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Stefan Ioannou's Ways to Ride the Next Zinc and Nickel Waves

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Base metals prices are feeling the undertow but Stefan Ioannou, mining analyst with Haywood Securities, says that this is temporary—and that investors may not have to wait long for the next wave of higher zinc and nickel prices. Ioannou says zinc prices could even reach "bonanza" prices over the medium term. Nickel prices, meanwhile, could rebound as quickly as late 2015. In this interview with *The Gold Report*, Ioannou discusses some equities well positioned to ride the base metals waves as they come in cycles

***The Gold Report*:** In late June, zinc and nickel prices on the London Metals Exchange (LME) dipped on concerns surrounding the economic fallout from Greece exiting the Eurozone. What's your view?

Stefan Ioannou: When the referendum was first announced in late June there was a big reaction. There is no doubt the issue is a political crisis. However, unless you live in Greece, the actual financial impact is questionable. That's not to say that it hasn't justifiably sparked concern for the well being of the greater Eurozone. Although there is now better clarity regarding the European Union's bailout package, the jury is still out on the ultimate implications of the situation. Nevertheless, we expect general market sentiment regarding the base metals will continue to be centered on Asian demand. Looking further ahead, we continue to anticipate a lack of timely new mine development will lead to a supply constrained market, which will drive market fundamentals.

TGR: The spot price for zinc flirted with $1.10/pound ($1.10/lb) in May, but now it's around $0.90/lb. Which zinc price is real and which one is the imposter?

SI: Relatively high zinc inventories are behind the current zinc price. The zinc price spiked to $1.10/lb in the spring, but our feeling at Haywood was that it was a bit too much too soon. Nevertheless, higher prices appeared to be driven by steady inventory drawdowns on the order of 2,000 tonnes per day. This relatively persistent trend saw LME inventories drop by half over the last year. However, more recently we have seen sporadic inventory spikes, on the order of 5,000 tonnes per day, occur more regularly, which in turn has prompted the LME inventory levels to stagnate around the 450,000-tonne to 460,000-tonne level, which hasn't helped near-term zinc pricing or sentiment.

TGR: What is your near- and medium-term forecast?

SI: Looking a little further out, there's a strong argument that zinc prices will rally as we go into 2016. We've seen a number of large zinc mines shut down over the last couple of years. The Brunswick mine in New Brunswick, which provided roughly 2% of the world's supply, shut down in 2013. Later this year, the Century mine, Australia's largest open-pit zinc mine, and Ireland's Lisheen mine will cease zinc production. The production from those two mines alone is roughly equivalent to the zinc that's on the LME today. We're losing mines and there aren't any new large-scale projects being developed to fill that gap.

The market continues to face an undersupplied medium-term outlook, which will drive prices higher. The one black box consideration is China. It has always been able to fill zinc supply gaps. However, the consensus is that a lot of the Chinese production is higher cost and that's why we haven't seen much of it to date. Haywood's zinc price forecast includes US$0.95/lb this year and a long-term price of $1.15/lb. However, in the medium term, say the 2016–2018 timeframe, there is potential to see spectacular prices on the order of $1.50/lb to $2/lb. That said, one thing to remain cognizant of is that higher medium-term pricing will prompt additional production over the longer term, which will eventually balance the market and regulate zinc pricing.

TGR: Is it fair to say that you are more bullish on zinc than any of the other base metals?

SI: Yes, at least from a timeline perspective. All commodities are cyclical, but we're the closest to seeing higher zinc prices versus copper or arguably even nickel.

TGR: Please give us an update on some of the zinc-focused equities that you cover.

SI: One interesting thing about the zinc space is that there are not many zinc-focused equities to invest in if you are seeking zinc exposure. If you're looking for zinc producers versus zinc development names, the list is even shorter. It's really only one name: Trevali Mining Corp. (TV:TSX; TV:BVL; TREVF:OTCQX). The company is in production in Peru at the Santander mine and it is ramping up production at a second mine in New Brunswick called Caribou. Trevali stands to reap the rewards of higher medium-term zinc pricing with production that's already underway, as opposed to trying to establish production in time to catch the zinc wave.

