

## Solitario Exploration & Royalty: Think Zinc - Impending Shortage Could Lead To Big Gains

Feb. 21, 2014 10:00 AM ET  
by: Fincom Investment Partners

**Editor's notes:** A pending zinc shortage and XPL's low valuation set shareholders up for a profitable cycle. Fincom Investment Partners sees big returns possible as the company's zinc story gains attention.

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*(Editors' Note: This article covers a stock trading at less than \$1 per share and/or with less than a \$100 million market cap. Please be aware of the risks associated with these stocks.)*

Primarily known for a majority-owned Mt. Hamilton gold project in Nevada, Colorado-based Solitario Exploration & Royalty ([XPL](#)) is a low-risk participant in several advancing metal projects. Not only are Solitario's separate components significantly undervalued, a *fully-covered interest in a world-class Zinc project equates to a value worth nearly 3X the current price*. If the metals recovery continues, and the shortage scenario we will outline materializes, Solitario has an additional "multi-bagger" upside. It is presently a deep-value, low-risk entry in an near-optimal value/timing investment scenario.

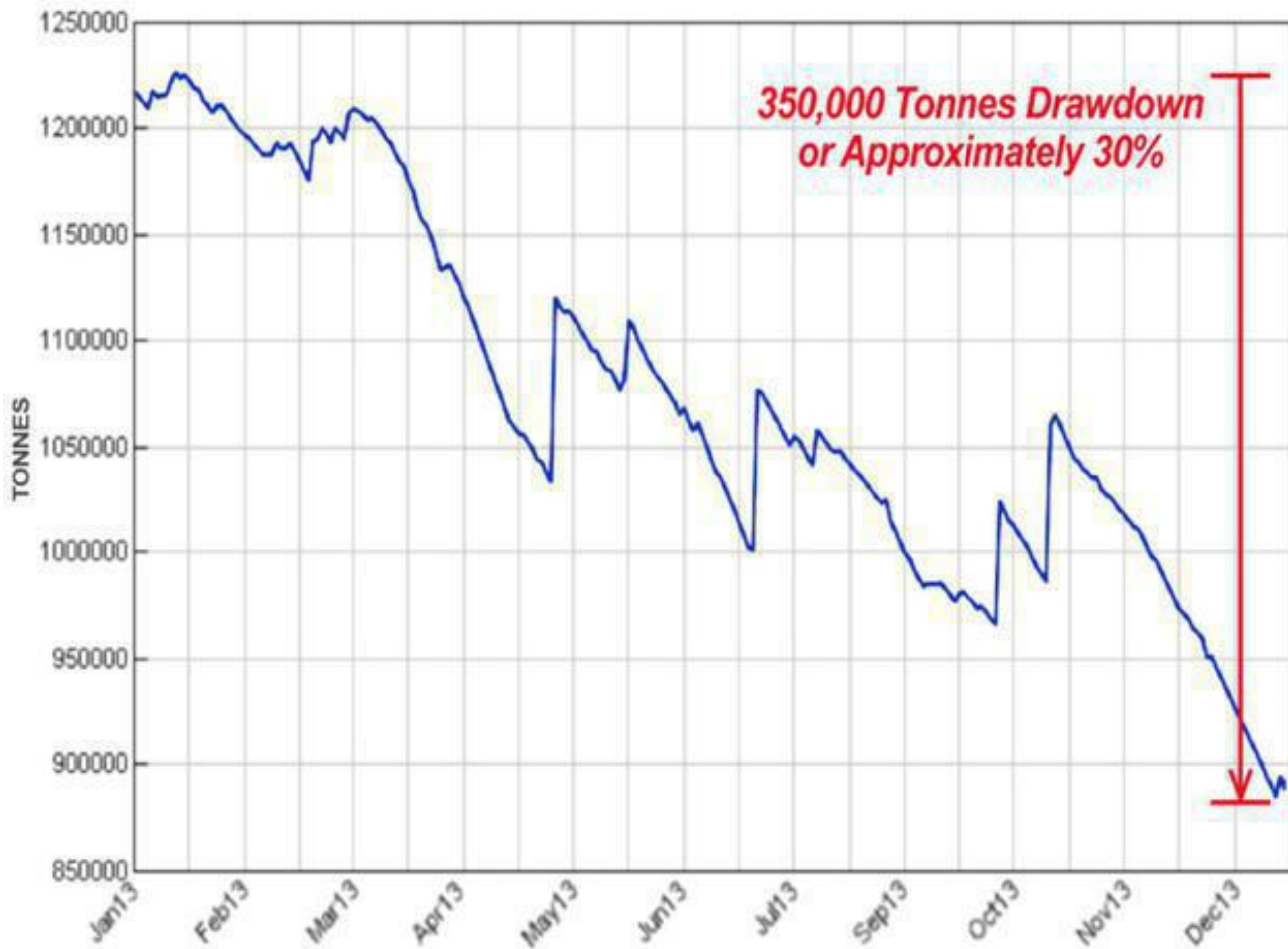
### Some things never change...

One source of our frequent amusement is the Resource world's mad dash from bubble to bubble. Over the years, we have seen stories of "imminent shortages", and subsequent bubbles, in everything from uranium, fertilizer, rare earths, etc. Somehow we managed to make handsome profits, scaling in when the rumors swirled, running for the exit when the mania overtakes common sense. We always keep a casual eye out for the next one.

