

# Classical Insights

Global Investment Analysis Based on the Classical Economic Model

## Classical Insights Morning Bullet Points April 22, 2009

### ML CN -- \$1.05

*all figures are in US dollars*

#### Sales and earnings

	2008	2009e	2010e	2011e
Sales (US\$ mlns)	29	100	252	290
Sales growth		245%	153%	15%
EPS	(0.38)	(0.14)	0.30	0.41
Cash flow	(0.36)	(0.03)	0.37	0.49
FCF	(2.11)	(0.45)	0.28	0.43
Cons. EPS		(0.05)	0.36	0.36

#### Target price & valuation data

Our 12-mo target	\$2.04	(based on 5x 2011 EPS)	
Upside to target	94%		
Mkt cap (US\$ mlns)	\$148	Enterprise value	\$257
P/sales (2009e)	1.48	EV/sales (2009e)	8.86
P/E (2009e)	nmf	EV/EBITDA (2009e)	57.9
P/E 2010e)	3.6	EV/EBITDA (2010e)	2.5
P/E 2011e)	2.6	EV/EBITDA (2011e)	2.0

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

### We are resuming coverage of Mercator Minerals with a US\$2.04/share price target.

Mercator has successfully ramped up production at its Mineral Park copper/moly mine in northwest Arizona and is now producing at a rate of roughly 32 million lbs/year (plus moly). By year-end, Mineral Park could be at 50 million lbs/year, plus nearly 10 million lbs. of molybdenum. ML is attractively priced if one assumes a copper price of \$2.35/lb. in 2010 and \$2.75/lb. in 2011. On that basis (and assuming moly prices of \$12/lb. and \$13.50/lb. in 2010 and 2011, respectively), we arrive at EPS estimates of US\$0.30/share next year and \$0.41/share in 2011.

Mercator traded as high as \$13/share last June, but then plunged to as low as \$0.24/share in December when it appeared as if the firm's substantial debt burden might push it into bankruptcy. Mercator shares have bounced back a bit (in step with the copper price), allowing the firm to do several equity offerings to strengthen its balance sheet.

#### Points:

1) Mercator acquired the Mineral Park mine in 2003 and re-started commercial operations in January 2005. In January 2006, the firm commenced operation of an SX-EW plant, and in 2007 began construction of a mill complex.

2) Mercator is modeling for a 25-year mine life, but the mine almost surely can run much longer. In the table below the moly resources are scored on a 5-1 ratio *vis a vis* copper resources. On that basis there are roughly 5 billion copper equivalent lbs. at the site. That makes Mineral Park a fairly large resource by international standards.

#### Mineral Park: Copper resources (0.3% Cu equivalent cut-off)

Mineral Park	Reserves (short tons)	Copper EQ grade *	Copper Equivs (mln. pounds)	assuming 78% recovery rate
Measured & Indicated	490,142,000	0.35%	3,431	2,779
Inferred	218,703,000	0.37%	1,597	1,293
<b>totals</b>	<b>708,845,000</b>		<b>5,028</b>	<b>4,072</b>
<b>Years of life @ 2011 rate (18.2 mln tonnes/year):</b>				<b>38.8</b>

\* moly scored at 5 to 1 ratio to copper

Sources: Mercator, Churchill Research estimates

In reality, Mineral Park can probably run 50-100 years. Similar mines in the area have been in operation that long, and ore grades at Mineral Park remain mineable for nearly a mile below the current pit floor. The grades at Mineral Park are just okay, but the strip ratio is extremely low at 0.18 to 1. (There is little overburden because the mine had already been in operation prior to Mercator's acquisition of it.)

3) The new Mineral Park mill is now running at about 29,000 tons per day, which should allow the firm to produce 32.5 million lbs. of copper this year, as well as 3.7 million lbs. of moly. We assume an expansion to 50,000 tpd is completed by year-end, allowing for production of 60 million lbs. of copper and 9.3 million lbs. of moly in 2010, 2011 and 2012:

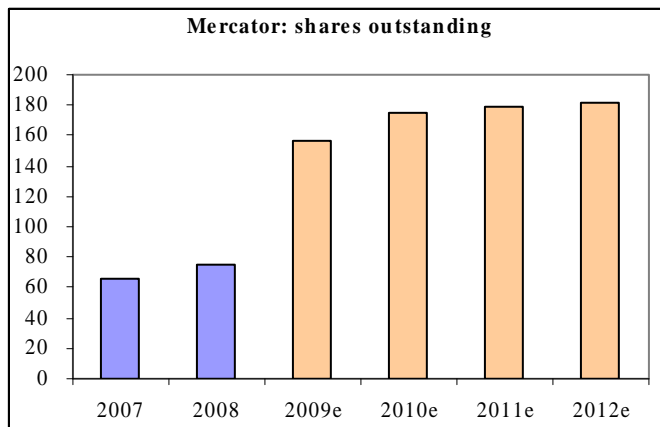
**Mineral Park: Projected revenues by metal type (in US\$ millions)**

