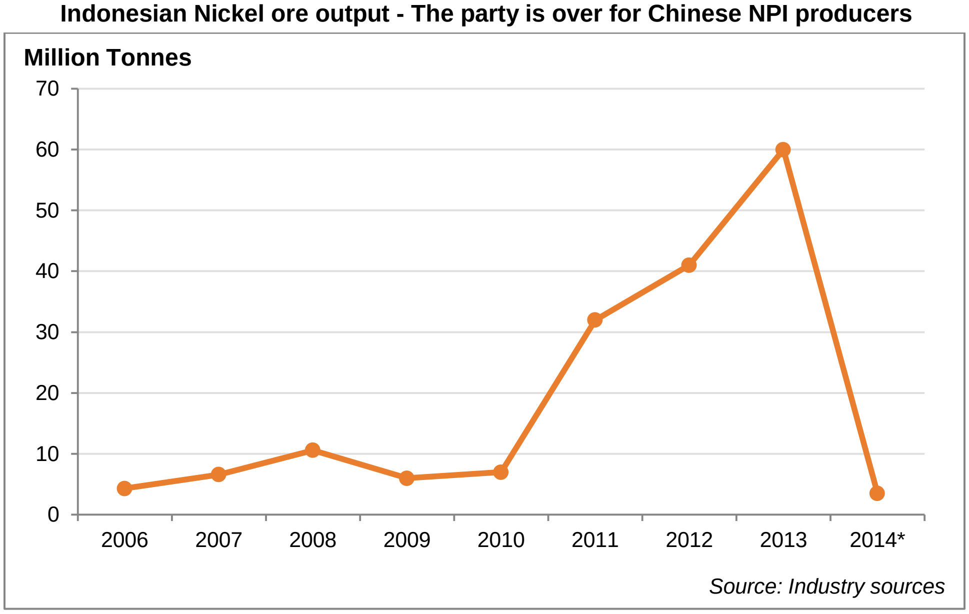
瑞東 REORIENT

REORIENT SALES COMMENTARY

Why Nickel is heading to $30,000/t sooner than you think.

Our exclusive REORIENT Nickel event on Monday with the Indonesian Ministry of Mines confirmed that the export ban is for real and that nickel prices are going to US$30,000 per tonne near term. To us this feels a lot like June 2006 just before the nickel market took off and tripled in price. The only difference between now and 2006 is that there is an overhang of nickel metal inventory held in warehouses today that will prevent it from going to $50,000 per tonne near term. If you want to know why nickel is going higher, refer to the chart below - it illustrates the growth in Indonesian nickel ore production since 2007. Last year a staggering 60 mn tonnes of nickel ore were mined either legally or illegally from the three main producing islands of Southeast Sulawesi, Central Sulawesi and North Maluku. The ore was then barged to ships and loaded for China to feed the booming nickel pig iron industry (some to Japan and India also). Today, 90% of that mining has stopped and the 10% that continues is going to local smelters and producers like INCO IJ and ANTM IJ. The Indonesian government's January 2014 decision to enforce a ban on exports is well known and a decision we applaud. The environmental damage this form of mining was doing and the lack of economic returns it was giving to Indonesia make the decision an obvious one. However, what we hadn't realized was just how much nickel was mined last year in a lead-up to the export ban. Assuming an average ore grade of 1.5% nickel, 60 mn tonnes of ore represents 900,000 tonnes of contained nickel or 55% of the global nickel supply.

