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HALLGARTEN & COMPANY

Initiating Coverage

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MFC Industrial Ltd (TSX:MFC, NYSE: MIL)
Strategy: Long

Key Metrics			
Price (CAD)	$ 6.85		
12-Month Target Price (CAD)	$ 8.00		
Upside to Target	17%		
12mth hi-low CAD	$ 6.17 -8.16		
Market Cap (CAD mn)	$ 428.5		
Shares Outstanding (mns)	62.6		
Dividend Yield	2.9%		
	FY11	**FY12e**	**FY13e**
Consensus EPS		n/a	n/a
Hallgarten EPS		$0.56	$0.76
Actual EPS	$0.19		
P/E	36.1	12.3	9.0

MFC Industrial

A Below-the-Radar mini-Glencore

- + The company is morphing from a royalty trust into a major trading house
- + An acquisition of Decometals would take MFC from the second tier of trading houses to the bottom of the first tier, making it a force to be reckoned with in iron ore and ferro-alloys
- + Cash and liquids are around US$330mn, some $100mn less than the market cap.
- + On top of this the royalty held on the Wabush iron mine of Cliffs Natural Resources could be monetized for as much as US$300mn
- + The company has a history of doing canny deals and is not married to any asset if there is an opportunity to take a significant profit by vending it
- + While it has been tangentially involved in mining in the past (e.g. cobalt in Uganda, iron ore in India) it is now going to have the focus on its efforts to revive the Pea Ridge mine in Missouri which could make it one of the largest iron ore producers in North America.
- × Opaque is the most charitable word for the company's less than forthcoming attitude on the details of its business model. Investors should not be asked to operate on faith alone
- × The board could do with an overall, adding one or two known figures to the list to reassure investors on the corporate governance at the company

A New Trading House on the Rise?

MFC Industrial is a global commodities supply chain company, which sources and delivers commodities and materials to clients, with a special expertise on the financing and risk management aspects of their businesses. It is active in a wide 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 was previously known as Terra Nova until late September 2011 when it changed its name to the current incarnation.

If it pulls off the merger with the stricken Austrian trading house, Decometals, then MFC will move from the second tier of the trading firmament to the bottom of the first tier, with a very strong position in ferrous metals and ferro-alloys.

On Traders

Glencore's less than stellar market debut in 2010 made "Global Traders" into something more prosaic than that "obscure object of desire" that they had formerly been. The emphasis should be placed on the word "obscure" though for traders essentially live by their wits and the less they reveal about how they move and shake the more effective their stratagems can be employed.

The traditional trader model was for the trader to merely intermediate with an element of proprietary trading that also included owning the means of conversion (mills/refineries etc.) or of storage (silos, warehouses, tank farms) but rarely the actual means of production (mines, farms or oilfields). In this pre-historic era the rulers of the trading world were the likes of Phillip Brothers and J. Aron in metals and oil and Cargill, Bunge y Born, Louis Dreyfus, Archer Daniels and Continental Grain. The new age has seen the rise of the vertically integrated trader with Glencore being the example par excellence, now on the cusp of integrating its mine-owning satellite Xstrata into the mother-ship. This has established the new paradigm and to varying degrees the other heavyweights of the mineral trading space have gravitated towards the *soup to nuts* formula. Some have attempted to avoid the ultimate step of buying the mine, as that flies in the face of their experience that this is a sure way for things to end in tears, but a ferocious competition for assets and “flow” has driven parties to countenance the unthinkable. That MFC should also have joined the fray though buying iron ore mines is not surprising at all considering that it might almost have been viewed as a miner before it was a trader.

Of course trading houses prosper by not only knowing about supply (i.e. mine output and its control) but also by knowing the buyers and their current and expected levels of demand. Sitting in the catbird seat at a trading house gives the trader an immeasurable advantage over the “mere” miner who quite often in centered more on the hole that supplies their livelihood. Relations to end users are really reserved mainly for the very biggest majors (BHP, RTZ, Vale, Codelco etc) or specialty metal miners, who may have a very limited universe of buyers (e.g. LG Group with Indium producers, Woulfe Mining with IMC). The vast bulk of miners sell a product to an intermediate party whether a refiner or converter or trader.

The model has become increasingly blurred though as Xstrata grew and occasionally appeared (or had ambitions) to be the tail that wagged the Glencore dog. Theoretically traders owned refineries and storage facilities (sometimes even ports) while miners owned mines and occasionally smelters. In iron ore and bauxite, sometimes the miners owned ports as well. However, both Glencore and Xstrata owned mines and smelters, though Xstrata was always, by far, the larger in mining. The model has looked tempting for outsiders since 2003 onwards as the brutal eye-gouging competition amongst miners that produced (amongst other things) copper at 63 cts per lb in the late 1990s was repleaced by a rising perception of an imminent supply crunch in key base metals and absolute shortages (and squeezes and corners) in specialty metals (e.g. REE, Tungsten and Antimony) precipitated by Chinese actions. Not only did a shortage threaten some trades, it threatened long term dominance of the trading netherworld. When Glencore revealed in its prospectus that it controlled more than 60% of the global trade in zinc, this was a major “whoah” moment for metal markets. However, what some saw as dominance we saw as vulnerability because several of the largest zinc mines heading for closure were Glencore/Xstrata satellites and showed that Glencore needed to snap up stragglers in the space and tie down supply or what was 6o% plus market share one year could be 40% five years later. Not being top dog in a metal definitely makes one an underdog, those trades and the market intelligence that comes from directing them heads elsewhere.

This looming crunch has created all sorts of new activities with Trafigura buying into mine properties, industrial end-users buying into specialty metal miners, and pure smelters/refiners like Nyrstar attempting to secure their upstream by vigorous acquisition campaigns (e.g. Farallon and Breakwater amongst others). Some of the asset grabs have been perpetrated by nationally inspired entities whether it was Chinese national champions-directed (attempted) moves on Rare Earth assets in Australia or Korea’s KORES roaming far and wide securing offtakes for users back in the Motherland via taking equity stakes in projects. The more vertical integration there is then the less intermediation the market has and that is bad news for traders. As any old Marxist can tell you, it’s all about controlling the means of production.

