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Analysts' Ideas of the Week - Another One Bites the Dust!

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Another One Bites the Dust!

Recently, Vale (NYSE: VALE) announced its decision to suspend its operations at the Rio Colorado potash project in Argentina. This decision came primarily because of the steep increase in the capital cost estimate of the project. This is the second project that Vale is trying to abandon/suspend – just a few months ago, Vale had announced it is putting up its Saskatchewan potash project, Kronau, up for sale. Kronau is estimated to have a capacity of up to 2.9 million tonnes of potash.

The revised capital cost estimate for the Rio Colorado project is approximately $11 billion, much higher than the initial estimate of $5 - $6 billion. This steep rise in costs is very similar to what happened with BHP's (NYSE: BHP) Jansen mine in Saskatchewan. Jansen's capital cost estimate increased from $5 billion to $12 - $15 billion. Jansen, which is slated to be the world's largest potash mine, has a very uncertain future because of its massive CAPEX. Barrick (NYSE: ABX) has also been affected – the CAPEX of its Pascua-Lama project in Chile/Argentina, which is expected to one of the world's largest mines, is up by 70%. Rising labour / equipment costs are to be blamed for the rise in costs; also, the average grades of new deposits have dropped considerably in the past decade.

The most common question in 2012 was – "Why is my mining stock down so much if commodity prices continue to be strong?"

The answer - rising capital costs are increasingly becoming a major concern in the space, and that is one of the key reasons why resource equities have not been performing in line with commodity prices. Although margins and operating cash flows of mining companies have improved over the past few years, FCF (free cash flows) are down 39% p.a. in the past three years. FCF is defined as operating cash flows minus investing cash flows. The rise in capital costs (investing cash flows) is the reason for the decline in FCF. **Basic finance tells us that valuation / share prices should drop if FCF declines – which is exactly what we are currently experiencing.**

As rising capital costs continue to hurt the sector, I think the flavor of the year will be companies with low CAPEX and operating costs. Investors these days are not responding to projects with positive feasibility study results if they have medium to high CAPEX requirements. High capital costs and delays in development of mines are good for commodity prices as they restrict supply, **so look for companies with low cost operations which should benefit in this environment!**

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Everyone Wants a Piece of the Pie

First Nations communities throughout Canada have become more vocal in voicing their displeasure with the mining sector over the past year. This has caused a series of protests, road blocks, and lawsuits, throughout Canada, which are largely associated with the Idle No More campaign. These protests have affected the mining industry mainly via road blocks, denying access to, or from mine sites, for short periods of time. These have yet to cause large impacts on any mining operation. Although the protesters state environmental issues, territorial concerns, and lack of First Nations consent as leading issues, when it comes time to make demands, it's generally all about the money.

Many mineral exploration and mining companies within Canada strive to form relationships with the First Nations bands near their projects. In the past, this has typically taken the form of hiring locally, or providing payouts. These methods are no longer enough for some bands, who are demanding higher compensation from mines near their Reserve lands.

Options moving forward include part ownership of the development property or royalty agreements. What First Nations bands need to be aware of is that being a part owner (say a 30% stake) of a property that will require initial capital expenditures of $100 million, means that the band may end up holding the bill for $30 million of the development costs. If things run over budget, as mining projects tend to do, the bill could be much higher. Holding a part ownership stake in a mine is not all sitting back and waiting for the money to start rolling in. It is something that any group needs to consider before making these kind of demands.

Another option for Native Bands is to demand royalties from the mine once commercial production is achieved. However, many mining projects in Canada are located on Crown land, for which First Nations do not hold legal ownership. This is a major factor to consider because if the land does not belong to the bands, they do not have a legal right to demand compensation or revenue sharing from companies. Thus, this is likely to cause push back from some mining companies.

Overall, I believe, it is unlikely that the anti-mining protests in Canada are a major threat to the mineral resource sector. It seems that most of the bands are just looking for a way to increase incoming capital, and from an outside viewpoint, the mining industry appears to be an easy source of money. If investors want to reduce the risk associated with the current movement, they should look for companies with long standing positive relationships and agreements with the First Nations bands near their projects.

