

Can Sherritt Capitalise on Cuba's Capitalisation?

Frankly the management of Sherritt, since way back, have not been seen as amongst the sharpest knives in the drawer. While they have rightly been obsessed with their *persona non grata* status in the US due to their supposedly falling foul of the wretched Helms-Burton Act, they have largely taken the ball off the means by which they could remake the company to maximise value for the long-suffering shareholders.

Here I shall examine the rather dire handling of the matter of the scarcely-known energy assets the company holds in Cuba, which are NOT subject to Helms-Burton problems but are being largely ignored as the country barrels towards a Vietnam-style "opening to the West". The obvious solution is to demerge these assets and let them evolve as potentially one of the purest play entry points for emerging market investors into this nascent frontier market.

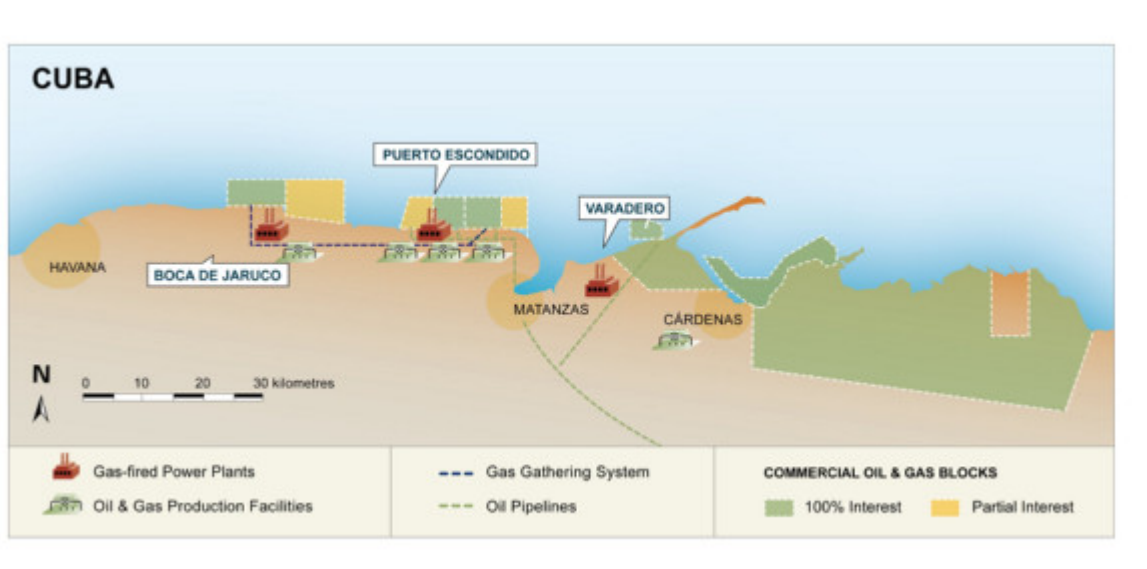
Electricity generation

One of the interesting positions that Sherritt has built up using its non-remittable funds in Cuba has been its push into electricity. This division has an internal logic in that Sherritt also has an interest in natgas production in Cuba. The company is also pushing into power generation in Madagascar in association with its Ambartovy project.

Sherritt holds an indirect one-third interest in Energas, a joint venture established to generate electricity for sale to the Cuban national electrical grid. The remaining two-thirds interest in Energas is held equally by two Cuban agencies, Union Electrica and Cubapetroleo. Energas runs a power generation system with 506 MW of gross production capacity with generation derived from gas supplied from Cuba's north

coast by Cubapetroleos.

Energas produces around 12% of Cuba's total power output. The location of the plants and their individual capacities are shown on the map below.



Sherritt financed, constructed and commissioned each of the integrated gas treatment and power generation facilities located near the Varadero, Boca de Jaruco, and Puerto Escondido oil fields.

The Varadero facility is located approximately 140 km east of Havana. The facility consists of two integrated raw gas processing plants, three gas turbines and associated electric generators, a heat exchange system for generating high-pressure steam, and a steam turbine and associated electric generator. In addition, the Varadero site includes an electrical substation and transformers, to facilitate connection of the facility to the Cuban national grid, and an integrated maintenance and administration facility. Aggregate net power capacity of this facility is approximately 329 MW.