Lately, we have been hearing chatter about..... Zinc.

This one may even be real. China has played, once again, the resource game to perfection, oversupplying the zinc market for years, driving down prices, thereby cutting off new mine development. So now, just as several new zinc mines are due for shutdown, China stops exporting unprocessed zinc. Supplies have crashed. Funny how that works.

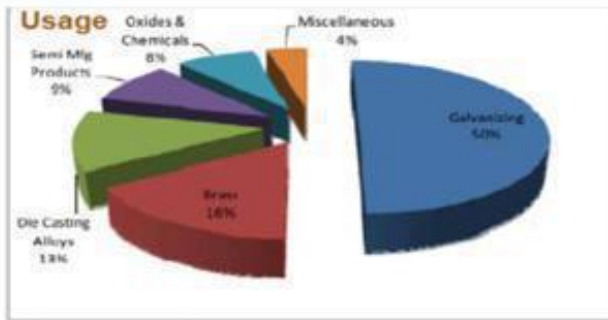
# 1 Year LME Zinc Warehouse Stocks Level



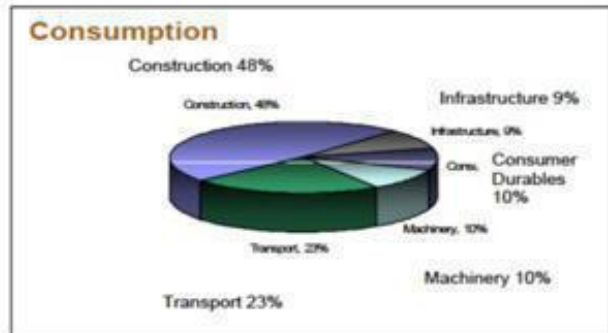
Slide sources: Solitario

We recently learned the giant Japanese conglomerate, Mitsui just raised processed zinc prices by a whopping 70%. *This is a big deal.* Mitsui has been mining since 1874, smelting zinc since 1928. In the conservative Japanese culture of "saving face", where customer relationships are measured in decades, such a move betrays a great deal of thought. In fact, it was most likely approved at the very top.

# Zinc Usage and Consumption



Source: Brook Hunt, Paradigm Capital Inc.



- Zinc is primarily used in galvanizing of steel, brass and diecast alloy parts.

- Consumption is primarily linked to construction and transportation sectors.

This is a solid "tell". Our curiosity led us to inquire with a friend who worked (as a metals trader) for Mitsui for many years; he confirmed our belief. Mitsui must have had a reasonable certainty of a serious zinc shortage - it lives and breathes metals - in order to take such drastic step.

Commodity prices tend to swing wildly from boom to bust, but zinc prices have lagged the plunging supplies; still selling at around \$.90. This continues to squeeze zinc miners and has inhibited new mine development. In fact, Glencore Xstrata ([OTCPK:GLNCY](https://www.sec.gov/edgar/disclosure/OTCPK/2014/000119312514000001/OTCPK-GLNCY)) just shut down its open pit portion in Burkina Faso (months after it opened).

# Supply Challenge - Large and Medium Mine Depletion

## Scheduled Depletion of Several Large and Medium Mines Commencing 2012

Mine	K tonnes	Depletion Date
Lennard Shelf	75	Shutdown
Galmoy, Ireland	80	Shutdown
Brunswick, Canada	265	2012
Perseverance, Canada	135	2012
Golden Grove, Australia	140	2012
Lisheen, Ireland	175	2013
Mt. Garnet, Australia	55	2013
Rosh Pinah, Namibia	67	2014
Century, Australia	600	2014
Iscaycruz, Peru	174	2017
Skorpion, Namibia	171	2019
<b>Total</b>	<b>1,937</b>	

\* Data from Wood Mackenzie, June 2011 Zinc Report

**Credit Suisse** (January 12, 2010 Research Note) projected the need for a 60% increase in mine production by 2016 - this means more than 6,000,000 tonnes of new mine development.

**Xstrata Zinc** (October 2010 LME presentation) President stated we could lose 1.9M tonnes of mine supply by 2016 while only adding 800,000 tonnes; and expected that we will need 7 million tonnes of new mine supply by 2020 and 14 million tonnes by 2025 to meet demand.

