

# Classical Insights

Global Investment Analysis Based on the Classical Economic Model

## Classical Insights Afternoon Bullet Points November 19, 2009

III CN -- \$9.48

all data are in C\$

### Sales and earnings

	2008	2009e	2010e	2011e
Sales (C\$ mln)	<b>294</b>	<b>265</b>	<b>279</b>	<b>295</b>
Sales growth		-10%	5%	6%
EPS	<b>1.83</b>	<b>(0.05)</b>	<b>0.91</b>	<b>1.16</b>
Cash flow	2.73	0.64	1.57	1.80
FCF	1.04	(0.03)	0.83	1.08
Cons. EPS	(0.01)	0.33	0.18	0.56

### Target price & valuation data

Our 12-mo. target	\$15.61	(5.5x '11 EPS + C\$9.24/sh	
Upside to target	65%	for Red Chris & Sterling)	
Mkt cap (C\$ mln)	\$344	Enterprise value	\$333
P/sales (2009e)	1.30	EV/sales (2009e)	1.25
P/E (2009e)	nmf	EV/EBITDA (2009e)	4.7
P/E (2010e)	10.4	EV/EBITDA (2010e)	4.1
P/E (2011e)	8.2	EV/EBITDA (2011e)	3.9

cash flow defined simply as EPS + depreciation. FCF defined as cash flow - capex.

**Imperial Metals reported spectacular drill results at its Red Chris project last week, and Red Chris is on track to become a major copper/gold mine.** I am raising my price target on Imperial to C\$15.61/share (was C\$9.00), chiefly to reflect greater value for Red Chris. Here are the EPS estimate changes:

### Changes to Imperial EPS estimates

	was	is
2009e	0.67	<b>-0.05</b>
2010e	0.79	<b>0.91</b>
2011e	1.42	<b>1.16</b>
2012e	--	<b>1.16</b>

Source: Churchill Research estimates

The new price target is based on 5.5x expected 2011 earnings plus C\$9.24/share for cash and projects. (Red Chris represents C\$8.04/share of that.) The old target was based on 6x the old 2010 EPS estimate plus C\$3.06/share for cash and projects. Earnings in 2009 have been low due to losses on the hedge book, which covers about one-third of copper production through 2011. My 2010 estimate has risen due to higher copper and gold price forecasts. The 2011 estimate has declined due to higher cost forecasts and changes in the overall model. (Imperial's financials are extremely difficult to model due to hedging, forward sales and treatment charges. Treatment charges are not reported by the company.)

### Points:

1) Last week, Imperial said it encountered 152 meters of 4.12% copper and 8.83 g/tonne gold from one drill hole at Red Chris. That represents \$600/tonne rock. I can't remember ever seeing grades that good in North America over such a length. The catch is that the interval begins at a depth of 540 meters, which is below the bottom of the proposed open pit design. Imperial thus would need to build a much-bigger open pit, or sink a shaft and do underground bulk mining to get at the high-grade ore. Both approaches require heavy upfront capex. As such, Imperial likely will need a partner to develop the deeper parts of Red Chris.

Importantly, this hole wasn't a freak event (though it the best so far). The best previous results came from hole RC07-335, which showed 1.01% copper and 1.26 g/tonne gold over 1.02 kilometers. Those are very high grades over a very long distance. Most North American copper producers are happy to mine 0.45% copper coupled with 0.3 g/tonne gold. Kinross's Fort Knox

mine in Alaska is producing over 300,000 gold ounces annually at a grade of just 0.5 g/tonne (which implies \$20/tonne rock).

2) This all begs the question of how to value Red Chris *today*. I've seen various models for this and I think they all undervalue the asset, which is world class. The most recent resource estimate dates from 2005, at which time Red Chris was shown to contain 6 billion copper lbs. and 7.75 million gold ounces. That's huge -- and the new drill results will make it even bigger.

