

Attempted Theft of Two Nickel Producers

Last summer the base metal market was a buzz with the bidding wars for nickel producers Falconbridge and Inco. The whole affair was intriguing with multiple bids and cross bids of takeover targets. Nickel at the time was on the move and had doubled from \$6/pound in January. The victors in these battles were Xstrata taking over Falconbridge for \$18 Billion and CVRD claiming Inco at \$17.6 Billion. Falconbridge was purchased for a handsome 15X cash flow multiple and Inco shareholders were rewarded with a 9X cash flow multiple.

In the past couple of weeks, new bids were made for two profitable nickel producers, LionOre and Rio Narcea. The price of nickel last week hit a life-time high of over \$23/pound. Considering the nickel price was almost half of today's price when the Falconbridge and Inco take-overs were raging, one would think that LionOre and Rio Narcea shareholders would see comparable or higher bids relative to cash flow: think again.

LionOre:

At the end of March, Xstrata made a friendly take-over bid for LionOre (TSX - LIM) for C\$18.50 per share. This values LionOre at C\$4.6 Billion (\$4 Billion US). Both Xstrata and LionOre said that the deal was fair to shareholders, strongly recommending acceptance of the offer. The investment community was rather skeptical of their recommendations. Using present nickel prices and considering LionOre has guided 2007 payable production of 40,000 tons (88 million pounds), places Xstrata's bid at about 4.5 times cash flow, half of what Inco share holders received. There has been a chorus of investors and analysts noting the lack of premium in the bid. Bill Belovay of the BMO Resource Fund proclaimed "The Company is being stolen".

In defense for his support of the deal, LionOre's president and CEO Colin Steyn, said current nickel prices are unsustainable over the long term and recommended to LionOre share holders to sell while the nickel market is still good. Shareholders of LionOre should question why Mr. Steyn is bearish about nickel's future. Is demand going to soften? Are large amounts of supply soon to come on the market? Perhaps we should take a look at nickel fundamentals to see what may support his implied bearish position towards nickel, which was used to justify the purchase of his company at a low cash flow multiple.

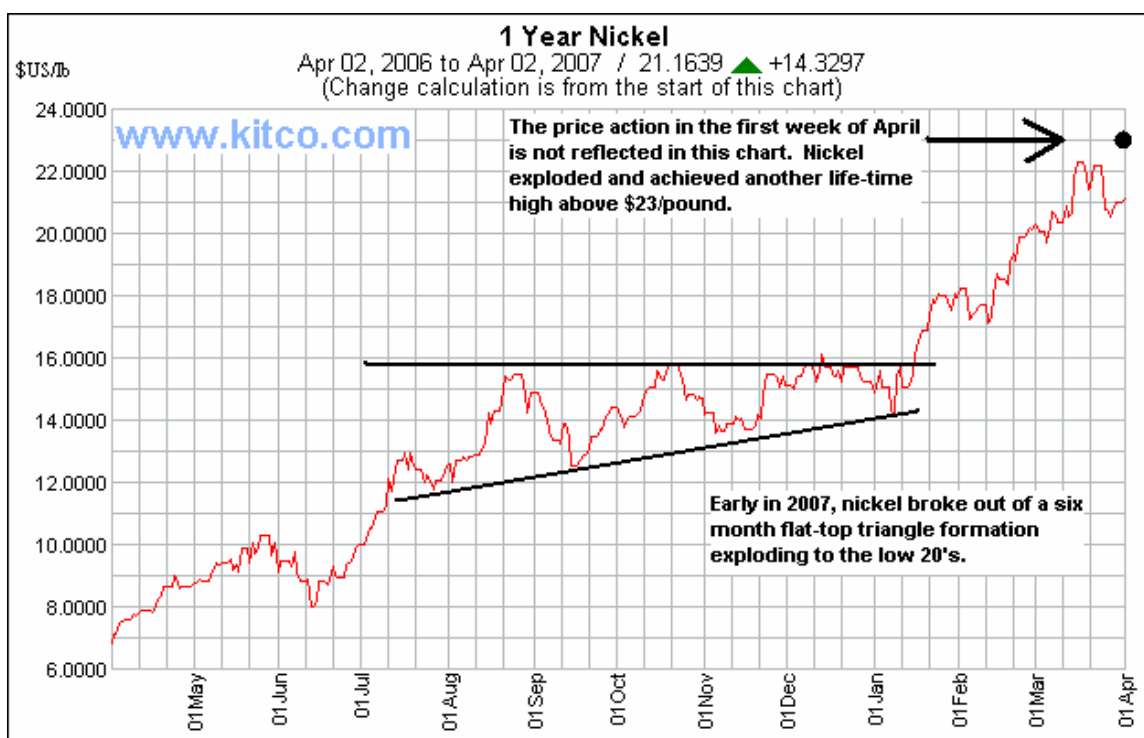
For the past several months, nickel storage levels monitored by the London Metal Exchange (LME) have hovered around just enough supply to support a single day's global consumption. Demand has been supported by tremendous growth of China's stainless steel market. Despite historically high prices, China's stainless steel production growth is expected to grow in 2007. Stainless steel uses the most nickel of any industry. The 300 series stainless steels are the most corrosion resistant and require 6-12% nickel. Last year the Chinese began to use less nickel to reduce costs by manufacturing 200 series stainless steel

