21 APRIL 2020

Stocks Down Under

> *It's how you deal with failure that determines how you achieve success.*

- David Feherty (b. 1958), former professional golfer

RAFAELLA RESOURCES

The pilgrimage for a company-making mine

GALENA MINING

New kid on the lead block

PERENTI GLOBAL

Five directors buying can't be wrong

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Stocks Down Under rating: ★★★★

ASX: RFR
Share price: A$ 0.061
Market cap: A$ 4.4M

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Share price chart

Source: Tradingview

Back in May 2018 the US Department of the Interior published a list of 35 mineral commodities considered critical to the economic and national security of the United States. It was part of the Trump Administration's efforts to help America be ready against the day when a hostile power controlled a large amount of the commodities in question. One of those commodities was a little-known metal called tungsten, chemical symbol W, atomic number 74.

Donald Trump likes tungsten

If you've visited your local hardware store recently you may have come across a few products made of tungsten, such as tungsten electrodes used in welding, or tungsten carbide blades for paint scrapers. Not to mention light bulbs which have long come with tungsten filaments. However, tungsten has a habit of showing up all over the place whenever industry needs more wear-resistance in metals. Only diamonds are harder than tungsten, which is why it's the metal of choice when you're making drill bits. Or, indeed, military hardware. More recently there's been more and more of it showing up in construction, automotive, aerospace and electronic applications.

There's a simple reason why the Trump Administration is so interested in tungsten – something like four fifths of the world's annual mine output comes from China. This makes any new supply from outside China very valuable from America's strategic point of view, not to mention to buyers of the commodity looking to diversify their supply risk, preferably to an OECD country, including European countries.

Rafaella potentially has a new tungsten mine in Spain

Which brings us to Rafaella Resources and the opportunity with Santa Comba. The town of Santa Comba is in the Galicia region of north-western Spain, only 33 km from the famous Santiago de Compostela, the termination point for the Way of St James pilgrimage trail. The port town of La Coruña is about 60 km north. Rafaella's project covers an old tin and tungsten mine just outside Santa Comba, last worked in 1985 but which the present management team believes can easily be resurrected at current prices.

There's a lot going for the Santa Comba project and for Rafaella. For one thing there's a high grade JORC 2012 resource of 5.3 million tonnes grading 0.24% WO3 - that is, tungsten trioxide - containing about 12,600 tonnes of the stuff, but, as we noted above, that's likely to be upgraded soon thanks to recent drilling. Rafaella reckons it can expand the resource to perhaps closer to 50 million tonnes over time.

Then there's the Feasibility Study. This will be completed potentially in the third quarter of the current calendar year. There's already a processing plant onsite so Rafaella reckons that if this feasibility work reports favourably in terms of the expected cost base, the company can be restarting production not long afterwards, helped by the fact that a lot of the resource is near surface and not covered by overburden. The only thing to worry about at the moment, apart from Covid-19 (obviously), is what happens to the price of tungsten.

Good times may be ahead for tungsten

Tungsten ran up smartly between 2016 and 2018 when China was pushing hard to close down environmentally hazardous mining and mineral processing operations. The peak for the metal was in June 2018, when APT (ammonium paratungstate, the usual traded form of tungsten) peaked at US$350 per mtu (metric tonne unit). We believe the market reached an important support level at about US$175/mtu last September, driven there in part by stocks that had to be auctioned off related to the failure of a metals exchange in China. Tungsten has since rallied although, like most commodities during the Coronavirus Crisis, it's suffered a little in recent days.

The risk for Rafaella shareholders right now is that we don't know what the Feasibility Study is going to say. However, much of that risk is already in the price given the fact that you need a magnifying glass to see the Enterprise Value. That would explain why director Robert Wrixon, Chairman Peter Hatfull and Managing Director Steven Turner have all been on-market buyers just this month. Rafaella might be a good reason for ASX investors with an appetite for speculation to extend their pilgrim's way past Santiago de Compostela to take in Santa Comba.

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Share price chart

Source: Tradingview

Let's face it, lead, chemical symbol Pb, atomic number 82, is not a sexy metal. Indeed, because it's a health hazard the times you're generally hearing about lead on the news is when it's being phased out or banned, most notable when it was removed from petrol between the 1970s and the 1990s, but more recently when an EU directive came out in 2003 ordering it removed from solder. Basically, lead's last remaining large-market application has been in the lead-acid batteries in your traditional non-electric vehicle, which accounts for about 80% of current demand. And the assumption by many here is that lead-acid batteries will go the way of Windows 95 as lithium-ion batteries rise.

Don't write off lead just yet

Actually, lead's future is quite bright in the era of Tesla. Not only will it be a while before all of us have an EV in our garage, but when we do get one it will likely still have a lead-acid battery for 'SLI', that is, Starting, Lighting and Ignition. Moreover, that same battery will also power newer automotive functions such as electronic door-locking and in-car entertainment. Not to mention the computers that run the lithium-ion battery management system itself. Outside of the Electric Vehicle, lead is the energy storage solution metal of choice for all sorts of electric power providers and users because its cost per unit of energy stored is so low. Therefore, we believe it's fair to say that lead will be with us for a while yet.