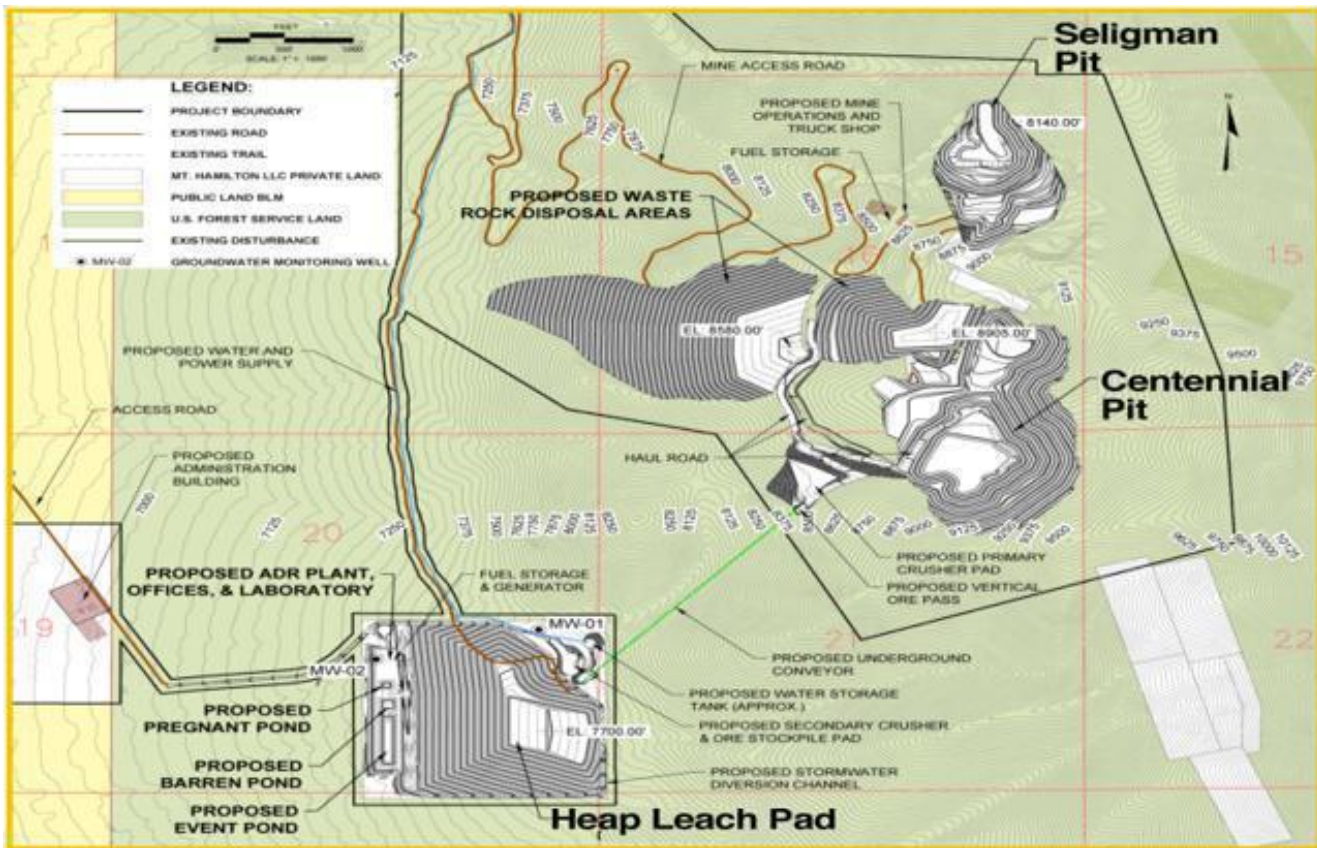
**Wood Mackenzie** (August 2011) forecasts loss of 1.7M tonnes by 2015, and 8.2 M tonnes of mine production by 2020.

Since actual zinc miners are still getting clobbered on earnings, *we believe the optimal investment is not in a zinc producer, but a new mine developer coming on in a 1-4 year window.* We went through our "bag of tricks" looking for quality pure-plays in the zinc space. There are very few. Most of the world's zinc is produced as a by-product, along with gold, silver, copper and lead. Conglomerates such as Glencore-Xstrata, Teck Resources ([TCK](#)), Goldcorp ([GG](#)) and BHP Billiton ([BHP](#)) produce the majority.

Since zinc mines tend to be smaller in size, finding a pure-play, up-and-coming zinc developer, which also possesses our *preferred investment formula*: (good value, location, expansion potential, low CAPEX, excellent management, tight share structure and near-term catalysts), was not easy. Solitario, which we have followed for several years, owned in the past, and now are re-accumulating, stands out.

Here's why:





Solitario's main project is Mt. Hamilton (80% ownership) in central Nevada, a small primary gold mine, although with good economics and great expansion potential. Mt. Hamilton has the exact component the "market" wants today: low cost.

Using the higher capital cost estimate at only \$80 million, and the Total Cash Cost estimate of \$600 per oz. At current (\$1300) gold, that's an EBITDA of \$42 million. At market, the pre-tax IRR is a respectable 27%, with a (5% discount) NPV of \$103 million (\$2.51 per share).

## Mt. Hamilton Feasibility Study Highlights

	2012 Feasibility Study	Optimized Scenario (Under Review)
<b>Production Rate (Tons/Day)</b>	<b>8,500</b>	<b>10,000</b>
<b>Mine Life</b>	<b>8 Years</b>	<b>10 Years</b>
<b>Gold / Silver Recovery</b>	<b>79% Gold / 40% Silver</b>	<b>Same</b>
<b>Life of Mine Stripping Ratio (T=Tons)</b>	<b>2.4 T Waste : 1.0 T Ore</b>	<b>Same</b>
<b>Initial Capital Cost</b>	<b>\$72 Million</b>	<b>\$80 Million</b>
<b>Sustaining Capital Cost</b>	<b>\$35 Million</b>	<b>\$40 Million</b>
<b>Total Cash Costs (Gold-Eq.)</b>	<b>\$575-\$600/ounce</b>	<b>Same</b>
<b>All In Costs *</b>	<b>\$875/ounce</b>	<b>Same</b>
<b>Avg. Annual Gold-Equiv. Production</b>	<b>54,000 Oz</b>	<b>60,000 Oz **</b>

\* Total Cash Costs + Initial Capital + Sustaining Capital + Corporate G&A

\*\* First six years of production; Value distribution: Gold-90%; Silver-10%.