TGR: Nonetheless, Trevali's stock price is demonstrating some weakness. Are there near-term catalysts that could change that?

SI: We've seen the zinc price reach the low-$0.90/lb range and that's reflected in Trevali's share price. One catalyst should occur once Caribou reaches commercial production, likely sometime in early 2016. Once that happens there is definitely potential for a rerating. Caribou was run by other operators before and had some metallurgical challenges related to grind size. The previous operator put in something called ISA mills, which effectively solved those problems but they only ran for about two months before the global credit crisis in 2008 forced the mine to shut down. Trevali has restarted production using those ISA mills. So far so good, but it remains a little bit of a "show-me" story.

TGR: Are there any debt issues with Trevali?

SI: The company has about $69 million ($69M) of long-term debt on its books. Until recently it was something we were watching with a bit of skepticism, but Trevali recently raised about $30M in an equity financing. That's in addition to its $18M cash position. The company now has a decent cash buffer to cover its debt repayments and the remaining startup costs at Caribou, which are estimated at only $5M, even if zinc prices remain relatively low over the foreseeable future.

TGR: How is the management team?

SI: They are definitely proving themselves. President and CEO Mark Cruise is a very good geologist. However, the risk you run when you have a resource company operated by geologists is that they're great at finding deposits, but they're not necessarily so great at operating mines. Hats off to Mark and the team. They've done a great job. The Santander mill reached commercial scale in six weeks, which is unheard of in the mining industry. Trevali had some help from Glencore International Plc (GLEN:LSE), but nevertheless it went quite smoothly.
So far Trevali is hitting its timelines at Caribou, and I think management has demonstrated the ability to take significant geological finds and turn them into operating mines. We're still seeing the company's geological expertise shine through as well. The team found two new high-grade zones over the last couple of years that are benefiting the Santander mine plan today. And in New Brunswick, Trevali has also been making strides on the exploration front at Caribou and a neighboring deposit called Stratmat, where recent high-grade drill hole intercepts are setting the stage for longer mine life in the province.

TGR: What's your target on Trevali?

SI: Haywood has a CA$1.25 target price and a Buy rating on Trevali.

TGR: Trevali is basically the only zinc-focused producer on the TSX, but in previous interviews you've talked about some companies that are developing deposits with significant zinc components. What is happening with some of these companies?

SI: There is Foran Mining Corp. (FOM:TSX.V); its flagship deposit is McIlvenna Bay, just over the border from Manitoba in Saskatchewan. Provincial boundary aside, McIlvenna Bay is still in the Flin Flon Greenstone Belt, a world-class mining camp that hosts multiple volcanogenic massive sulphide (VMS) deposits including HudBay Minerals Inc.'s (HBM:TSX; HBM:NYSE) 777 and Lalor base metals mines. McIlvenna Bay is one of the giants of the belt at 25 million tonnes (25 Mt), about the same size as Lalor.
Foran published a preliminary economic assessment for McIlvenna Bay on a standalone basis about a year or so ago. But the company recently finished a winter drill program focused on infilling a few known historical satellite deposits in the area, one of which is Bigstone. The results returned thick intercepts of very high-grade mineralization. Even if Bigstone doesn't turn out to be a giant, like McIlvenna Bay, it could provide a great source of higher-grade satellite feed, which would benefit a mine plan in the initial years of production when a company is trying to pay back capital costs.

TGR: What is the next step at Bigstone?

SI: Over the summer Foran will conduct metallurgical work on that drill core, which will feed into an updated NI-43-101-compliant resource estimate for Bigstone. The deposit could really enhance McIlvenna Bay's economics, which are already robust. Potential exploration success on a number of other good satellite targets near McIlvenna Bay also offer similar upside.

TGR: Will Foran be financing soon?

SI: That's always a good question. Foran has around $3M and is fully financed for this year's work, but the company is going to need to raise more money. It probably needs another $15–20M to advance the project to construction-ready status.

TGR: What is your target and rating on Foran?

