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Old West Opportunity Fund, LP

Interview One

Old West Investment Management, LLC was founded in 2008 and manages concentrated investment strategies based on its value-oriented investment process. In its All Cap strategy, Old West has returned 10% per year for over 10+ years.

Last year, the management team launched Old West Opportunity Fund, LP as a thematic fund to gain exposure to the most compelling areas of the market as identified by the manager. The fund is currently focused on the uranium industry, which Old West believes presents a rare opportunity with numerous near-term catalysts.

While the firm has a sizeable weighting to uranium miners in its legacy strategies, the manager launched this new fund to more fully capitalize on the theme. Below, Brian Laks, CFA, a Portfolio Manager at Old West, discusses the opportunity in the uranium industry and two of the companies Old West owns in the Opportunity Fund portfolio.

To start at the beginning: Can you explain why you're so bullish on uranium?

It's rare to find a situation with such an incredible fundamental setup that is almost completely ignored by the general investing public. At its heart is a simple supply/demand imbalance. Demand for uranium has been steadily growing as the developing world strives to generate clean electricity from nuclear power. At the same time, supply has been cut dramatically as a decade-long bear market has ravaged the industry. We believe the excess of demand over supply will force prices to rise to encourage the development of new supply. Our conviction has grown so strong over the last year or two that we recently launched a new fund specifically to target this opportunity.

This is not a new commodity so why invest now? What makes the industry so attractive at this point in time?

Investors have largely abandoned the industry as the market caps of only a few of the biggest companies remain investable to major pools of capital. From several hundred companies and a market cap of \$150 billion, the industry shriveled to a low of \$5 billion a few years ago and only a few dozen companies remain. This exodus paired with a steady improvement in industry dynamics has led to a significant disconnect between the valuation of the equities and their underlying fundamentals. We believe there are a number of meaningful catalysts in the near term that will work to unlock that value. As an example, within the next month the US is set to rule on the national security implications of our complete reliance on uranium imports to satisfy domestic demand. Even though we are the world's largest consumer of uranium, we produce very little and a large portion of the



imported product comes from countries in the Russian sphere of influence. Given the current political climate, the US may seek to reinforce domestic production capabilities through Section 232 trade relief and a decision is due in the next few weeks.

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The industry has been in decline for some time with uranium prices stagnating and production coming offline, why do you think this trend is going to reverse?

It is precisely those two factors that we believe will lead to the trend reversal. Production coming offline continues to tighten the supply side of the equation and with prices stagnating below the cost of new production, there is little incentive to develop new supply. As demand continues to increase with dozens of reactors under construction globally, we believe we have reached a tipping point where new supply will be needed. The only way this supply will come online is through the incentive of much higher prices.

Do you see a threat to the nuclear industry as the cost of renewable energy continues to fall?

No, we think renewables will play a role in the future energy mix but do not see them as a viable alternative to baseload nuclear power.

The intermittency and variability of renewable generation are huge challenges that must be overcome. They are typically met by installing backup power, which ironically is often generated from the burning of fossil fuels, offsetting much of the perceived benefit. Land use is also an issue. The energy density of nuclear is far superior to that of popular renewables such as wind and solar. It can take hundreds of times more land to generate the same amount of electricity from a wind/solar farm than from a nuclear plant.

What’s your prediction for industry demand growth and uranium prices over the next five to 20 years?

Demand growth is expected to be fairly steady over the next several years, with nearly 60 reactors under construction worldwide that will be entering a fleet of about 450. This is occurring at a time when almost no new supply is being brought online. We believe the supply deficit that is forming will lead to significant upward pressure on prices, as those companies with viable projects will only choose to develop them if the price they receive is greater than their cost to mine. In many cases, this market-clearing price is greater than \$50 per pound, more than twice the current price level. Our view is that prices must rise to this level at a minimum, with the potential for much higher prices the longer the current situation persists and the more acute the supply shortage grows. Longer term, we think growing demand for electricity coupled with increasing concern about climate change will drive a movement toward decarbonization that will see nuclear power play a major role. There are hundreds of additional reactors in the planning/proposal stage that may be put into construction as these environmental concerns drive the long term plans of developing countries.



