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Hallgarten & Company

Position Coverage

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HudBay Minerals

Strategy: Upgrade to Neutral

Key Metrics			2009	2010e	2011e
Price (CAD)	$ 10.53	Consensus EPS		n/a	n/a
12-Month Target Price (CAD)	$ 11.00	Hallgarten EPS		$0.56	$0.52
Upside to Target	4%	Actual EPS	$0.73		
High - Low (12 mth)	$5.35-16.24	P/E	14.3	18.9	20.3
Market Cap (CAD mn)	$ 1,698.1	Dividend	n/a	n/a	n/a
Shares Outstanding (millions)	154.4	Yield	0.0%	0.0%	0.0%

HudBay

Capitulation by the market's *naïfs*

- \+ Valuations have come back down to levels that prompt us to close our Short position in the Model Mining Portfolio and rate the company a Neutral
- \+ It has a stash of cash that now amounts to over CAD$900mn and is seemingly clueless on what to do with it.
- \+ Company has been buying back stock (in a falling market) which at least is better than sitting on its cash pile ad infinitum
- \+ The nickel assets may finally attract some more attention from potential buyers
- ✘ The recent results looked OK but then one notes that copper was held over from 4Q09 and sold in 1Q10 when prices were higher. This cannot be repeated.
- ✘ The company still faces the danger that it may have to pay $100mn or more in damages and back payments to Callinan for its long-term failure to report and pay NPI
- ✘ The company has a preponderance of downstream assets that make it a quasi-industrial entity. Many of these are in shutdown mode or shortly to be.
- ✘ The company has declining volumes of production in every category of metal

Dream On

Market talk has it that there are still some hedge fund and arbitrage types out there that think that HudBay will be taken over. We suspect that if one asked them who the foolish party might be to undertake this venture they would be at a loss for words. Try as we might we cannot think of any major that would cough up $2bn to buy a company which:

- ➢ has a principal asset (FlinFlon) that expires in 2019
- ➢ that faces a long-standing and intractable lawsuit from Callinan Mines (CAA.v)
- ➢ has a nickel mine project where nothing is going on
- ➢ has a $900mn cash pile
- ➢ has no CEO
- ➢ a board with mass-onset narcolepsy

At price levels prevailing late last year when we instituted a Pairs Trade (Long CAA/Short HBM) in the Model Mining Portfolio any buyer would have been paying a mighty premium cash. This is not something major miners do. Or at least not if they want to stay major miners.

Background

HudBay is an "institution" (in all senses of the word) in the largely depleted mid-tier space in Canada. It almost has the look of a museum specimen of what a diversified miner on Bay Street looked like for decades. The carnage in the ranks of major Canadian miners has left HudBay as a lonely survivor, with Teck being its only “lookalike” out there.

The company was founded over 80 years ago and has mainly had a focus on base metals. The current time finds it at a transitional moment with several major assets having run the course of their natural lives and several new production assets being still in construction (or suspension thereof).

Recent results

Company reported strongly improved results over 1Q09 with net profit after tax of CAD23.5mn vs a loss of CAD3.9mn in the year earlier period. The company attributed this to higher copper prices and lower admin costs

We would note however that the company sold heavily from inventories (see table below) particularly in copper that did not make apparent some fairly massive declines in production volumes, particularly in silver.

		1Q10	FY09	4Q09	1Q09	FY08	4Q08
Production							
Zinc	tonnes	27,011	106,782	28,715	25,640	125,323	25,943
Copper	tonnes	11,725	58,551	12,501	16,239	74,682	18,859
Gold	troy oz.	20,764	91,357	22,774	21,262	108,527	30,102
Silver	troy oz.	209,360	2,006,638	473,028	564,875	2,293,862	702,173
Metal Sold							
Zinc	tonnes	29,766	110,070	29,299	26,949	126,172	25,907
Copper	tonnes	15,881	59,981	8,864	16,191	77,021	18,272
Gold	troy oz.	27,507	94,263	19,342	28,624	103,511	32,760
Silver	troy oz.	456,704	2,185,407	474,195	606,031	1,870,179	667,035

Cash now exceeds CAD$900mn.