SI: Haywood has a CA$0.35 target price and a Buy rating on Foran.

TGR: Given the performance of nickel equities in recent years investors might call nickel stocks, "fickle" stocks. Are there reasons to believe that could change over the near to medium term?

SI: There's definitely a bullish argument for the nickel price over the medium term. One of the key recent events in the nickel space was the Indonesian government's ban on nickel ore exports at the beginning of 2014. The country was a major supplier of nickel laterite ore to China, which the ban basically cut off overnight. The initial global sentiment was that the ban wouldn't last, but it's still in place. It prompted a spike in nickel prices up to about $9/lb last year, but unfortunately nickel is back to about $5.10/lb now.
Nevertheless, the bullish medium-term argument is that up until now China has been relying on high-grade ore from Indonesia that was stockpiled in China before the ban. That stockpile is dwindling, now below 4 Mt, from over 15 Mt prior to the ban. Once it is consumed, the nickel market will realize that supply is much tighter than today's prices would suggest. China will have to look elsewhere to secure nickel feed for its plants and that could put a squeeze on prices by as early as late 2015. LME inventories have actually increased modestly year-to-date. However, Chinese consumption of this metal, once the country's own stocks have been depleted, could set the stage for higher prices. The key consideration behind this scenario is improving stainless steel demand.

TGR: The Shanghai futures exchange recently approved Russian nickel miner Norilsk Nickel (GMKN:RTS; NILSY:NASDAQ; MNOD:LSE) for delivery. It's the first foreign company to receive approval. Is this a tangible sign that the Chinese are running shy on nickel?

SI: The Chinese know better than anyone else how much life is left in that nickel laterite stockpile. Seeing them try to secure supply from Norilsk is a sign that they're thinking 12 months ahead and making the appropriate arrangements.

TGR: What companies are poised to benefit from higher nickel prices or from acting as Chinese nickel suppliers?

SI: There are a number of large, lower-grade sulphide deposits in North America and probably the most advanced is Royal Nickel Corp.'s (RNX:TSX) Dumont project in Québec. These are like the copper porphyries of the nickel world—very large tonnage, very low grade. They require a lot of capital to get off the ground, but they offer long mine life and significant annual production. Royal Nickel is attempting to secure a partnership to help fund development at Dumont.

TGR: Royal Nickel recently did a $600M deal with a Swedish bank but it still needs another $600M or so. How should the market read that news?

SI: It's definitely positive. A couple of weeks ago Royal Nickel received the final environmental permit for the project. Dumont is now fully permitted, which lends comfort to potential partners. As you mentioned, Dumont's initial capital requirement is about $1.2 billion. A strategic partner would likely play a major role with regards to financing Dumont, whether it's at the project interest level, focused on production offtake, or in some other form.
A lot of equipment would be required for this large, open-pit operation, so that also leaves the door open for equipment financing to partially fund the $600M balance. There's potential for streaming agreements as well, which could backstop any working capital needs. And there are the equity markets. Royal Nickel plans to have Dumont fully financed by Q1/16.

TGR: What do you make of some of the drill results on the Frontier zone on West Raglan?

SI: Royal Nickel is definitely on to something. The interesting thing about Royal Nickel is that it has Dumont, a very large, low-grade project, but it also has West Raglan in Nunavik and the Aer-Kidd project in Sudbury, both of which are high-grade sulphide targets. The drill results at West Raglan have returned very high grades and definitely warrant additional follow-up drilling, which the company is going after this year. It's a short field season given the harsh conditions near West Raglan in far northern Québec. We have high expectations that we're going to see more thick, high-grade sulphide intercepts. The key up there is defining sufficient tonnage around that high-grade mineralization to support a mine.

TGR: What is your target and rating on Royal Nickel?

SI: Haywood has a CA$0.50 target price and a Buy rating on Royal Nickel.

TGR: What are some other nickel stories you can share with us?

