

## OM Holdings Ltd (OMH)

Recommendation: Buy

22 December 2008

### Earnings estimates downgraded

- OMH confirmed that high grade manganese ore shipments have been suspended in the December quarter 2008 in response to very weak market conditions. OMH anticipates that shipping activities will recommence early in the March quarter 2009.
- In order to match expected lower demand, OMH's Bootu Creek production rate will be reduced by ~30% to a 500ktpa rate for 2009 (our previous assumption: 730ktpa).
- Our earnings estimates for OMH for 2008 and 2009 have been downgraded to \$104m and \$96m respectively following recent company updates (15/19 December 2008).
- OMH is still relatively well placed given the company's strong net cash position (\$138m at 30 September 2008, est. \$75m at 31 December 2008), relatively low estimated earnings multiples (4.9x – 5.3x), favourable industry position and still reasonable medium term fundamentals for the high grade manganese ore market (assuming a recovery in China's growth during 2009–10). Short term, we continue to expect that the resources sector will underperform the S&P/ASX-200 index.
- OMH has just reported (19 December 2008) that Consolidated Minerals Ltd ("ConsMin") has recently acquired a further interest in the Company, taking its disclosed investment position to 57,231,393 shares or 12% of the Company's issued capital. A ConsMin representative has advised that its holding in OMH is "financial in nature". However, in our view, ConsMin's move raises the chance of a bid for OMH.
- At \$1.07 per share, we retain a Buy recommendation on OMH (recently upgraded from Hold following the initial advice that ConsMin had acquired an 11% holding in OMH). Despite a strong balance sheet, OMH should be viewed as relatively high risk.

|   |             |             |             |             |
|---|-------------|-------------|-------------|-------------|
| Share price:  | \$1.07      |             |             |             |
| Market Capitalisation:  | A\$511m     |             |             |             |
| Year to 31 December   | <b>2007</b> | <b>2008</b> | <b>2009</b> | <b>2010</b> |
|   | Act         | Est         | Est         | Est         |
| Reported Profit   | 57.3        | 103.7       | 96.4        | 140.1       |
| Underlying Profit   | 49.4        | 103.7       | 96.4        | 140.1       |
| EPS (cps)   | 10.3        | 21.7        | 20.2        | 29.3        |
| P/E ratio (x)   | 10.3        | 4.9         | 5.3         | 3.6         |
| DPS (c)   | 3.00        | 6.50        | 6.50        | 6.50        |
| Franking (%)  | 100%        | 100%        | 100%        | 100%        |
| Net Yield (%)   | 2.8%        | 6.1%        | 6.1%        | 6.1%        |
| <i>Assumptions</i>  |             |             |             |             |
| \$A/US spot   | 0.840       | 0.833       | 0.655       | 0.685       |
| Manganese ore 44% Mn cif (US\$/dm <sup>3</sup> ) <sup>1</sup> | 5.35        | 12.05       | 9.00        | 9.00        |
| Manganese ore shipped (mtpa)                                  | 0.516       | 0.515       | 0.500       | 0.760       |

<sup>1</sup> OMH received price is below reported benchmark prices for 44% Mn.

## Marketing & Production Update

OMH confirmed that product shipments have been suspended in the December quarter 2008 in response to very weak market conditions.

We also understand that **neither BHP Billiton, nor Eramet, shipped any high grade manganese ore to China this quarter.** BHP had announced on 3 December that it had cut manganese production at its 60% owned Samancor operation due to weak market conditions. The cuts were expected to reduce ore production by 21% and alloy production by 23% for the 2009FY. (The reduction in manganese ore output was expected to be balanced between GEMCO (Australia) and Hotazel (South Africa). Like OM Holdings, resources at both these operations have shifted to development and re-building product inventories, which are severely depleted.)

OMH anticipates that shipping activities will recommence early in the March quarter 2009 in response to better visibility of supply and demand, the corresponding market clearing price, as well as lower product inventory stockpiles located at various smelters and ports in China.

In order to match expected lower demand, OMH's Bootu Creek production rate will be reduced by ~30% to a 500ktpa rate for 2009 - compared to our previous assumption of 730ktpa (slightly less than previous company guidance). Emphasis will be placed on increasing pre-stripping activity and rebuilding of run of mine (ROM) ore stockpiles.

