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A Closer Look at Nickel: An Unsustainable Current Reality?

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As contrarian opportunities go, nickel offers an interesting case study. Throughout much of 2014, nickel market participants were almost universally bullish based on the Indonesian government's plan to ban exports of nickel-bearing laterite ore. Nickel ore exports from Indonesia account for approximately 15% of global supply, so any curtailment in exports would have a material effect on pricing. It was also believed that other metals including tin would follow suit.

As China, the main destination for global nickel supply, had no real options to satisfy its insatiable demand (the Philippines is an exporter but on a smaller scale), the belief was that upward price pressure on nickel would ensue. While there was a rally after the ban went into effect, it was not sustained.

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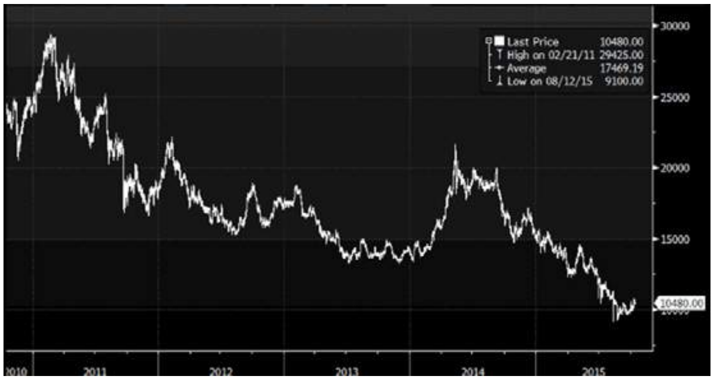


Source: Bloomberg

As the data above shows, this bullishness was premature. A closer examination of Chinese port data has revealed ample nickel metal stocks. Exacerbated by China's economic slowdown, excess supply exists in the nickel market today and has driven the 3 month nickel price to a $10,480 per tonne on the LME ($4.76 per pound), a decrease of 30.83% YTD as of October 14, 2015. The chart below shows nickel's performance relative to other base and precious metals in 2015.

Precious	2Day	Price	Net Chg	%Chg	Time	%YTD	%YTDCur
1) Spot Gold		1185.24	+1.12	+0.09%	20:52	+0.07%	+0.07%
2) Spot Silver		16.13	+0.00	+0.00%	20:51	+2.67%	+2.67%
3) Spot Platinum		996.00	-2.25	-0.23%	20:51	-17.55%	-17.55%
4) Spot Palladium		701.67	+1.58	+0.22%	20:50	-12.03%	-12.03%
5) COMEX Gold	d	1185.40	+5.60	+0.47%	20:42	+0.09%	+0.09%
6) COMEX Silver	d	16.13	+0.01	+0.08%	20:42	+3.63%	+3.63%
7) COMEX Platinum	d	998.00	+2.60	+0.26%	20:41	-17.42%	-17.42%
8) COMEX Palladium	d	701.90	+1.05	+0.15%	20:17	-12.09%	-12.09%
Base							
9) LME 3mth Aluminium	d	1593.00 y	-1.00	-0.06%	10/14	-14.01%	-14.01%
10) LME 3mth Copper	d	5299.00 y	+26.00	+0.49%	10/14	-15.89%	-15.89%
11) LME 3mth Zinc	d	1817.00 y	-3.00	-0.16%	10/14	-16.57%	-16.57%
12) LME 3mth Nickel	d	10480.00 y	+5.00	+0.05%	10/14	-30.83%	-30.83%
13) LME 3mth Lead	d	1793.00 y	+16.00	+0.90%	10/14	-3.50%	-3.50%
14) LME 3mth Tin	d	16100.00 y	+200.00	+1.26%	10/14	-17.01%	-17.01%
15) COMEX Copper	d	241.60	+0.05	+0.02%	20:41	-14.49%	-14.49%
16) Shanghai Copper	d	39940.00	+230.00	+0.58%	12:59	-14.91%	-16.78%
17) Shanghai Zinc	d	14545.00	+50.00	+0.34%	12:59	-12.83%	-14.75%
18) Shanghai Aluminium	d	11355.00	-60.00	-0.53%	12:59	-13.06%	-14.97%
19) Shanghai Steel Rebar	d	1831.00	-2.00	-0.11%	12:59	-33.64%	-35.10%