MFC's History - a Moving Feast

The company is nothing if not mobile. Few companies show the type of dynamism that this one has shown over the years in making and remaking itself morphing and dividing itself in various ways in an attempt to gain value for shareholders. The team at MFC Industrial has 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. Despite this though the company essentially trades at little more than its cash-value which has been a long term feature of this company's valuation by the markets.

The company began in 1984 with the acquisition of a small real estate company, and then migrated through various forms until 1996, when MFC Bancorp was created and spun off as a dividend to shareholders.

In 2005, MFC Bancorp identified a troubled opportunity, Humboldt Wedag AG. (KHD AG), a 150-year-old German basic materials company specializing in cement plant engineering. It acquired control of KHD AG, which was traded on the Frankfurt Exchange, and implemented a new strategic plan with new access to capital and a new management team. Over the next several years the company grew in value well more than tenfold, and generated hundreds of millions of dollars in cash. MFC changed its name to KHD Humboldt Wedag International Ltd (KHD), and KHD began trading on the NYSE.

In 2006, the majority of the financial assets of the former MFC Bancorp were transferred to a subsidiary known as Mass Financial Corporation (Mass), which began to trade in Vienna, and the shares were distributed to shareholders.

In 2010, after the successful reorganization of KHD, the Board decided to spin out the KHD operations to the shareholders and to resume its trading on the Frankfurt Exchange. That spinout was accomplished in four tranches over 2010, and the company changed its name to Terra Nova Royalty Corporation, which has traded on the NYSE as TTT, with its primary assets a cash-rich bank account and a royalty stream from the Wabush iron ore mine in Newfoundland. It was around this time that the company appeared on our radar screen.

In mid-2010, the company decided to re-integrate Mass Financial Corp (the former MFC Bancorp) into the company, and that merger was approved by both sets of shareholders and finalized prior to the end of 2010.

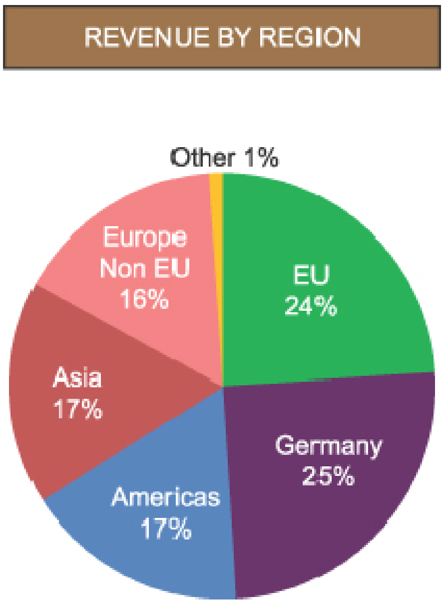
In August 2011, the company announced that it would rename itself MFC Industrial Ltd, and to change its NYSE ticker to MIL.

Trading Operations

The main focus of the company now is 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 space. Thus for trading to rise to become its main activity, does 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. What we do have is information like this pie chart (at right) showing geographical breakdown but that tells us little novel beyond the company having a big exposure to the fate of the German economy.



From information gleaned elsewhere and snippets in the company's conference calls we can say that the main areas of focus are 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.

A mooted transaction discussed further on in this note will significantly change the firm's balance towards metals should it be consummated with a further strengthening of status in the iron-steel complex-related metals, with a quantum leap in its chromite activities.

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).

There are few trading companies with adequate financing to compete with the PRC, which now dictates price. Additionally, Chinese steel capacity has topped at just over 700 million mt per year. The *pig going through the python* effect of going from 100 million mt in 2000 to 700 million mt in 2010 will not be repeated. The easy time for trading steel raw materials is now behind the traders. Headwinds from the Chinese now face every trading house regardless of the size of their cheque book.

The Wabush Royalty

A major source of revenue for MFC (and the reason it was formerly called Terra Nova Royalty) is its cash flow from the production royalty revenue from a mining sub-lease of the lands upon which the Wabush iron ore mine is situated in Newfoundland and Labrador, Canada. The mine is operated by Cliffs Natural Resources (NYSE: CLF, Paris: CLF). Iron ore is shipped from the mine to Québec where it is pelletized. Shipments in recent years are shown in the table below. Such shipments are subject to seasonal and cyclical fluctuations.

Year	Tonnage Shipped				Total Tonnage Shipped	Gross Royalties Received	Gross Average Royalty Rate/Ton Received
	Q1	Q2	Q3	Q4			
2005	789	1,392	1,299	982	4,462	$ 13,736	$ 3.08
2006	751	1,296	942	1,289	4,278	16,393	3.83
2007	472	1,607	1,591	1,339	5,009	22,357	4.46
2008	694	1,437	1,117	705	3,953	31,288	7.91
2009	402	386	1,202	1,198	3,188	17,350	5.44
2010	874	941	832	1,105	3,752	22,915	6.11
2011	719	796	1,173	646	3,334	30,280	9.08

Source: MFC Industrial

In October 2009 a tussle over this valuable asset erupted when Consolidated Thompson Iron Mines (CLM.v) announced an agreement with Wabush Mines' other two joint venture partners, U.S. Steel Canada (44.6%) and ArcelorMittal Dofasco (28.6%), to acquire their interests for approximately $88 million in cash. Under the terms of the Wabush Mines partnership, Cliffs had a right of first refusal to acquire both U.S. Steel Canada's and ArcelorMittal Dofasco's interest and promptly announced that it planned to exercise its right and acquire their interests in the joint venture. By exercising its right of first refusal, Cliffs increased its ownership stake of Wabush Mines to 100%. With Wabush Mines' 5.5 million tons of rated capacity, acquisition of the 73.2% increased Cliffs' North American Iron Ore rated equity production capacity by approximately four million tons. The Wabush Mines began operation in 1965 with Cliffs as the managing partner from the beginning.