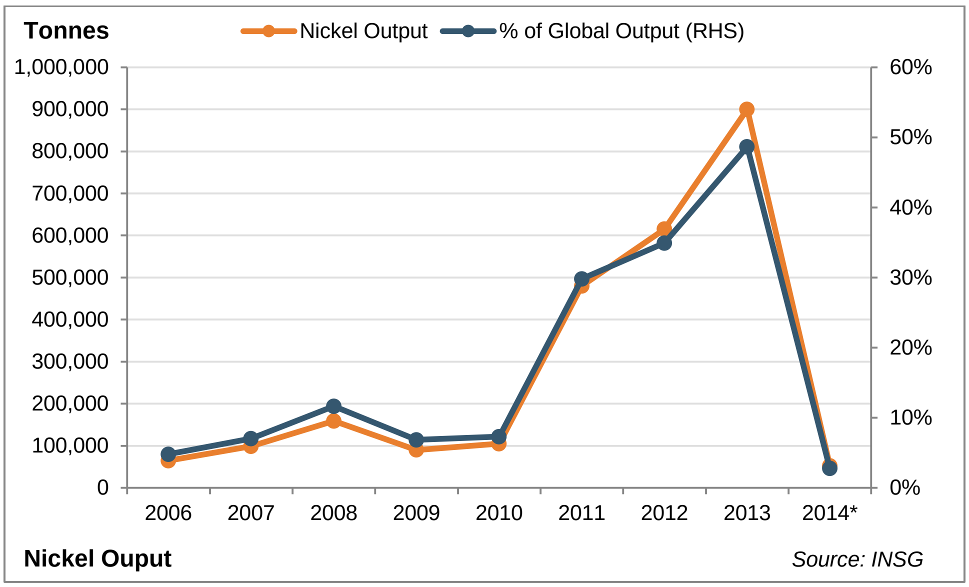
Indonesian Nickel ore output - The party is over for Chinese NPI producers



It's a mind-boggling number and proves that the Chinese NPI producers were aggressively stockpiling ahead of the January ban to ensure feed for the smelters in 2015. Now stockpiles in China of Indonesian ore are dwindling to less than 10 mn tonnes and we also believe those stocks are held by just a few smelters. The Chinese producers have gone to other sources for ore, but the Philippine ores are lower grade and the volumes lost from Indonesia cannot be replaced. The price of Philippine ore has jumped from US$43 per tonne in late 2013 to over US$140 per tonne today, making it also more difficult for the Chinese NPI producers to make a return at current nickel prices. There are other sources available also like Brazil, PNG or Samoa but their grades are 0.8-1.0% nickel and would not be economic unless nickel is north of US$30,000/tonne. In short the Chinese NPI industry is about to face major shutdowns as their inventories run down which we think will lead to the second phase of the nickel rally. The only reason prices have not yet gone silly is because of the LME metal overhang and the large stockpiling that occurred from the record mine output that we show in the chart above in Indonesia.

Looking back, the speed at which the Chinese industry has grown from sourcing Indonesian ore explains why nickel prices have been in a four year bear market. When an unknown private company like Shandong Xin Hai Technology can grow from nothing to over 100,000 tonnes of nickel output in just five years while BHP's Nickel West struggles to maintain output at 96,000 tonnes explains why the nickel market got smashed. Our nickel event on Monday this week with the Indonesian Ministry of Mines confirmed in our mind that this ban is for real. Whatever the outcome of the presidential election in Indonesia on July 9th we think Law 4 which enforces the export ban will remain firmly in place. The Indonesian government wants the Chinese NPI producers to invest directly in Indonesia and so far there are 29 NPI smelters under proposal. In reality we think fewer than 10 of those will be actually producing by mid-2015 which means nickel ore production could recover to 15 mn tonnes in 2015 (from its peak of 60 mn tonnes last year).

Indonesia represented 55% of global nickel supply in 2013. In 2014 it will be sub 8%



Note that although Indonesia represented 55% of global output at least 1/3 of that was used for stockpiling purposes for 2014 consumption.

