Monday, March 7, 2011

HALLGARTEN & COMPANY

Coverage Update

Christopher Ecclestone
cecclestone@hallgartenco.com

Lundin Mining (LUN.to, LUMI.omx)

Something Worth Fighting Over

Strategy: Accept the EQN Offer

Key Metrics			
Price (CAD)	$ 7.90		
12-Month Target Price (CAD)	$ 8.00		
Upside to Target	1%		
12mth hi-low CAD	$2.91 -8.22		
Market Cap (CAD mn)	$ 4,594.7		
Shares Outstanding (mns)	581.6		
Fully Diluted (mns)	587.6		
	FY09	**FY10e**	**FY11e**
Consensus EPS		$0.87	$1.02
Hallgarten EPS		$0.83	$1.07
Actual EPS	$0.550		
P/E	14.4	9.5	7.4

Lundin Mining

Something Worth Fighting Over

- + Never rains but it pours.. Lundin Mining now has two offers on the table
- + The first offer looks merely attractive. A no-premium merger with Inmet
- + This offer would create a base metal major with the potential to fill the gap left by the downfall of so many Canadian majors in the middle of the last decade
- + The second offer by Equinox brings a large cash component and a higher offer all around
- + This offer would make a major Australian-based base metals miners with a wide geographical diversity
- + Disposals of Zinc mining assets could boot further the ambitions of other groups wanting to position in this space
- ✘ The Inmet proposal comes with a heavy presence of the same management that made Inmet so *ho-hum* of late
- ✘ The Equinox offer piles substantial debt (between $2.4 and $3.2bn) onto the balance sheet pre-disposals, this should not be a concern to those accepting the cash option though

Barbarians at the Gate

Cold breezes are blowing through the dusty corridors of Bay Street. The old axiom of "no hostile bids for us, we are Canadians" seems to be open to challenge. That doesn't stop the powers that be moving to stop interlopers. However their concern is rarely enough that they will put up some of their own money to outbid the "riff-raff" that dare challenge the status quo.

So now we have one of those situations we crave, a Canadian three-way takeover struggle. It's safe for us though, from a distance, to enjoy these cat-fights but as usual Canadian mining managements are trying to disenfranchise shareholders with egregious breakup fees. It's not so fun to be a shareholder in on of these "done deal" situations (as Capital Gold's shareholders at the tender mercies of Gammon Gold have been finding out).

Still we live in hope though, as Equinox has just waded into the "written in stone" Inmet/Lundin merger and upset the certainties. We shall discuss here a few of the issues raised.

The Inmet/Lundin Merger

On the 12th of January Inmet Mining (IMN.to) and Lundin Mining announced that they had entered into an arrangement agreement to merge in a no-premium transaction, creating a new entity called Symterra Corporation. They valued the transaction at approximately CAD$9bn.

Under the terms of the agreement, each Inmet shareholder would receive 3.4918 shares of Symterra, and each Lundin shareholder will receive 0.3333 shares of Symterra for each share held. The number of issued and outstanding shares of each party that will be exchanged for common shares of Symterra at closing is expected to be 61,549,172 for Inmet and 580,745,911 for Lundin. The exchange ratio represents no premium to either party based on the 30-day volume weighted average price (VWAP) on the Toronto Stock Exchange for each of Inmet and Lundin to January 11, 2011.

The deal lacked a "go-shop" component so minority shareholders got little say or consideration in the proceedings. (The company claimed that there is significant overlap between shareholders of Inmet and shareholders of Lundin so that continuing shareholders of both companies represent well in excess of 50% of the merged entity). Each party agreed not to solicit any alternative transactions. Each company agreed to pay the other a break fee of C$120 million in certain circumstances. In addition, each company has granted the other a right to match any competing offer. Though how that might work in a no-premium transaction escapes our mind.