Old West Opportunity Fund

One of the companies you are backing as a play on this trend is \$480 million market cap NexGen Energy Ltd (NXE). What first attracted you to this business?

When looking around the world for the best projects to capitalize on this improving industry dynamic, two of the most important criteria are size of deposit and grade of ore. On both metrics, it is hard to find a better example than the Arrow deposit that NexGen has defined in the southwest Athabasca Basin in Canada. With over 300 million pounds of resource, it is the largest undeveloped uranium deposit in the world. In addition, the grade of the ore is almost unbelievable. The high-grade zones are close to 20% uranium, more than 100 times the world average. This means not only do you have massive scale, but the high grades lead to extremely low operating costs because of the value of each ton of rock that is mined. Combine that with its location in Canada, which has a long history of uranium mining, and you have the perhaps the world's greatest project in one of the world's best mining jurisdictions.

What's so attractive about its assets? Why does NexGen stand out compared to the multitude of other early-stage uranium businesses on the market at the moment?

It's really hard to overstate how unique the asset is. Their mine plan calls for an average annual production of 25 million pounds, which, if operating today, would be the largest mine in the world and account for roughly 20% of global production. This is a staggering amount and would make them a dominant force in the industry. As an analog, consider the entire country of Saudi Arabia only accounts for about 12% of global oil production. Yet it is the quality

of this massive deposit that may be the most impressive. Due to the incredibly high grades, not only will it be the largest producer but it will also firmly occupy the low end of the cost curve.

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The business is still in its early stages of development and is generating no revenues. Many would view this as a high-risk opportunity. What's your assessment of the risk here?

The main risk is that the uranium price doesn't rise enough to justify the development of the asset. In that case, the project would sit fallow waiting for better days while they continue to fund company overhead. We would not be involved in this company (or any others in the industry for that matter) if we believed that to be the case. The other risk is the permitting timeline. The company plans to deliver all of the relevant documents to the government by the middle of next year, after which a review period begins to determine whether the project should be permitted and licensed. At this point, it is out of the company's hands and a lengthy review process could dampen investor enthusiasm. We believe the review process should go quite smoothly given the abundance of data the company has compiled over the years and the importance of the project to the province.



What are the projected project economics of its Canadian assets?

The company released its prefeasibility study last November which showed just how extraordinary this project is. At \$50 uranium, the project has a net present value of C\$3.7 billion, over 5 times the current enterprise value. The payback period is less than 2 years with an IRR of 56%. This is not just an incredible uranium project; it is perhaps one of the best projects in the entire mining industry. And given the extremely high grades, the operating cost is an astounding \$4 per pound which yields close to 90% operating margins. This leads to after-tax cash flows of close to C\$1 billion per year, which means you can buy the project today for less than one times the cash flow it will generate when in production.

How is the company funded, and what are its plans for funding going forward?

The company is well-financed, with roughly C\$100 million in cash on the balance sheet. This should be sufficient to cover ongoing costs and get them through the feasibility study and into permitting. If the project is approved and they decide to begin construction, they have a number of options available for project financing.

One of the benefits of having extremely high margins is that the project will be able to support a high level of debt financing, upwards of 70% of the capital cost. They plan to finance the remainder with a combination of offtake agreements, royalty streams, and forward sales. The deposit also holds salable byproducts of gold, silver and rare earth elements.

Who are the people behind the company and what experience does management have?

Leigh Curyer, the CEO, founded the company in the wake of the Fukushima disaster when sentiment toward the industry had plummeted. This turned out to be fortuitous timing as he was able to put together a massive land package of 260,000 hectares in the Athabasca Basin that would be almost impossible to duplicate today. Within the last few months, the company made another brilliant move when they brought on Brad Wall to the board of directors. Brad most recently served as Premier of the province of Saskatchewan for over a decade before joining NexGen and brings a wealth of invaluable political experience to the company at a critical juncture in their history. It is hard to imagine a better person to help them navigate the regulatory environment than the one who ran the province for the last ten years.

