

## Lodestar Investment Holdings Corporation (LIHC)

BUY

November 19, 2009

# Turnaround

### The Company

Lodestar Investment Holding Corporation (LIHC, Lodestar, or the Company) was initially a mining company with tenements in Masbate, Cebu, Negros Occidental, and Palawan. In 2003, the Company decided to change its primary purpose. From a mining company, Lodestar became an investment holding company, increasing its flexibility in the types of investments it could undertake. LIHC has been quiet since then, accumulating small losses each year. All that is about to change however as the Company believes it has found a very attractive project.

Price	P10.75
Target	P25.23
Market Cap	P537.5 M
O/S Shares	50 M
52-week High	P12.00
52-week Low	P1.70



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## Acquisition

On September 21, 2008, Lodestar, in a joint venture with Music Semiconductor (MUSX on the Philippine Stock Exchange), undertook to acquire Abacus Coal Exploration Development Corporation (ABACOAL) from Abacus Consolidated Resources Holdings, Inc. (ABA on the Philippine Stock Exchange). Lodestar and Music was to split ABACOAL 45% to 55%. This was, however, amended on May 2009 such that Lodestar was able to acquire 100% of ABACOAL and its coal property. The 7,000 hectare coal property is covered by Coal Operation Contract (COC) No. 148. Knowing that it did not have the expertise and operational capacity to utilize the coal property's potential, it turned to someone who could.

Immediately after acquiring 100% of ABACOAL, LIHC signed a Memorandum of Agreement with Oriental Vision Mining Philippines Corp. Oriental's chairman is Salvador Zamora II and it has mining sites in Dinagbat Island, Bohol, Negros, Biliran, and Samar. Oriental deals with a wide variety of materials that include Nickel, Manganese, and Chromite. Lodestar believes that Oriental has the financial resources, technical competence, and skills necessary to explore, develop, and operate the coal property at a level that Lodestar alone would not be able to. The MOA relegates the exploration, development, and operation rights covered by Coal Operating Contract No. 148 to Oriental.

## Coal

In exchange for the right to explore, develop, and operate the coal property, Oriental shall pay Lodestar 8% of its gross revenues derived from the mining and selling of coal found on the coal property. Oriental shall also undertake to complete its exploration work so that the COC may be converted into a COC-DP (Coal Operating Contract for Development and Production). Any expenses in the exploration and subsequent development and operation of the coal mine shall be borne by Oriental. Commercial operations are set to begin one month after the COC-DP is secured. In addition, the MOA also states that should Oriental find other minerals on the coal property, the 8% royalty fee still applies.

As long as Oriental operates the mine, Lodestar makes money. LIHC gets a percentage of the gross revenue so the factors affecting how much it gets is the volume that Oriental ships and the price it is able to get for its coal. Given that the local coal demand in the Philippines exceeds the local supply, Oriental should have no trouble looking for buyers. Furthermore, there is also a market for exporting coal to other Asian countries. A look at the quality of the coal that can be found in Lodestar's property reveals similarities with that of Semirara's. Semirara Mining Corporation (SCC on the Philippine Stock Exchange) is the country's largest coal producer.

	Coal Property	
	Lodestar	Semirara
Location	Tago, Surigao del Sur	Semirara Island
Type of Coal	Sub-bituminous	Sub-bituminous
Btu range	7761 – 9121+	8600 – 10450
Ash (%)	2.86 – 25.91	5 – 10
Moisture	14.9 – 20.1	20 – 28
Sulphur	0.85 – 2.18	0.30 – 0.90
2008 volume	N/A	3.3 million MT
2008 average selling price	N/A	P2,549/MT

Lodestar data sourced from Lodestar

Semirara data sourced from their website and 2008 annual report

## Risks

There are, however, risks, as is the case in any endeavor. The biggest risk is the possibility of Oriental failing to operate the mine. The Philippines is rich in mineral resources but a look at the mining companies listed in the PSE reveals that a majority are not making money. The problem is the failure of most companies to sufficiently mine their properties. An attractive coal property needs to be properly operated in order to fully realize its value. Thankfully, Oriental's track record speaks for itself as it is already operating several mines all over the Philippines. Furthermore, should Oriental fail to operate the mine, Lodestar has the option to look for a company that is willing and able to.