The largest shareholder of each of Inmet (Leucadia, representing 17.94% of Inmet) and Lundin (Lukas Lundin and Lundin family trusts, representing 12.32% of Lundin) executed an agreement to vote their shares in favour of the proposed merger subject to customary fiduciary waivers in the case of a superior offer. The directors of each company agreed to vote their shares in favour of the merger.

The Rationale for the Deal

Long advocates of the creation of a more Canadian "majors" to replace the fallen of the past decade, we initially greeted the announcement of this deal as exciting and a major step forward. We had never been enthused by Inmet's management but we had liked Lundin intermittently mainly on value grounds. Thus our only reticence was with relation to Inmet ending up on top in this arrangement. We also wondered whether it also reflected a signal on the part of Lukas Lundin that he thought the mining market boom was either maturing or peaking. We particularly liked the spread of assets both geographically and across different metals.

The companies claimed that the transaction provided a solid base of low cost, long life mines. They cited:

- Five low-cost, long-life mines located in Europe.
- Substantial pro forma cash flow generation ensures future growth is financed.
- Two world class copper development projects: With development of Cobre Panama and attributable copper from possible expansions at Tenke Fungurume, Symterra will have the potential to produce over 500,000 tonnes of copper annually1 by 2017 at costs within the lowest quartile.
- "Robust" cash flow generation in a company with substantial opening cash: Symterra will have a pro forma cash balance of $1.3 billion, substantial cash flow generation, and no debt.
- Diversified metal production: with the added attraction of exposure to zinc and other base metal markets from existing operations and through the existing asset expansions.
- Shared commitment to corporate responsibility. (Though this doesn't include allowing investors any alternative bidders!)
- Doubling of market capitalization to C$9 billion: should enhance trading liquidity, supported by listings on both the TSX and the OMX Nordic exchange.
- "Complementary" management:

The board of Symterra would initially comprise ten directors:

- Lukas H. Lundin, Chairman
- Jochen Tilk, President and CEO
- David R. Beatty, Vice Chairman
- Donald Charter
- Paul Conibear
- Paul E. Gagné
- Thomas E. Mara
- William A. Rand
- Douglas Whitehead
- Phil Wright

Completion of the proposed merger was conditional on approval of Inmet and Lundin shareholders, and satisfaction of other customary approvals including regulatory, stock exchange, and court approvals. The required shareholder approval would be two thirds of the votes cast by each of the holders of Inmet and Lundin common shares at shareholder meetings held to consider the proposed merger. Shareholder meetings for Inmet and Lundin was originally scheduled for March 14, 2011 but has now been put off until March 28.

The Equinox Offer – a Fox in the Henhouse

The best laid plans…. On the 28th of February 28, 2011, Equinox Minerals, the up-and-coming force in copper mining, announced a surprise counterbid for Lundin with an offer to acquire Lundin Mining for approximately CAD$4.8 billion in cash and shares. Under the terms of the offer, Equinox proposes to acquire all of the outstanding common shares of Lundin for a combination of cash and Equinox shares for a total consideration value of C$8.10 per Lundin share. Each Lundin shareholder can elect to receive consideration per Lundin share of either CAD$8.10 in cash or 1.2903 Equinox shares plus $0.01 for each Lundin share, subject to a pro-ration based on a maximum cash consideration of approximately CAD$2.4 billion and maximum number of Equinox shares issued of approximately 380 million. The offer reflects a 26% premium to the closing price of CAD$6.45 per Lundin share on the TSX on February 25, 2011.

We might note that Equinox has Goldman Sachs and TD Securities as its advisors so it is not going into this fight unarmed. In light of the general “unbearable lightness of being” in the Canadian mining M&A fraternity (who would all fit in a telephone booth), Inmet/Lundin will be pushed to come up with a team of similar consequence.

Equinox had long looked like a one-trick pony with its Lumwana mine project in Zambia until it launched a takoever in October 2010 for the Australian-listed Citadel Mining valuing the target at $1.25bn (of which around $260mn was paid in cash). The latter was the owner of the Jabal Sayid project in Saudi Arabia. This changed not only the look of Equinox (turning it into a Australian/Canadian enterprise) with multiple properties and geographical diversification but also made it pop up on radar screens as an aggressive player to watch. As this deal did not close until mid-January we can see why Equinox have had to spend some time gathering their thoughts before launching into this latest move.