### Close out of Foreign Exchange Contracts

Lower planned shipments have impacted on the delivery of OMH's forward exchange contracts against planned manganese ore revenues.

An additional cargo of ore sold during September 2008 (that was brought forward from Q4 2008) allowed OMH to discharge its October 2008 forward exchange contract commitments. During November 2008, OMH closed out forward exchange contracts with a mark-to-market loss of A\$6.0m.

OMH expects to close out further forward foreign exchange contracts maturing by 31 December 2008 with an expected mark-to-market loss now of A\$4.7m, assuming an \$A/US rate of 0.70.

As part of the Company's review of its hedging profile and strategy, OMH has just reported (19 December 2008) that it has closed out its longer dated foreign exchange contracts covering the period 30 June 2009 to 31 December 2009, with a value of US\$85.4m, realising a mark-to-market loss of A\$13.1m. The close out of these contracts have negatively impacted our 2008 earnings estimate.

### Remaining Foreign Exchange Contracts

OMH's remaining short dated 2009 forward foreign exchange contracts total US\$61m at an average \$A/US rate of 0.8258 with a current notional mark-to-market loss of A\$13.3m, assuming an \$A/US rate of 0.70.

### Consolidated Minerals' interest

OMH has just reported (19 December 2008) that Consolidated Minerals Ltd ("ConsMin") has recently acquired a further interest in the Company, taking its disclosed investment position to 57,231,393 shares or 12% of the Company's issued capital. A ConsMin representative has advised that its holding in OMH is "financial in nature". However, in our view, ConsMin's move raises the chance of a bid for OMH. OMH's board and management currently control about 22% of the stock.

ConsMin's owner, **Palmary Enterprises Ltd**, is a Ukrainian-owned company and is both a producer and end user of manganese.

Palmary Enterprises Ltd, which is backed by Ukrainian conglomerate Privat, had completed a takeover offer for Consolidated Minerals Ltd in January 2008 after a competitive and prolonged bidding duel with Pallinghurst Resources Australia.

### September Quarter Report

OMH had reported a very strong and better than expected September Quarter financial performance with cash reserves increasing by \$74m to \$138m at 30 September 2008 (including \$4.5m of cash collateral; equivalent cash at 30 June 2008: \$64m). The increase in OMH's cash position has been due to:

- Continued strong demand and historically high manganese ore and alloy prices during the September 2008 Quarter. The US\$ manganese price received per tonne of ore sold for the September Quarter was 37% higher than the price received for the June Quarter;
- A weaker \$A/US rate (0.88 for the September Quarter; 0.95 for the June quarter);
- Bringing forward a shipment planned for the December Quarter (resulting in seven shipments for the quarter); and
- Reducing inventory levels from those as at 30 June 2008.

The **Bootu Creek Manganese Mine** in the NT delivered another strong production performance during the September 2008 Quarter, with total production of 183kt at an average grade of 41.5%

Mn (12% higher than the June quarter 2008). The mine's operating profit increased by more than 50% from the June Quarter.

At OMH's **Qinzhou Smelter in China**, production of 8,284 tonnes of High Carbon Ferro Manganese (HCFeMn) from one operating furnace was in line with the company's reported guidance of 41.2kt for the full year.

*Footnote:*

*Manganese, in the form of HCFeMn and silicomanganese, is added to steels to increase strength and impact resistance.*

## Development Projects

OMH is continuing to advance the planned commissioning of the sinter plant at the manganese ferro-alloy plant in China towards the end of 2009 and deferring the planned commissioning of the proposed rejects re-treatment plant at Bootu Creek, which is expected to initially generate a further 150ktpa of 35% Mn fines, so as to coincide with the commissioning of the sinter plant.

## Interim result

OMH reported (on 28 August 2008) a record interim profit of \$96.9m (2007 June half: \$15.2m), above the company's guidance of no less than \$85m. Reported diluted EPS for the half year was 20.3cps (2007 interim: 3.9cps). The reported result included an impairment write back of \$9.7m relating to a write down for the Bootu Creek Mine in the 2006FY. Our adjusted earnings for the June half are \$87.2m.

