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HALLGARTEN & COMPANY

Portfolio Strategy

Editor: Christopher Ecclestone
cecclestone@hallgartenco.com

Model Mining Portfolio:
Teck & its Discontents

Performance Review – June 2020

Model Mining Portfolio

Teck & its Discontents

- **Gold keeps threatening to make a quantum leap towards $2,000 per oz put never quite gets up the required head of steam**
- **Base metals edging up glacially**
- **Financings are recovering briskly in the Canadian market and in Australia are quite robust**
- **Takeover action is bubbling away, particularly in the gold space**
- ✗ **Trump Administration slip-sliding toward oblivion and with it goes the chance of serious pushback against China**
- ✗ **The "dreaded" Millennial investors may be playing in corners of the mining space**
- ✗ **London financing market lags**

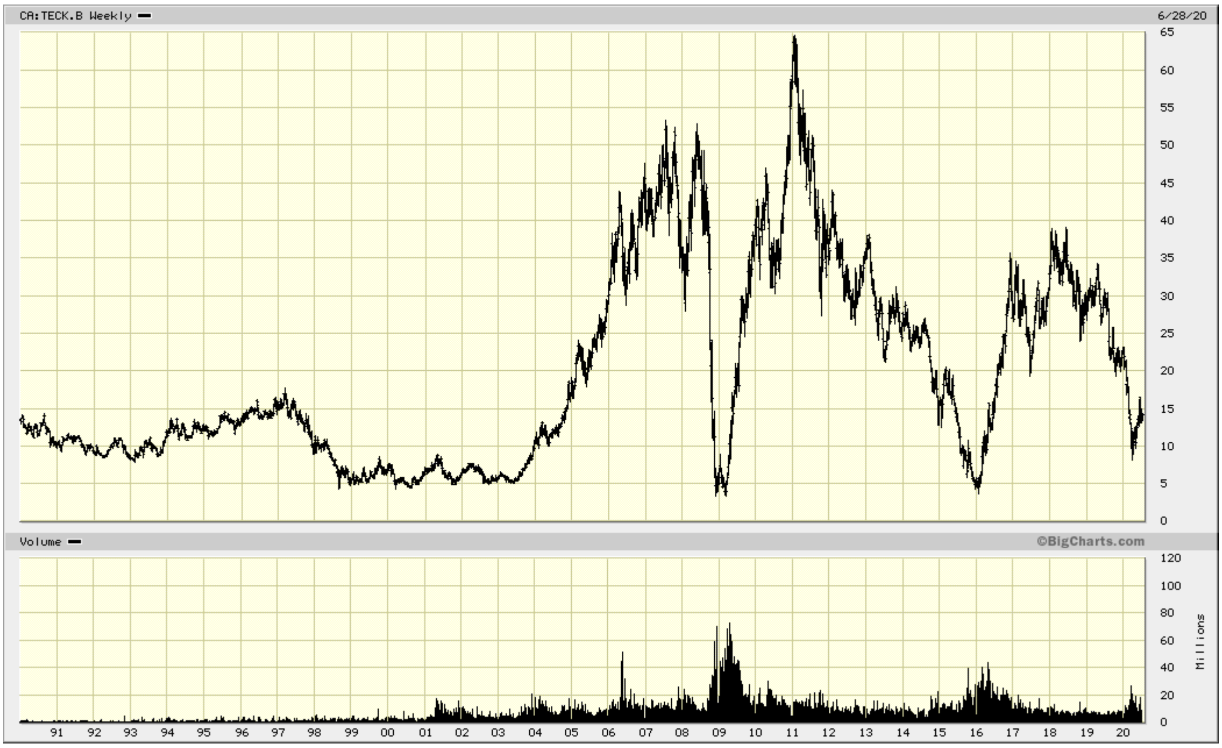
Teck – a Flightless Bird

The first decade of this century may have been good for some individuals in the Canadian mining scene but it was a real ego bruiser for the status of Canadian mining in general. The list of the dearly departed majors is a sad litany indeed with Noranda, Falconbridge and finally Inco falling to foreign interlopers. That left in 2008, Teck Cominco as the only one with potential to be a diversified international major. What did management do? They decided to go trendy and drop the Cominco from their name, then strapped on the suicide vest and bought Fording Coal for around CAD$14bn in the midst of the global financial crisis. This was funded in part by CAD$9.8bn in debt. Hooray…

The deal smacked of "buying on the rebound" after being thwarted by Inco. It also came hot on the heels of two other deals, now largely lost in the mists of time, the CAD$4.1bn purchase of Aur Resources in 2007 (which shifted the company toward copper) and its $415 million takeover of Global Copper (GLQ.TO) for its Relincho copper-molybdenum deposit in Chile.