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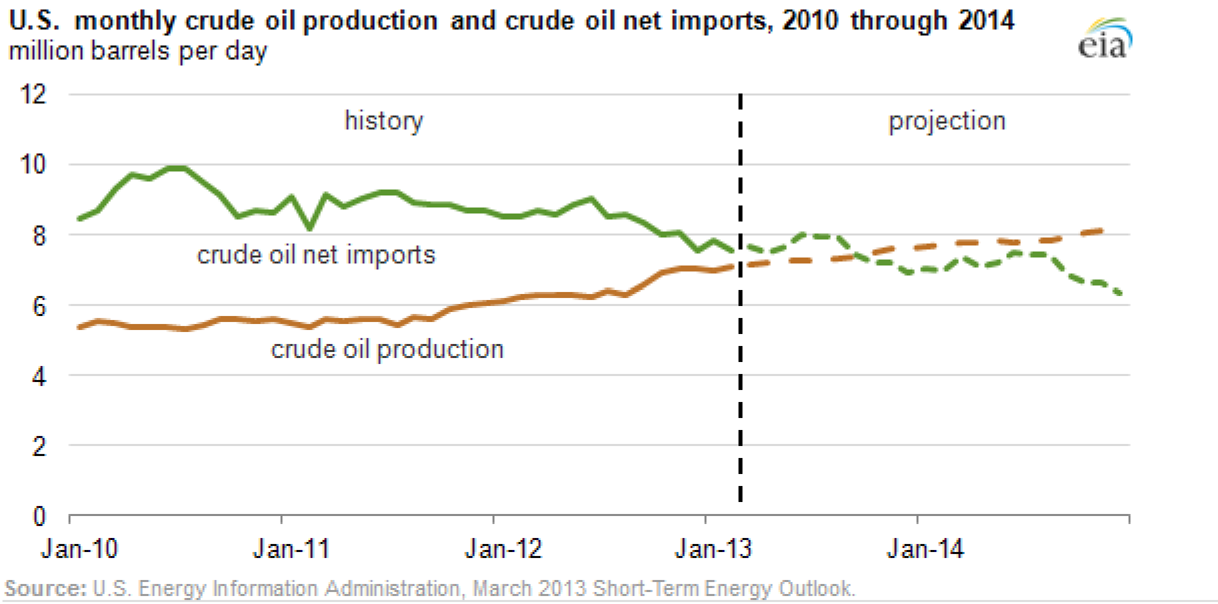
Recent News Shows Risks for Canadian Oil Sands Investment

Canada has the 3rd largest oil reserves in the world, estimated at 175 billion barrels, with 99% located in the oil sands. Recent news headlines have marred the outlook for companies with operations in the Canadian oil sands. In a report released March 20, 2013, by the U.S. Energy Information Administration (EIA), crude oil production in the United States is expected to surpass imports for the first time since 1995. The increased production is expected to impact the amount of Canadian oil imported, which accounted for 29% of U.S. petroleum imports in 2012 (EIA).



The major increase in U.S. oil is from shale oil production. Major shale reserves such as the Bakken project in North Dakota, and Eagle Ford in Texas, have significantly increased oil production. North Dakota's oil production is at an all time high of 770,000 barrels per day in January 2013 (EIA). Texas has increased their production to over 2 million barrels per day. Total U.S production is the highest it has been since 1992, at over 7 million barrels per day (EIA).

Deep water exploration in the lower tertiary of the Gulf of Mexico has also shown substantial reserves. Anadarko (NYSE: APC) just increased its estimate for its Shenandoah well to 500 million barrels. Shell (NYSE: RDS-A), Exxon (NYSE: XOM), and Chevron (NYSE: CVX), all have discoveries in the hundreds of millions of barrels in the area. Estimates of oil reserves in the lower tertiary region range from 3-15 billion barrels.

The U.S. has steadily decreased its reliance on foreign oil from 60% five years ago, to 40% at the end of 2012 (EIA). The International Energy Agency forecasts the U.S. to continue its expansion of oil production, **anticipating the U.S. to be the world's largest producer of oil by 2020**.

Already, a major Canadian oil sands project may be scrapped due to the increased U.S. oil production. Suncor (TO: SU) is expected to announce in the next few days whether it plans to construct or scrap its $11.6 billion Voyageur upgrader project. The upgrader would convert heavy crude to lighter oil. Suncor officials have said that they do not know if the cost will be justified given U.S. producers increasing their production of oil.

The planned Keystone Pipeline and Northern Gateway pipeline have been met by social and political resistance. These pipelines would allow a significant increase in production by oil sands producers, with the current pipeline infrastructure very inefficient. Nomura (NYSE: NMR) economist Charles St-Arnaud says the inefficient distribution costs the Canadian economy $2.5 billion a month because the oil cannot get to where demand is the highest.

The recent news displays significant challenges in the short and long-term for Canadian oil sand producers. In our opinion, the short term risks outweigh the potential upside, and we would avoid investment in oil sand producers.

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Update on Real Estate Forecasts

Over the next few weeks I will be giving my assessment of the Real Estate Market in North America, starting with a general outlook on the Canadian housing market including my outlook on selected regions (provinces or cities).

The Canada Mortgage and Housing Corporation (CMHC) recently released its Q1-2013 outlook on the Housing Market in Canada, in which it updated its forecasts for major housing market indicators (housings starts, sales and average resale prices). These are presented in the table below.