That is correct: **Solitario is selling at about 1X forward EBITDA**... that is just for Mt. Hamilton.

We expect final permitting will be finished in the third quarter; construction is expected to be completed by third quarter of 2015. The final project financing has yet to be formalized, but our conversations with management indicate there is no shortage of financing interest - especially for a proven, experienced management team.

In terms of value, no absolutely perfect comparable exists, one miner (which we own) has similar production levels, SilverCrest ([SVLC](#)) (it actually produces 75% gold, at present) with production at 44,000 gold equivalent ounces, growing up to 55,000. SilverCrest has a rather nice expansion potential, which we believe is not appreciated by the market, hence the value, but even so, SilverCrest trades at a \$250 million valuation versus Solitario's \$45 million. Yes, it is producing, however, we will argue this is a roadmap for XPL investors, in addition, we believe a great location in Nevada is worth more than a similar project in Mexico. Sorry if we have offended anyone.

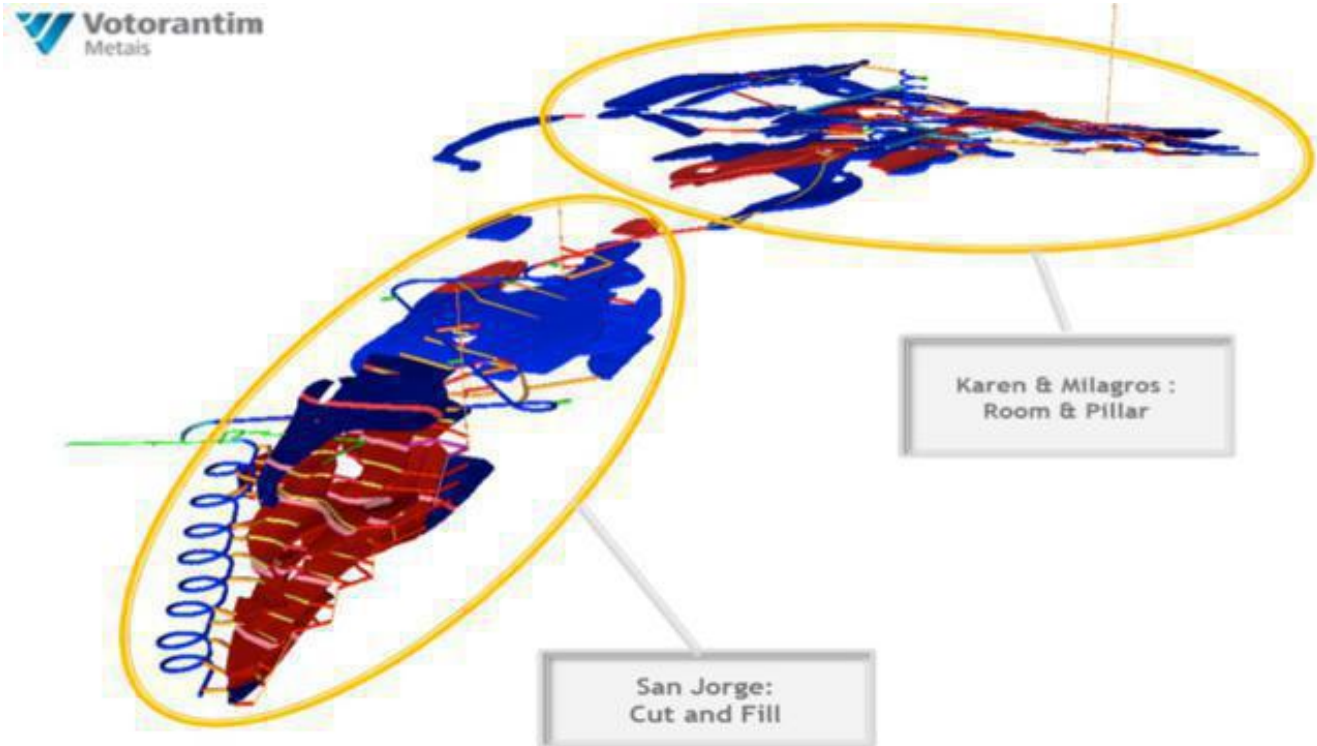
Two other approximate valuation comparables include St. Andrews Goldfields, producing around 100,000 gold ounces/year but with limited expansion potential, and trading for \$130 million. Pershing Gold ([OTCQB:PGLC](#)), also a developing Nevada project, at around the same gold production estimates but with less resource ounces, trades at a valuation over \$100 million - that would be \$2.50 in comparable Solitario valuation.

So yes, we believe Solitario is undervalued... but there is much more:

### Bongará Zinc Project

We believe the real driver for Solitario's price appreciation in 2014 will be due, in great part, to the high-grade Florida Canyon zinc deposit in Bongará, Peru. The best part: Solitario is fully carried to production by JV partner Votorantim Metais, the \$20 billion (2013 sales) private Brazilian behemoth. Votorantim is into everything from wood to orange juice; it also owns South America's largest zinc smelter and is the world's 5th largest zinc producer - *but does not presently own a zinc supply source*. The terms are ideal for Solitario, since Votorantim pays for everything (including construction) (it also owns its own bank).

In exchange, Solitario has kept a 30% interest in the project. This means there will be no further dilution for Solitario shareholders - one of the chief complaints we hear from professional investors about mining. Over \$60 million has been invested in Bongará to date.