**Red Chris copper & gold resource (size estimates as of 2005)**

Metal	reserves		contained Cu (mln. pounds)	Assuming 87% Recovery rate	value US\$ mlns	value CA\$ mlns
	(tonnes)	copper grade				
Copper	830,800,000	0.33%	6,080	4,864		
<i>measured &amp; indicated</i>	446,100,000	0.36%	3,538	3,078		
<i>inferred</i>	384,700,000	0.30%	2,542	2,212		
value at \$0.02/lb.					<b>\$121.6</b>	<b>\$128.3</b>
Metal	reserves		contained Au (mln. ozs)	Assuming 55% Recovery rate	value US\$ mlns	value CA\$ mlns
	(tonnes)	gold grade (g/tonne)				
Gold	830,800,000	0.29	7.75	4.26		
<i>measured &amp; indicated</i>	446,100,000	0.29	4.16	3.33		
<i>inferred</i>	384,700,000	0.28	3.46	2.77		
value at \$20/oz.					<b>\$154.9</b>	<b>\$163.5</b>
<b>Total value</b>					<b>\$276.5</b>	<b>\$291.8</b>

Sources: Imperial, Churchill Research estimates

I am valuing the Red Chris copper pounds at \$0.02 each and the gold ounces at \$20 each, generating a valuation for the entire project of US\$276 million, or US\$7.67/share based on a share count of 36 million. There is no perfect way to value Red Chris, particularly given that the best grades are found deep down. Imperial paid \$70 million for Red Chris in 2007.

3) Imperial has a permit to develop Red Chris (including construction of a 30,000 tpd mill), but the permit is currently in abeyance pending a legal challenge. Canada's Supreme Court is set to rule on the legal challenge in January. (A hearing was held in October and the court has 90 days from the hearing date to make a decision.) My best guess is that the permit will be upheld as is. But if it is not, management believes it may have to do another year's worth of work to clear the last permitting hurdles. That may not be a big problem, however, for that year would give the firm extra time to devise approaches for getting at the deep high-grade zones discovered this year.

4) Copper production at Imperial currently comes from two mines: the 100%-owned Mt. Polley mine and the 50%-owned Huckleberry mine. As the table below shows, copper production at Mt. Polley fell sharply this year, as ore was mined from lower-grade zones. There are more higher-grade zones on the property, though, so production should gradually rebound in coming years.

**Imperial copper production**

Mine	Province	million pounds of copper/year							
		2005	2006	2007	2008	2009e	2010e	2011e	2012e
Mt. Polley	Brit. Columbia	30	56	52	60	37	43	47	48
Huckleberry	Brit. Columbia	37	35	28	19	23	19	19	19
	<b>Total</b>	<b>67</b>	<b>91</b>	<b>79</b>	<b>79</b>	<b>60</b>	<b>62</b>	<b>66</b>	<b>67</b>

Sources: III, Churchill Research estimates

5) Gold grades have been strong at Mt. Polley for the last two years. They should continue to be good because management is specifically targeting gold-rich areas, even at the expense of slightly lower copper grades. I'm modeling for 49,000 ounces/year of gold production between the two mines from 2010-2012:

### Imperial gold production

Mine	Prov/state	gold ounces per year ('000s)							
		2005	2006	2007	2008	2009e	2010e	2011e	2012e
Mt. Polley	Brit. Columbia	31	38	35	47	49	48	48	48
Huckleberry	Brit. Columbia				1	1	1	1	1
	<b>Total</b>	<b>31</b>	<b>38</b>	<b>35</b>	<b>48</b>	<b>51</b>	<b>49</b>	<b>49</b>	<b>49</b>

Sources: III, Churchill Research estimates

Mt. Polley's official mine life is five years but near-mine exploration has been successful and there is plenty of copper in the area. Huckleberry is officially slated to end in 2012 but that, too, is likely to be extended based on recent drilling results. The equipment at Huckleberry is worth about \$10 million, and it could be transferred up to Red Chris if Imperial gets the permits and backing to build that mine (and if Huckleberry closes).