If it succeeds in it latest bid, the combined company will consist of five substantial producing operations by mid 2012, with wide geographic and base metal production diversity. Equinox operates the Lumwana mine in Zambia (100%) and is currently constructing the Jabal Sayid project in Saudi Arabia (100%). Lundin’s assets include the Tenke Fungurume copper mine (24%) in the Democratic Republic of the Congo, Neves-Corvo in Portugal (100%) and Zinkgruvan in Sweden (100%).

The company is its releases, thus far, repeats a mantra of copper (understandably as Zn and Pb still remain somewhat in the investors’ doghouse despite us liking them). However, two of Lundin’s main exposures are in Zn/Pb mines. This prompts us to wonder whether there might be a possibility that these two assets might be quickly sold-on. Is it a coincidence that Nyrstar, the most aggressively expanding stock in the Zn space, should be currently in the process of raising Euro 500mn to spend on buying Zn mines and developing Zn projects. With its main refineries in Europe (and Australia) and no Zn ore production near Europe, Nyrstar would be a natural buyer for the Zn assets of Lundin.

Debt financing

The cash consideration of Equinox’s offer is financed through a US$3.2 billion bridge facility being led by Goldman Sachs Lending Partners and Credit Suisse Securities though we would note that Equinox has capped the amount of cash it will pay out at $2.4bn (presuming most Lundin holders go for cash). Equinox expects the financial strength of the combined company to allow it to return to a net cash position within four years based on current analyst consensus copper price forecasts. Equinox intends to refinance the bridge facility through a combination of medium and long-term debt instruments. Equinox claimed to have no plans to undertake an equity raising as part of the refinancing of the bridge. Once again we note it refers to the expanded company as a pure copper play, which obviously implies the Zn assets will be jettisoned, providing funds for debt reduction and a faster return to a net cash position than the projected equilibrium at the end of FY13.

The Naysayers

We were left somewhat surprised by the vehemence of some of the attacks from the Canadian mining community upon the transaction. It seems the press went out of their way to find negative buzz. Most bizarrely the Toronto Globe & Mail on the 1st of March 2011 carried a report in which an executive of HudBay Minerals (HBM.to) “lashed out against deals made simply to gain scale, calling them “very value destructive” – and he questioned the rosy outlook for base-metals companies”. It went on to quote, “We are not in a super cycle, this is a cycle,” HudBay’s chief executive officer David Garofalo told investors. “When the central banks find religion on inflation again, the cycle will be over.”

This might disturb investors if it wasn’t for the quarter from which it emanates. For a company that has singularly sat out the recovery from the 2008 lows and missed umpteen opportunities to go on the attack is rather curious. HudBay it may be recalled picked the top of the nickel surge in 2007 to buy Skye Resources, a troubled asset indeed, paying top dollar. Then it tried to buy Lundin at the bottom of the market offering a price that was not fair to HudBay’s shareholders and rightly the board was ousted in quite exceptional circumstances. HudBay then sat on over $900mn in cash while bargains were lying around like sand on the beach, only to wade in and buy Norsemont Mining in January 2011 for CAD$363mn (it only paid a 3% premium because insiders held a massive 37% and supported the deal).

HBM paid $4.39 per share but could have bought the company for as low as $1.40 in the last twelve months. We think that this is rather a case of the pot calling the kettle black. If the cycle is about to end then why isn't HBM following its usual practice and sitting on the sidelines? The Norsemont deal looks more HBM vintage 2007 than the post-crash HBM. What does HBM have to do with the Lundin-Inmet tie up anyway? Is there some asset shakeup planned here which will benefit HBM that we are not hearing about??