Source: Votorantim and Solitario

A free-riding 30% may seem small, but it's a real blow-out and a fantastic deal for Solitario, along with shareholders. Investors will catch on. Bongará is a very high-grade mine; the economics are shaping up as "excellent", and Votorantim will lend the \$70 million (Solitario's 30% interest) in capital to construct the mine... which then gets repaid at the rate of 50% of EBITDA. Phenomenal.

High-grade, consistent drill results.

Drill Hole	Intercept (meters)	Zinc (%)	Lead (%)	Lead + Zinc (%)	Silver (g/t)
V-404	6.8	19.42	0.39	19.81	22.04
V-405	7.0	15.34	1.44	16.78	24.85
	10.2	7.15	0.18	7.33	13.35
V-407	3.6	26.31	1.59	27.90	74.87
V-410	9.9	22.94	3.09	26.04	20.61
V-431	4.3	17.24	0.25	17.50	6.21
V-432	21.1	8.31	1.71	10.02	12.11
V-433	5.0	38.22	3.89	42.12	60.76
V-456	15.7	6.50	0.46	6.96	7.21
V-458	25.5	7.22	0.55	7.77	6.21
V-465	10.7	45.60	5.25	50.84	106.71

To help with a relative comparison, Solitario this week posted a slide comparing its 30% interest along with Peruvian zinc miner Trevali ([OTCQX:TREVEF](https://www.otcmarkets.com/stock/TREVEF)) (TV.TO). For simplicity's sake: they are roughly similar. That is, **Solitario's 30% about equals Trevali's entire 100% of current production.**

	Trevali Mining *	Solitario
Market cap - US\$	\$240 million	\$33 million
	<b>Santander Mine-Peru</b>	<b>Bongará Mine-Peru</b>
Mine Status	Production	Pre-feasibility; Financed to Production
Production Rate	2,000 TPD	5,000 TPD
Mine Life	15+ years	12+ years
Mill Grade Zn + Pb	4.90%	7.50%
		<b>100% Project   Solitario's 30%</b>
Annual lbs. Zn + Pb	67 million	256 million   77 million
Annual oz. silver	705,000	356,000   107,000
* Potential to double current production by bringing Caribou Mine in Canada into production.		

We believe Trevali is cheap. If zinc prices rise by 50%, or more, which several professionals who make their living buying and selling base metals have remarked to us, the *leveraged impact* on zinc miner earnings will be tremendous. In any event, we suspect the market will soon start bidding up values in anticipation of such an event. It usually does.

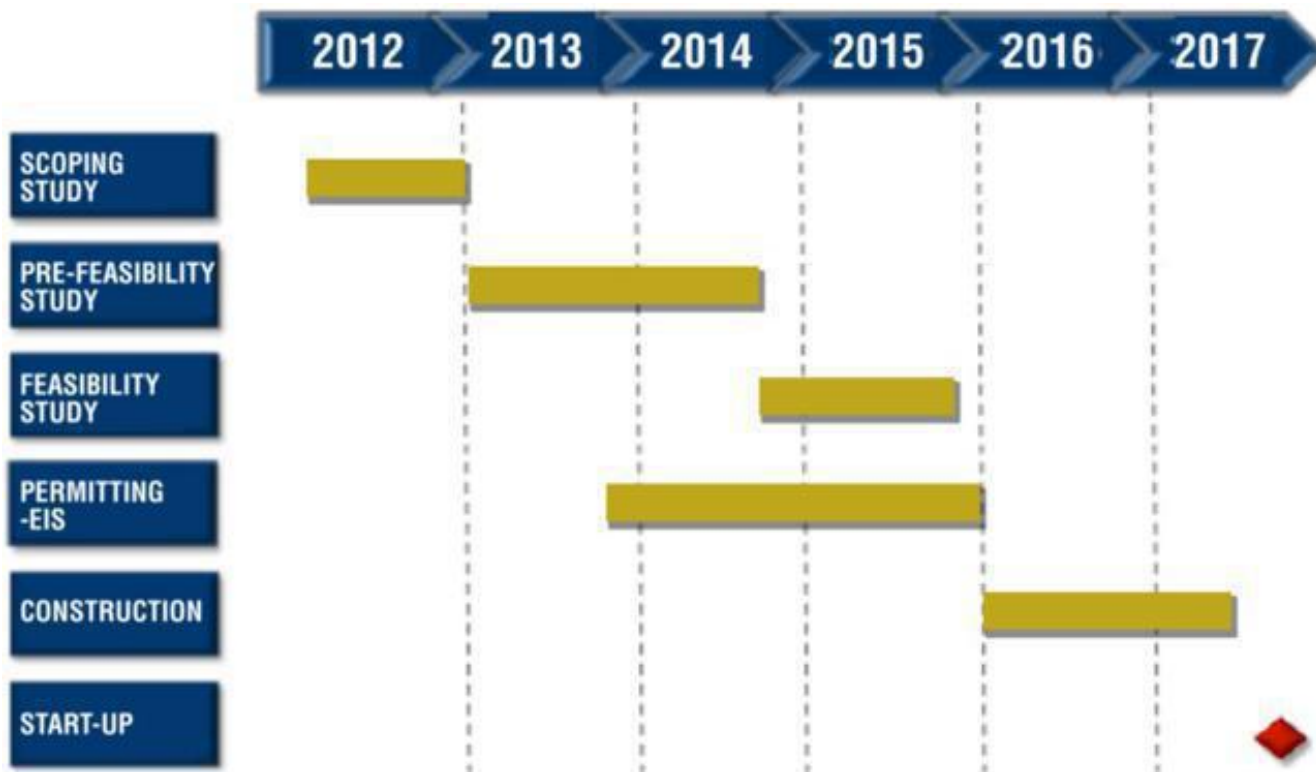
Trevali has another interesting project in Canada (Caribou) expected to go on line later this year. However, our best sense is the market is completely ignoring any value - especially since the last two owners went bust trying to run it. Trevali had problems getting Peru into production, which hurt the stock. Plus, almost all non-producing mineral properties got absolutely "whacked" during the recent mining bloodbath. We see this frequently these days; we just got in on 80 million ounces of in-ground silver, valued at only \$5 mm. A steal.