MFC's sub-lease commenced in 1956 and expires in 2055. The lessor is Knoll Lake Minerals Ltd., which holds a direct mining lease from the Province of Newfoundland and Labrador. The royalty is paid quarterly and is based on the tonnage of iron ore pellets shipped. Pursuant to the terms of the mining sub-lease, the royalty payment is not to be less than CAD$3.25mn per annum until its expiry. In 1988, the royalty rate was amended to require a base royalty rate of CAD$1.685 per ton with escalations as defined in the sub-lease. MFC is indirectly obligated to make royalty payments of CAD$0.22 per ton on shipments of iron ore pellets from Québec, to Knoll Lake Minerals, which holds the direct lease over the mine property. Cliffs applies a portion of the royalty payments under the sub-lease to make such royalty payments to Knoll Lake Minerals. In August 2011, MFC reorganized its royalty asset to hold an indirect 99.44% economic interest therein.

In the first quarter of 2012, the decrease in royalty revenue to $4.4mn was regarded by the company as a disappointment, this being due to lower than expected tonnage of pellets shipped by the mine operator. The operator only shipped a total of 482,000 tons of iron ore pellets during 1Q12 versus 719,000 tons of iron ore pellets during the first quarter of last year. The reduction in pellet shipments experienced during the latest quarter was directly attributable to ice problems experienced by the operator, resulting in its access to the St. Lawrence Seaway being closed for a period of time and a customer postponing delivery of its order from March to May.

However, on the positive side, in 1Q12, MFC received a higher royalty rate than it did in the same period or 2011 and that it is now anticipating that the mine will ship 3.7 million tons of pellets in 2012.

Pea Ridge – but not what you may think..

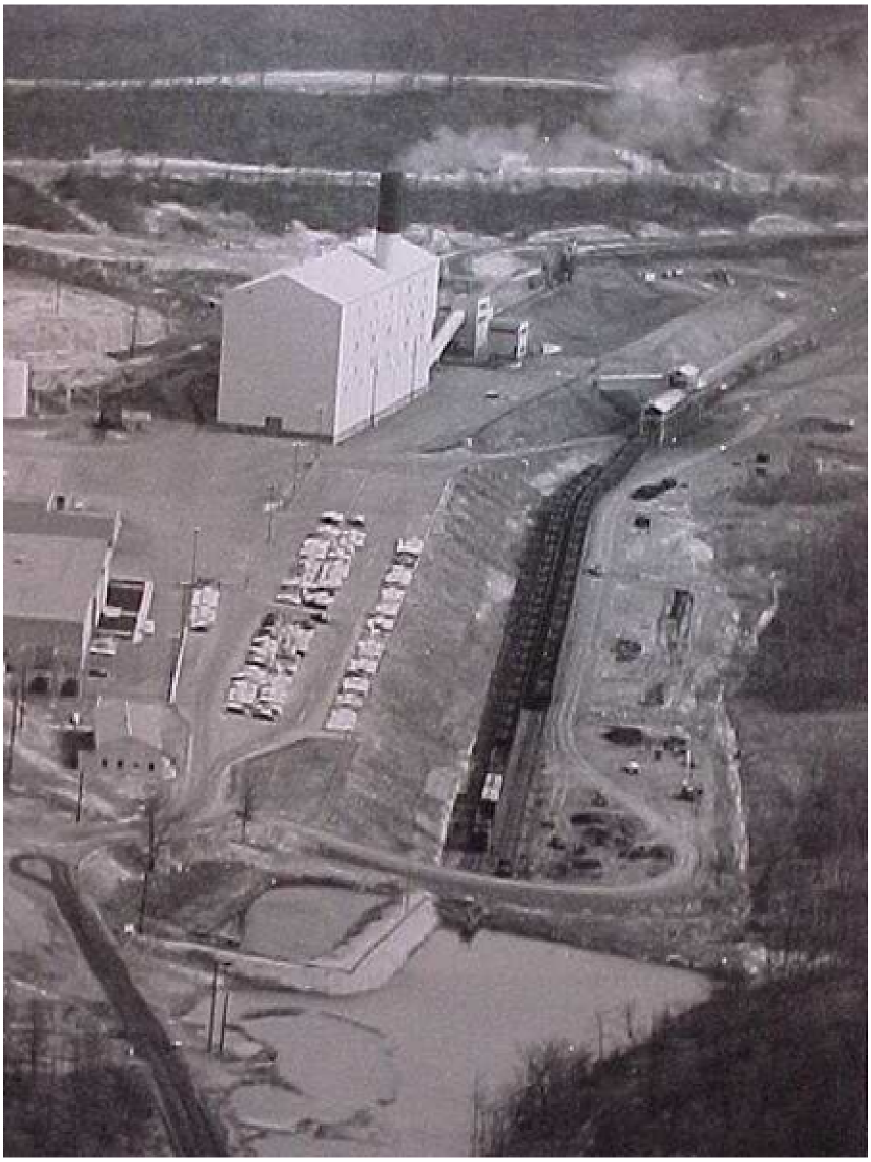
For those in the Rare Earth space, the words Pea Ridge evoke a rather shrilly-marketed project that is promoted as being better than anything else on the planet (and better politically connected to boot). This is quite a tall order in a metals sub-space well known for one-upmanship. In early January 2012, MFC announced that it had acquired, together with its partner in the project, the iron ore component of the long-troubled Pea Ridge iron ore mine located in Sullivan, Missouri. There had been numerous contractual disputes and lawsuits with the previous owners of the mine, which had been settled. Most notable was the confrontation with China Minmetals. This was nominally about a loan but in reality whipped up a political storm about Chinese potential ownership of REE assets onshore in the US.

Source: Google Maps

MFC has partnered with Alberici Group, Inc., a Missouri-based multinational design-build and construction services firm on this transaction. Both partners hold an equal interest in the project.

Alberici has experience in the water, manufacturing, building, heavy industrial, including mining, and automotive markets for three generations. The partners intention is to jointly develop the Pea Ridge Mine, including completion in the short term of a NI 43-101 compliant feasibility study on the project, with the mandate to re-open the underground mine, including exploiting the site's existing large tailings accumulation (excepting those tailing rich in REE) and exploring other areas for ferrous mineral production. Prior infrastructure remains in place at the mine, including access to underground workings, two vertical mine shafts with hoists and headframes, a plant building and tailings/settling ponds.