This act of massive self-(and shareholder-) harm should never have happened. Bear Stearns had gone bust months before and the warning lights were flashing all over. Still, management at Teck persisted in their folly and the one chance that Canada had of maintaining a player in select circle of international majors was blown. Beginning October 1, 2008, Teck Cominco began rebranding itself as Teck, throwing the (zinc) baby out with the bathwater.

Here we are twelve years later and Teck is a much diminished thing. Its current market cap is around half of what it paid for Fording alone and down two thirds (in US$ terms) from its high-point this century.



The chart shows a wild ride indeed, particularly after the Fording buy.

To put this further in perspective, Teck's market cap in 2006, pre-Fording, was US$14.4bn compared to CAD$7.2bn nowadays (or around US$5.3bn). So management has managed to shrink the market cap by 2/3rds in 15 years.

Origins

It's worth looking back at how an entity could have come to this sorry pass.

In the beginning there was Cominco. This component of what would eventually become Teck started in 1906 as The Consolidated Mining and Smelting Company of Canada, formed by the amalgamation of several units controlled by the Canadian Pacific Railway. CM&S, or "Smelters" as it was often called by investors, changed its name to Cominco in 1966.

Cominco's core Sullivan Mine in Kimberley, British Columbia which began production of lead, zinc, silver and tin in 1909, would operate for more than 90 years until its ore reserves exhausted in 2001.

Then there was Teck-Hughes Gold Mines Limited, which was established in 1913 in Ontario, following the discovery of gold in 1912 by prospectors Sandy McIntyre and James Hughes, in Teck Township—now known as Kirkland Lake. Who knew that?!

An American group of investors led by Charles H. Denison —including International Nickel Company (INCo)'s Ashton W. Johnston—acquired two thirds of Teck-Hughes' shares. It was Ontario's first gold mine in commercial production. When the ore was exhausted in the 1960s, after 50 years of production, it had produced 3.7mn ounces of gold. The Beaverdell Mine, purchased by Teck in 1969, went back even further to 1898, and produced silver until 1991. For many decades from the 1960s until recent times the company was dominated by the Keevil family. From 1979 to 2015, Norman Keevil Jr. oversaw Teck's major mining projects including Hemlo, Voisey's Bay and Antamina. Over the same time period, Teck became one of the world's largest producers of metallurgical coal.

The association between Teck and Cominco began in 1986, when Teck and two industry partners acquired a shareholding from CP Limited, and culminated with the merging of the two companies in July 2001.

In the first flush of the mining "Supercycle", on the 8th May 2006, Teck Cominco offered to purchase Inco for US$16bn, but CVRD eventually purchased it for US$17bn.

The biggest disaster in recent history was the aforementioned decision, in late July 2008, on the verge of the global financial markets crisis to acquire 100% of Fording Canadian Coal Trust, which owned a 60% stake in the Elk Valley Coal Partnership. Teck Cominco was already a minority owner of the Elk Valley Coal Partnership, with a 40% stake. The facilities are located near Fernie, British Columbia. The purchase was closed on October 30, 2008, with a final cost of US$14bn.

Elk Valley Coal Corporation was renamed Teck Coal Limited. The purchase resulted in Teck taking on US$9.8 billion in debt, suspending dividends, cutting spending, and selling some assets to raise funds. Coal production targets were also lowered by 20% in response to declining worldwide demand for steel, in the midst of the global financial crisis.

