, pipes, tubers and merchant bars. Elsner has longstanding relationships with many steel mills in Eastern and Southern Europe as well as the Baltic States and the CIS. Revenue for the fiscal year ended June 30, 2013 was US$160mn.

The purchase price was for nominal consideration and certain contingent payments making it sound like the company was in some distress and MFC was riding to the rescue.

Changing of the Guard

After a rather protracted tussle the rebel Kellogg group managed to secure an agreement in late 2013 that finally gave them board representation. After having long been the largest shareholder and long pushed for representation, this was finally conceded. In December 2013 MFC and IAT Reinsurance Company, Ltd. and Peter Kellogg agreed that Peter Kellogg and William Horn would be elected unopposed as directors of MFC at its shareholders meeting held on December 27, 2013. Frankly, we had long felt it was time for a change of direction at MFC and that the Kellogg grouping offered the best chance of achieving this. Peter Kellogg is a scion of the family that formerly controlled the largest specialist firm on the NYSE, Spear Leeds & Kellogg that was taken over by Goldman Sachs last decade in a multi-billion dollar transaction.

In late March of 2014 the company announced that its board of directors had appointed James M. Carter as Chief Financial Officer, Peter Kellogg as Chairman and Dr. Shuming Zhao as a director of the company to fill the vacancy created as a result of the death of Ian Rigg.

Then in May 2014, Gerardo Cortina, who had hitherto been the Managing Director of Possehl, was appointed CEO of MFC.

Then in late June 2014 it was announced that Samuel Morrow had been appointed Chief Financial Officer to replace James Carter, who was going to continue with MFC as Vice President, Finance, focusing on resource interests. This last move essentially signaled the final transition from the old guard to the new guard at the company.

The Banking Move

For those with long memories, banking is somewhat of a "been there, done that" for MFC. However that was years ago and in recent months the company has signaled that it "intends to grow and focus on our trade finance and supply chain solutions businesses. To support this vision, we intend to partner with a European bank, which will become our in-house bank, enabling us to expand the services we provide to our customers and improve our profit margins".

All well and good. Listening to the conference call for the Q1 results though gives one the distinct impression that the company is being cagey in its printed statements but in fact is likely to actually acquire a bank. From all the signs this would also seem to signal a bank in a Germanic country and frankly Austria seems to be the place. We do not know enough on the Austrian banking scene to actually identify what the target might be. However, it could also be that MFC might pick up a trade finance division of an existing bank rather than acquiring a whole bank. Whatever the target is, we would suspect that it shall be a bite-sized acquisition rather than anything substantial. MFC certainly sees enough business (and has enough capital) to massively expand a quite small operation over a relatively short period of time.

This move strikes us as the most exciting development at the company at this time.

The Status of the Wabush Mine

As noted in our previous coverage MFC indirectly derived royalty revenue from a mining sub-lease of the lands upon which the Wabush iron ore mine is situated in Newfoundland and Labrador, Canada.

In the first quarter of 2015, Cliffs commenced proceedings under the Companies' Creditors Arrangement Act (Canada) with respect to its Canadian operations, including the subsidiary that holds a majority interest in its Wabush mine joint venture. While the Wabush mine is not directly a party to the CCAA proceedings, the assets comprising the mine have been included in any sales process.

Cliffs is obligated to pay us a minimum lease payment of C$3.25 million per year. MFC currently believes that Cliffs will at some point terminate the sub-lease, in which case MFC, as the landlord, will exercise its step-in rights, which allow the company to take back the mine and purchase certain infrastructure onsite. The question then is whether the asset has any residual value for MFC as long as the iron ore price slump endures.

Hydrocarbon Asset Preservation

Our words from 2012 come echoing down the years "Compton was a seriously flawed entity pre-takeover and it was not just a case of excessive debt". The only thing the deal had going for it was tax benefits and now that they have been exploited the rest has just proved to be a drag on MFC Industrial.

The company's current strategy is to preserve long-term natural gas reserves and ensure that that these are not depleted at uneconomic prices. MFC initiated a program to curtail production at certain of its wells. To date, this program has focused on its properties in central Alberta that produce a higher mix of

natural gas liquids. It has focused on these properties because, while MFC is able to effectively hedge natural gas, it is not able to effectively hedge natural gas liquids. When production at such wells becomes economical, MFC says it will resume operations.

In 2015, MFC began hedging a portion of its natural gas production with AECO-based Canadian dollar futures to protect against further price declines in the near-term. The intention is to continue this program and hedge additional volumes to preserve assets and maximize value over the long-term. We read this as being "for sale" in the long term.

There is basically no fit with the other industrial commodities that the company trades.