Stock Information June 14, 2019 | NXE
Data Source: Morningstar

Market Cap.	Average Vol. (3m)
\$531m	314,308
P/E (forward)	P/B
N/A	4
EV/EBITDA	ROIC (ttm)
46.9	3.60%
Divident Yield	Debt to Equity (gross)
N/A	84%



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How is management incentivized?

This is something we pay attention to closely and which plays a major role in our investment decisions. It is comforting to see an original founder as CEO, and one that maintains a substantial position in the stock. We also like that the management team receives a significant portion of their pay in stock, rather than cash compensation, and strives to maintain and increase that ownership over time. With management and the board owning a healthy chunk of the company, we are confident that our interests are aligned and that they will work to maximize shareholder value rather than the value of their salaries.

Who are the largest owners of the business?

The company was given a huge boost when Li Ka-Shing, one of Hong Kong’s richest men, took a large stake in the company through CEF Holdings, a JV between his Cheung Kong Holdings and CIBC. The stake amounts to almost 20% of the company and, in a rare vote of confidence, is subject to an investor rights agreement effectively ceding voting power to NexGen management. Adding the shares held by management and the board and several meaningful stakes by uranium-focused funds leaves a tightly-controlled ownership group of long term investors.

Can you give us an outline of how you expect the business to develop from here over the next five or ten years?

Over the next 12 months, they will continue progress on their delineation drilling and feasibility study and once the government receives all of the documents (mid-2020), the permitting review can begin. After the project has been permitted and licensed, there is a 2-3 year construction period followed by a nine-year mine life that would see the mine producing 25 million pounds a year on average (with closer to 30 million pounds in the first five years). We believe the project will get approved for development and be a major force in the world supply picture. The biggest question we have is whether it is done under current ownership or whether a more established mining company moves to acquire it as it gets closer to a final investment decision. Cameco, the large Canadian uranium producer, sees their primary producing mine running out of ore in the mid-2020s. This would be an excellent replacement for that lost production and they have the development expertise to get it done. With the exemplary project economics, we would not be surprised to also see serious interest from more diversified mining companies.

What are the primary threats you see to the firm’s plans from now until production?

The most obvious would be a delayed recovery of the uranium price. Even though the project boasts robust economics at relatively low prices, management may decide to defer production if prices stay low and they believe they could get a better price environment down the road. Our view is that the global supply/demand picture necessitates a rebalancing of the market at a minimum to price levels that would be sufficient to develop their project. The other main risk is permitting. Once the technical and environmental documents have been submitted to the government, a review period begins with



no clear timelines. We estimate a year or two though this could be delayed if the government requests more information. Alternatively, given the size of the project and the importance to the region in terms of jobs and tax revenues, it is possible the permitting is expedited. We think the appointment of former Premier Brad Wall to the board gives them the best chance to see a smooth process.

How have you approached valuation here? Can you outline some of your assumptions for growth?

The most straightforward way to assign a valuation would be to assume the company goes into production and value the cash flows they would generate under various price scenarios. We think the \$50 price assumption the company uses is reasonable and leads to a valuation that is multiples higher than where it currently trades. Alternatively, we can look at the potential value to an acquirer based on comparable takeout valuations. Theoretically, these two approaches should align with similar valuations, though potential acquirers may have different assumptions for the commodity price outlook which would impact the price they pay. During the last cycle, we saw acquisitions in the range of \$8-10 dollars per pound of resource, which would lead to a roughly similar valuation. Both approaches lead to a base case valuation several times that of the company currently.

In the bull case, how much do you think the business could be worth?