SI: In the nickel space grade is king, and we have a preference for sulphide deposits. One name that Haywood is watching this summer is Balmoral Resources Ltd. (BAR:TSX; BAMLF:OTCQX). The company has a project called Grasset in northern Québec where drilling has hit some very high-grade massive sulphide intercepts. Balmoral is looking to put a few more drill holes into the discovery and potentially define a meaningful resource. It's probably not a 50+ Mt Voisey's Bay deposit, but it is very high-grade with good proximity to existing infrastructure.

The company's market cap is about $75M. Balmoral also continues to delineate a high-grade gold discovery near Grasset. Based on what we know to date, is it worth $75M on a relative peer-valuation basis? Probably not. On the flip side, Grasset is one of the market's current marquee high-grade nickel-sulphide exploration stories that remains open in multiple directions. But is it worth $75M on its own? Probably not. However, Balmoral's market valuation becomes more compelling when one realizes the quality potential both assets offer.

That said, in comparison, Sirius Resources NL (SIR:ASX) has a nickel project in Australia that's under construction called Nova-Bollinger, which is a 14 Mt massive sulphide deposit grading about 2% nickel. The company recently received a friendly takeover bid for AU$1.8 billion, which is undoubtedly a very big number for something that is probably geologically similar to Grasset, as well as to the northern part of Talon Metals Corp.'s (TLO:TSX) Tamarack deposit in Minnesota. The reality is that if one of these explorers develops a 10+ Mt high-grade resource that over time garners a fraction of Sirius's takeover bid, it's still going to be a home run for everyone.

TGR: Did the initial resource estimate at Tamarack surprise you?

SI: No. It's right in line with expectations at around 7 Mt grading roughly 2% nickel equivalent. The key is that the Tamarack intrusion is shaped like a tadpole. The current resource is focused on the tail of the tadpole and just a portion of the tail. The resource is open in multiple directions. The reality is that the tail portion of the Tamarack intrusion could easily be 15–20 Mt with additional drilling. The company is starting to step out along the tail and has had some spectacular intercepts earlier this year.

Tamarack is a joint venture with Rio Tinto Plc (RIO:NYSE; RIO:ASX; RIO:LSE; RTPPF:OTCPK). Rio Tinto continues to hold onto it because of the potential the tadpole's head offers at depth based on geophysics. Comprehensive drill testing is still required, but if the head of the tadpole represents something like a Voisey's Bay-type structure—50–100 Mt of massive sulphides—it would move the needle for Rio Tinto and Talon would be along for the ride.

TGR: Could you mine it in Minnesota?

SI: Lundin Mining Corp. (LUN:TSX) just started commercial production at its Eagle nickel and copper mine, which is in northern Michigan. That speaks volumes about permitting a mine in the northern U.S. One example people will point to in Minnesota is PolyMet Mining Corp. (POM:TSX; PLM:NYSE.MKT), which has had issues getting its operations permitted. One of the key differences is that Tamarack is not located within a national forest or within federal lands. Furthermore, based on what we have seen to date, Tamarack would most likely be mined using underground methods, which intrinsically entails a significantly smaller surficial footprint.

TGR: What is your target and rating on Talon?

SI: Haywood has a CA$0.35 target price and a Buy rating on Talon.

TGR: Copper recently made some gains after positive U.S. economic data, but took a deep dive in early July on Chinese economic data. What's your updated copper forecast?

SI: Right now we are modeling a $2.65/lb average copper price this year, which is in line with year-to-date averages. We anticipate the price will ramp up modestly over the next few years to a long-term price of $3/lb from 2017 forward. This price deck is in line with base case parameters we are seeing in recent copper project feasibility studies.

TGR: China drives the bus in terms of copper. How is the Shanghai stock market collapse likely to affect copper?

SI: Copper is an industrial commodity. It's used to build things. But over the last few years we've seen China use copper and other bulk commodities as collateral in financing mechanisms. However, unlike gold, copper is not money. We would argue this realization has in part, prompted the notable decline in Shanghai copper inventories over the past three months relative to essentially flat inventory levels on the LME.
We definitely see day-to-day mixed messages in economic data out of China. But over the longer term, the Chinese will continue to consume a lot of copper and going forward will consume more copper in absolute terms, whether it be on large scale regional infrastructure such as power grids, or personal items such as mobile telephones and refrigerators. It just might not happen quite as quickly as we expected a few years ago.