	<i>FY 2009</i>	<i>FY 2010</i>	<i>FY 2011</i>	<i>FY 2012</i>
Copper (mln lbs.)	32.5	59.9	59.9	59.9
\$/lb.	2.05	2.35	2.75	2.75
<b>Copper revenues</b>	<b>\$67</b>	<b>\$141</b>	<b>\$165</b>	<b>\$165</b>
Moly (mln lbs)	3.7	9.3	9.3	9.3
\$/lb.	9.00	12.00	13.50	13.50
<b>Moly revenues</b>	<b>\$33</b>	<b>\$112</b>	<b>\$126</b>	<b>\$126</b>
Mining costs: \$/ Cu lb.	1.40	1.10	1.18	1.25
Mining costs: \$/Mo lb.	10.00	7.25	7.50	7.50
<b>Sales (US\$)</b>	<b>\$100</b>	<b>\$252</b>	<b>\$290</b>	<b>\$290</b>

Sources: ML CN, Churchill Research estimates

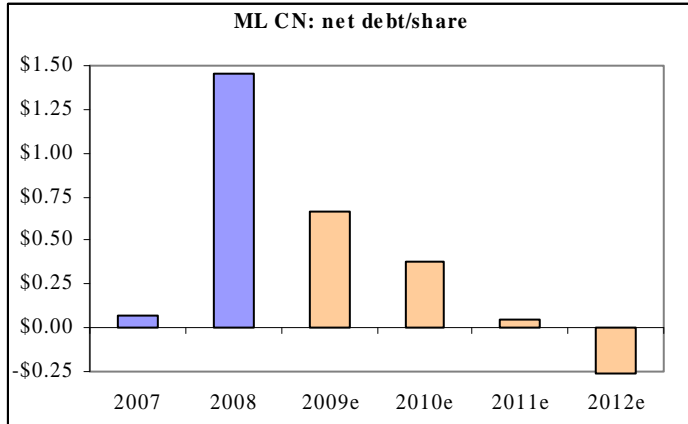
4) From the outset, Mercator's plan has been to build its mill complex in two phases. Phase I (the construction of a 25,000-30,000 tpd mill) is now complete. Moreover, the process of completing Phase I actually included 70% of the work needed to complete Phase II (which is the increase to 50,000 tpd). In our model we assume Mercator issues more shares to fund the Phase II expansion by year-end.

5) Mercator has done several financings in recent months and now has 141 million shares outstanding, plus another 10 million in warrants and options. In our model we assume the firm issues 30 million additional shares this year. That would bring the average share count for this year to 156 million, and the year-end 2009 share count to 171 million.



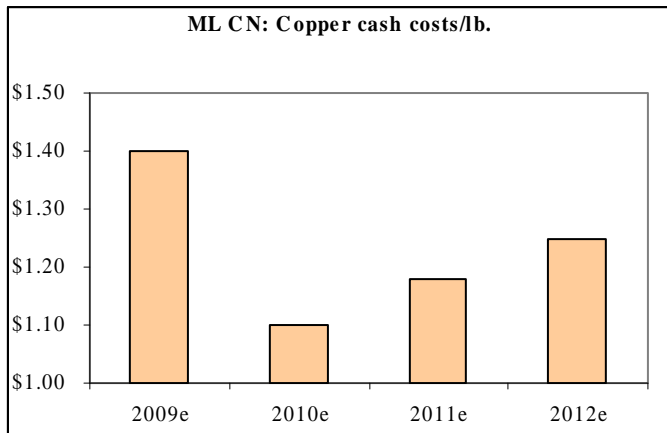
Why so much dilution? Because Mercator still has a hefty debt load. At year-end 2008, the firm had US\$112 million in debt and just \$3 million in cash. It has already flirted with violating debt covenants so new funds really will need to come from the equity market now.

As the chart below shows, capital raisings are helping to reduce the debt level on a per-share basis. By year-end, we foresee debt of US\$0.67/share. That will look okay if the share price is \$1.00+. Put differently, if current metal prices hold, Mercator will survive its brush with bankruptcy.