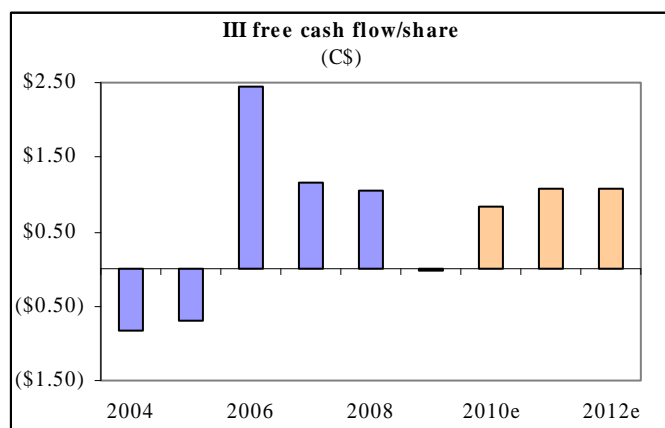
### Imperial Metals: Projected revenues by metal type

	2009e	2010e	2011e	2012e
Copper (mln lbs)	60	62	66	67
\$/lb.	2.60	3.08	3.15	3.35
<b>Copper revs (US\$ mlns)</b>	<b>\$156</b>	<b>\$191</b>	<b>\$206</b>	<b>\$223</b>
Gold ('000 ozs.)	51	49	49	49
\$/oz.	975	1,145	1,145	1,145
<b>Gold revs (US\$ mlns)</b>	<b>\$49</b>	<b>\$56</b>	<b>\$56</b>	<b>\$56</b>
<b>Silver &amp; moly sales</b>	<b>\$8</b>	<b>\$8</b>	<b>\$9</b>	<b>\$10</b>
<b>Gross sales (US\$ mlns)</b>	<b>\$213</b>	<b>\$255</b>	<b>\$272</b>	<b>\$288</b>
CAD exchange rate	1.11	1.06	1.06	1.06
<b>Gross sales (C\$ mlns)</b>	<b>\$237</b>	<b>\$271</b>	<b>\$288</b>	<b>\$306</b>
TC/RC (in C\$ mlns)	\$48	\$57	\$60	\$66
True ups	\$7	\$0	\$0	\$0
<b>Net sales (C\$ mlns)</b>	<b>\$196</b>	<b>\$214</b>	<b>\$228</b>	<b>\$240</b>

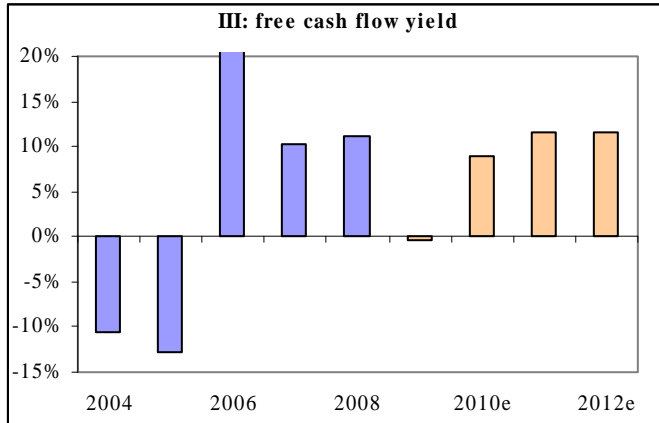
Sources: Churchill Research, Imperial

5) I'm assuming capex of C\$24 million this year, followed by C\$28 million annually from 2010-12. Depreciation should run about C\$25 million/year. If Imperial decides to undertake a major mine development at Imperial or one of its other two projects (Sterling and Ruddock Creek) that would send capex much higher.