Earnings Outlook – Q1 was the high water mark

Our earnings outlook for FY10 is shown in the table at the end of this note. The first quarter was clearly a high water mark because of the shifting of copper revenues from Q4 of the previous year into the March quarter when copper prices were at what will probably be their highest levels of FY10. From here it’s all downhill. Production volumes are declining and prices of zinc and copper are well off. Surprisingly gold is holding up well. Thus for the rest of FY10 we see lower average quarterly revenues and a full year sales number of CAD$785mn with a net revenue of CAD$86mn representing 56 cts per share.

Spotlight on Nickel in Guatemala

One interesting part of HudBay that it seems incapable of articulating a clear strategy on is its nickel interests in Guatemala. Despite this incoherence the potential value of this asset becomes apparent through the IR efforts of a competitor, Anfield Nickel (ANF.v) rather than through any efforts of HudBay itself.

HudBay owns 98.2% of the Fenix brownfield nickel laterite project in Guatemala with Measured and Indicated resources of 36.19 million tonnes of 1.92% nickel contained in saprolite in an open-pit mine. This asset came on board through the merger with Skye Resources (an expensive and ill-timed all stock deal worth around $450mn) in August 2008. The mine has been mothballed since 1980. The existing 25 million pound per year process plant is slated to be upgraded to approximately 50 million pounds and the process flowsheet will consist of a coal-fired dryer, two calcine/reduction kilns, a 90 MW electric arc furnace, and a ladle refinery to produce a 35% ferro-nickel product. The existing process plant was well maintained and many of the components will be reused. The dryer, one kiln, and the refinery will be new. The stated plan is to upgrade the existing furnace with new technology to achieve the required capacity.

Production over the 30-year project life is estimated to be 1.3 billion pounds of nickel. The average production for the first 20 years after start of full production is planed to be 48.5 million pounds per year of nickel contained in ferro-nickel. The saprolite grades at 1.63% nickel.

Due to the nickel price slump the company limited expenditures in November 2008 until economic conditions improve, HudBay continues to explore lower cost power supply solutions and transportation options, and to develop infrastructure, such as upgrading the access road. In the most recent results notice the company talked of more resource drilling which is a classic Canadian stalling tactic. Not much information is available on just how much the rejuvenation of the existing plant will cost.

Hudbay claims that Fenix is a significant nickel project and a key growth opportunity. We are firmer in our nickel sentiments now than we were last year and see potential for nickel to top $10 again (it recently hit $12.50 per lb) before its recent slippage. While we are fans of Mirabela Nickel in Brazil, its project is on the verge of production and relatively bite-sized capital wise. Felix is a much larger proposition and faces the potential to be coming into production just as some of Vale's mega-projects like Goro start churning out product.

In light of the difficult reputation Guatemala has (maybe unjustly) the company has busied itself by involving the local community and all levels of government to ensure the project is perceived to benefit the people of Guatemala. The chief problem at the project now is an upwelling of local protestors. The exact nature of their grievances is unclear and we would not discount plain old blackmail. We hear that it has more to do with rough treatment handed out to communities by Skye's contractors more than any actions that HudBay may have taken. A more problematic note was injected into the problem when a pitched battle with the police last year that left one of the usurpers dead.

Despite these negatives we are feeling bullish towards nickel. The heavy promotion of Anfield Nickel, a Ross Beatty Group company, whose Greenfield prospects surround HudBay's much more advanced (and infrastructure-rich) project makes us think that Fenix is worth a multiple of Anfield Nickel's current market cap of around $90mn, with the Chinese being the obvious buyers. Despite this we still feel it is highly unlikely that HudBay would recoup the money spent on this acquisition back in 2008. We also feel that HudBay are just marking time on this one in the hope that a buyer takes it off their hands.