MFC previously acquired various secured debt and interests respecting the properties, with its investment being approximately US$12.1mn to acquire its indirect 50% interest in the Pea Ridge Mine. The previous owners will now retain a 2.6% net smelter returns royalty on ferrous minerals produced at the mine. Additionally, the previous owners hold 70% of a new entity which has a mineral license respecting non-ferrous minerals at the mine, with the remaining 30% of such entity indirectly held jointly by MFC and Alberici.



The partners anticipate that future mining operations at Pea Ridge would include beneficiating the resource in a processing plant or mill, similar to past production practices at the mine. This would involve the removal of the non-iron bearing portion of the resource and generally results in iron-rich concentrates. Historic data for Pea Ridge indicates that beneficiation resulted in iron-rich concentrates that were typically in the range of 66% to 69% iron.

Some Background

The Pea Ridge Mine operated as an underground mine between 1963 and 2001, being originally developed as a partnership between Bethlehem Steel and St. Joe Minerals, operating as the Meramec Mining Company. The photograph on the following page shows the mine in its heyday. From 1981 to 1987 the mine was operated by Fluor and was subsequently acquired by Woodridge Resources until its closure in 2001. The Pea Ridge Mine project includes the historic mine deposit along with a large tonnage of tailings material. Historic data and records indicate that approximately 58.5 million short tons of iron ore were removed from the mine between 1963 and 2001. Since 2001, operations at the Pea Ridge Mine have been limited to reclamation of resource settlement ponds located below the historical production facilities.

During such period, the prior owners completed iron resource estimates respecting the Pea Ridge Mine project that were not NI 43-101 compliant. A historical resource estimate prepared in February 2008 and commissioned by the prior owners of the project, which included the approximately 58.5 million short tons of ore previously mined, estimated an in situ measured iron resource in all categories of mineralized material, except the breccia pipes located on the property, of 94.1 million short tons averaging an estimated 58.0% total iron, including 50.8% magnetic iron (almost all as the mineral magnetite), an indicated iron resource of 94.1 million short tons averaging an estimated 58.9% total iron, including 51.9% magnetic iron and an inferred iron resource of 54.9 million short tons averaging an estimated 55.9% total iron, including 40.6% magnetic iron.

The foregoing resource estimates are before beneficiation and were based on prior data and reports obtained and prepared by previous operators and their consultants. The Company has not completed the work necessary to verify the classification of the mineral resource estimates as current mineral resources under NI 43-101.

HISTORICAL MINERAL RESOURCE ESTIMATES (CLASSIFIED EXPANDED IN SITU)

Class	Short Tons	Magnetic iron %	Total iron %
Measured	94,124	50.8	58.0
Indicated	94,116	51.9	58.9
Inferred	54,000	40.6	55.9
Previous production	58,542	–	–

MFC is not treating the historical resource estimates as current defined resources however estimates of remaining iron resources provide an indication of the potential of the Pea Ridge Mine project. Clearly the Pea Ridge Mine will require further evaluation.

Infrastructure is good with the site being served by paved highways connecting to the U.S. Interstate highway system, and in addition has a presently unused rail spur line connecting to the Union Pacific railway system. The acquisition also includes a leasehold interest in riverfront land suitable for creating a deep water port for transportation on the Mississippi River.

Other iron ore assets

Iron ore in India is not a much discussed topic. It has somewhat of a low-grade reputation while also suffering from the perception that resource nationalism in India makes it not worth pursuing except by Indian-owned players. This is somewhat ironic that India should be so nationalistic in a metal where its own companies have risen over the last two decades to control a swathe of the world's steel production capacity.

To get around the local ownership restrictions, MFC has agreements with third party leaseholders of iron ore mines in the state of Goa, under which the leaseholders agreed to sell iron ore to MFC at a fixed price per ton based on the extraction costs plus a royalty payment to the owner dependent upon the iron content of the iron ore. MFC has also been contracted to extract iron ore on behalf of the leaseholder at a fixed fee per ton. The agreements are presently in force and continue until September 2014 and the company has been granted the right to renew the agreements for three year terms until September 2020. The company is once again rather hermetically sealed on what these properties produce and their profitability for the parent.

Source: MFC Industrial

The company reported that in 1Q12 it had entered into an agreement respecting the processing, purchase and sale of iron ore from a new mine property also located in Goa. The new property is in very close proximity to its existing iron ore operations. This proximity will enables it to use common facilities, laboratory, engineering staff and other equipment when the mine becomes operational. The company is now in the process of obtaining the necessary permits to commence operations.

Cobalt in Uganda – on the way out

When Terra Nova was just a royalty trust one of its assets that intrigued us was its cobalt exposure in Uganda. This was held through a NASDAQ-listed entity called Blue Earth Refineries Inc.(BBLU). In March

2012 MFC acquired a 75% equity interest and a shareholder loan in BBLU's subsidiary, Kasese Cobalt Company Limited (KCCL) for consideration of US$28mn paid to Blue Earth. This transaction moved the mineral refinery (pictured below) and power plant in Uganda into MFC's direct control. At full capacity, the refinery can produce 720 tonnes per annum of crushed cobalt cathode averaging 99.9% purity. The Mubuku III hydroelectric plant is relatively small at 9.9MW and is located in the nearby Mubuku valley. Excess power generated is utilized by the national grid. The assets also include the Hima limestone quarry which is situated 20 kms north of Kasese on the main Kasese-Fort Portal road. Limestone blasted and primary crushed at the quarry, is added to the refining process to control the pH balance and precipitate dissolved iron.

Source: Blue Earth

The refining operation is now focused on the recovery of cobalt metal from pyrite tailings located near the refinery as the original ore body is now mined out. KCCL has approximately a 17-month supply of tailings left to process. It is claimed that, with completion of the processing of the remaining tailings, the refinery will have no alternative use and MFC will shut down the site and start the procedures for environmental cleaning that will return the site to its original state.

The company sees the dam and its electrical generating capacity as the real attraction in this deal. Whether it intends to be in the Ugandan utility business in the long-term is doubtful but once the mill is gone the power plant will be available to be flipped to the highest bidder.