The Boca de Jaruco facility (pictured below) is located 50 kilometres east of Havana. The site initially consisted of a sour gas processing plant, one gas turbine and an associated electric generator with a net power capacity of 33 MW. The

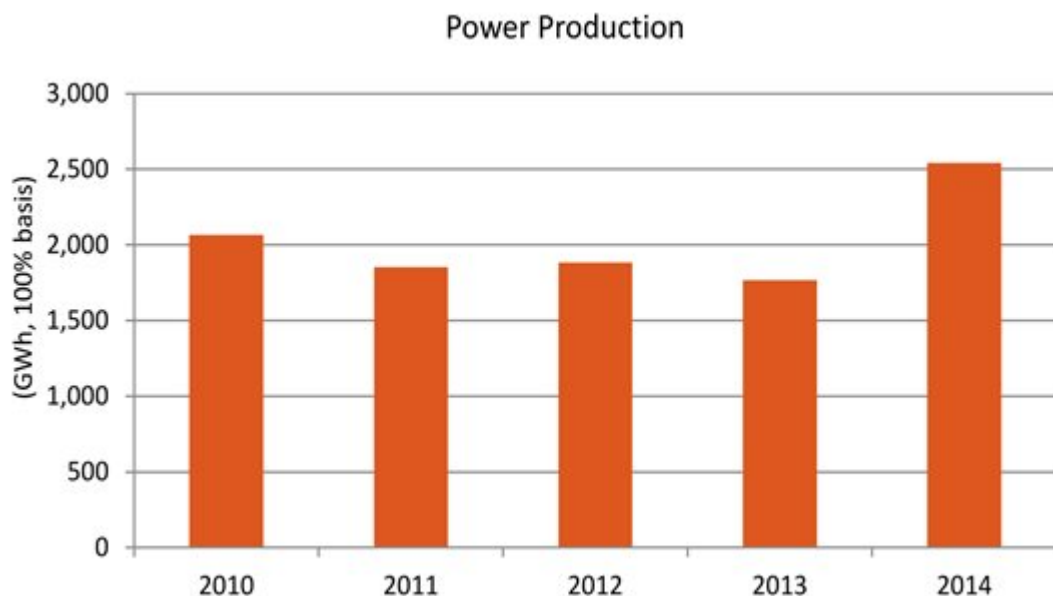
site also includes an electrical substation, a transformer to facilitate connection of the facility to the Cuban national grid and an administration facility. The facility commenced operation in August of 1999.



The 85 MW Phase 6 expansion of the Boca de Jaruco facilities completed in 2006 included the installation of two additional gas turbines and associated electric generators at the Boca de Jaruco plant site with a net power capacity of 65 MW and a third gas turbine and associated electric generator with a net power capacity of 20 MW located at a new plant site in the Puerto Escondido oil field. This phase of the expansion also included the installation of sour gas processing facilities at the Puerto Escondido plant. The Phase 7 expansion of the Boca de Jaruco facilities completed in 2007 included the installation of two additional gas turbines and associated electric generators with a net power capacity of 65 MW.

Then the company embarked on a project to expand capacity to 150MW via a combined cycle plant which came online in February 2014.

Depending on the availability of gas reserves, Sherritt could add a second 70MW phase.



Obviously as economic activity rises in Cuba then electricity consumption will rise. The chart above shows production by Sherritt's Energas soaring. Indeed since last year these have risen even further. In the September quarter sales were 30% higher in dollar value than the same quarter of the previous year. They were up 23% in the nine months over the same period in 2014. Realised prices were up 20% also showing that demand is leading to firmer prices.

