17 January 2020

Stocks Down Under

'There are four types of countries: developed countries, developing countries, Argentina and Japan'

- Paul Samuelson (1915-2009), American economist

Orocobre – Adjusting to the New Argentina

Stocks Down Under rating ★★★★

ASX:ORE   Share price: A$ 3.63   Market cap: A$ 937M

On Tuesday 7 January 2020 in Stocks Down Under, we expressed some optimism regarding the long-term prospects for lithium when looking at Pilbara Minerals (ASX: PLS), which owns a hard rock lithium mine in the Pilbara region of Western Australia. In this edition of Stocks Down Under we look at one of the leading brine producers of lithium, a Brisbane-based company called Orocobre, which operates the Olaroz Lithium Facility in Argentina. At Stocks Down Under we are bullish on all kinds of lithium producers. For Orocobre we're particularly enthusiastic, since the cost of production for brine players tends to be much lower than for hard rock lithium, and in Orocobre's case it is now moving up the lithium chemicals value chain. With the new government in Argentina so far proving friendly to the local lithium industry, and lithium pricing marginally improved as 2020 started, we think there is potential for Orocobre stock to break the $3.80 resistance level it formed in March and April 2019.

Before we go on, permit us to explain the brine versus hard rock divide in lithium. As we explained in Edition 6, hard rock lithium means lithium extracted from rock-borne minerals such as spodumene. Brine lithium, by contrast, means lithium contained in underground reservoirs of salt water. Brine lithium is cheaper to obtain than hard rock lithium because all that is required is to pump the lithium-rich brines to the surface into a series of evaporation ponds, after which only modest downstream processing is required to obtain the end product usually sought, which is lithium carbonate.

Company Share Price Chart

Source: Tradingview

A pioneer in the Lithium Triangle

Argentina is a great place to find low-cost brine lithium because the northwest of that vast country sits in one corner of the so-called Lithium Triangle alongside southern Bolivia and northern Chile. In this part of the world the lithium lies beneath salt lakes called ‘salars’, one of which is Olaroz, located in the Argentine province of Jujuy (pronounced hoo-HWEE), around 230 km northwest of the provincial capital, San Salvador de Jujuy. Orocobre went public on the ASX in 2007 to develop the Olaroz salar and in 2010 teamed up with Toyota Tsusho, the trading arm of Japan’s Toyota Group, to start producing lithium carbonate on site. By February 2015 the Olaroz Lithium Facility was up and running, majority owned by Orocobre. Olaroz was a major achievement for this pioneering Australian company because no new lithium operation had gone into production for the previous 20 years. Also, the operation went into production only about a year before the global lithium boom really got going in late 2015.

Up until now Olaroz has supplied around 12,000 tonnes p.a. of battery-grade lithium carbonate from what it calls Stage 1 of the Facility. Soon it will go live with Stage 2, where it will start producing technical-grade lithium carbonate at Olaroz and, importantly, convert some of this technical-grade material into lithium hydroxide at a plant that will be built in the Japanese city of Naraha, in Fukushima Prefecture (coincidentally, not far from where the Daiichi nuclear disaster happened in 2011). Technical grade lithium carbonate has a lower purity level that battery grade lithium carbonate (~99.3% as opposed to the >99.5% necessary for battery cathodes) but there's still a big market for it in ceramics and glass. However, the really big money in Electric Vehicles batteries in the future is expected to be in lithium hydroxide, which already commands a price premium to lithium carbonate. It is expected to be in greater demand in the future as the Electric Vehicle industry shifts over to so-called NCM811 batteries. Basically, Olaroz Stage 2 is Orocobre moving seriously up the lithium chemicals value chain.

Betting on Olaroz Stage 2

Lithium-ion batteries – which is what the fuss is really all about in terms of long-run lithium demand – are simply batteries with a lithium metal at the cathode and carbon at the anode, usually graphite. The push is on in the battery industry to find the cathode metal combination with the highest energy density, thereby increasing the battery lifespan and allowing an Electric Vehicle to go further on a single charge. It's believed that NCM811 batteries, where the non-lithium elements in the cathode are 80% nickel, 10% cobalt and 10% manganese, are what the market will ultimately be looking for. This chemistry works best with lithium hydroxide. With Orocobre now a lithium hydroxide player thanks to Naraha, it's expected to be at the forefront of this shift in lithium demand. The Naraha facility is expected to commission sometime in 2021. As Olaroz Stage 2 matures, Orocobre's numbers start to look good on consensus, with the EV/EBITDA ratio falling below 5x in FY22 and about 3x in FY23.