Of course, Trevali is in production. Solitario is not. There is, and should be, a premium for production. However, given that Solitario is *fully-carried*, we believe Bongará is currently worth several times Solitario's paltry \$45 mm valuation. The project economics are fantastic, with *50% margins, even if \$1 zinc sticks, Solitario could see cash flow (EBITDA) of nearly \$40 million annually.* The joint venture estimates that known resources support a 12-year mine life that produces about 250 million pounds of zinc + lead per year, plus a little bit of silver on top of that. On top of that, excellent potential exists to add a lot more resources to the project in the future!

**\$40 million a year is an EBITDA of 1... again, this is just for Bongará.**

Our best guess on pricing, garnered from industry experts, is that given the aforementioned supply circumstances, \$1.50 zinc should not be a problem. That's a 50% price increase and a smashingly large leveraged impact for a zinc miner. *That scenario would imply a \$77 million annual cash flow, or an EBITDA of .5.* Again, this does not include Mt. Hamilton.





To us, our bet is that Votorantim ends up buying Solitario's 30% stake before it goes into construction. After all, why would Votorantim advance \$70 mm when it could buy out the minority 30% interest for...?

Admittedly, it is tough to price. We have seen metals projects of this size/caliber sell for \$2 or \$3 billion in better markets. At present, you would need a sizable zinc shortage for something like this. Our current thinking is a value of around 3X forward EBITDA, which equates to \$120 million (\$2.92 per share) - or at 1 ½ X CAPEX or \$345 million (\$103 mm to XPL, or pre-tax \$2.50 per share). The value increases as the project moves forward, so when we say you could triple your money in Solitario based on the valuation of Bongará alone, we are not kidding. This is a scenario we are willing to watch develop over 2014 and is not something we are saying will happen overnight.

With total construction costs estimated at \$230 million ("peanuts" for a mammoth like Votorantim) and since it would have to advance Solitario's \$70 million anyway, why not just buy it?

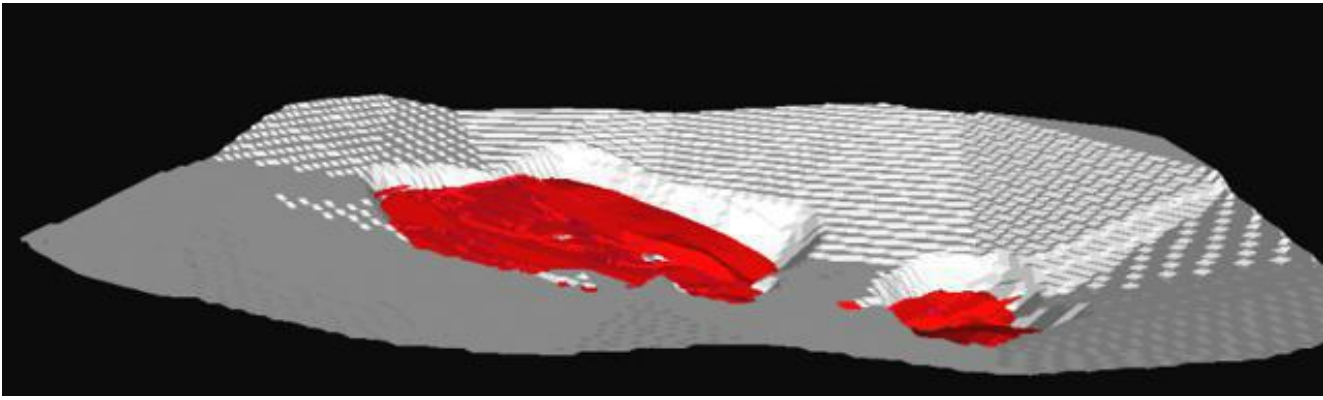
Yes, Solitario must pay back its part of the costs, over several years, but we hope readers connect with what we believe will become an obvious choice for Votorantim because 1) it is in the zinc business, 2) it owns a zinc smelter but has no in-house supply, and 3) it will most certainly be in tune with the zinc supply situation. Certainly, it is aware of what is happening with China and at Mitsui.

Most mining buyouts typically happen during the pre-to-full feasibility stage, which is ongoing (see slide). Strangely enough, big mining companies actually pay/treat their partners quite well; they want lower risk and will pay for it. However, investors should be aware there is no guarantee of a buyout, nor even a project "greenlight" (although that seems unlikely, as the drill results and early economics have been excellent), but we must note the final feasibility study will not be finished until 2015. In addition, since Votorantim is a private, family-owned conglomerate, it will act in a time and manner of its own choosing. We see this as a manageable risk, as we believe there is no market value given for Bongará anyway.