Zinc

In Slovakia the company has 100% of Brock Metals s.r.o., a zinc-alloys producer. The Mazak brand alloy is used for the die-casting of high volume, high precision components as used in the automotive or white goods industries. In addition its produces tailor made zinc based alloys as used in the galvanizing process for strip steel or hot dip galvanizing of fabricated structures. This company was originally established as part of the MAZAK group of the UK, a part of Rio Tinto. Later the company was owned by Pasminco of Australia, then Mount Isa Mining of Australia, then Britannia Alloys & Chemicals, UK, and by Trident Alloys, UK, before becoming independent as Mazak Limited. Brock Metals s.r.o. is the surviving part. This division was established in Košice, Slovakia, in 2003 as a new investment and a subsidiary company of Mazak Limited, Bloxwich, UK, following the opening up of Eastern Europe. The Slovakian operation became independent in early 2009, when the UK plant ceased to exist whilst the Slovak plant continued production.

Aluminium

MFC holds two positions in the aluminium industry, both in Germany. These are the 55%-owned AFM Aluminiumfolie Merseburg GmbH and the 55%-owned MAW Mansfelder Aluminiumwerk GmbH. Both are processors of aluminium into various shapes and foils for further industrial value-added by other parties.

Source: MFC Industrial

Decometal - In the Sights?

There are two trading houses of global import located in Vienna but despite the roles they play in their respective niches neither is a household name in Vienna or elsewhere. MFC we have already dwelt upon but the other is called Decometals (and sometimes known as DCM). The latter firm is much more storied than MFC with Decometals having its roots in the mid-1800s when Austrian companies were leaders in the mining and technological applications of the new metals that were being discovered. DCM survived through the various vicissitudes of the two World Wars had become, by the turn of the current century, a leading player in Chromite, Manganese and Titanium trading, and a minor player in refining and mining (at least in Chromite).

DCM´s marketing network spans over 50 countries with representative offices in Austria, Canada, China, Russia, South Africa, Ukraine, UAE and USA. It has marketed, through this network, high-grade manganese and chromium ore in Australia and iron ore in Ukraine, which it ships to Europe and the Middle East. It trades principally in iron ores, bulk ferro-alloys and noble alloys directly from producers, which it then sells to customers worldwide. These include silico manganese, ferro-managanese, ferro silicon, ferro chrome, ferro molybdenum, ferro vanadium and ferro-titatinum for the steel industry in Europe, the Americas and the Middle East. At least in the iron ore category it resembles the activities of MFC.

DCM also operates financing, logistics and warehousing division to meet customer needs: all aspects of transportation and the supply of bulk commodities, as well as just-in-time deliveries through its international warehousing network.

As is typical of such patriarchal firms a moment arrives when the scions cannot be said to be a chip off the old block and DCM ran into problems in the middle of the last decade when it overstretched itself in the easy money of the pre-2008 era and accumulated itself some Australian assets (particularly in mineral sands, through Australian Zircon and Territory Resources) which have proven to be a disaster.

Ever since 2008 the firm has been limping and skirting the grim reaper in the form of Raffeisen Bank, which has now ended up as a shareholder and debtholder of size and really calls the shots. As holding the steering wheel in any sort of non-banking financial endeavor (particularly involving proprietary trading) is now a serious negative in European banking circles, the motivation for Raffeisen to exit from the asset is high. The founding Depisch family had already been forced to cede management on to a “restructurer”, Erhard Grossnigg.

In our opinion the most interesting part of DCM is its Chromite operations. These consist of:

ACR Albanian Chrome which is the holding company for DCM’s activities in Albania, formerly one of the world’s leading Chromite producers, but which has fallen on hard times since the fall of the Communist regime in the early 1990s. DCM managed to pick up the gem of the industry, i.e. the Bulquiza mine and mill. Since February 2007, it has been producing high grade chrome ore from this mine. In theory the mine employs 660 people but has recently had industrial action and even a fatal accident which have cut production. In theory the mine complex has an annual output of 82,000 tonnes of the lumpy ore and fines, at a grade of 40-45% chromite. DCM had plans to invest approximately fifteen million euros in extending the reserve base, improving the work and safety conditions for miners and increasing production capacity to approximately 100,000 tonnes. However these plans have run foul of the parent company’s own financial travails.

DCMchrome Pty Ltd, which is the company’s excursion into the South African chromite industry. South Africa is the largest producer of this metal at the global level. DCMchrome purchased the Rooderand chrome project from Chrometco in 2007. With this investment DCMchrome acquired the mining license from the South African government for the undeveloped area. Rooderand is on the western limb of the Bushveld complex, which is rich in platinum and chrome. South Africa's Bushveld chromite reserves constitute 75% of global chromite reserves (though this is probably more a case of imprecise assessment of other countries’ reserves) and SA produces approximately 50% of the world´s chromite.

DCM also has a stake (since 2007) in Gulf Ferroalloys Co. (Sabayek), which owns a ferroalloy complex at Al-Jubayl, a location accessible to high-purity quartz and inexpensive energy. The complex built in 1996 includes a 35,600-t/yr-capacity ferrosilicon plant, a 10,000- t/yr silicon metal furnace, and a 27,600 tpa silico-manganese and 10,000 tpa ferromanganese production. The ferrosilicon production was expected to be exported as Saudi Arabia’s domestic needs did not exceed 3,000 tpa. Silicon metal, silico-manganese, and ferromanganese production was intended for local consumption. The attraction of placing such plants in the Middle East is primarily the cheap energy rather than the availability of the mineral feedstock. We recall that Baja Mining (TSX:BAJ) had talked of sending Manganese from its El Boleo property in Mexico to the Middle East for precisely this reason.

However this spending spree has now brought DCM to its knees and MFC has appeared on the scene brandishing wads of cash from its war chest, which is a sight for sore eyes for the Austrian banks. In November of 2011, it was reported that DCM was unable to repay its debts at their due date with the Raiffeisen bank system, in particular, having a sizeable exposure, amounting to nearly €140mn of which Raiffeisen Styria´s exposure amounts to €40mn, loans by the Styrian Hypo total €30mn. Raiffeisen Upper Austria´s loan volume is € 40mn and RZB´s exposure accounts for €30mn. Other creditors are Erste Group (€ 50mn), Bank Austria (€ 30mn) and VB AG (€20m). Apparently the involved banks decided to extend the loans and provide another € 25m. “With this bridge-loan until end-2012, we hope to achieve the restructuring process", an involved person said. The banks did make any comments.