Don't cry for me Argentina

Share-price wise, Orocobre went through a difficult period between August and December because of concerns about the political situation in Argentina. On Friday 9 August Orocobre closed at $3.01 per share. Then over the weekend Argentines voted for Presidential candidates in primary elections which produced an unexpected outcome: the poll suggested that the incumbent, and pro-business, President Mauricio Macri, would be defeated in the forthcoming general election in favour of the left's candidate, Alberto Fernandez.

Since Argentina's economy has historically not coped well with left wing governments, suddenly on the markets all hell broke loose - the Argentine peso dropped like a stone and the Buenos Aires Stock Exchange experienced panic selling that took the country's main stock index down by half in the subsequent weeks. Orocobre stock was taken down with it – by 26 August it had reached $2.26 and it tested this resistance level again on 22 October just prior to the 27 October election which Fernandez won by 48% to Macri's 40%.

Not too much sovereign risk

Interestingly, the 6 December low was slightly higher at $2.34. By then the market had decided that Alberto Fernandez was no great threat to the Argentine lithium industry because the President badly needed its exports to keep the country from going bankrupt, and, even if he didn't care, Argentina's Federal system of government meant that resource-rich provinces like Jujuy could protect Orocobre from anything deleterious emerging from out of Buenos Aires. It's worth remembering that the left, under former President Cristina Kirchner (now Fernandez's Vice President), was in charge in Argentina for the period from 2010 to 2015 when Olaroz was being developed.

We think the rally since 6 December was also helped by improved spot pricing for lithium. Orocobre indicated on 3 October that its expected average selling price for the December 2019 quarter would be US$5,400 per tonne, down 24% on the previous quarter, but spot pricing seems to have improved since then and we expect better numbers for the March 2020 quarter. And, as we argued in Edition 6, the closer we get to 2021, the better the fundamentals for lithium become as demand closes in on supply.

We think that as sentiment returns towards lithium, Orocobre, as a brine producer and future lithium hydroxide supplier, and operating in low cost Argentina, is well placed to re-rate. After $3.80 the next resistance level is around $5.00. At the moment the shorts, who represent over 13% of the register, seem to be betting that $3.80 won't be broken. We believe it can be.

Nearmap: In danger of falling off the map

Stocks Down Under rating 

ASX:NEA **Share price: A$ 2.63** **Market cap: A$ 1.23BN**

Sure, Nearmap is a world-beating company and a superstar in the exciting world of Software as a Service (SaaS) with its aerial imagery delivery technology. This Sydney-based company sells into a US$7bn market that will be likely be US$10bn before too long. And the company is growing out of its Australian base into the lucrative US market as well as other large market opportunities. In FY19 revenues grew by 45% to A$35.5m. Annualised Contract Value was $78m in FY19, up 44%, and at the Annual General Meeting in November Nearmap told shareholders that it expected ACV of $116-120m in FY20, which would represent growth of 29%–33%. However, it's not profitable yet at the NPAT line, and, indeed, the losses widened in FY19 instead of reducing. That's why we'd be worried about Nearmap stock right now.

Company Share Price Chart

Source: Tradingview

The FY19 result was a disappointment to some

Nearmap, which back-door listed on ASX in 2012, really only started to get on investors' radar screens in early 2016 when the stock was just over 30 cents. By June of last year, it had reached $4.20, but the FY19 result and the widening loss brought the stock back down to the current resistance level of around $2.50 by September. Since then the highs have been lower and one wonders if the stock drops through $2.50 – which it could do if the half-yearly numbers disappoint in any way – if the next stop could be below $2.00.

Nearmap is currently valued on a price to revenue multiple of 11x. That's pretty high in anyone's valuation book even with a company growing its top line at the level of the November 2019 guidance. At this share price level we're still worried. A lot of the market seems to agree with this. Nearmap is currently 12% shorted on ASX.

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