In our bull case, the price of uranium rebounds much higher than the \$50 level and we potentially see a repeat of the 2003-2007 time period when utilities scrambled to secure supply in the face of shortages. At \$80/lb, the after-tax NPV is estimated to be C\$6.6 billion, over 9 times the current enterprise value. Keep in mind this is just for the Arrow deposit as measured thus far and gives no credit to any additional adjacent resource

that may be defined by further drilling or the other 260,000 hectares of surrounding land. Needless to say, we think the upside in this name is extraordinary.

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Also, if uranium prices continue to stagnate, or fall further, how would this impact your outlook for the business?

Our positive outlook is predicated on our view that the supply/demand imbalance developing in the industry will necessitate higher prices and additional sources of greenfield production. If we are wrong in this view and prices are flat or decline from here, we would expect the company to defer a production decision. If we felt that the industry was permanently impaired and the demand growth we have witnessed began to falter or reverse, we would reconsider our investment in the business. All of the news we have seen recently out of the industry suggests demand is strengthening, and our outlook for the business remains strong.



Old West Opportunity Fund

Your next pick, Energy Fuels (UUUU). Can you explain what you like about this business?

Energy Fuels is the largest uranium producer in the US. In addition to having a large production capacity, they also own the White Mesa mill, which is currently the only operational uranium mill in the country. Given the time and expense it would take to permit, license and construct a new mill, we think ownership of this key infrastructure gives the company an enviable position when the market rebounds. Additionally, there is a decision pending in the recently completed trade investigation by the Department of Commerce which may provide meaningful support to the industry and Energy Fuels would be a primary beneficiary.

This is not just a uranium business, it also produces vanadium. How does this factor into your overall investment plan?

Vanadium is a metal that is mainly used in steel alloys to increase their strength. There was a lot of excitement last year as China raised the required quality standards for their rebar, mandating an increase in the vanadium content. As investors questioned the ability of a relatively small market to absorb a large increase in demand, prices for the metal shot up dramatically from \$10/lb at the beginning of the year to over \$30 in November. The uranium deposits that Energy Fuels mines also contain significant quantities of vanadium, though it had historically been treated as a waste product because the price rarely justified the expense of processing. As a result, they have several million pounds of dissolved vanadium in their tailings ponds as well as 32 million pounds of in-ground resource. At the higher price levels, the company determined that it would make sense

to run a recovery circuit to separate out the vanadium for sale, which could provide much-needed cash flow as they wait for an improvement in the uranium price.

During the first quarter of the year, the company lost \$12 million. With only \$47 million of cash on the balance sheet, it is currently on track to run out of money next year. Does this concern you, and what is the business doing to alleviate funding concerns?

We think it is this concern that has led to the opportunity to acquire it at such a distressed valuation. The average investor would look at that financial situation and most likely avoid it, without understanding the industry situation and the company's leverage to an improving price environment which we believe is imminent. They have a number of levers they can pull to alleviate the funding concerns if prices don't rebound in the next year. The vanadium component is one, and the company expects it can produce 160k-200k pounds per month. They also have substantial uranium inventories which could be monetized if needed. The White Mesa mill is also incredibly valuable, as a comparable facility would cost several hundred million dollars and take years to build. They could potentially monetize a portion of that asset if needed. Finally, if all else failed, an equity raise could be considered. Given the company's importance to the industry by way of their production capacity and the incredibly strategic infrastructure they control, we expect they would find receptive investors with minimal dilution.



“The White Mesa mill is also incredibly valuable, as a comparable facility would cost several hundred million dollars and take years to build. They could potentially monetize a portion of that asset if needed.”

When do you expect Energy Fuels to become self-funding?

We see prices rising throughout the second half of this year and into the next as a resolution of the Section 232 trade investigation gives utilities the clarity they need to return to contracting long-term volume requirements. The higher prices they will have to pay to secure supplies will benefit the company in a number of ways, whether through direct contracts being signed or a revaluation of their inventories and an incentive to increase production. We think the improved price environment will allow them to increase their production over the next year to levels that would sustain profitability and believe their current financial capacity is sufficient to get them to that point.