Although Decometal´s assets are long-term investments, its debts (primarily to fund the trading book and past equity misadventures), which account for € 250m, are largely short-term with the largest part falling due at the end of 2011. Meanwhile a corporate bond is due by 2013. In Austrian press reports from last November, it was claimed that, for 2011, Decometal expected losses. In 2010, sales reached €350m (though these had been over €500mn before the 2008 debacle), operating profits in 2010 were only €4.5mn.

DCM's troubles go beyond overreach though. Problems have been building at DCM since mid-last decade as their sources of tied supply began to dwindle. The past grip on the non-BHP flow of Manganese from Australia was weakened in recent years, despite the temporarily profitable trade in Consolidated Minerals. When Privot (of the Ukraine), through a hostile takeover, acquired Consolidated Minerals' Woodie Woodie manganese mine in the Pilbara in 2007 (in which DCM had a material minority interest), this left DCM holding an empty bag. This classic Mn mine was DCM's central supply channel for its flow of discounted high-grade Mn ore. Not only did it lose its source, but also lost its customer in the Ukraine, that was now vertically integrated and in a position to eschew DCM's services, the erstwhile intermediator of its Mn supply.

DCM got all hot and bothered about a Mn past-producer in Panama, subsequent to their loss of Woodie Woodie. This was what initially brought the low-profile DCM to our attention. Nothing transpired there as DCM increasingly became focused on the financial noose dangling in front of it. Now if MFC can fill this void, even partially, by supplying from its own Mn sources, then the margins on the DCM Ferro-Alloy smelters in the Middle East may be helped. Much depends on the internal cost and location of the MFC Mn sources.

With MFC appearing on the scene with its *sotto voce* offer of reputedly USD$150mn, the chances of success are high, though if this price involves writing off the bank's debt with amounts owed being at least 40% higher in USD terms then the Austrian bankers will be feeling some pain. Watch this place…

Management

The board of MFC does not have the usual look of a Canadian mining-oriented story, in fact it doesn't much look like any type of Canadian board.

In a rather remarkable feat of corporate roleplaying, the key man at the company fills a skein of titles that might justify some of the wariness that investors have shown towards this entity. Michael J. Smith, the CEO (since March 2010) has been the Chairman since 2003 and a director of the company since 1986. He was previously the Chief Financial Officer from 2003 until October 16, 2007 and is currently our interim Chief Financial Officer and was our Secretary until March 1, 2008. Mr. Smith was also our Chief Executive Officer between 1996 and 2006. He was also previously the President, Chief Executive Officer, Secretary and a director of Mass and served as a director and officer of various public companies. He has experience in corporate finance, restructuring and taxation planning.

Dr. Shuming Zhao has been a director of the company since 2004. He is Chair Professor and Honorary Dean of the School of Business, Nanjing University, China. He serves as President of the International

Association of Chinese Management Research, Vice President of Chinese Society of Management Modernization, President for Jiangsu Provincial Association of Human Resource Management, and Vice President of Jiangsu Provincial Association of Business Management and Entrepreneurs. Since 1994, he has acted as management consultant for several Chinese and international firms. He is also a director of the Chinese companies, Little Swan Company, Ltd. and Daqo New Energy Corp. He has been a visiting professor at Marshall School of Business, University of Southern California and the College of Business, University of Missouri-St. Louis.

Robert Rigg has been a director of the company since 2010. He is a retired accountant and holds a commerce degree in economics and accounting from the University of Melbourne and was a member of the Institute of Chartered Accountants in Canada. He has experience as both a director and chief financial officer of several public companies.

Indrajit Chatterjee has been a director of the company since 2005. He is a retired businessman who was formerly responsible for marketing with the Transportation Systems Division of General Electric for India. Mr. Chatterjee is experienced in dealing with Indian governmental issues.

Ravin Prakash has been a director of the company since 2011. He is the Executive Chairman of Magnum Minerals Private Limited. He has over 35 years of corporate banking and financial management experience, specialized in recovery and restructuring of doubtful assets, the raising of project and trade finance and risk assessment.

With the board ranging in age from 59 to 68 (and skewed towards the latter), veteran would be flattering word for the team. We would feel more comfortable with an injection of not only new blood but a few household names from the international financial/mining sphere and probably someone with some more detailed mining history.

Results Outlook

The challenge with earnings estimates for MFC is that it is well-nigh impossible to know where estimates came from in the past, let alone trying to project the unknowns of the past to be the knowns of the future (to paraphrase Donald Rumsfeld). To further complicate the matter we have the relatively known Decometals to potentially put in the mix. However in preparing our earnings model we decided not to factor in the DCM deal as it may yet not happen.

MFC made more in net profits in the first quarter of the current year (despite the slack Wabush royalty) than it made in all of FY11. The slower pace of global growth, particularly in Europe, will ultimately prove a drag on its steel business. While all the Indian iron ore goes to China, the trading operations in Vienna are particularly oriented to Germany (a good thing) but also weighted towards Eastern Europe (not a good thing at this time.

Thus for the rest of 2012, we envisage slightly higher sales (up 9%) than in FY11 and better Wabush royalties producing a post-tax result of around US34.8mn or EPS of 55 cts per share. In our model, FY13 is not viewed as being very much different with an even slighter increase in revenues, the royalty adding more to the pot and post-tax revenues of around $47.4mn (or EPS of 76 cts). Both of these years could see meaningful dividend increases.