alloys. What they found out is less nickel equals more rust, hence replacing 300 series stainless with 200 series stainless has become much less attractive despite the cost savings.

What about nickel mine supply? This is one of the biggest factors that could create a downward spiral in prices should a large quantity of new production hit the market. There are two primary types of ores from which nickel is produced: sulfides and laterites. Presently the most abundant identified resources are laterites, but most production comes from nickel sulfide ores. Sulfide ores are the most desirable because they use less capital to develop and cost less to produce. The problem exists today with grades of sulfide ores declining and the presence of few large, high grade projects in development. Essentially, production from sulfide ore projects is expected to only slightly increase through 2010 as declining production at older mines is balanced by new mines. This leaves the nickel industry relying on laterite projects to offset increasing nickel demand.

There are two laterite mines expected to bring new supply to the market in 2007. European Nickel's Caldag mine is expected to produce 21,000 tonnes per year (tpy) and the Mao Bay expansion project is to add an additional 16,000 tpy. Considering nickel market demand has on average been growing in excess of 4% per year, these two projects are only bringing enough supply to satisfy the increase in demand for the year. Next year more laterite projects are expected to begin production. Just last fall, laterite projects were expected to bring as much as 120,000 tpy to market in 2008. Included in the 2008 total were a combined total of approximately 40,000 tpy production from BHP's Ravensthorpe and CVRD-Inco's Goro mines. Due to the complexity of mining laterites, Ravensthorpe production has been delayed (again) until late 2008-early 2009 time frame. The Goro project has suffered setbacks due to labor issues and is not expected to be producing for several years. Therefore, it is very unlikely a sudden surge in nickel production will cause nickel prices to fall anytime soon and tight supply should exist through to the end of 2008.

The technical price picture of Nickel could not be any brighter. The chart below is the 1 year view of nickel's spot price. Nickel consolidated for several months forming a flat top triangle. Early this year the price broke through resistance finding its way in the low \$20/pound range. Nickel was experiencing a minor correction in price until last week when office workers threatened a strike at a nickel mine. The supply side of the nickel market is so tight that nickel prices soared to above \$23/pound marking a new life-time high for the metal. Neither supply, market demand nor the recent price action in nickel support a medium term bearish sentiment for its price. Technically, the metal is in a short term over bought situation, but it does not indicate the price has formed a top and is heading on its way to down. In fact, technicians absolutely love life-time highs as the market has not created a resistance point for which a market top can be identified.



Now back to the LionOre takeover bid at 4.5 times cash flow. LionOre's CEO is making the case for shareholders to support Xstrata's takeover bid because the deal is fair and nickel prices are near or at the top. This bearish view towards the metal does not seem to be supported by any information available today. LionOre shareholders need to ask the CEO to provide his source of information supporting weaker nickel prices for the foreseeable future. Perhaps his source can reveal how well they have predicted nickel prices for the past couple of years. As late as December of last year, industry analyst "experts" were revising their average 2007 nickel prices from \$7 to just over \$10.

Rio Narcea:

Just when the shock of the widely viewed low ball offer for LionOre was waning a new bid was made for another nickel producer, setting a new low for cash flow multiples. Last week, Lundin Mining (Amex – LMC) offered C\$800 million for Spanish nickel miner Rio Narcea (TSX – RNG, Amex – RNO). The deal represents just over a 2X cash flow multiple, at current nickel prices. It appears that nickel producers are trying to play leap frog with successively lower valuation metrics. Inco was taken out for 9X cash flow. LionOre is recommending half that at 4.5X cash flow. Now Rio Narcea is attempting to out do LionOre with an even lower 2X cash flow multiple. Many may be surprised that the bid for Rio Narcea is that low. The following table is a break down of the proposed takeover costs to better identify the approximate total purchase price.

