EUREKA report

Santos steps up

By Tim Treadgold
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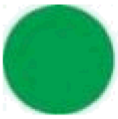
PORTFOLIO POINT: Santos could soon take the mantle from Woodside, Norseman lifts production and why nickel is a no-go.

Minefield is not about share tipping; rather it is about those stocks with a good story to tell but which are struggling for oxygen in a very crowded market. There will be no outright recommendations, but a simple measuring tool in traffic light colours: Green for “good”; amber for “proceed with cautious confidence”; red for … well … caveat emptor (let the buyer beware).

Here are some stocks that have slipped through the cracks.



Santos (STO)

Santos has been playing second fiddle to its bigger oil and gas cousin Woodside Petroleum for the past 20 years, but from an investment perspective that might be about to change.

Both companies have been sold-off substantially in recent weeks, as concern grows about a poor outlook for energy prices, and about the potential for political interference in some of their major projects.

Between June 30 and the close of business on Friday, Woodside had fallen by 13.5% from $41 to $35.44. Santos was down 18.3% from $13.54 to $11.07. Both have probably fallen too far, too fast, in a market reeling from European and US debt shocks.

Woodside has environmental protestors camped outside its James Price Point construction camp, is struggling to make headway with the government of East Timor over its Sunrise project, has failed to deliver the Pluto liquefied natural gas project on time, and has an “under new management” sign on its front door.

Santos has just been hit with a worrying outbreak of sovereign risk at the Papua New Guinea LNG project, in which it is a minority partner, and has environmental protestors crawling over its emerging flagship project, the Gladstone coal-seam methane LNG project in Queensland.

Under normal circumstances – and these are far from normal – Woodside is the unquestioned leader of Australian LNG. Santos, which has suffered from a reputation of being run as an agency of the South Australian government, is a relatively new player in LNG and has spread its exposure more widely than Woodside.

Over the next few months investors should take a fresh look at the cautious growth profile of Santos, which will be a minority partner in a series of LNG developments, while Woodside tries to get a grip on its mega projects and might be forced to sell an interest in some projects such as Browse, which could have a final price tag up to an indigestible $40 billion.

Over the next three years, Santos will see a series of new projects come on line, including first oil from the 31.9%-owned Chim Sao field in Vietnam (next month), first gas from the 45%-owned Devil Creek processing centre in WA (by Christmas), first LNG from the 13.5%-owned PNG/LNG project (in 2014), and first LNG from the 30%-owned Gladstone project in 2015.

That spread of assets, together with existing interests in the Darwin LNG project (11.5%), offshore WA oil and gas fields, and the company’s core interests in the Cooper Basin of South Australia is the biggest difference with Woodside, which has fewer, but bigger assets.

Santos is also sitting on a potential game-changer in the shale gas potential of its big tenement position in the Cooper Basin. In last week's announcement of a 13% increase in underlying profit to $236 million for the six months to June 30, no mention was made of Cooper Basin shale despite another explorer in the same location, Beach Energy, reporting an eye-catching inaugural resource of two trillion cubic feet of gas.

Interestingly, major investment banks continue to rate Woodside more highly than Santos. Goldman Sachs has Woodside as a buy and Santos as a hold. More interestingly, it is tipping a 12-month share price target for Woodside of $51.20 (44% higher than recent trades), while tipping a target of $16.20 for Santos (up a potential 49%).

Norseman Gold (NGX)

Norseman has been tackling one of the toughest jobs in Australian gold mining: how to make consistent profits from the old and "nuggety" gold fields around its namesake town south of Kalgoorlie in WA.

First mined as far back as 1894, the Norseman fields show similarities to those of Bendigo and Ballarat in Victoria, with pockets of rich gold spread between areas of low-grade.

The nature of the gold, often in small nuggets, makes it almost impossible to produce a detailed resource and reserve estimate that satisfies modern geological (and banking) reporting requirements.

What's needed at Norseman is a large amount of capital to increase the number of mine "faces" that can keep ore flows to the processing facility – what's known as a "keep the mill full" approach – but one that has eluded several phases of mine management, until, perhaps, now.

A hint of the improvement underway at Norseman came in the June quarter report, which featured increased production (11,781 ounces in the March quarter, up to 15,001 in June) and a cash cost that fell from a totally unacceptable $A1492 to a still high $A1081 an ounce.