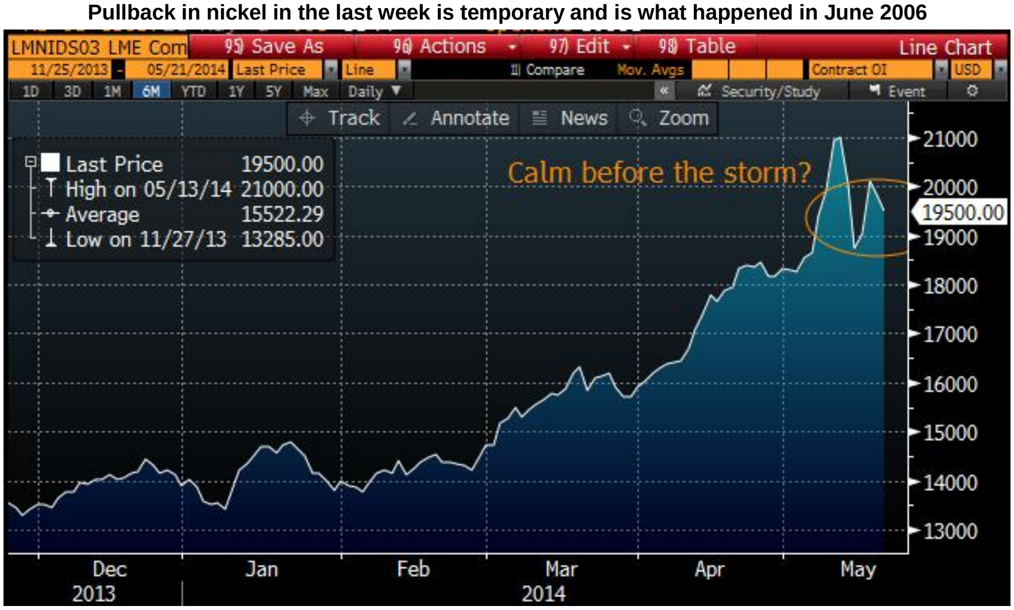
In the last great nickel bull market in 2006 and 2007 the key theme was the lack of sulphide nickel supply from Australia and Canada. Back in the day, analysts wrote at length about the lack of investment in these traditional sources of supply. The Chinese read those same reports and invented nickel pig iron to get around the problem of $50,000 per tonne nickel. The success of NPI and the negative impact it had on the nickel market was much greater than anyone expected. Today, we are in a similar theme as to 2006. We have had 5-8 years of limited investment in the traditional sulphide producers at a time when the NPI industry in China has been cut back dramatically because of the export ban. In reality there is no reason why nickel prices won't repeat what they did in 2006-7 and go back to $50,000 per tonne but for now we think $30,000 per tonne is more realistic given the metal overhang on the LME. The key risk of course is that the ban is lifted, but we think that is highly unlikely near term. Physical tightness in the nickel markets is about to become more pronounced as NPI's take downtime and inventories on the LME begin to drawdown. To put the Indonesian export ban into perspective it's the same as if Russia, Saudi Arabia and Iran switch off their oil wells and reduce global supply by at least 30% overnight. Imagine what that would do the oil price so that is why $30,000 per tonne nickel is not inconceivable near term.

Nickel Dejavu – It feels a lot like June 2006

Source: Bloomberg

In this environment we recommend investors use every dip in names like WSA AU, INCO IJ, ANTM IJ and 5713 JT to build structural longs. We are in a new bull market as 25-30% of global supply has essentially been switched off and is unlikely to come back onstream anytime in the next 12 months. Even when it does the "Indonesia to China" model is now switching to the "China to Indonesia" model which means supply additions will take time but provide valuable investment and jobs for Indonesians. Many of the NPI Chinese players are financially hurting from the export ban and we doubt they are in a position to now move their operations to Indonesia that quickly. We are now seeing a return to the traditional nickel industry before the invention of Chinese NPI where the sulphide producers in Australia, Canada and Russia will enjoy substantially improved fortunes. Nickel stocks should be core longs in your portfolio.

Pullback in nickel in the last week is temporary and is what happened in June 2006



Source: Bloomberg

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