Results in electricity

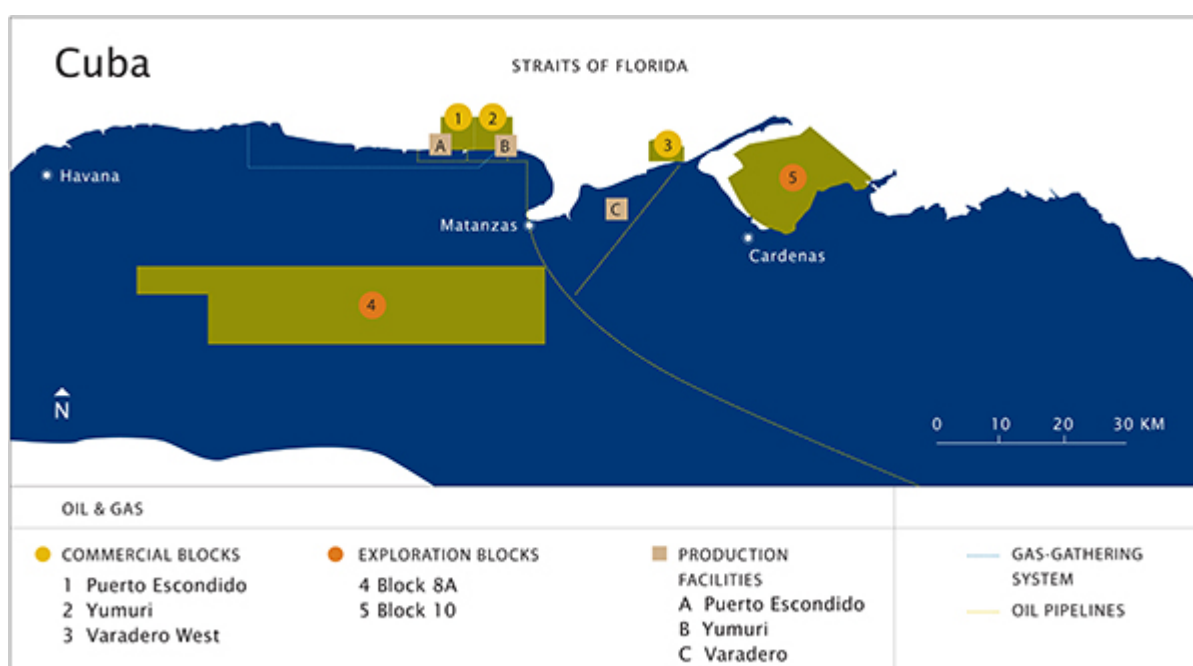
One gets the feeling that Sherritt is "hiding its light under a bushel" in its energy divisions. Why it should do this is anyone's guess. It reports high losses despite the EBITDA soaring. The electricity business made adjusted EBITDA of \$24.5mn in the nine months to September 2015 (compared to \$19.4mn in the first three quarters of FY14). Total revenues were \$39mn (compared to \$37.31mn). Cash provided by operations was \$55mn.

Oil & Gas assets

Sherritt has interests in oil & gas fields in Cuba (as well as Spain and Pakistan, though those make up less than 4% of sales in the division). Its Cuban oil joint venture is juicier than

its nickel. Average gross working-interest production in the first nine months of 2015 for the Cuban JV was 18,666 bopd (down from approximately 20,164 bopd in 2012). This makes the JV the largest domestic oil producer in Cuba, representing half of total production. Production had been even higher until early 2009 when the company was compelled to surrender its position in one producing block.

The company has production-sharing contracts for four offshore exploration blocks and vertically integrated operations, with seven production sharing contracts in the deepwater zone in the Gulf of Mexico northwest of Havana. These blocks cover approximately two million acres with proven and probable reserves of 50.5 million barrels. The oil in Cuba is located about 1,500 metres below sea level and it drills directional wells up to 5,600 metres long to pump oil to the surface.



With \$132.1mn in revenues in the first nine months of FY15 and \$219.7mn in the same period of FY14, the EBITDA so far in 2015 was \$72.2mn (compared to \$165.6mn in the same period of FY14) the Cuban oilfield business remains highly lucrative for Sherritt. It's worth noting that the unit operating costs were \$9.04 in Cuba compared to \$43.8mn on the Spanish fields. This shows that Sherritt dropped the ball on selling the Spanish

assets when the market was hot. Will it miss the ball on realizing the Cuban assets while the demand for exposure to that economy is so heightened.

Conclusion

In coming back to review Sherritt's energy assets in Cuba, we went back to the research piece we wrote on this theme in 2009. We then went to the latest MD&A on Sedar for Sherritt. The shocking thing is that the asset base of these divisions has been virtually unchanged since that time. The division neither got larger nor smaller, only the numbers fluctuated with tariffs, demands and prices for oil & gas. The "orphan" O&G assets in Spain and Pakistan still made up less than 4% of the total. Any other company in the space would have ditched such small participations to focus management effort and reduce costs of travelling such great distances. Clearly Sherritt doesn't mind being spread too thin.

The Cuban power plants, being *de novo*, are relatively secure from rapacious émigrés (not that not having title would ever stop them wanting them). A scenario worth pondering is Sherritt either floating them off should a Havana Stock Exchange come into existence. They would be prime fodder for such a new market. Another possibility would be Spanish majors in the construction/utility space snapping them up in the nearer future to get positioned for an eventual wider opening of the economy.

With the rapid opening of the Cuban market to Western investors there is obviously a hunger for exposure to this emerging (or frontier) market. Investors in the EM space usually pay sizable premiums for exposure. Clearly they are not going to buy Sherritt shares with its overwhelming preponderance to Nickel and Cobalt to get leverage into an opening Cuba. What such investors (Templeton being a good example) want is "pure" exposures. In this case the most value could be realized by "liberating" the Cuban energy assets into

a spun-out vehicle and listing it on a US exchange. It would less like creeping around the Helms-Burton Act than bulldozing that antiquated and anomalous legal oddity.