Conclusion

The obvious transaction for HudBay is to take over Polymet once the political risk has been wrung out of this protracted permitting process. HudBay has missed the boat on a whole boatload of cheap copper production stories by being immobilized at the nadir of the markets in late 2008 and early 2009. It could have purchased three of the world's mid-tier copper producers with its cash pile and had change left over. That is reason enough for the board at HBM to be summarily fired (yet again).

HudBay is most definitely not a Buy. Maybe if it were to fall another $2 in price we might consider it. However in the short-term the Short call of last October has proven to be a bonanza and having this week crossed our target covering point of $11 we have resolved to cover the Short position in the Model Mining Portfolio and upgrade the stock to **Neutral** with a 12-mth target price of $11.

HUDBAY MINERALS CAD $ (millions)	FY11e	FY10e	1Q10	FY09	4Q09	3Q09	2Q09	1Q09	FY08	4Q08	FY07	FY06	FY05
Total Revenue	**755.00**	**785.00**	**240.842**	**720.722**	**194.608**	**194.608**	**197.66**	**161.78**	**981.89**	**178.78**	**1,269.84**	**1,129.00**	**652.03**
Cost of Revenue, Total	515.00	533.00	144.842	505.84	105.89	119.30	145.54	135.1	685.62	155.59	730.75	598.05	479.23
Gross Profit	**240.00**	**252.00**	**96.00**	**214.88**	**88.72**	**75.31**	**52.11**	**26.68**	**296.28**	**23.19**	**539.09**	**530.95**	**172.79**
Selling/General/Admin.	41.00	24.00	5.949	48.868	17.575	8.23	8.85	15.325	46.38	11.65	33.45	28.65	22.23
Depreciation/Amortization	97.00	103.00	27.359	100.73	27.65	28.82	23.22	21.03	88.3	20.31	94.70	64.93	53.1
Forex loss	0.00	8.00	4.875	17.75	1.44	6.90		-5.25					
Other Expense (Income)	2.00	3.00	1.21	4.49	1.15	1.11	-	1.113	30.43	3.2	20.17	20.07	1.28
Total Operating Expense	655.00	671.00	184.235	164.365	164.365	164.365	193.86	167.323	833.96	161.69	934.71	712.89	569.47
Operating Income	**100.00**	**114.00**	**56.085**	**556.357**	**30.243**	**30.243**	**3.8**	**-5.539**	**147.94**	**17.09**	**335.13**	**416.12**	**82.56**
Gain (Loss) on Sale of Assets	0.00	0.00	0	0.92	-0.46	0.22	-	-0.626	-	-	0	1.66	-
Exploration expense	7.00	21.00	5.755	7.61	3.99	0.98	1.58	1.05	25.58	5.7	33.07	12.31	11.28
Interest & other income	14.00	9.00	2.028	107.39	1.15	3.33	100.966	1.94	0	0	0.32	0.49	4
Income Before Tax	**114.00**	**123.00**	**52.365**	**141.90**	**9.67**	**32.80**	**104.7**	**-5.28**	**169.65**	**24.61**	**365.46**	**442.45**	**74.42**
Tax	33.06	36.90	28.806	29.13	2.33	12.83	15.28	-1.32	96.3	8.79	138.32	-121.54	-10.8
Net Income	**80.94**	**86.10**	**23.559**	**112.77**	**7.34**	**19.98**	**89.42**	**-3.96**	**73.35**	**15.82**	**227.14**	**563.99**	**85.22**
Diluted Weighted Average Shares	156	154.8	154.375	153.46	153.443	153.443	153.82	153.03	136.71	153.56	128.51	120.33	84.77
Diluted EPS	0.52	0.56	0.153	0.73	0.05	0.13	0.58	-0.03	0.54	0.1	1.77	4.69	1.01
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