All businesses contributed record results:

- The **Bootu Creek Mine** in the Northern Territory achieved a \$55.4m reported profit after tax, which included the impairment write back of \$9.7m. The result benefited from ongoing quarterly increases in realized manganese ore prices and higher production, slightly offset by higher unit production costs (\$4.47/dmtu; 2007 June half: \$3.03/dmtu) associated with pre-strip activities being fully expensed and higher royalty obligations.
- The **Singapore-based trading operations** generated a strong operating profit after tax of \$37.6m for the half year, with record volumes of 531,635 tonnes of manganese and chrome ore and alloys traded into China at significantly higher prices based upon strong market demand.
- OMH's **Qinzhou Smelter in China** contributed an operating profit after tax of \$12.9m, driven by record production of

27,276 tonnes of High Carbon Ferro Manganese (HCFeMn).

OMH's effective tax rate was only 6.2% for the June half. The company utilised prior period carry forward tax losses of \$35.5m. In future, OMH's effective tax rate will be around 30%.

Consolidated cash flows from operations were \$50.8m for the half year. The seemingly low cash flow was due to the purchase of ore from third parties close to 30 June 2008. Trade and other payables increased from \$41.7m as at 31 December 2007 to \$72.2m at 30 June 2008.

An interim dividend of 3.5 cents per share was declared (2007 interim: 2.0cps before 2:1 share split). Presumably the interim dividend has been constrained by the on-market buy-back announced on 12 August 2008. Whilst the interim dividend was in line with our estimates (estimated full year: 7.5cps), we had thought there may have been some upside to this estimate.

Reported EBIT margin and return on capital employed were 36.3% and 40.3% respectively. As expected, the EBIT margin of 36% is well below BHP's EBIT margin for Manganese of 58% for 2007-08 (and which would be significantly higher for the comparable 2008 June half). **Both BHP's manganese business and OMH will report higher EBIT margins for the 2008 December half.**

Cash reserves at 30 June 2008 increased to \$63.6m (including cash collateral: \$3.8m); debt was minimal (\$1.7m).

## Earnings Outlook

OMH's earnings outlook is highly dependent on the price outlook for high grade manganese ore (a change of US\$1.00/dmtu in our 2008 price assumption changes our 2008 earnings estimate by A\$25m). The manganese ore price CIF China 43-45% Mn had increased more than five-fold over the past 18 months (2008 September quarter benchmark price for 44% Mn: US\$16.20/dmtu cif China). We assume benchmark prices for 44% Mn during 2009 around US\$9/dmtu cif China.

Steel and alloy producers' lack of access to credit, specifically trade and working capital financing, continues to impact on the regular flow of business.

The anticipated Chinese government economic and financial stimulus package together with initiatives to ease the access to credit will assist in the eventual recovery. While OMH expects short-term volatility to continue, Chinese steel demand is expected to remain strong in the medium to long term. High-grade manganese ore producers with favourable value-in-

use (MIU) product characteristics and logistics for the Chinese market will continue to be well placed in the market, even under more moderate Chinese GDP growth.

## Iron Ore & Steel Market Outlook

The severe downturn in the global steel industry (in every region) is likely to continue well into 2009.

Steel producers in Asia, Europe and North America are cutting back production by up to 30-50% in the current quarter in response to collapsing demand. International steel prices (for hot-rolled coil) have fallen by 50-60% since June 2008.

Production cutbacks announced (5 November 2008) by ArcelorMittal (the world's largest steelmaker) of 30-35% of steel capacity globally in the current quarter are typical of the cutbacks by POSCO, Korea's largest producer; ThyssenKrupp and Salzgitter AG, Germany's largest steelmakers; and Chinese steelmakers. BHP Billiton noted at the company's AGM on 27 November 2008 that China's steel

production had decreased 17% year-on-year – a larger fall than most commodity analysts have estimated. A de-stocking phase is underway everywhere in the steel industry – steel mills are widely reported to be cancelling or postponing raw materials shipments (for iron ore and coking coal).

CRU, a London-based metals consultancy, had noted last month that a recovery in steel markets in the June quarter 2009 seemed optimistic. At the American Institute for International Steel's annual conference, **World Steel Dynamics anticipates that the collapse in steel demand is likely to continue well into 2009 and possibly beyond.**

The steel over-supply may last through most of 2009, according to Eurofer, the EU steel producers' federation. Real steel consumption has been on a weakening trend since mid-2008, and the latest projections are for the decline to accelerate in the first half of 2009. The worst affected sectors are construction and automotive.

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