TGR: What are some copper-focused equities that you cover?

SI: Producers arethe safe haven for investors because access to capital is rather limited for the developers. Among the producers, the one company I would point toward is Nevsun Resources Ltd. (NSU:TSX; NSU:NYSE.MKT). The company is mining a large, high-grade VMS polymetallic deposit in Eritrea. Bisha has been in production since early 2011 over which time the company has developed a strong relationship with the Eritrean government. Bisha started as a very high-grade gold mine in an oxide cap. Nevsun is now mining supergene ore grading 4–6% copper in an open pit with a low stripping ratio. This is highly profitable.
Over the next year or so Nevsun will transition from Bisha's supergene enrichment blanket into the primary massive sulphides, which are a mix of copper and zinc. The amount of copper being produced will go down, but the zinc production will come up. The zinc should come to market just as global zinc supply tightens. The timing is perfect. Nevsun has over $440M in cash or about CA$2.60 a share, and no debt, which puts the company in a very strong position to pursue opportunistic corporate growth initiatives.

TGR: Is it using some of that cash for exploration?

SI: Last year Nevsun committed $10M to regional exploration in Eritrea along strike from Bisha and some other deposits. The company was extremely successful. Nevsun drilled off a high-grade deposit called Harena, which is already underpinned by a 10 Mt resource that is open in multiple directions and is situated just six miles from Bisha's mill. This year the company is following that up by drilling a series of other satellite targets. VMS deposits typically form in districts or camps. We see that globally. Nevsun has clearly demonstrated that Bisha is in a VMS camp. It's going to be pretty exciting to watch the exploration results this year.

TGR: With its recent exploration and operational success, is Nevsun clearly on the radar screens of larger players?

SI: I think so. This could turn into a pretty significant VMS camp very quickly. And the potential of Bisha at depth has never really been looked at in a formal mine plan. One of the big pushes this summer is to update Bisha and Harena's mine plan to consider the economic potential higher throughput and/or ramp-accessed underground mining could offer, noting Bisha's current open-pitable reserve provides mill feed to about 2025 in our model.
TGR: What is your target and rating on Nevsun?

SI: Haywood has a CA$5.00 target price and a Buy rating on Nevsun.

TGR: What are some other copper equities that you're keeping the pulse of?

SI: One developer of note would be Highland Copper Company Inc. (HI:TSX.V). It's developing four deposits in a historical mining jurisdiction of northern Michigan's Upper Peninsula. The idea there is to take four deposits, which are relatively close together, and process them through a centralized facility. The Copperwood deposit alone is close to 30 Mt grading 1.4–2% copper, which provides a great source of higher-grade initial feed to boost project economics. All deposits considered, we anticipate the integrated operation could produce about 150 million pounds of copper per year, which is the type of asset that would attract a "mid-tier producer." Now it's just a matter of defining project metrics and getting it off the ground.

TGR: What is your target and rating on Highland Copper?

SI: Haywood has a CA$0.35 target price and a Buy rating on Highland.

TGR: Do you have any parting thoughts on base metals?

SI: Patience is key. Investors have to remember that industrial commodities are cyclical both on short-term and, more importantly, long-term cycles. We can see light at the end of the tunnel. We mentioned zinc as a potential 2016 story, which is coming up quickly. There's a solid argument there that we could see bonanza pricing over the medium term. Again, nickel prices are in a trough now, but with dwindling Chinese nickel stockpiles, we could see nickel prices move higher as we move into next year. It's all about catching the wave at the right time and knowing when to get off.

TGR: Thank you for your market insights today, Stefan.

Stefan Ioannou *has spent the last eight years as a mining analyst covering mid-cap base metal companies at Haywood Securities. Prior to joining Haywood, he worked with a number of exploration and mining companies, as well as government agencies as a field geologist in Nevada and throughout the Canadian Shield in both the gold and base metal sectors.*