Natural Gas Participation Agreement

MFC has an agreement with an operator to develop certain properties in the Niton area of Alberta, Canada. This arrangement provides MFC with the opportunity to develop its properties at minimal risk and, at the same time, provides a potential source of revenue through royalty and processing arrangements. Under the agreement, the operator will spend a minimum of CAD$50mn to drill at least three net wells per year and a total of twelve net wells during the initial three-year term, which commenced in November 2013.

The operator has drilled and completed seven wells on the lands subject to the participation agreement. Some of the wells have exceeded expectations for similar wells in this area. Five of the seven wells are currently producing, and the natural gas from four wells is currently being processed at MFC's facilities with one additional well expected to be tied in shortly. MFC elected to receive the 10% royalty on each producing well. Frankly, this business looks very detachable as well and we wuld not be surprised to see it hived off.

Natural Gas Power Plant

MFC is in the final stages of completing the construction of a 16.5 MW natural gas power project at its gas processing plant near Calgary, Alberta. Upon completion, which is expected be in the second quarter of 2015, the project will supply the processing plant's electrical needs, with excess power being sold into the grid based on Alberta Electricity System Operator's rates.

The Alberta electricity market is fully deregulated, which provides MFC with the option to run as a peaking power plant, supplying electricity only when volatile prices are at their highest.

Return of Capital

The company obviously has more money than it knows what to do with at the moment, therefore it is no surprise that the company has announced a plan to rationalize certain MFC Energy assets and return the net proceeds to shareholders.

The process is not hurried though and the company admitted it had no specific timeline to meet these goals. On the conference call for the Q1 results, some callers wanted to see a buy-back (not something we are keen on) and management said that was not their desired course. Before making distributions to

shareholders, the bank debt that MFC incurred to refinance the acquisition of these assets will be repaid as well as a provision for decommissioning costs. The estimates for the amount to be gleaned from this process are shown in the table here:

NATGAS RATIONALIZATION

All amounts in thousands of USD

As of March 31, 2015

Property, plant and equipment	55,299
Resource properties	139,985
Hydrocarbon probable reserves	39,931
Hydrocarbon unproved lands	19,616
Less	
Decommissioning obligations	($81,872)
Long-term debt	($72,918)
Net Proceeds	$100,041

Recent Results

The results for the first quarter of FY2015 were feeble, if truth be told. On $334mn in turnover the company could only provide a profit of $840,000. This just goes to reinforce the low margin nature of the business that the outgoing management put together. Sales have soared since the inclusion of the Norwegian business but the bottom line has faded. Much of the collapse has to do with the travails of the oil & gas segment but still this just highlights that the "global supply-chain" business is one without much value-added and with very little discretion to build up higher margins.

MFC Financial

In Millions of USD	FY16e	FY15e	1Q15	FY14	4Q14	3Q14	2Q14	1Q14	FY13	FY12	FY11
Total Revenue	**1,452.00**	**1,360.00**	**334.52**	**1,411.79**	**391.32**	**391.76**	**397.34**	**231.38**	**813.94**	**485.66**	**513.9**
Cost of Revenue, Total	1,296.00	1,228.00	303.37	1,271.06	360.97	355.29	357.25	197.55	710.36	406.71	428.59
Gross Profit	**156.00**	**132.00**	**31.15**	**140.73**	**30.35**	**36.47**	**40.08**	**33.83**	**103.58**	**78.95**	**85.32**
Selling/General/Admin. Expenses	76.8	74.5	17.34	85.89	22.6	18.9	27.01	17.38	63.09	47.75	47.6
Unusual Expense (Income)	-	-	-	28.91	28.91	-	-	-	6.59	-171.78	12.41
Total Operating Expense	1,372.80	1,302.50	325.5	1,402.40	415.74	378.7	389.34	218.62	795.21	294.31	495.79
Operating Income	**79.20**	**57.50**	**9.03**	**9.39**	**-24.42**	**13.06**	**8.00**	**12.76**	**18.73**	**191.35**	**18.11**
Income Before Tax	**73.2**	**54.3**	**10.27**	**3.78**	**-27.3**	**11.74**	**10.53**	**8.81**	**16.08**	**198.38**	**17.18**
Tax	13.18	8.15	3.66	1.71	-9.11	4.96	3.35	2.51	6.58	-2.63	5.98
Income After Tax	**60.02**	**46.16**	**6.61**	**2.07**	**-18.19**	**6.78**	**7.18**	**6.3**	**9.5**	**201.01**	**11.2**
Minority Interest	-1.85	-1.31	-0.29	-1.23	-0.27	-0.36	-0.11	-0.5	0.16	-0.87	0.99
Net Income Before Extra. Items	**58.17**	**44.85**	**6.31**	**0.84**	**-18.46**	**6.42**	**7.08**	**5.8**	**9.66**	**200.14**	**12.19**
Diluted Weighted Average Shares	64.50	64.00	63.14	62.96	64.03	63.09	62.95	62.55	62.76	62.56	62.56
Diluted EPS	0.902	0.701	0.100	0.013	-0.29	0.1	0.11	0.09	0.15	3.2	0.19
Dividends per Share	0.44	0.32	0.00	0.24	0.06	0.06	0.06	0.06	0.24	0.22	0.2
Diluted Normalised EPS	0.90	0.70	0.10	0.26	0.01	0.10	0.11	0.09	0.22	1.41	0.32