The other zinger in the Globe & Mail coverage was the gem "Analysts are already predicting copper will begin to slide from an annual average of $4 this year and next to about $3 by 2015 as new mines come into production and increase supply. Then there's the potential impact of a drop in demand as rising inflation begins to cool off economies around the world". Are these the same analysts who we hear rah-rahing, like Sue Sylvester's cheerleaders, about copper heading to the moon? Do these analysts have "Sells" on HudBay and Teck? Sounds like either sour grapes that they didn't think of grabbing Lundin themselves or that the denizens of Toronto's clubland have stirred from their gin and tonic induced somnolence to "defend one of our own".

The Equinox Management team

In light of these criticisms of Equinox's approach, one might imagine that the challengers to the status quo were inexperienced interlopers with no credibility in the mining space or on Bay Street. The team in place at Equinox is far from lightweight.

Peter Tomsett, the Chairman, is a mining engineer with over 30 years of experience in the mining industry, including 20 years with Placer Dome Inc. He served as President and Chief Executive Officer of Placer Dome from September 2004 until its acquisition by Barrick Gold in January 2006. After starting his career with CRA Ltd at Broken Hill, Mr Tomsett joined Placer in 1986 in the Project Development group and subsequently held senior executive roles including responsibility for Placer's Asia Pacific region as Executive Vice-President and later also took on responsibility for Placer Dome Africa, which operated mines in South Africa and Tanzania. He joined the Equinox board as Chairman in July 2007.

Craig Williams, the President and CEO, is a geologist involved in mineral exploration and development for over 35 years, co-founding Equinox in 1993 along with the late Dr Bruce Nisbet. He has been directly involved in several significant discoveries, including the Ernest Henry Deposit in Queensland and a series of gold deposits in Western Australia. He has extensive corporate management and financing experience.

David McAusland, a Director (and Chair of the Corporate Governance and Nominating Committee), is an experienced senior executive, lawyer and corporate executive. From 1999 to February 2008, he held the position of Executive Vice-President, Corporate Development and Chief Legal Officer of Alcan Inc. Prior to joining Alcan, Mr McAusland was the managing partner of a major Canadian law firm. Mr. McAusland holds a Bachelor of Law and a Bachelor of Civil Law and has had global responsibilities including strategy, major transactions, legal and regulatory affairs, and government relations.

David Mosher, a Director (and Chair of the Health, Safety, Environmental and Sustainability Committee) is a former gold mining company CEO experienced in operations in Canada, Russia and Burkina Faso. He served as the President and Chief Executive Officer of High River Gold Mines, from 1988 to November

2008. He has over 35 years as a geologist and mining executive with experience in Australia, North America, Russia, Asia and Africa with experience in mine development, corporate management and financing.

Jim Pantelidis, a Director (and Chair of the Compensation and Human Resources Committee) is an experienced senior executive and is currently Chairman of the Board of Parkland Income Fund and has served as a director of Parkland since 1999. Mr Pantelidis is Chairman and Director of The Consumers Waterheater Income Fund since 2002. From 1999 to 2002 he served as Chairman and Chief Executive Officer for the Bata Shoe Organization. He also spent 30 years in the petroleum industry and was at one time President of both the upstream and downstream divisions of Petro-Canada.

Brian Penny, a Director (and Chair of the Audit Committee) is Executive Vice President Finance of New Gold Inc and Vice President Finance and CFO of Silver Bear Resources and formerly Chief Financial Officer of Western Goldfields Inc.; Vice President, Finance and Chief Financial Officer of Kinross Gold. He is a Certified Management Accountant (Ontario) and has in excess of 20 years experience of accounting, financial and corporate management, and corporate governance within the mining industry.