Source: Bloomberg

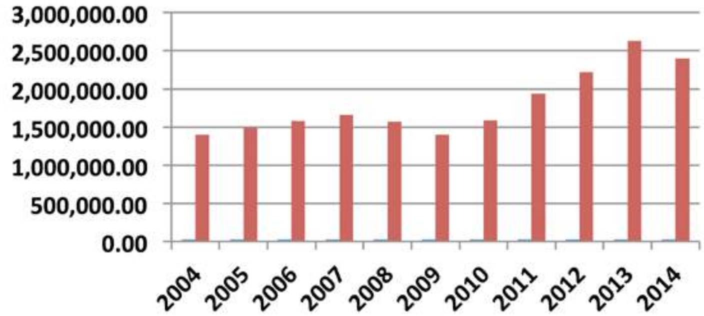
With current production of approximately 2M t per year as per the metals consultancy CRU, the nickel market is roughly $34 billion in size owing primarily to nickel's use in stainless steel. Nickel is certainly one of the most ubiquitous metals, but a build-up of capacity must be worked off before higher nickel prices can return, and along with it, the incentive to explore for future supplies.

	2013	2014	Reserves
United States	NA	3,600	160,000
Australia	234,000	220,000	19,000,000
Brazil	138,000	126,000	9,100,000
Canada	223,000	233,000	2,900,000
China	95,000	100,000	3,000,000
Colombia	75,000	75,000	1,100,000
Cuba	66,000	66,000	5,500,000
Dominican Republic	15,800	NA	930,000
Indonesia	440,000	240,000	4,500,000
Madagascar	29,200	37,000	1,600,000
New Caledonia	164,000	165,000	12,000,000
Phillipines	446,000	440,000	3,100,000
Russia	275,000	260,000	7,900,000
South Africa	51,200	54,700	3,700,000
Other Countries	377,000	410,000	6,500,000
TOTAL	2,630,000	2,400,000	81,000,000

Source: USGS

Nickel production has remained steady as per the USGS:

GLOBAL NICKEL PRODUCTION IN METRIC TPY



Source: USGS

The increase in production since 2009 is likely due to a number of factors, including additional production capacity built up in the earlier part of the decade.

WHAT CHANGED THE BULLISH THESIS?

There are several answers to the above question. Perhaps the most surprising was the inability of nickel to sustainably rally after the Indonesian laterite export ban went into effect. The increase in nickel stocks on the LME shown below has acted as a "cap" on the price and has delayed a price recovery.

Source: Bloomberg

Nickel stocks at the LME are just off their all-time high of 470,376 tonnes set this past summer. While the trend has peaked, we await an identifiable turn.

Other factors affecting nickel prices (as well as other commodities) include the strong US Dollar. The USD has appreciated by 6.2% in 2015 and is up by 12% on a year-on-year basis. With the Federal Reserve recently declining to raise short term interest rates, the USD rally has slowed and experts are divided on the future path for the currency.

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Source: Bloomberg

With nickel effectively a "dollar denominated" commodity, the USD strength has made it relatively more expensive on world markets. However, the overwhelming amount of nickel produced in non-USD as well as a lower oil price means nickel has been relatively cheaper to produce, adding to existing supply.

Slack demand for nickel pig iron, a cheaper alternative to pure nickel used in stainless steel production is also widely believed to be responsible for the downward pricing pressure.