The Globe & Mail newspaper estimated at the time of the Fording buy that the revenue mix would become massively (60%) weighted to met-coal in 2009. So how did this turn out:

Teck - Revenue Mix

	2007	2009 e	2019
Met Coal	15%	60%	46%
Gold	3%	1%	
Copper	34%	25%	21%
Zinc	48%	15%	25%
Bitumen			8%

The One that Got Away

In the "what might have been" category the Canadian government allowing Vale to buy Inco is way up there on disastrous moves. If the government had blocked the deal then Teck would have ended up with the prize and Canada would have had a large diversified mining group on the scale of BHP or RTZ. Teck may not have done the Fording deal and dodged that bullet.

The same year Noranda-Falconbridge was allowed to be sold off to Xstrata (and eventually to Glencore).

Definitely not a good period for Canadian miners, though shareholders cried themselves all the way to the bank. Short-termism triumphed.

We suspect a merger with Noranda-Falconbridge would have been the best outcome of all for Teck.

The Way Out of the Mess

We have a sneaking suspicion that Teck's management actually likes its coal division as it is the perfect poison pill against potential acquirers. It's also a poison pill against potential investors, but who needs them anyway?

In the absence of reversing the error of 2008, the next best exit for Teck is the "South32 solution". In retrospect, BHP's disposal of unsexy businesses at the wrong point in the cycle was one of its dumbest decisions. But we suspect that demerging the "energy" assets of Teck would not be something the company would come to regret. The formula goes like 2-1=3. The sum of the parts is worth more than the whole.

Ideally then the company could carry out a meaningful acquisition that diversified its mineral mix (in a positive direction. Taking over Sherritt (in an all-stock deal), might be an idea to bolt-on the long-missing Nickel (and Cobalt) component. It might not be a bad idea to acquire the similarly clueless Metals X (ASX:MLX), picking up Tin exposure and the promising Wingellina Nickel project. The copper assets might even be better managed than they have by MLX's current crew. Even a merger with First Quantum sounds appealing.

This is not rocket science, but with Teck's current management, one wonders if they had an idea it would be lonely.

It's difficult not to be uncharitable about Teck. It has frankly gone from being a major with the potential to sit at mining's "top table" with BHP-Billiton, RTZ etc to being an obscure play that it far from being a "must-have" in institutional portfolios.

We have had this in the Model Mining Portfolio for several years now and it did well on the Zinc recovery in 2018/19 but has since slid back. Its inclusion is not an endorsement of the torpid management in any sense. Nevertheless hopes spring eternal of some activist coming along and applying the electric cattle prod where its most effective and thus we reiterate a **LONG** call and reaffirm our twelve-month target price of CAD$18.

Portfolio Changes

There were no changes to the Model Mining Portfolio during the month.

What next in Rare Earths

One is reminded of Aesop's Fable about the man that killed the Goose that laid the Golden Egg when regarding the spoiler tactics of certain players as it comes to the DoD's selection of "champions" to liberate the US military/industrial complex from the burden of Chinese domination in Rare Earths.

By delaying this measure they are implicitly relying (hoping?) that a Biden-led regime will be as sympathetic to Rare Earths as the outgoing Trump Administration has been. To read the runes on this one we would strongly recommend that they look at the Obama years and what he did for resource nationalism. Is that "Bubkis" I hear someone in the back row shout? Give the man a Kewpie Doll!

The Trump may have been a very brief high tide in the resistance to Chinese domination of the strategic metals space. The Democrats have shown themselves more than willing many times to roll over and have their tummies tickled in the cause of globalization. There is no reason to believe that there will not be a return to "business as usual" with business being the operative word. The likely outbreak of an internecine culture war in the US will put trade (or commodity) wars with external forces well into the back seat.

So if the DoD's tender process still sits in the "too hard" basket in the first week of January of next year, then it's more likely to be tipped down the garbage chute than be revived. So its current critics may yet rue the day they decided to call "Foul" on the process.

The two mud-flinging parties have only recently seen their day in the sun precisely because of US concerns about China-dependence, not because of any inherent shortage of Rare Earths or a price surge for REEs. Indeed both of the US projects that fancy their chances don't have much in the way of Heavy Rare Earths of consequence.

Ultimately this whole *schemozzle* goes to show that the players in the Rare Earth space will need to prosper (or fail) on economics alone with no higher intervention.