Despite this we see potential for improvement with the obvious "easy money" being in a reduction in the heavy GSA. In a business such MFC's the "sales" part of GSA is vital and not easily reduced but the "admin" part has always struck us as being very well-padded and consistent with previous management's *modus vivendi*. Therefore it is ripe with potential savings and already seems to be in decline.

Our projections for FY16 revenues are driven higher by the potential synergies that shall arise from the banking venture, presuming it is undertaken. We suspect that investors will be pleasantly surprised by the bottom line results in FY15 and FY16 which we are estimating at EPS of 70cts in the former and 90 cents in the latter.

Balance Sheet

The balance sheet is fairly self-explanatory and shows the substantial cash hoard that the company is sitting on. The balance sheet footings have expanded with the growth of the trading business in recent years, most particularly in inventories, accounts receivable and accounts payable.

MFC Financial - Balance Sheet

In Millions of USD	Dec 2014	Dec 2013	Dec 2012	Dec 2011
Cash and Short Term Investments	297.7	338.62	280.63	400.28
Total Receivables, Net	203.07	146.09	91.13	50.17
Inventory	212.58	88.84	142.93	81.22
Prepaid Expenses	7.75	26.91	26.66	9.04
Other Current Assets, Total	143.71	110.56	138.46	23.48
Total Current Assets	**864.8**	**711.02**	**679.81**	**564.19**
Property/Plant/Equipment	543.67	525.88	509.07	257.11
Accumulated Depreciation, Total	-89.68	-71.56	-45.19	-33.78
Long Term Investments	32.76	26.83	32.02	30.33
Other Long Term Assets, Total	107.13	126.43	150.75	7.52
Total Assets	**1,458.68**	**1,318.60**	**1,360.62**	**858.96**
Accounts Payable	118.33	83.19	-	37.46
Accrued Expenses	17.05	39.25	-	3.56
Notes Payable/Short Term Debt	161.34	129.78	160.86	114.24
Current Port. of LT Debt/Capital Leases	56.98	44.87	44.17	26.98
Other Current liabilities, Total	26.24	17.61	59.31	20.73
Total Current Liabilities	**379.94**	**314.71**	**343.74**	**202.97**
Long Term Debt	256.15	189.87	131.09	20.15
Total Debt	**474.46**	**364.52**	**336.11**	**161.37**
Deferred Income Tax	10.22	3.57	3.39	61.05
Minority Interest	1.05	0.17	6.19	2.52
Other Liabilities, Total	140.94	110.71	145.63	25.65
Total Liabilities	**788.3**	**619.03**	**630.04**	**312.33**
Shareholder's Equity	670.39	699.57	730.59	546.62
Total Liabilities & Shareholders' Equity	**1,458.68**	**1,318.60**	**1,360.62**	**858.96**

Conclusion

As we have noted before trading houses are notoriously opaque and with good reason. That is also one of the reasons why they tend to dwell in the information penumbra of private ownership. MFC through its varied history of chameleon-like transformation to suit the tenor of the times has morphed into a publicly traded trading house "slash global supply-chain" business. Under its previous management,

MFC employed smoke and mirrors to keep prying eyes at a distance. That has now changed.

Also changed is the pursuit of transactions purely for their taxation attractions. While this worked in the past it has come a cropper with the purchase of Compton with its oil & gas assets. This looked clever to some at the time and provided a large asset write-up. Instead it has been nothing but trouble over the last two years as natural gas prices have slumped and it has become a drag on the rest of the business (with which it has no synergies). The decision to liquidate some of these natgas assets in the short term and return capital to the shareholders is a good decision.

The "global supply-chain" business is, alas, low margin and that is made very clear by the results for the March quarter. In eschewing minerals trading in the expansion campaign the company has let opportunities pass it by, with Decometals being the biggest slip. However trading house skillsets are imminently transferable and MFC has enough critical mass in more elaborated products to construct *de novo* a proper metals trading house if it wishes. This would be further enhanced by the proposed "bank" that the company has mooted.

The stock price has been badly battered of late for no good reason. We are upgrading MFC Industrial from a **Neutral** call to a **Long** call at this time with a twelve month target price of $6.30.

Important disclosures

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