Table 1: Approximate Purchase Price for Rio Narcea

Lundin's Bid Value	C\$800 M
Convert Bid to USD, C\$1.15/USD	\$695.5 M
Subtract sale of Tasiast Gold Mine, \$225 M	\$471.5 M
Subtract Tasiast Mine Debt, \$42.5 M	\$428 M
Approximate Total Purchase Price¹ =	\$428 M

¹ Excludes short term debt, Chariot Resources investment value.

Rio Narcea's projected nickel production in 2007 is 16 million pounds. Their last earnings report was Q4, 2006. In that report, fourth quarter cash flow was \$42.3 million largely derived from their nickel operations. Approximately \$7.2 million was generated from their now discontinued gold operations. The three month LME price average for Q4 was \$14.44/pound. For Q1, 2007 the average rose to \$17.63/pound. The company has guided they have improved efficiencies at their Aguablanca nickel mine, so we can anticipate nickel sales volumes to be equal to that of Q4. Using 3.9 million pounds sold, the additional revenue from increased nickel prices is \$12.4 million raising Q1 cash flow to a little below \$50 million. Considering nickel prices today are over \$5 higher than Q1 and \$8 above Q4, Rio Narcea's quarterly cash flow going forward is in excess of \$50 million. On an annualized basis, Rio Narcea's cash flow is well over \$200 million. Lundin is therefore attempting to buy Rio Narcea at roughly 2X cash flow.

The 2X estimated cash flow multiple can be projected to be lower considering the Spanish government owes Rio Narcea damages resulting from revoking their right to mine their Salave project in northern Spain. In their last conference call, Rio Narcea's CFO said they are seeking compensation of 200 million Euros (\$267 million). Even if the damages are settled for less than one quarter sought, it will effectively bring Rio Narcea's purchase price below 2X cash flow.

Under most circumstances, when an acquiring company makes an offer for another, its price goes down. In an all share offering, arbitrage players short the acquiring stock and buy the takeover target. The Lundin offer is an all cash offer. They are going to finance the takeover with debt. One would expect with \$500 million of new debt on the books and if the price paid was fair achieving top dollar for Rio Narcea shareholders, it would result in Lundin's stock falling. However after the announcement, Lundin's stock did exactly the opposite closing up 17% adding over \$550 million in market capitalization. Rio Narcea shareholders should begin to ask themselves if they are getting the best price when the benefit to the other company is worth nearly its entire market cap plus the addition of \$500 million in additional debt!

A glimmer of hope for LionOre and Rio Narcea Shareholders:

LionOre's stock has traded nine days since the Xstrata bid and Rio Narcea for two. It appears the market is rebuffing both board of director's recommendations to support their respective takeover offers. LIM has traded 100 million shares (41% of shares outstanding) at an average of C\$19.30, well over Xstrata's bid

price of C\$18.50. In fact, last Thursday it closed at an all-time high of C\$19.50. Rio Narcea in just two days has traded over 70 million shares (44% of outstanding shares) with 98% of the shares trading over Lundin's bid price of C\$5.00. The market is telling Xstrata and Lundin their bids are too low. Considering the low cash flow multiple Rio Narcea share holders are getting, hedge funds may begin to move in with arbitrage trade. Hedge funds could short Lundin's stock carrying its 17% post announcement premium and buy Rio Narcea's stock to vote down the takeover. A sweetening of the bid by Lundin or another competing bid would likely cause Lundin's stock to fall creating a profitable short. In the process, Rio Narcea's stock would go up creating profits with the long trade.

Base Metal Sector Implications

The two takeover bids by Xstrata and Lundin, if they should succeed in their present form, have negative implications for the future valuations of the entire base metal sector. If they can effectively purchase producers at low premiums and cash flow multiples when commodity prices are high, what will happen in the years to come when metal prices soften?

LionOre and Rio Narcea shareholders may only be considering their immediate investment results in each stock. However, by accepting a low valuation for their holdings in these two stocks it's likely to lead to lower valuation multiples for other stocks they own within the sector (such as copper, zinc or other nickel miners). Instead of offering high cash flow multiples approaching 10, future suitors may decide well below five as the new norm.

Disclosure:

This article is written with the intent to inform share holders as to the underlying assumptions that were used to value both companies and to bring into question whether either takeover bid truly represents fair, full value. The author has not been paid to write this article, nor received any other incentive to do so. The author holds positions in LionOre and Rio Narcea and will benefit from their stock price increase.

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Toby Hansen is a successful private investor. He has a master's degree in Mechanical Engineering and holds several patents. Mr. Hansen writes a quarterly newsletter subscribed to by several hundred resource investors.