

SEP 7 1976

Canadian Investment Letter

Vol. 36, Folio 36

INVESTMENT COUNSEL — SINCE NINETEEN-FORTY

September 4, 1976

THE NICKEL INDUSTRY

The nickel industry is characterized by a number of large producers of which INCO remains the biggest. Traditionally the Sudbury area has dominated production but new sources of supply are originating from lateritic deposits, generally in countries with tropical climates such as New Caledonia, the Philippines and Australia. These mines possess enormous reserves but there are drawbacks.

TREND STATISTICS FREE WORLD NICKEL

(thousands of metric tons)

	Consumption	% Change	Refined Production	% Change
1971	397		484	
1972	432	8.8	459	(5.2)
1973	514	18.9	505	10.0
1974	548	6.6	563	11.5
1975	410	(25.2)	507	(10.0)
Av. Growth 1971-1974		11.4		5.2
1971-1975		0.8		1.2

Mining nickel from lateritic deposits is an energy-intensive process which drives up production costs and there are no profitable byproducts of other metals such as obtained from the sulphide deposits in Canada. The ability of nickel to offer corrosion resistance and strength in steel and other metal alloys leads to its widespread use. The largest consumers are the capital goods industries, machinery, automotive, transportation and construction. Nickel demand is closely tied to activity in the steel mills. A negative is the accelerating trend toward smaller cars under government pressure, which will likely reduce the amount of nickel required per unit in the automotive industry. On the favorable side, increased spending on energy and chemical facilities as well as rapid transit equipment, represent new sources of demand.

Although free world nickel consumption has historically grown at an average annual rate of 6-7% per year, demand took a sharp plunge in the recessionary environment of 1975. Consumption was down by about 25% with weakness evident in all sectors. There has been some recovery in 1976 in response to improving business conditions. The turn-

around in the steel industry has been encouraging. Car sales have been a bright spot while improvement has been noted in capital spending in the U.S. Generally, conditions remain far from buoyant. Consumer goods have been lagging, influenced by some slowing in the economic recovery, high unemployment and financing charges and lack of confidence.

In the face of evaporating demand last year, inventories reached record proportions at both the producer and consumer level. Generally, production was maintained, forcing the companies to increase stockpiles while absorbing sharply higher financing expenses. At the 1975 year-end, excess stocks on hand were double normal levels at about 5 months' shipments. Producer inventories continue high, probably still building in some cases. However, the latest U.S. statistics indicate favorable trends. Consumption is on the upswing although remaining well below 1973 and 1974 levels. Consumer inventories, which peaked 14 months ago, have shown steady reduction through the first five months of 1976 to near normal levels. The rise in producer shipments this year is expected to be moderate, with improved output forecast for 1977 as industrial activity throughout the world reaches a higher pitch.

Price Increase Expected at Year-end

Nickel prices have consistently advanced over the past decade, rising at an average annual rate of 11.4% over the 1970-1975 period. Surprisingly, supply and demand is not the dominant factor in nickel pricing. INCO is the pace-setter, establishing prices in relation to its expenses and profit margin trends. The current price is \$2.20 per pound compared with \$1.62 in 1974. Aggressive competition is currently leading to price discounting, but higher prices are required to cover costs and we expect INCO to initiate a further increase around the year-end. Looking ahead, we anticipate further price hikes to not only offset escalating operating and construction costs, but also to improve return on investment.

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Expansion must be encouraged if the anticipated nickel requirements of the 1980s are to be met. It is estimated that a price in excess of \$3.00 per pound is required to warrant new production commitments.

In assessing the outlook, it must be kept in mind that the industry traditionally lags GNP trends by a considerable margin. Statistics indicate that the worst is over and we expect nickel consumption to reflect the slow, gradual pace of the economic recovery in the major consuming countries, led by the U.S. Production should fall into better balance with demand in 1977. Basically exporters, the nickel companies are in a favored position under the AIB profit guidelines.

FALCONBRIDGE NICKEL (\$44) — One of the world's larger nickel producers, Falconbridge has been cutting back following declines last year in shipments of nickel (31%) and copper (23%). Net income dropped by 89% to 65c per share. The slump in demand and resulting inventory accumulation strained the company financially. Sudbury operations became unprofitable and the company last fall instituted a 33% reduction in nickel output, immediately after settlement of a 2½-month strike raised operating costs. The \$95 million smelter modernization program was suspended pending higher cash flow levels. Reduced demand for ferronickel also produced a production cutback at the Falconbridge Dominican operations.

Falconbridge with its substantial debt position amounting to \$255 million at the year-end, is struggling. Huge sums of money are required for its capital projects and methods of raising funds are restricted. To ensure that money is available, the company recently provided for the creation of three million special preference shares of \$25 par value.

A favorable tax development came last fall when the Ontario government ruled it would allow companies to deduct foreign processing costs from Ontario taxable income. For years Falconbridge has processed its nickel in Norway. Earnings rebounded from a loss of 16c per share in the first quarter to 75c in the second quarter, the highest level since the second quarter of 1974, in response to higher metals prices and improved deliveries. Strengthening markets should allow earnings to rise to above \$2 this year but we continue to favor INCO for investment exposure in the nickel industry.

INCO (\$32¾) — INCO is the leading nickel producer maintaining more than 40% of the free world market. The decision to retain production at high levels has resulted in a significant inventory buildup, as stocks on hand continue to advance, up 17% in the first six months from the 1975 year-end. The company has adequate financial strength to allow this inventory accumulation and will reap the benefits as demand firms. Signs of improvement in copper fundamentals are encouraging as INCO is an important producer, shipping 335 million pounds last year.

The acquisition program underway is designed to make earnings less cyclical and augment growth potential. ESB, a large U.S. battery manufacturer benefitting from better auto industry performance, contributed 29% of first half sales and appreciably higher profits. A new major battery plant is under construction for completion late in 1977. Daniel Doncaster, the English metals company acquired in August, 1975, accounted for 4% of sales. Several new projects have been announced, including a Sudbury plant for coinage to be completed in mid-1977, and a scrap processing plant in Pittsburgh.

The company is facing rising costs for energy and capital expenditures and a higher Canadian dollar but progress is occurring. Nickel deliveries in the second quarter rose to 105 million pounds, the highest level since 1974, up 47% from 71 million pounds in the first quarter. Profit margins are improving. Shipments are expected to remain strong through the third quarter as a result of the discount pricing arrangement for forward buyers. It is possible that INCO could further expand its share of the market this year. Additional capacity of 35 million pounds annually will come on stream shortly in Indonesia, with expansion to 100 million pounds per year scheduled for 1978. In 1977 the Guatemalan project will add initial annual production of 28 million pounds. These new nickel supply sources are significant as planned additions to world capacity are minimal.

Earnings in the second quarter were virtually level at 72c, adversely affected by an unfavorable currency adjustment of \$2.5 million. First half results showed a decline of 31%: \$1.03 per share versus \$1.49. For clients who do not already hold large positions, we recommend accumulation of the stock. The shares appear reasonably priced and offer an attractive yield in relation to the quality offered.

COMPARATIVE STATISTICS

	Recent Price	1975 Revenue (millions)	Percentage Nickel Deliveries in		Earnings Per Share			P/E (1976 Est.)	Indicated Dividend	Approximate Yield
			(millions of lbs.)	Decrease in Deliveries from 1974	1974	1975	1976 (Est.)			
Falconbridge Nickel	\$44	\$ 429.5	115.4	31	6.05	0.65	2.20	20.0	\$1.00	2.3%
INCO	32¾	1,694.7	351.1	36	4.01	2.51	2.80	11.6	1.60	4.9