MFC Industrial - Earnings Model												
In Millions of USD	**FY13e**	**FY12e**	**1Q12**	**FY11**	**4Q11**	**3Q11**	**2Q11**	**1Q11**	**FY10**	**4Q10**	**FY09**	**FY08**
Revenue	523.12	495.00	134.09	451.40	128.08	101.921	142.03	113.245	61.57	57.01	-2.63	607.062
Royalty	35.00	29.00	4.40	30.28				5.5	22.92		17.35	31.288
Merchant Banking	22.10	21.70	4.56	22.49		6.957		11.401				
Other Revenue	14.20	13.60	4.59	16.55	1.38	4.85	1.65	3.691	0.95	0.95	0	-
Total Revenue	594.42	559.30	147.63	520.71	129.46	113.73	143.69	133.84	85.43	57.96	14.72	638.35
Cost of Revenue, Total	493.00	476.00	121.63	435.39	116.21	92.28	120.46	106.45	49.35	37.77	8.53	516.63
Gross Profit	101.42	83.30	26.01	79.41	11.87	19.82	21.57	26.14	35.12	19.24	6.19	121.72
Selling/General/Admin. Expenses	47.00	41.60	9.43	47.6	8.94	9.64	10.39	18.629	18.39	9.09	13.76	60.56
Unusual Expense (Income)				12.41	12.41	-	-	-	-41.06	-41.06	0	31.97
Other Operating Expenses, Total	1.30	1.00	0.01	-	-	-	-	-	-	-	-	-27.18
Total Operating Expense	541.30	518.60	131.06	502.6	138.39	104.13	133.03	127.04	29.67	8.78	22.76	581.97
Operating Income	53.12	40.70	16.57	18.11	-8.93	9.59	10.65	6.79	55.76	49.18	-8.04	56.38
Interest Income(Expense)			-1.83	-	-	-	-	-1.968	-	-	-	-
Forex Income (loss)			0.77	-	-	-	-	-2.215	-	-	-	-
Other, Net	-	-	-	-	-	-	-	-	-	-	-	0.14
Income Before Tax	53.12	40.70	15.52	17.18	-8.17	9.16	11.61	4.58	52.16	47.38	-20.79	12.43
Tax	7.70	7.00	0.62	5.98	1.68	1.66	-0.32	2.96	6.98	1.47	-4.47	18.66
Income After Tax	45.42	33.70	14.90	11.2	-9.85	7.5	11.93	1.62	45.18	45.91	-16.32	-6.23
Minority Interest	2.00	1.10	-0.31	0.99	0.44	-0.81	0.07	1.3	0.58	0.66	-1.05	-0.72
Net Income Before Extra. Items	47.42	34.80	14.59	12.19	-9.41	6.69	12	2.92	45.77	46.56	-17.37	-4.88
Extraordinary Items	-	-	-	-	-	-	-	-	-15.45	-	54.04	-
Net Income	47.42	34.80	14.59	12.19	-9.41	6.69	12	2.92	30.32	46.37	36.67	-4.88
Diluted Weighted Average Shares	62.56	62.56	62.56	62.56	62.56	62.56	62.58	62.63	35.86	62.56	30.35	30.4
Diluted EPS Excluding Extraordinaries	0.758	0.556	0.233	0.19	-0.15	0.11	0.19	0.05	1.28	0.74	-0.57	-0.16
Dividends per Share	0.40	0.30	0.05	0.20	0.05	0.05	0.05	0.05	0	0	0	0

In a scenario where DCM is added to the mix then sales could potentially nearly double. The problem in making any sort of judgement of the DCM effect is the consideration that accurate numbers for DCM are non-existent for outsiders. Will the act of putting two medium size ferro-alloy traders together mean that 1+1=3, and we suspect it will have this type of synergistic effect. DCM has clearly been financially limited in recent times, and being properly funded could be transformative for the combined group.

Much depends upon one's view of the progress of the global economy. As noted elsewhere we are not bearish but neither are we ravingly bullish. We are not persuaded the Chinese economy will be allowed to slow down much, so steel demand should hold up.

Financing

As a trading house, credit lines are just as much an important part of the financial make-up. As previously noted the company is well padded with $329mn in cash and liquids at the end of March 2012. This had been $50mn higher at the end of 2011, but payments for Pea Ridge and the Ugandan purchases decreased this balance. Debt at the end of the March quarter was only $22mn.

The padding trading operations of size comes from the facilities that the company has with various banks and other sources. At December 31, 2011, MFC had credit facilities aggregating $366.3 million as follows:

- unsecured revolving credit facilities aggregating US$169 million from banks;
- revolving credit facilities aggregating US$45.4 million from banks for structured solutions, a special financing. The margin is negotiable when the facility is used;
- had a specially structured factoring arrangement with a bank for up to a credit limit of US$110.3 million for our commodities activities (Generally, MFC factors its commodity receivable accounts upon invoicing at the inter-bank rate plus a margin
- had a foreign exchange credit facility of US$41.6 million with a bank.

All of these facilities are renewable on a yearly basis. We would note that some of the numbers floating around on the cost of DCM go as high as € 150 mn.

Dividends - a rather rare bird

Bucking the trend of the notoriously stingy listed Canadian stocks, MFC has a history of returning equity to shareholders. An original shareholder of MFC Bancorp in 1996 would have seen their investment grow substantially through cash distributions and dividends with $1000 invested in 2000 having grown to over $6300 by the end of 2010.

The company also currently pays a cash dividend based on the annual dividend yield of the New York Stock Exchange Composite Index for the preceding year, plus 25 basis points. The rate for 2011 is $0.20 cash dividend payable in four quarterly installments. As is well-known, dividends are music to our ears and this long term commitment to a decent pay-out (as well the frequent uses of demergers, another favorite of ours) puts the company ahead of the pack in our estimation on its attitude towards investors.

There's More to Life than…

The two constants are said to be death and taxes, and while MFC may not claim to be immortal it has prided itself (and sometimes excessively) on its "tax efficiency". This goes down well amongst a certain set of investors but frankly to others it gives the spooks and conjures up visions of chickens coming home to roost at some future date. As a main claim to fame, it is also rather thin gruel.

In FY11, MFC recognized an income tax expense of $6 million (income taxes of $1.3 million and resource property revenue taxes of $4.6 million), compared to $7 million (income taxes of $0.2 million and resource property revenue taxes of $6.7 million) during the same period of 2010. Back in FY09 it realized an income tax recovery of $4.5 million (recovery of income taxes of $7.5 million and resource property taxes of $3.0 million). As the resource property revenue is pretty much the tax on the Wabush royalty and unavoidable, we can see that the company "excelled" in minimizing its taxation rate on its non-Wabush income. This was done through a collection of offshore entities, particularly in the Marshall Islands and Barbados. The CEO is based in Hong Kong.