Other risks include the coal property and coal prices. Current studies place the potential geologic resource of the coal property at 182 million MT of coal. This, however, is only an estimate. The real amount of coal that the property contains can be more or less than 182 million MT. A report by Verum Terra Geoscience, Inc confirms the 182 million MT potential while putting the inferred resources at 3.54 million MT. While coal prices are currently trending upwards, there is no guarantee that it will continue to move higher in the next few years. A drop in the prices of coal will limit profitability and may even cause Oriental to stop operation if the prices drops low enough.

## Operations

Oriental is expecting to start operations at the end of this year. Once the COC-DP is granted, Oriental can start operations on a large scale. For 2010, Oriental is looking at a volume of 3 million MT at a price of 45\$/MT. The actual volume and selling price, both of which can change, is the basis of how much Lodestar will make next year. Shown below is a table of what the EPS of Lodestar will be in 2010 given certain volumes and coal prices. The assumptions used are an annual expense of P21 million (a combination of the amortization of the acquisition price of ABACOAL and other expenses), an exchange rate of P45:\$1, and outstanding shares of 90 million (after the issuance of shares used to acquire ABACOAL).

		2010 EPS of Lodestar						
		Volume in Metric Tons						
		1,500,000	2,000,000	2,500,000	3,000,000	3,500,000	4,000,000	4,500,000
Price (Php/MT)	675.00	.60	.87	1.14	1.41	1.68	1.95	2.22
	1,125.00	1.14	1.59	2.04	2.49	2.94	3.39	3.84
	1,575.00	1.68	2.31	2.94	3.57	4.20	4.83	5.46
	2,025.00	2.22	3.03	3.84	<b>4.65</b>	5.46	6.27	7.08
	2,475.00	2.76	3.75	4.74	5.73	6.72	7.71	8.70
	2,925.00	3.30	4.47	5.64	6.81	7.98	9.15	10.32
	3,375.00	3.84	5.19	6.54	7.89	9.24	10.59	11.94

### **Valuation and Recommendation**

Given that coal prices continue to trend up as oil prices increase and the coal property has 3.54 million MT in inferred reserves makes the base case very probable. At an EPS of P4.65 and a price of P10.75, Lodestar is only trading at a P/E of slightly higher than 2. This makes the stock very attractive. While there are risks, they are well mitigated. Oriental's track record shows their capability in operating the mine. The table shows that only in extreme cases will Lodestar make less than P2 per share (which is still attractive at a P/E of 5). The combination of the attractiveness of the coal property, the expertise and capability of Oriental to operate the mine, and the upward trend of coal prices make Lodestar a buy. Because Lodestar has not made money in the past years, few expect it to suddenly make a lot of money, which explains the depressed level of its share prices. This presents a wonderful opportunity to invest in Lodestar.

Lodestar has no debt and, as an investment company, does not have required capital expenditures. Therefore, LIHC is free to use the cash it receives from the operation of the coal mine for other purposes. The company can invest in other attractive endeavors that it can find. More interesting, LIHC is in a position to declare dividends once the cash starts pouring in. It's current deficit of P45 million can easily be wiped out, paving the way for dividend declarations. From a discounted cash flow perspective, assuming Oriental will operate the mine for 10 years at the base case level, the value of LIHC is P25.23 per share. It is currently trading at P10.75, representing an opportunity to more than double. This is, however, not the final value of the company. The value can easily rise as the true amount of coal the property contains is ascertained. With a great upside and more positive factors than risks, investing in LIHC at P10.75 is a sound decision.