Parting Shot

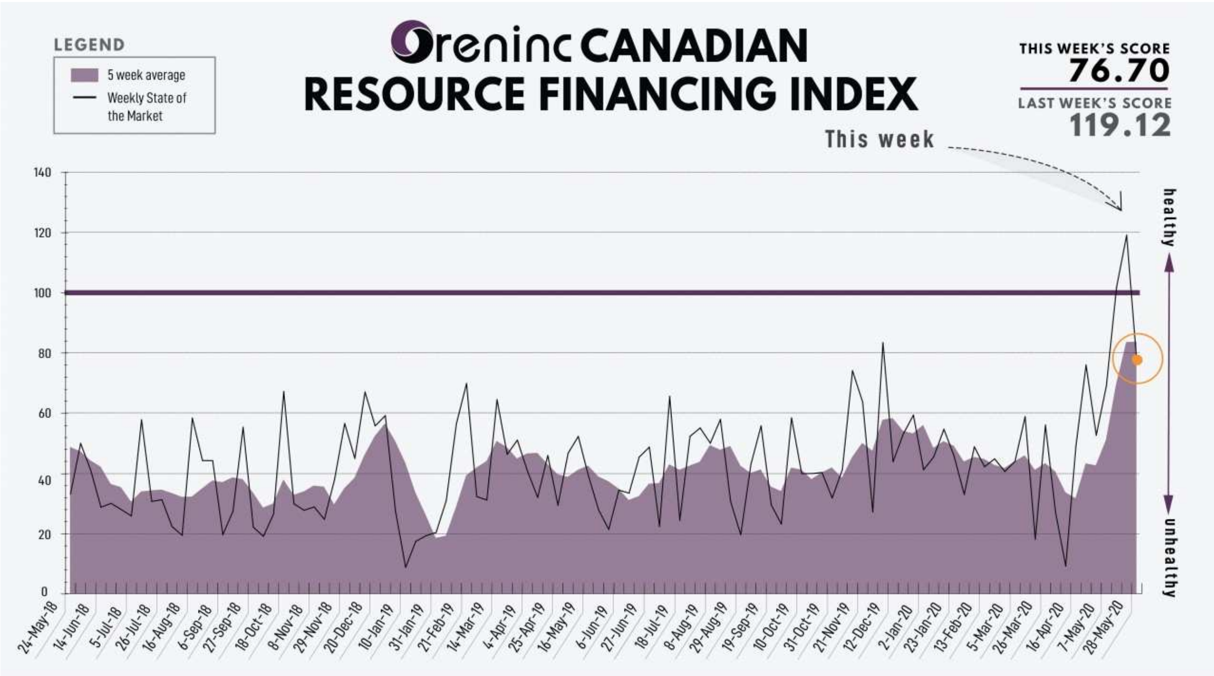
Mining is ether feast or famine… and sometimes it is both feast and famine.

The current times are more confusing than usual. Financing markets seem to be turning on a dime. Canada is finally starting to bubble up with placing activities and merger & acquisition deals on the increase. Many in that market are still suffering from PTSD from the events of the past eight years. We noted this in recent weeks when someone in the external IR business commented to us that one of their companies rose nicely on the back of a good announcement and then went soaring on <u>no</u> further news. This prompted him to the thought that it would all end in tears and was not in the best interests of the company. We wondered why this would be but then he expressed the thought that maybe the stock had (briefly) become a hobby horse for the mythic "Millennial traders" and that they would rampage into the stock then out of it leaving it none the better.

There has been a noticeable rise in the number of requests from the exchanges for explanations from managements about sudden price surges and, uniformly, the answer seems to be "no known reason".

We would note that corporate raiders could slip under the cover of this latest phenomenon with managements being none the wiser. However we are still not at a moment in which aggressive unsolicited bids start to rise in numbers.

Despite a slight downturn at month end the Oreninc Index, which covers Canadian financings still looked a quantum better than it's been in recent times.



Practitioners (and listed companies) continue to bemoan the London market woes. Takeovers are almost irrelevant as mining in London has been becalmed for a long while. A number of moribund AIM-listed miners are being repurposed for "new" stories but the supply is finite. We are told that the corporate brokers (despite the lockdown) are frenziedly working away on deals but the raising of new funds is measly to say the least.