What experience does management have in this space? Can you give us a bit of background on who is running the business?

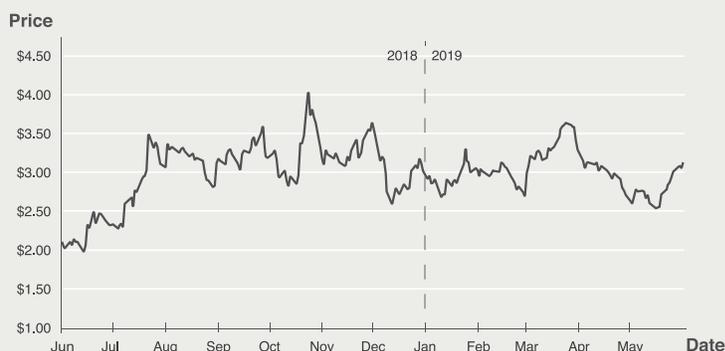
Mark Chalmers, the CEO, has made a career operating uranium assets on several different continents. Before Energy Fuels, he was Executive General Manager of Production for Paladin Energy where he oversaw projects in Africa and Australia, including the well-known Langer Heinrich mine in Namibia. He has managed in-situ recovery (ISR) projects as well such as the Beverley mine in Australia and the Highland mine owned by Cameco in the US. Additionally, he served as Chair of the Australian Uranium Council for 10 years.

Do you see any upcoming catalysts for the share price?

Yes, the most imminent of which is the decision on the Section 232 investigation which is due in mid-July. If the administration rules that the industry deserves some measure of support, we view Energy Fuels as a primary beneficiary. Regardless of the outcome, however, we think the clarity that a decision provides will allow the utilities to return to long-term contracting which will provide the price discovery mechanism that reveals the need for a higher uranium price.

Stock Information June 14, 2019 | UUUU

Data Source: Morningstar



Market Cap.	Average Vol. (3m)
\$293m	1m
P/E (forward)	P/B
N/A	2.2
EV/EBITDA	ROIC (ttm)
N/A	N/A
Divident Yield	Debt to Equity (gross)
N/A	11.00%



Finally, Cameco has made clear their intentions to acquire a substantial quantity of material in the spot market this year to fulfill their supply contracts, upwards of 10 million pounds. This should put significant upward pressure on the uranium price in the second half of the year. It is worth noting that they recently attempted to secure a mere 1 million pounds and were unable to do so on acceptable terms.

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What is your bull and bear thesis for the stock?

Our bull thesis is that a positive Section 232 decision provides support to the industry, allowing the company to ramp up over the next few years to their full production capacity. Their mill will begin generating cash flow from both the company’s ores as well as from processing those of nearby producers. The CEO has said he would prefer to do this via joint ventures rather than simple toll milling, which could provide additional equity upside through stakes in their partners. Overall, the rebound in the industry as a whole will mean a much healthier price environment and allow them to not only achieve sustained profitability but increase their production capacity through further development of their asset base. The bear thesis is that Section 232 is a dud, providing no immediate relief for the domestic industry. Prices stay lower longer than investors expect and the company continues to burn cash, eventually needing to resort to some of the fundraising measures discussed above.

What potential risks is the company facing? What sort of downside protection do you have – i.e., what would you be looking for that would tell you it is time to exit?

The main risk we foresee is that the price recovery we expect due to global supply and demand factors does not materialize. We think this would be most likely to occur due to a factor that weakens the demand side, such as strong anti-nuclear sentiment in the western world leading to reduced reliance on nuclear power or a slowdown in the pace of reactor construction in the developing world. If either of these were to occur on a sustained basis, we would have to revisit our original thesis of an industry rebalance and an investment in a company like Energy Fuels. On the contrary, we’ve seen the trend strengthen from the demand side amid continued supply cutbacks which was the original reason we launched this uranium-focused fund.