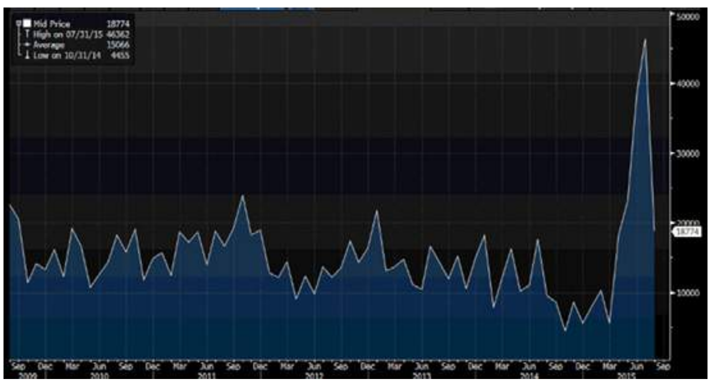
This has all led to an environment of slight excess nickel supply globally. This is likely to reverse once the Indonesian export ban is felt.

NOTHING CURES LOW PRICES LIKE LOW PRICES

According to Norilsk Nickel CEO Vladimir Potanin, roughly 60% of the nickel industry is operating at a cash loss as of the end of August 2015. For the sake of reference, about 50% of global nickel supply is not profitable at $5.23 per pound as per Wood Mackenzie in Q1 2015.

This situation is unsustainable and we would expect to see expansions halted or reviewed and high cost nickel supply erased from the market. Any new nickel project development will only move forward in an environment of a substantially higher nickel price. This allows for a higher project IRR. The paradox is that the current nickel price, while harming balance sheets and discouraging growth, is sowing the seeds for higher nickel prices in the coming years and along with it, additional exploration and development.

Regarding the China demand story, we found the following chart of Chinese refined nickel imports surprising:



Source: Bloomberg

We view the above chart as constructive in that it may go some way to explaining the current state of the nickel market. Given the low nickel price, one must assume that China is taking advantage of this by stockpiling metal. Additionally, a nickel contract is now traded on the Shanghai Futures Exchange and the imports represented above could be used for physical delivery of the Shanghai nickel futures contracts where appropriate. It has been confirmed that these imports are coming mainly from Russia as the Indonesian ban remains in effect and ore from the Philippines is limited.

In order for a new equilibrium to return to the nickel market, we see a key question that needs to be answered:

How soon will the downstream processing capacity in Indonesia be built out?

Mining officials in Indonesia announced that $2.4 billion had been committed towards the building of eleven nickel smelters in the country since the ban went into effect. These smelters need a nickel price of $15,000 per tonne to break even, but as this comes on stream in phases, you would expect the supply overhang to diminish as demand remains steady. PT Sulawesi Mining Investment, a joint venture between Star Group Eight and Tsingshan Holding Group (China's second largest stainless steel company), will reportedly invest $1.04 billion for the second of a three phase project to grow nickel pig iron (NPI) capacity in Indonesia. The planned capacity is 600,000 tons per year. This is on top of a first phase of the project for 300,000 tpy at a cost of $635.56 million. We view these sums as significant and another forward-looking positive sign.

The oversupply in the nickel market is likely to continue until the smelting capacity is in production, though Norilsk sees a deficit to the tune of 60,000 tonnes returning to the market as soon as 2016. This is primarily dependent on the drawdown of nickel stocks at the LME and a resurgence of demand for NPI in China.

THE MARKET PARTICIPANTS

Given the size of the nickel market and its uses in the global economy, there is no shortage of current and aspiring production stories in the nickel space. From a producer perspective, the current landscape is quite similar to other metals: a halt to exploration and a rather severe cutback to production or planned expansion until some stability returns to the market. Norilsk Nickel, the largest nickel miner in the world is deep in the throes of a "capital discipline" program, but has still found the time (and capital) to implement a share buyback program worth over $150 million USD since June. This is in addition to a dividend program worth over $2.1 billion USD in 2014. If the largest nickel miner in the world sees the best way to reward shareholders being share buybacks and dividends versus organic growth, we think these actions are more telling than any spin in a press release.