An aside on shareholdings

It is intriguing to note that the largest shareholder with 22.1% of the shares is Peter Kellogg. He joined his father's firm, Spear, Leeds & Kellogg, one of the NYSE's largest specialist firms in 1967 after working at Dominick & Dominick. His fortune is primarily from his successful leadership of SLK in the 1980s before its sale in 2000 to Goldman Sachs for a reported $6.5 billion.

Risks

The main risks we can envisage with MFC Industrial are:

- Very opaque reporting as to the origins of income aside from the Wabush royalty flow
- High exposure to iron ore and the steel industry. The former has had a great time over the last decade but much is dependent upon on-going growth in China
- Plastics is a trading niche with low barriers to entry and low margins in recent years
- A board that does not appear to have depth or breadth
- Decometals may be too much of a wounded beast to be turned around. However, this company has been suffering more from debt issues than actual failings in its trading capabilities. The Albanian chromite assets are endangered due to poor relations with the government over failure to meet investment promises

Most of these problems are not insurmountable. The corporate governance issues in particular can be easily solved. Bulking up in iron ore and ferro-alloys may make one over-exposed but in the trading game, owning all or part of a particular niche gives one maximum information dominance and leverage over buyers and sellers.

The biggest risk with traders is a bad trade (as Sumitomo Metals and Metallgeschaft can attest). A trader is only as good as their last trade. It certainly helps in the case of MFC that the organization is not too large, is conservative by nature and moves mostly in three niches (iron ore, ferro-alloys and plastics) that do not have rapidly fluctuating prices. "Mark to market" shocks are virtually impossible in these materials.

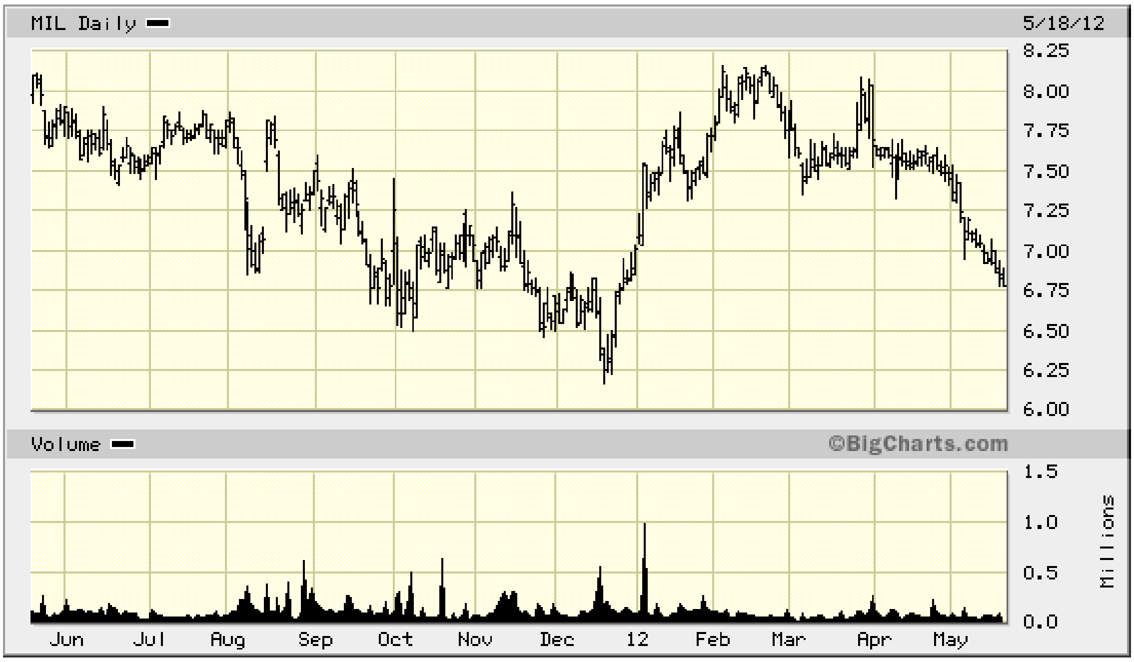
Conclusion

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. However the company has not gussied up its disclosure to match the potential interest in a trading entity that is accessible to investors. However we would note that the most recent PowerPoint presentation for the company is dated February 2011 and represents a corporate entity quite a few morphings in the interim. And even this old PowerPoint was skeletal to say the least. Self-promotion and investor awareness should be made of sterner stuff.

This “coyness” goes quite some way towards explaining the company’s very low valuation. It has a market capitalization of around $430mn and cash and liquids of just under $330mn. The Wabush royalty alone is probably worth over $300mn if vended to a royalty trust, where it properly belongs. In light of the money the trading businesses are spinning off, the rest is easily worth several hundred million dollars as well. There is a clearly a discount applied by investors for some aspect of this business, and this is not a product of the latest slump but a long-time feature of this stock. Some soul-searching is required by management to identify the problem, though the hunt need not be a long one.

On the value front though it is evident that MFC Industrial represents an asset-rich and income-rich situation at a low valuation. The addition of Decometals (DCM) to the mix would effectively double trading operations and make the combined group into one of the largest global traders of iron ore and ferro-alloys. There may yet be a stumble on the road to that goal but the banks at DCM are motivated sellers and MFC intimately knows the space with only a handful of other traders of end-users being possibly buyers with synergistic advantages and seemingly they are not at the bargaining table. MFC also has the spare cash to expedite such a deal.

Thus for investors there is the challenge of whether to cast one’s lot into this story for the clear undervaluation, strategic position in the trading space and long history of canny deals and dividend flows or to stand back from the opaque nature of the corporation and its management. In these times of proliferating buying opportunities due to undervaluation, but a scarcity of good income generating situations, we have resolved to put a **Long** call on MIL with an expected 12-month price target of US$8.



MIL Daily
5/18/12
8.25
8.00
7.75
7.50
7.25
7.00
6.75
6.50
6.25
6.00
Volume
©BigCharts.com
1.5
1.0
0.5
0.0
Millions
Jun
Jul
Aug
Sep
Oct
Nov
Dec
12
Feb
Mar
Apr
May

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