7 January 2020

Stocks Down Under

'The trouble with Socialism is that eventually you run out of other people's money'

- Margaret Thatcher (1925-2013), British Prime Minister 1979-1990

Pilbara Minerals – Reports of its early death have been greatly exaggerated

Stocks Down Under rating ★★★★

ASX:PLS Share price: A$ 0.36 Market cap: A$ 756M

2019 was, by and large, not a good one for shareholders of Pilbara Minerals (ASX:PLS), the Perth-based company which owns the Pilgangoora Lithium and Tantalum Mine in the Pilbara region of Western Australia. On 22 May Pilbara Minerals stock closed at 83.5 cents. By 12 December it was 70% lower at just 25.5 cents. The decline had nothing to do with what appears to have been the murder of a worker at Pilgangoora around 11 November, which briefly led to a suspension of the stock before Pilbara Minerals established it was contract personnel and not its own employees that were involved in the incident. What killed Pilbara Minerals stock was a sharp decline through 2019 in the price of lithium. We predict that Pilbara Minerals will recover with the lithium price as we move closer to 2021.

Company Share Price Chart

Source: Tradingview

Electric vehicles driving demand for lithium

Lithium is a metal that the world is going to need a lot more of in the near future. A heck of a lot more. As the world's stock of motor vehicles rapidly goes electric over the next decade or two, powering all those new-era cars and trucks will be rechargeable lithium-ion batteries. Currently, the world consumes around 200,000 tonnes of lithium a year. Once the electric vehicle revolution really gets up a head of steam (to use a phrase from another transportation era), some have suggested that demand will have risen to more like 3.5 million tonnes a year. And that head of steam is building right now, as any Tesla shareholder can tell you. In 2017, global sales of new electric vehicles passed the one million mark for the first time. In 2020 the number could be more like 4 million vehicles.

In 2019, alas, it didn't look like the revolution had arrived if you were a lithium supplier, because there was a temporary oversupply of the metal from new mines like Pilgangoora. As a consequence, lithium prices were down about 30% through the year. Many expect lithium prices might fall again in 2020, although less severely than in 2019. By contrast, 2021 is widely expected to be the recovery year for lithium once marginal supply (including recycled metal) is off the market and demand races ahead. When that happens, Pilbara Minerals with Pilgangoora will be in the box seat. Right now, however, a lot of people think things will get worse before they get better, which is why Pilbara Minerals stock was 8% shorted on ASX as at 6 January.

Production capacity to be dramatically increased

Pilgangoora, which lies around 120 km from Port Hedland, and is 100% owned by Pilbara Minerals, is one of the largest deposits of spodumene and tantalum in the world. Spodumene is the mineral which yields the lithium, while tantalum, often associated with spodumene, is valuable for its use in electronics and alloy metals. Pilgangoora commenced commercial production in April 2019, around the time of last year's share price peak. Currently, the mine's nameplate capacity is 330,000 tpa of ~6% spodumene concentrate and 321,000 pounds p.a. of +5% tantalite concentrate, from 2 million tonnes of ore mined. Stage 2 of the mine will increase this up to 5 million tonnes. Clearly Pilgangoora has a good future if you're not worried about lithium today. A Definitive Feasibility Study in August 2018, with reasonable price estimates, suggested project economics for Stage 2 of A$2.16bn for Pilgangoora on a 10% discount rate after capital costs of A$231m. Currently, Pilbara Minerals' market cap on ASX is just under $670m.

Hard rock lithium versus brine lithium

The trouble with Pilbara Minerals from a sentiment perspective is that it's a 'hard rock' lithium play. Many observers of the battery minerals space are dismissive of hard rock lithium sources since they are costlier to mine than lithium sourced from underground brine deposits. Long-term, in a rising market that is likely to need all the lithium it can get, we expect that Pilgangoora will be just fine. Also, the naysayers on spodumene lithium forget that only this kind of lithium can convert directly to lithium hydroxide, the lithium chemical many expect will be needed in greater amounts over lithium carbonate to improve energy density in batteries in the years ahead.