NAME	Ticker	Market Cap	Stage
Independence Group NL	IGO	1.682B AUD	Development
Polymet Mining	PLM	215.7M USD	Development
Noront Resources	NOR	80.5M CAD	Development
Balmoral Resources	BAR	61.8M CAD	Development
Poseidon Nickel	POS	42.5M AUD	Development
North American Nickel	NAN	37.2M CAD	Exploration
Royal Nickel	RNX	32.1M CAD	Development
Wellgreen Platinum	WG	25.8M CAD	Development
Sama Resources	SME	19.9M CAD	Exploration
Metals X	MLX	620.7M AUD	Development
Equitas Resources	EQT	13.8M CAD	Exploration
Wallbridge Mining	WM	5M CAD	Development
Nickel One*	NNN	3M CAD	Exploration

Source: Bloomberg, Company Docs; IGO to commence trading on 9/23; *Public listing imminent

The nickel "majors" are all well known and include Norilsk Nickel, Glencore, BHP Billiton, Sherrit, Lundin Mining, First Quantum, and Talvivaara. However, there likely rests a longer-term opportunity in those companies that could be ready to either actively contribute to nickel supply once the market definitively turns or companies which have made legitimate discoveries and have the potential to contribute to growing demand for nickel in the future. Some of these companies are listed in the chart above.

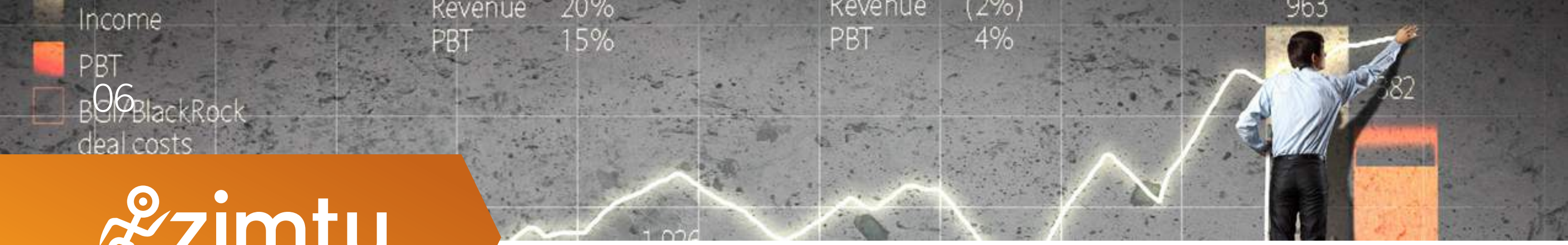
Ultimately, we think it is the behavior of the producers that will sow the seeds for the resurgence in nickel as available and future supply may not be able to keep up with steady demand. Market participants we have spoken with believe the market could tip into deficit as early as 2016. The forecast deficits range from 35,000 to 70,000 tonnes.

CONCLUSION

Until the excess capacity in the nickel market is effectively soaked up, this will remain a market under pricing pressure. The keys going forward will be to watch Chinese import figures, watch for the drawdown of stocks on the LME, and watch for the pace of the processing build out in Indonesia. The relative success or delay of these three factors will chart the future direction of the price of nickel.

With so much of the current global nickel supply operating at below its respective cash costs, existing producers will continue to retrench and take supply off the global market. Norilsk and Glencore are only two examples of companies who are suddenly focused on "balance sheet optimization".

One would think that those companies brave enough to be developing early stage nickel deposits at this point in the commodity cycle could fill the gap of lost production in coming years. This is of course all subject to a rebound in the nickel price. This rebound could commence as early as next year as the Indonesian laterite ore ban makes itself felt. Only time will tell.



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While China's economy is slowing, we argue that it is also maturing. This has implications for the metals and commodities which are better positioned given the country's maturation. While "early cycle" commodities such as iron ore have been under pressure for a number of reasons, "mid" or "late" cycle metals should arguably perform better going forward. We would submit that nickel is one such late cycle commodity and is better positioned relative to other metals.

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