#### **But wait, there's more**

We wonder if Solitario's biggest "surprise" in 2014 may come from its Pedra Branca Platinum-Palladium project in Brazil. Joint-ventured with Anglo Platinum (the world's largest platinum producer), Solitario is basically carried to production, in exchange for Anglo earning a 51% interest. With over 300 drill holes to date, and a new drill program expected shortly. We understand the engineers are thinking it should be a 1 million+ ounce deposit (not yet compliant).

Anglo Platinum pit design for Esbarro



Given the problems Anglo Platinum is having with strikes and rising costs in South Africa, we suspect its attention towards "safe" jurisdictions will increase. This would then have a huge impact on Solitario's value, in our opinion, as IF Anglo moves forward, that 49% stake could be worth \$100-\$200 million for Solitario, or perhaps \$4 per share.

Indeed, we recently looked into the various platinum-palladium projects in the Americas, seeking the type of resource, deep value and quality management we prefer. We only came up with Wellgreen Platinum ([OTCQX:WGPLF](https://www.otcmarkets.com/stock/WGPLF)), which we continue to accumulate as the final share overhang gets flushed out. We are patient value and opportunity buyers, not "flippers", and we write our reports solely for our kind.

### **Management**

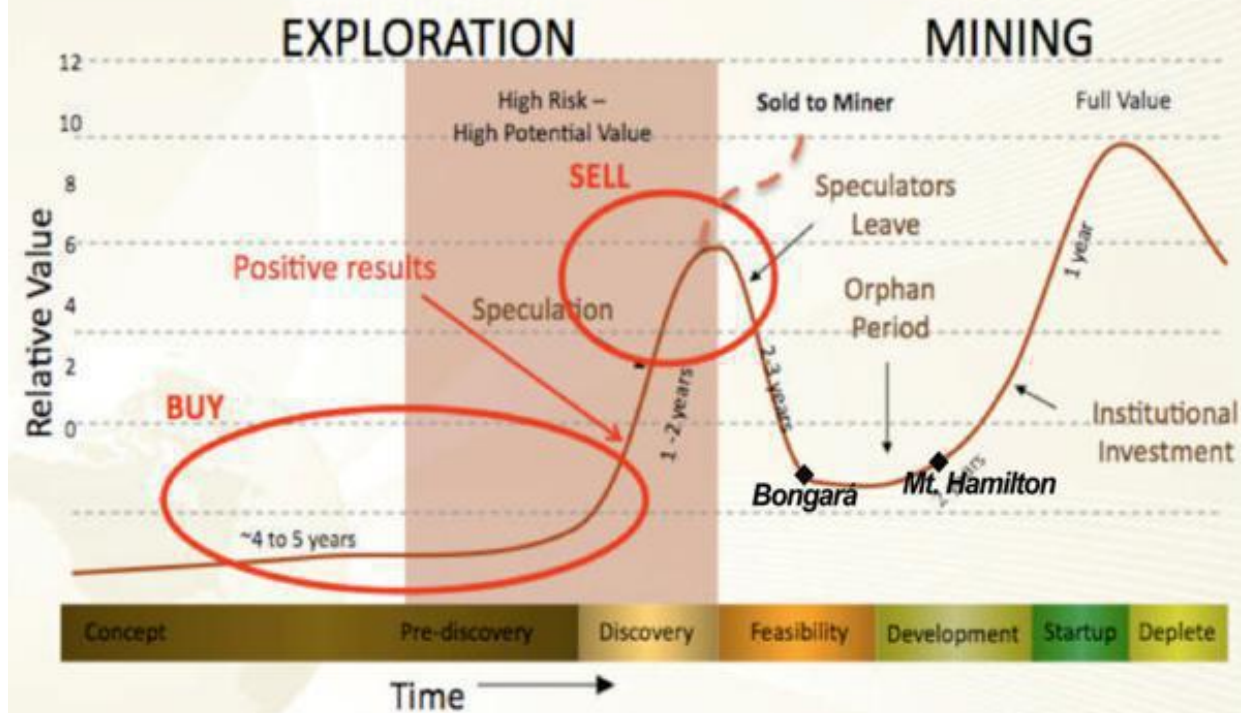
We have spoken with Solitario senior management numerous times - we like to put this part in - because we are shocked at the chutzpah of our "competition", that is, "analysts" who offer a recommendation and opinion, but never seemingly meet, or even speak to the people actually running the company. We cannot count the number of "stories" that looked good on paper, but fell apart after meeting management. We hope this, plus 30 years' experience at "reading between the lines" sets Fincom Investment Partners apart from the "wannabes".

Investors can get full details at the company website: The team is led by Christopher E. Herald, CEO since 1999. Mr. Herald also served as CEO, president, and director of Crown before its sale to Kinross in August 2006 for about \$200 million. Prior to joining Crown, Mr. Herald was a senior geologist with Echo Bay Mines and Anaconda Minerals. Mr. Herald also serves as chairman of the Denver Gold Group.

### **Conclusion**

We are not picking one "target price". We would encourage investors to pay scant attention if we did. Basically, in the space/time intersection known as "now", Solitario's time has arrived.