Norseman's managing director, Barry Cahill, acknowledges the challenge of revitalising the Norseman gold fields but says the plan now in place will ensure a more reliable flow of material from a blend of high, medium and low-grade ore bodies. Additional sources of ore will give management greater flexibility.

Cahill, who has been stung by previous production and cost forecasts that have come unstuck, says the target is to get over the 100,000 ounce-a-year mark, and get costs down into the $A700–800 an ounce range, numbers that once looked high but now equate to a margin of close to $A1000 an ounce.

Uranex (UNX)

As its name implies, Uranex is exploring for one of the investment world's least favourite metals, uranium, with the key difference between it and a fistful of other hopefuls in a troubled sector of the mining industry being the quality of the discovery.

At the Mkuju prospect in Tanzania, east Africa, Uranex has found what looks to be a world-class uranium deposit with grades consistently above 1000 parts per million (0.1%), which is close to double the ore grade at Extract Resources (EXT) Husab project in Namibia.

In one drill intersection, a 24 metre section assayed 836ppm, but included 4 metres at 3064ppm and 1 metre at 4961ppm.

That announcement, at the height of last week's market downturn on August 12, sank without trace. By the close of business on Friday, Uranex had slipped from 42¢ to 40¢.

Difficult as it is for investors to develop any enthusiasm for uranium, given Japan's nuclear meltdown, and the fact that the short-term price of uranium has slipped to around $US50.50 a pound, there will always be interest in any high-grade mineral discovery.

Mkuju's location, Tanzania, is also a good one, with that country keen to encourage a uranium mining industry to complement its big gold mining sector.

This also a bonus with Uranex. Alongside Mkuju is a promising coal discovery called Songea, near the eastern bank of Lake Nyasa, where outcropping seams of coal have been identified on the company's 3500 square kilometre package of tenements in an area known as the Ruhuhu Basin, which is host to 11 recognised coal fields.

Uranex's business plan over the next 18 months is to take Mkuju and Songea through to scoping studies while seeking buyers for two other uranium projects, Manyoni (also in Tanzania), and Thatcher Soak (in WA).

Nickel

In the **June edition of Minefield** a few eyebrows were raised when I suggested selling down a whole sector, those companies proposing to mine and treat low-grade magnetite iron ore.

It wasn't a bad call, with three stocks mentioned, Gindalbie (GBG), Grange (GRR) and Murchison Metals (MMX) all continuing a decline that started earlier in the year, and are lower again today.

There is a second sector in trouble for a slightly different reason. Whereas the magnetite hopefuls are in strife because of soaring costs in Australia and a flood of cheaper iron ore hitting the market over the next few years, the nickel miners are already being clobbered by over-production.

The nickel problem is a peculiar one that will fade over time, but right now there is a booming trade in low-grade dirt called "pig nickel" being shipped to China from the Philippines and other island countries of the Pacific.

Pig nickel (or nickel pig iron) is essentially raw ore grading little more than 1% nickel stripped by whatever environmentally destructive manner available, shipped, and processed in China, under-cutting conventional nickel producers everywhere else.

The result is a severely depressed nickel price, which has fallen from $US13.20 a pound just six months ago to about $US9.80, roughly where it was three years ago. On conversion to an Australian dollar price, nickel is down from around $A12.80 to $A9.40 a pound – reducing most local miners close to their break-even price after all costs are factored in.

In time, the pig nickel business will be shut down on environmental grounds, but before that happens it will do a lot of damage to local producers such as Mincor (MCR), Panoramic (PAN) and Independence (IGO), all of which, very significantly, see gold rather than nickel as their growth opportunity.

As for one of the more courageous investment decisions made in Australian mining over the past decade, the redevelopment of BHP Billiton's failed Ravensthorpe Nickel by Canadian-listed First Quantum Minerals, the jury is out – even though the nickel is almost in!

First Quantum paid $US340 million for Ravensthorpe and has sunk another $US190 million into its redevelopment over a 21-month period during which the nickel price has sunk and Australian costs have soared.

Restarting Ravensthorpe, which is underway now, will be closely watched by the mining industry, which is dreading the arrival of another 28,000 tonnes of metal a year from the mine, if it performs as promised.