Focus on the medium term, not the short term

Near term, the outlook is quite bright for Pilbara Minerals even if 2020 doesn't work out well as far as lithium price recoveries go. That's because the company is working on a joint venture with Posco, the South Korean steel maker which has been pushing for some years now to become a major global player in lithium. A Final Investment Decision will be made this year by the two companies on a downstream lithium chemicals complex, which will allow the Australian company to move up the value chain as, potentially, the 30% owner. Throw in improvements on production costs at Pilgangoora as the mine approaches its nameplate capacity for Stage 1, and 2020 could be a good year to be involved in this stock. The risk here, obviously, is that the market might choose to weigh current lithium prices ahead of a more optimistic medium-term view. Balanced against that is the current low EV/EBITDA ratio on forecast FY22 numbers – a mere five times. This is clearly one for the electric vehicle optimists.

New Hope Group – Time to be hopeful?

Stocks Down Under rating

ASX:NHC   Share price: A$ 2.04   Market cap: A$ 1.7BN

Just as 2019 was a bad year to be in lithium, it was a bad year to be in coal. After six bad years from 2010, coal prices started recovering in 2016 but that recovery had run its course by mid-2018 and most of it has since been lost. That hasn't been good for New Hope Group (ASX:NHC), owner of two coal mines in southeast Queensland and one in the Hunter Valley of NSW. New Hope's stock was $4.41 on 15 March 2019 but by early December 2019 it had more than halved, reaching $1.99. However, we wonder if 2020 will see some hope return for investors given the great management team, an excellent balance sheet and some really good thermal coal assets. Not to mention relatively few short sellers – the net short position on this one at the moment is only 2%.

Company Share Price Chart

Source: Tradingview

Environmental approvals seem to be getting close

The first thing to be hopeful for New Hope about is New Acland. This 5.2 million tonnes per annum thermal coal mine near Oakey, a small town 28 km northwest of the southern Queensland regional centre of Toowoomba, has been around since 2002. Around 12 years ago New Hope started to seek mining and water approvals for New Acland Stage 3, which would expand the mine to 7.5 million tonnes. The March 2019 peak for New Hope stock came just after the Queensland Department of the Environment allowed the 'Environment Authority' for New Acland Stage 3 to be amended in New Hope's favour. Then there was a Court of Appeal victory over an environmental group in early November. We think this judgement clears the way for New Acland to finally get the licenses it needs. It's worth noting that the Indian company Adani waited only nine years in the face of fierce opposition from environmental groups to finally get approval last year to develop the Carmichael Coal Mine in another part of Queensland. Approval for New Acland Stage 3 would add another ten years to its life and, given how controversial coal has become in some quarters, New Hope will gain a lot of media attention when the approvals are finally in.

Elections coming up

The second thing to be hopeful about is a change of government in Queensland, which could reasonably be expected to speed the process of coal mine approvals in the state. Queenslanders go to the polls in October 2020 with Labor's Annastacia Palaszczuk facing off against Liberal National Party leader Deb Frecklington. Labor could be in trouble in this election given how voters in regional Queensland loudly facilitated Labor's defeat in the May 2019 Federal election, partly because of mixed messaging on Carmichael. A change is likely to be favourable to current and would-be coal mine operators in the state.

Then there's Bengalla. This thermal coal mine, located 4 km southwest of Muswellbrook in the Hunter Valley region of NSW, is now a major New Hope asset after the company lifted its stake from 40% to 80% in mid-2018. New Hope is not known to make investment decisions like this one lightly, so there is potential for a well-regarded specialist coal miner to ramp up production significantly at Bengalla in the years ahead.

Valuation is compelling

Let's face it – times are tough for thermal coal producers right now with China taking less seaborne coal. However, New Hope argues that as other established Asian coals markets move to higher quality coal from Australia the market will recover, particularly as other markets move to increase their coal imports. Should this cause thermal coal prices in the region to stabilise in 2020, New Hope would be well placed. The fact that it is half owned by the respected investment company Washington H Soul Pattinson Co. means that New Hope would be a go-to stock for investors wanting exposure to coal on the recovery.

Right now investors can get New Hope for an EV/EBITDA on FY20 forecast numbers of just 5.7 times. Sometimes Hope comes cheap.

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