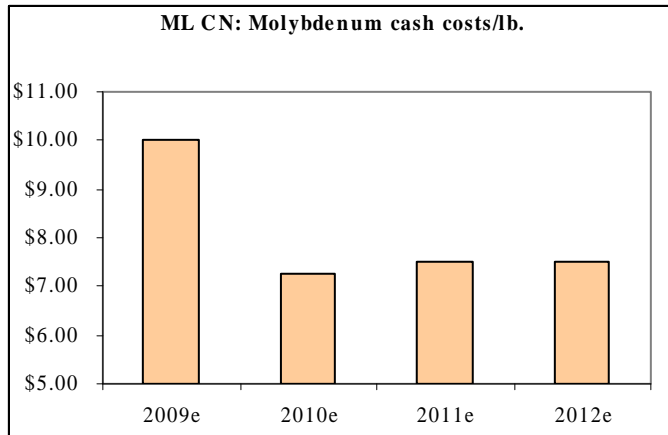


6) Mineral Park is projected to have fairly low cash costs. Management expects copper cash costs of around \$1.10/lb. at the current production rate -- and even lower costs as production ramps up toward 50-60 million lbs. late in 2009. For moly production, costs are expected to start at \$8.10/lb., and to fall as production increases. (Copper and moly are being scored as co-products in the income statement, and mining costs are being split evenly between the two.)

In our model we take a more conservative approach, assuming significantly higher costs this year (\$1.40/lb. for copper), a drop in costs in 2010 (as production increases), and a re-acceleration of costs in 2011 and 2012 on higher input prices. Here are our copper-cost forecasts:

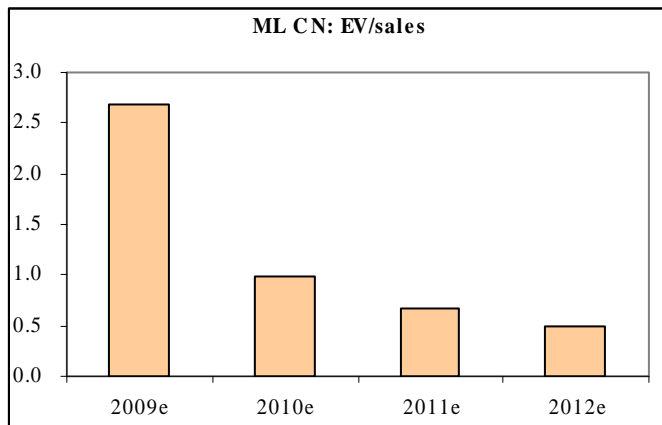


Here are the moly cost forecasts:



Management's forecasts for costs/lb. seem reasonable given the bi-metallic nature of the project, the low strip ratio, the new mill equipment and the presence of silver credits (which should offset \$4-5 million/year of costs). If ML's operating costs were indeed to rise sharply, it would probably be in the context of a broader commodity-price inflation that would carry copper and moly prices up as well.

7) If all goes according to plan, Mercator will have an EV/sales ratio of about 1x by the end of 2010. That is fairly inexpensive for a miner with a cost structure and asset base like Mercator's.



8) Here is our income statement. The 2008 results look terrible (loss of \$0.38/share), but this is a function of accounting policies for pre-commercial-production mines as well as a bit of inventory storing. (Mineral Park actually produced 10.2 million copper lbs. last year, via an SX-EW mill.)

**ML CN: Income statement items**

	2008	2009	2010	2011	2012
Sales (US\$ mlns.)	29.0	99.9	252.4	290.3	290.3
Cash COGS	28.0	82.5	133.3	140.4	144.6
Depreciation	2.0	5.0	12.6	14.5	14.5
SGA	14.0	13.0	16.0	19.0	22.0
Op income	(15.0)	(0.6)	90.4	116.3	109.1
Interest	13.6	15.0	12.0	6.0	0.0
Tax	0.0	(5.3)	26.7	37.5	37.1
Net income	(28.6)	(10.3)	51.8	72.8	72.0
Shares (dil.)	74.7	156.0	175.0	178.5	181.5
EPS	(0.38)	(0.14)	0.30	0.41	0.40
Capex	(131.3)	(65.0)	(15.0)	(10.0)	(10.0)
FCF	(2.11)	(0.45)	0.28	0.43	0.42

Sources: Churchill Research estimates

9) Valuation: Our price target of US\$2.04/share is based on a 5x multiple to expected 2011 earnings of \$0.41/share. The target P/E is low because the leverage is high and there are many uncertainties in the story. In particular, copper and moly prices *need to rise* for Mercator to make our forecasts. If, on the other hand, the current spot prices for copper and moly prevail in 2010 (\$2/lb. and \$8/lb. respectively), Mercator would earn just \$0.09/share next year.

10) Additional risks:

- a) The copper price may roll over and the moly price may continue to slide. Mercator probably needs \$1.75 copper and \$8 moly to service its debt and raise money for expansion;
- b) Copper and moly prices may not rise up to our 2010-12 forecasts;
- c) Management may not be able to (or may choose not to) fund the expansion of Mineral Park to 50,000 tpd. Another possibility would be that expansion is pushed back to 2010. Either scenario would jeopardize our 2010 estimates;
- d) Cash costs may exceed our forecasts.

The Classical Insights portfolio holds Mercator.

Mike Churchill

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