That's good news for Galena Mining – whose name comes from the principal ore of lead – as it gets ready to launch its new Abra Lead-Silver Mine, located in the Gascoyne region of Western Australia, between the towns of Newman and Meekatharra. This underground mine is based on a resource of 41.1 million tonnes with a very high grade of 7.3% lead, not to mention 18 g/t silver, and that makes the flowsheet for the metal quite straightforward.

A high-grade lead-silver mine

Partly as a consequence of those high grades and the fact that there will be substantial silver credits, once gets running on its initial 16 year mine life, Abra is expected to record in excess of $100m in annual EBITDA, helped by having 100% of all concentrate production committed under current offtake agreements. Abra will be 60% owned by Galena and 40% by the Japanese company Toho Zinc, which, as its name suggests, is a major player in the global lead and zinc space and which announced a major project investment in January 2019.

When Abra's Definitive Feasibility Study came out last July it came in with a pre-tax NPV of the project of A$553m after capital expenditure of $A170m. Galena has had enough cash from Toho and others to get started on surface infrastructure and the box-cut (i.e. the mine opening at surface) at Abra, and project debt is now being negotiated. That provides an opportunity. Galena's stock had already come down due to weaknesses in the price of lead prior to this Crisis. Now it's even lower.

The Chinese battery makers need more lead

In April 2019 lead was changing hands on the London Metals Exchange (LME) at around US$1,900 a tonne. By last month it was down below US$1,700 a tonne, which was mild but still disconcerting given concerns that the Coronavirus Crisis would severely disrupt demand for lead out of China for the foreseeable future. The assumption by many investors seems to have been that no self-respecting project financier would back a new lead mine like Abra during the current Crisis. Those naysayers forget that China's lead acid battery factories are now re-starting and that LME stockpiles of lead had been headed down sharply for about five years before the crisis started.

A few important investors are seeing Galena's currently low market capitalisation as an opportunity. Tim Roberts, of the Perth-based family that built Multiplex, just took his stake up to 19.6%. And Stewart Howe, a mining engineer from Melbourne who is a Galena non-executive director, was a recent on-market buyer. Clearly no Coronavirus concerns for these guys when it comes to the upside from Abra.

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Source: Tradingview

Time was that mining companies did everything themselves. Then in the 1980s they discovered that you could outsource most services the sector needed and the mining services industry was born. Perenti Global, which is named after Varanus giganteus (a big lizard native to Australia better known as the perentie), has been one of the stars in Australia. It started out with only a single drill rig in Kalgoorlie in 1987 and gradually evolved to the point where in mid-2018, with the acquisition of the underground mining specialist Barminco, it was a $1.7bn p.a. revenue powerhouse. Only Thiess, the mining services arm of CIMIC (ASX: CIM), is bigger.

Out of Africa

A big part of the secret to Perenti's success has been Africa. The company recognised earlier than most that Africa was becoming an easier place in which to do business as economies and governments evolved and that the mining industry in Africa would present strong opportunities. These days around half of Perenti's revenues come from Africa, where it regularly wins new work and is a trusted partner both with foreign and domestic operators in the region.

Of course, Africa is not without its challenges, as the 2019 Fada N'gourma attack showed. Perenti had been doing surface mining at a gold mine in Burkina Faso called Boungou, having been brought in by Semafo (TSX: SMF), the Montreal-based mine owner. Burkina Faso is currently grappling with an upsurge in Islamic militants in the east of the country and last November gunmen at a town called Fada N'gour attacked a convoy of workers who were headed to the Boungou mine. Around 37 people were killed and 60 wounded. That was bad news. However, Boungou was able to restart in February. Also, if one looks across the spread of African countries in which Perenti works, such incidents are rare.

A diverse revenue base

In the six months to December 2019 Perenti grew revenue 5%, to over A$1bn, and underlying EBITDA by 11%, to $222m. Encouragingly ahead of the Coronavirus Crisis, gearing came down to just 31%.

The great thing about Perenti is its revenue diversity. It does both surface and underground mining so the company is not hostage to problems that may crop up in either mining approach. And it has a strong business in Australia to offset any temporary problems in Africa, which is why it did so well in the most recent half. We are also encouraged by the fact that the main commodity in which the company is involved is gold given the favourable outlook for the yellow metal right now. As at December 2019 gold was 68% of the company's work in hand.

A P/E under 5 for this strong grower?

Obviously, Covid-19 is a challenge for the mining industry everywhere and makes life tougher for Perenti too. For example, on 15 April Panoramic Resources (ASX: PAN) suspended operations at the Savannah Nickel Mine in the Kimberley region of Western Australia. The mine had only restarted in November with Barminco a major contractor on which it now couldn't execute. There will be other hassles like this.

However, Covid-19 doesn't stop Perenti doing business development. As at December 2019 there was A$5.7bn of work in hand and another $7bn in pipeline. So, we expect the company will recover quickly once Coronavirus goes away.

Currently, Perenti is trading at an EV/EBITDA multiple of 2.7x and a P/E of only 4.7x for FY21. For a company with Perenti's track record of growth in recent years, that's tiny. No, wonder that CEO Mark Norwell has been a recent on-market buyer of stock, as have non-executive directors Mark Hine, Robert Cole, Alex Atkins and Andrea Hall. That's a lot of directors who like this company's prospects.

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