Housing Market Indicators	2012	2013(F)	2014(F)
Housing Starts	214,827	190,300	194,100
Total Residential Resale	453,372	451,100	472,300
Average residential Resale Price	$363,740	$367,500	$377,300

It is anticipated that housing starts will moderately decline in 2013 (from 214,827 in 2012 to 190,300 in 2013). In 2014, housing starts are expected to reverse and move marginally higher. Similarly, home sales are expected to slightly increase in 2014, after a decrease in 2013, reaching 472,300 from 451,100. These changes are mainly attributed to moderation in economic fundamentals, such as employment rates, migration, and economic growth, during the last few months, and an anticipated marginal growth of these factors later in 2013, and 2014. The resale price in 2013 is expected to be consistent with the relatively stable outlook for sales. It is anticipated that the average growth rate of resale prices will be close to the inflation rate (2%) over 2013 and 2014.

Among the three large provinces of BC, Ontario and Alberta, Alberta is the least overvalued; this is mainly because of the high correlation between housing prices and crude oil prices. Housing prices decreased with the drop in oil prices in 2008, and have not reverted to the record highs of 2007. The story is reverse for BC and Ontario, as prices hit their peaks. According to Fitch Ratings, the overvaluation in Alberta, Ontario and BC is estimated to be 15%, 21% and 26% respectively.

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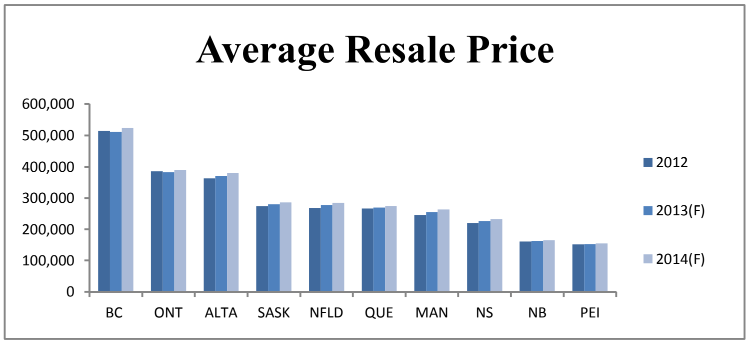

Among the 10 major cities, Vancouver, Toronto, and Victoria, are expected to have the most expensive housing markets, while Quebec, Saskatoon and Montreal are expected to have the least expensive housing market. The highest price to rent ratio will be in Vancouver, Montreal and Victoria. In contrast, the lowest price to rent ratio will be seen in Edmonton, Ottawa and Saskatoon. Considering these ratios, I would suggest investors focus on rental properties in Vancouver, and Victoria, and condominium investments in the provinces of Alberta and Saskatoon. At FRC, we cover a number of exempt market securities that can help investors gain exposure to these types of real estate in the mentioned areas.

#	Major Cities	Year	Average MLS Price	Rental Rate	
1	Vancouver	2012	$730,036.00	$	1,261.00
		2013(F)	$718,000.00	$	1,300.00
		2014(F)	$745,000.00	$	1,330.00
2	Toronto	2012	$498,973.00	$	1,183.00
		2013(F)	$493,000.00	$	1,200.00
		2014(F)	$505,200.00	$	1,225.00
5	Victoria	2012	$484,164.00	$	1,059.00
		2013(F)	$485,000.00	$	1,061.00
		2014(F)	$492,000.00	$	1,066.00
4	Calgary	2012	$412,315.00	$	1,150.00
		2013(F)	$423,000.00	$	1,200.00
		2014(F)	$434,000.00	$	1,240.00
5	Hamilton	2012	$360,059.00	$	886.00
		2013(F)	$362,000.00	$	900.00
		2014(F)	$369,200.00	$	920.00
	Ottawa	2012	$352,610.00	$	1,115.00
		2013(F)	$354,000.00	$	1,145.00
		2014(F)	$359,000.00	$	1,180.00
7	Edmonton	2012	$334,319.00	$	1,071.00
		2013(F)	$342,000.00	$	1,110.00
		2014(F)	$351,000.00	$	1,150.00
8	Montreal	2012	$326,389.00	$	711.00
		2013(F)	$330,000.00	$	720.00
		2014(F)	$335,000.00	$	730.00
9	Saskatoon	2012	$315,834.00	$	1,002.00
		2013(F)	$322,000.00	$	1,025.00
		2014(F)	$330,000.00	$	1,050.00
10	Quebec City	2012	$259,117.00	$	741.00
		2013(F)	$270,000.00	$	755.00
		2014(F)	$280,000.00	$	765.00

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