Thin on the ground

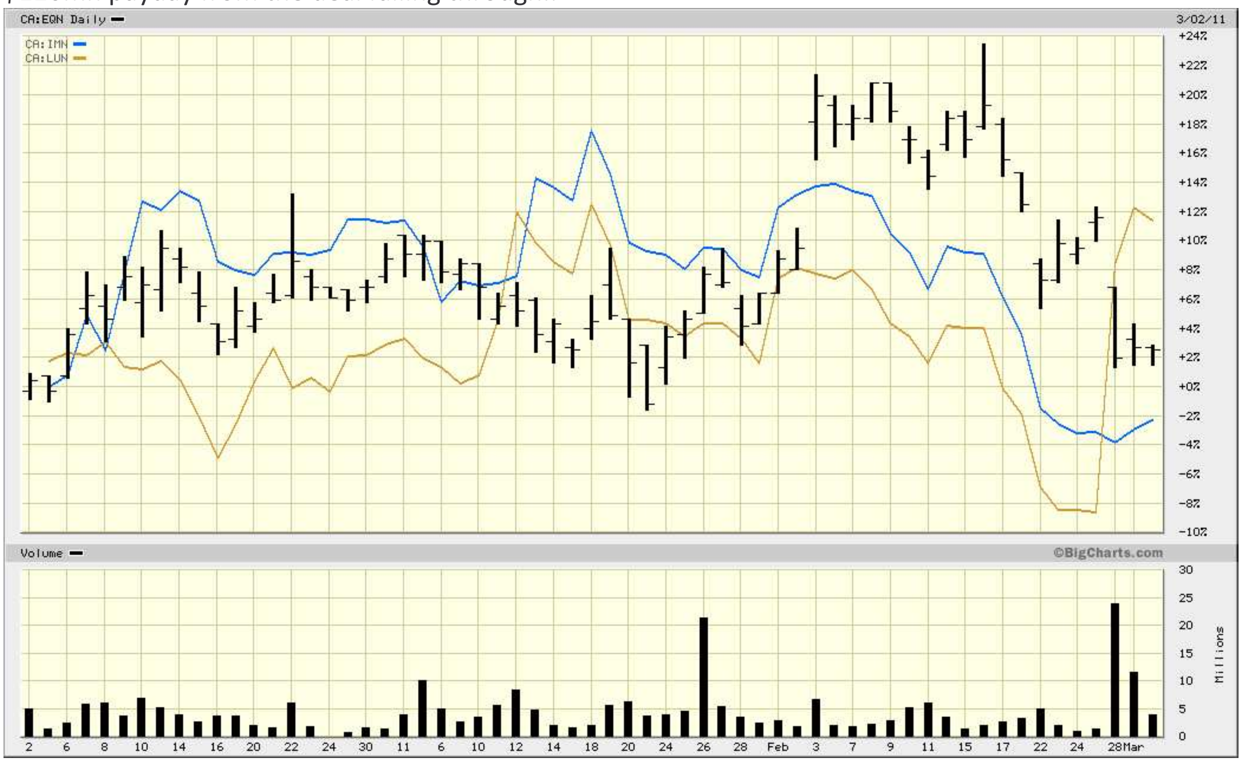
And then there were four… again… the counterbid for Lundin from Equinox (if successful) narrows the already thinly populated field of Canadian base metals quasi-majors down to Teck, Sherritt, Inmet and HudBay. Teck is obviously far ahead of the pack, but still doesn't rate, in our mind, as even a shadow of those lost over the last decade (Noranda, Falconbrodge, INCO). Hudbay is the perennial Clown Prince of the base metal space with its boardroom otherwise known as the Toronto branch of Madame Tussauds. Sherritt, much as we love it, is penned in by a pack of angry, yet politically-connected, Cuban pensioners infesting the swamps of Southern Florida that stymie it from reaching a wider audience. Inmet is alas almost as undynamic as HudBay and that is a tough challenge to match that level of torpitude.

Is it no wonder then that a whippersnapper company from Perth should zip in and upset the apple cart of the Inmet/Lundin marriage? More surprising still is that the Canadian mining industry that let its champions be carried off into captivity in the middle of the last decade should stir and decry the Equinox offer as dangerous because "it's the top of the mining market". If they are not lending the money, why should they care if Equinox is doing daring things? After all they wouldn't lend money to Lundin at the bottom of the market (and forced Teck to rattle its cup to the Chinese). They have singularly eschewed any serious base metals stories over the last 15 years preferring puff and instead propagated the "find it and sell it to the Chinese" school of mining promotion. Its heroes are those who sold out rather than those who built a business.