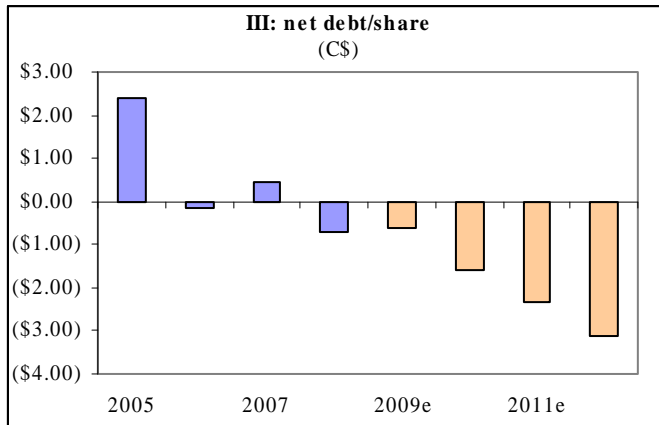
Based on these forecasts, free cash flow through 2012 should evolve as follows:



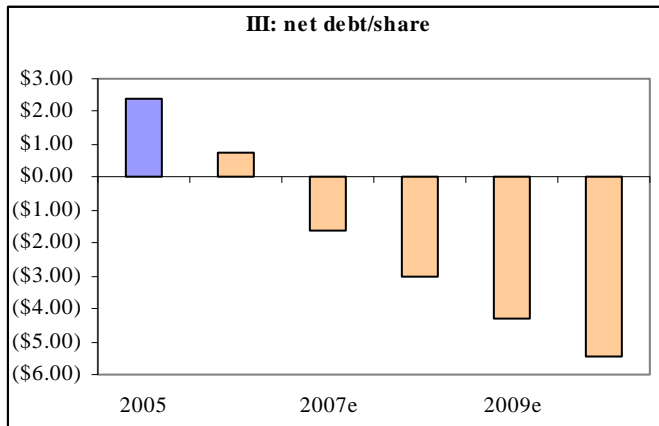
Free cash flow yield in this scenario would be 9% in 2010, rising to 12% in 2011-12:



Net debt would evolve as follows:



By the end of 2011, Imperial would have C\$2.40/share in cash – assuming that 75% of free cash stayed on the balance sheet.



In reality, Imperial is quite likely to spend that free cash flow, either on development of a major project or simply on stepped up drilling at Red Chris, Sterling or Ruddock Creek. Management has no particular interest in keeping cash around. They like to build mines.

6) Bottom line: At its current valuation, I would estimate that Imperial includes about C\$2.50/share in value for Red Chris. That figure should really be more like C\$8/share given the quality and size of the deposit. The next catalysts for Imperial shares would be:

- a) Favorable Supreme Court ruling in January,
- b) Further good drilling results from Red Chris;
- c) Improvement in copper grades at Mount Polley.

**III: Income statement items (in C\$)**

	2005	2006	2007	2008	2009e	2010e	2011e	2012e
Sales (C\$ mln.)	71	212	265	228	196	213	228	239
Cash costs	54	93	158	160	121	125	133	143
Depreciation	8	13	23	29	25	25	25	25
SGA	3	4	13	(0)	4	8	10	12
Op income	5	102	71	39	46	55	60	59
Interest cost	3	5	5	3	3	0	(2)	(4)
Non-op losses *	(18)	(7)	19	(45)	46	8	0	0
Tax	(2)	22	15	21	(1)	13	17	17
Net income	22	77	19	60	(6)	35	45	46
Shares (dil.)	29.0	31.2	32.4	32.5	36.3	38.0	39.0	40.0
EPS	0.75	2.61	0.98	1.83	(0.05)	0.91	1.16	1.16
Capex	(49)	(18)	(17)	(55)	(24)	(28)	(28)	(28)
FCF/share	(0.69)	2.45	1.16	1.04	(0.03)	0.83	1.08	1.08

Sources: III, Bloomberg, Churchill Research estimates

\* Big non-op gain in 2008 is from hedge book. Ditto the 2009 non-op loss.

7) Risks: The top risks are a) rejection of the Red Chris environmental permit, b) a sharp drop in copper and/or gold prices and c) production shortfalls at Mt. Polley or Huckleberry.

The Classical Insights portfolio holds Imperial.

Mike Churchill

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