# The Most Important Graph in Mining



Source: Brent Cook and Solitario

We hope investors are aware that we are illuminating a scenario which has not yet occurred, but only one which we have bought into. The future is never certain. We are not promising you will make a fortune overnight. In a nutshell, our investment thesis is: we believe Solitario's PV is at around \$2.50-\$3 per share and the zinc component has been completely ignored by the market. We believe it is just in the early stages of a recovery. If the market strength continues and both projects keep advancing as expected, then a combined forward EBITDA of 3X (quite conservative, we believe) equates to \$240 mm or 5.85 per share.

Then, assuming the zinc story gets legs, XPL is the type of NYSE-listed security that Wall Street and mainstream investors often pile into. Given the tight share structure, it could do rather well - and the shares appear to be heating up already. Indeed, we would not be surprised to see the shares go for in excess of \$10, at some point. IF zinc does get over \$1.50, or more, Solitario could hit \$15 - since everything over \$1 is almost pure profit. That is a 5X EBITDA value (with a reasonable gold price recovery assumed).

Plus, with two advancing projects, even at \$1100 gold it should hold the recent lows. The comps show XPL fetching \$3-\$5 at current, still depressed, metals prices.

Zinc prices may or may not leap higher. *We are buyers today because we like the combination of lower-risk value and "multi-bagger" upside.* We prefer Solitario because in the event of a global recession, we like the protection of also owning a gold mine, or, in case zinc prices do not elevate, we do not wish to be over-exposed. Conversely, if the 2013 scenario repeats and gold fares poorly as economic conditions improve, then we would expect zinc to do well.

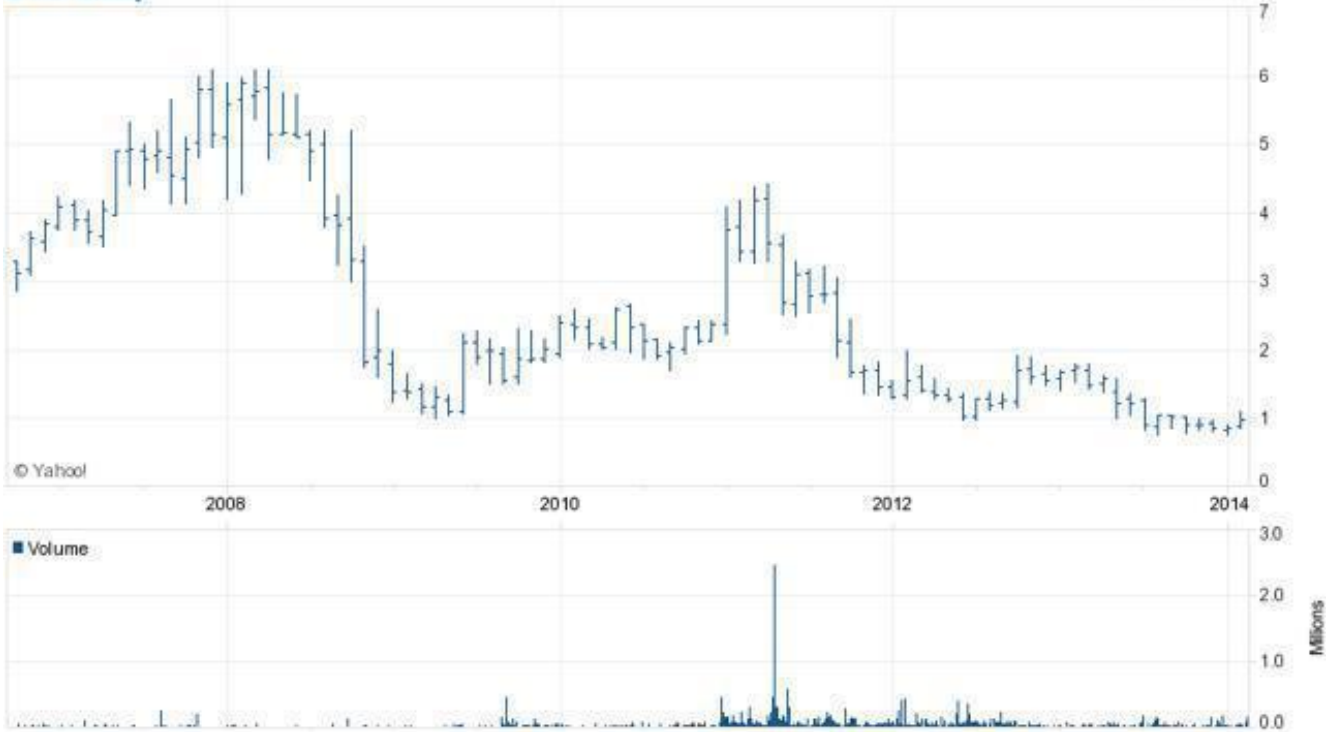
This makes us comfortable riding out the jolts and holding the shares for the "full monty". The reality of mining stocks: you make your biggest money the last few months of the run. So, buy value, management and opportunity at cycle bottoms; then relax and enjoy life.

**Solitario is getting hotter but it is still early:**

## Solitario Exploration & Royalty

■ XPL - Monthly

Feb 19, 2014



Source: Yahoo

The shares did well the last two cycles, and *this time it actually has production-ready projects*. The stock appears "sold out" and ready for a sizable multi-month rally. We believe new, all-time highs will come in due course as either scenario unfolds.

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