Maybe Canada does not deserve to have a base metals champion.

Trading

With Equinox in the CAD$5.70-$5.80 range it is well off its twelve month high of $6.96. The stock dropped precipitously from $6.30 to $5.80 on the news of the Lundin bid. The prey on the other hand gapped up from around CAD$6.40 to $7.80 on the bid announcement, and has been trading around that level. This is still 30 cents shy of the value of Equinox's cash bid. Inmet inteeting took a slight stumble (off $2) on the counterbid announcement but is back where it was before the offer at around $67.50. Does this imply the market does not care either way if this works out for Inmet? Inmet was $82 on the original merger announcement with Lundin and has thus given back serious ground as investors showed their dislike on marrying Lundin. This scarcely augurs well for Inmet proceeding. Moreover, it gets a $120mn payday from the deal falling through..



Conclusion

It was pleasing to see the original Inmet/Lundin proposal hit the table. Though the fleeting thought we had upon hearing it (and seeing Lukas Lundin's relative distancing from the entity) was that it was a classic top of the market exit for a veteran player looking to "wash and repeat" when the wheels fall off the metals boom. However while not base metals bears (far from it) we are on record as being less than enthused about current precious metals prices. Creating a champion for the beleaguered base metals space in Canada would have been an exciting outcome, even if Inmet's management leaves something to be desired to get the pulse racing.

Equinox appearing on the scene upset what was alas yet another cozy Canadian arrangement that didn't particularly reward shareholders and instead sets a mid-tier Australian group on the road to being another Australian champion (hopefully not in the mold of Oz Minerals).

There is little we feel that Inmet can do to counter this, though Teck wading into the fray would be an interesting possibility. This would dilute the Chinese and truly create a powerhouse in base metals within Canada. HudBay on the other hand has more than enough cash to counter Equinox's debt-financed effort. But would one want HudBay's management in charge of anything more than a lemonade stand?

For the moment, the Equinox deal looks far more attractive than the Inmet option. Consummation of this deal may make Equinox into a hot item with the attendant effect that it could refinance the debt with equity. Inmet on the other hand will look like the jilted bride at this party. The way its stock price has been performing, that seems to be an outcome some of its shareholders may prefer.

The market had already spoken on the Lundin/Inmet merger by marking down both names from their start of January highs despite the fact that copper has been holding up well and has hit new highs in the interim.

Thus if one is a Lundin shareholder one can little danger in accepting the Equinox offer with the largely cash component. If feeling more daring one could go for the cash and shares component even though the cash is merely token. Taking the Inmet offer at this moment in time doesn’t look attractive for anyone, not even Lukas Lundin or Leucadia. Thus we would be inclined towards taking the Equinox offer.

Important disclosures

I, Christopher Ecclestone, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

Hallgarten's Equity Research rating system consists of LONG, SHORT and NEUTRAL recommendations. LONG suggests capital appreciation to our target price during the next twelve months, while SHORT suggests capital depreciation to our target price during the next twelve months. NEUTRAL denotes a stock that is not likely to provide outstanding performance in either direction during the next twelve months, or it is a stock that we do not wish to place a rating on at the present time. Information contained herein is based on sources that we believe to be reliable, but we do not guarantee their accuracy. Prices and opinions concerning the composition of market sectors included in this report reflect the judgments of this date and are subject to change without notice. This report is for information purposes only and is not intended as an offer to sell or as a solicitation to buy securities.

Hallgarten & Company or persons associated do not own securities of the securities described herein and may not make purchases or sales within one month, before or after, the publication of this report. Hallgarten policy does not permit any analyst to own shares in any company that he/she covers. Additional information is available upon request.

Web access at:

Research: www.hallgartenco.com

60 Madison Ave, 6th Floor, New York, NY, 10010