Australia seems quite ebullient as the dire level of the Australian dollar enhances all earnings of commodities essentially priced in US dollars. It also helps that with so many other sectors of the economy (and stockmarket) *Downunder* looking battered by the Wuhan Virus, mining appears like an attractive oasis in which to take refuge. Firm gold prices also provide strong underpinning. In contrast to Canada we do not perceive Australian producers as eager to further dilute via financings or rights issues if they do not need extra funds. Meanwhile Canadian producing companies that are already cashed up have no shame in coming back for more financings as many/most don't pay dividends.

Brace yourself for dumb M&A… as surely as night follows day, that will be next up… after all, who remembers Underworld these days?!?

MODEL MINING PORTFOLIO @ END JUNE

	Security	Currency	Price	Change last 12 mths	Change last mth	12-mth Target
Long Equities						
Diversified Large/Mid-Cap	Teck Resources (TECK.B)	CAD	14.22	-53%	9%	$18.00
	Metals X (MLX.ax)	AUD	0.08	-68%	-11%	$0.14
Uranium	Uranium Participation Corp (U.to)	CAD	4.58	9%	-11%	$6.00
	GoviEx (GXU.v)	CAD	0.15	-6%	-6%	$0.17
Zinc/Lead Plays	WisdomTree Zinc ETF (Zinc.L)	USD	6.54	-16%	4%	$8.10
	Myanmar Metals (MYL.ax)	AUD	0.06	0%	20%	$0.08
	Ascendant Resources (ASND.v)	CAD	0.13	-87%	8%	$0.30
	Telson Mining (TSN.V)	CAD	0.13	-59%	63%	$0.25
Silver Producer	Excellon Resources (EXN.to)	CAD	0.83	-16%	4%	$1.10
Silver Explorer	Southern Silver Exploration (SSV.v)	CAD	0.50	178%	-12%	$0.80
Silver ETF	IShares Silver ETF (SLV)	USD	17.01	19%	2%	$18.50
Gold Producer	Soma Gold (SOMA.v)	CAD	0.25	-87%	39%	$1.20
Coking Coal	Colonial Coal (CAD.v)	CAD	0.70	67%	56%	$1.10
Project Generator	Altus Strategies (ALS.L)	GBP	32.94	36%	3%	£40.00
Copper Explorers	Panoro Minerals (PML.v)	CAD	0.12	-20%	50%	$0.18
Tungsten Producer	Almonty Industries (AII.v)	CAD	0.57	-30%	8%	$0.80
Vanadium Developer	Vanadium Resources (VR8.ax)	AUD	0.02	-75%	0%	$0.04
Lithium	Neometals (NMT.ax)	AUD	0.17	-19%	0%	$0.45
	Lithium Power Intl (LPI.ax)	AUD	0.18	-36%	38%	$0.30
Scandium Developer	Scandium International (SCY.to)	CAD	0.12	-8%	50%	$0.12
Gold Explorer	Cabral Gold (CBR.v)	CAD	0.16	-6%	23%	$0.15
	BTU Metals (BTU.v)	CAD	0.39	160%	86%	$0.42
	Gunpoint Exploration (GUN.v)	CAD	0.52	16%	-5%	$0.75
Fertilizers	Verde Agritech (NPK.to)	CAD	0.50	-11%	-12%	$0.90
Cesium et al.	Pioneer Resources (PIO.ax)	AUD	0.01	0%	0%	$0.03
Rare Earths	Northern Minerals (NTU.ax)	AUD	0.02	-75%	0%	$0.08
	Neo Performance Materials (NEO.to)	CAD	9.03	-28%	21%	$14.00
Tin Miner	Alphamin (AFM.v)	CAD	0.14	-42%	17%	$0.48
Mining Media/Events	Aspermont (ASP.ax)	AUD	0.01	0%	0%	$0.03
Short Equities						
Shorts	NioCorp (NIO.to)	CAD	0.81	42%	14%	$0.40
	Texas Mineral Resources (TMRC)	USD	1.82	367%	-5%	$0.30
	Abdn Standard Palladium Trust (PALL)	USD	182.79	46%	0%	$180.00
	Galane Gold (GG.v)	CAD	0.14	180%	8%	$0.04

Important disclosures

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