In one stroke Cuba would become instantly available to US equity investors. Meanwhile the long-suffering Sherritt shareholders would get a bonus prize that they could realise, or keep depending on their own investment objectives. Buried deep within the bowels of Sherritt this division does no-one any good.

What will make the Sherritt management see the light? Hmm.. interesting question. Anywhere else a shareholder revolt might trigger it. On past experience though, and in light of the bunker mentality that rules in the company, its more likely they would just put on their Pickelhaubers and hunker down for the fight rather than think forward as to what might be in everyone's best interest.

**“Todos somos americanos”:
President Obama and President**

Castro rediscover common sense

✘ US President Obama and his Cuban counterpart Raul Castro have put an end to a 53-year old crisis. In so doing, the White House has conceded that the embargo against Cuba has failed and that it was ruinous for both parties – as embargos often are. The first step of the emerging USA-Cuban détente will be a mambo of steps, the first of which will be the resumption of mutual diplomatic relations to be emphasized later through measures that dismantle the system of economic sanctions. Obama announced the shift in a speech that concluded with the phrase “Todos somos americanos” (we are all Americans); this will surely be remembered as a historic pronouncement in the same spirit of other momentous shifts from J.F.K’s “Ich bin ein Berliner” to Ronald Reagan’s “Mr. Gorbachev, tear down this wall!” It was the Kennedy White House that suspended diplomatic relations with Havana in 1961 following Fidel Castro’s revolution and, more significantly, his alliance with the Soviet Union.

The reopening of the US Embassy will happen shortly and there are, in fact, already US diplomats on the ground in Havana, given that a small US interests office has been operating for decades. From a more commercial standpoint, the closer diplomatic ties will allow for the rise of travel and tourism, surely to be followed by business, communications, credit cards, the Internet and of course remittances. A deeper discussion on Human rights will be possible after the political trappings of the embargo are brought down. Cuba itself is still governed by one of the very last surviving communist regimes; a phenomenon that has defied the odds, given the end, in 1992, of the Soviet support that sustained it and the continuing US embargo. Yet, the fact that two or three players defect every time the Cuban national soccer team

plays a World Cup qualifying match abroad, serves as a reminder that it is still very much a Communist dictatorship. Yet, Cuba is slowly creeping away from a long period of political staleness and changes could be in store for the Island nation. These changes are being encouraged by some important political events in its neighbors.

Obama announced the new Cuban policy through a rather pragmatic observation: the embargo has failed; it has created immense hardships in Cuba and still “half a century later the Communists Castro are still in power.” In contrast, the embargo has also reduced the United States’ capacity to influence Cuba – and other countries in Latin America, virtually isolating itself from major parts of the Western Hemisphere. Moreover, the Embargo provided Castro a global podium from where to spread his propaganda. Along with these general considerations, which should be applied to Washington’s other international disputes from Iran to Russia and North Korea, President Obama stressed the immediate need for frontline investment in telecom, which would vastly increase Internet availability to an island where only 5% of the population browse online – in expectation that American companies will bring their digital infrastructure and technologies to Havana. The pretext for this sensational shift in policy has come thanks to Havana’s release of American businessman Alan Gross, who was detained in 2009; he was exchanged with three Cubans accused of espionage in the United States. Perhaps, the democrats’ midterm electoral defeat has helped release Obama from trying to score political points to pursuing greater matters with deeper meaning and more progressive content than his previous six years. Foreign policy is one of the few territories where the president enjoys almost exclusive power and leadership, and Obama is determined to use this to gain his place in history.

We can presume that opening to Iran is next – perhaps, he is also freer to allow Putin to save face.

Speaking about the Cuban embargo, Obama spoke of the now distant failed Bay of Pigs invasion (as well as, the Missile Crisis and the tensions of the Cold War) and of the absurdity of clinging to a distant past. While, the struggle to promote human rights and freedom in Cuba, and everywhere, is a noble one, the embargo method has proved to be wrong, citing China, Vietnam, other countries (several in the Middle East for example) where human rights are trampled and yet Washington has chosen to engage in full diplomatic relationships. On his side, Obama and the Democrats have a new generation of Cuban-Americans, who do not share their parents' anti-Castro approach and this could play into the hands of the next Democratic presidential candidate in 2016 – especially if Jeb Bush, governor of Florida, should decide to run. The first major political and international venue where Cuba and the United States will have an opportunity to consummate their new relationship will be at the Summit of the Americas in Panama, where he will also discuss human rights, next April.

Secret negotiations between the Cubans and American parties started over a year in Canada and at the Vatican. The US administration has said that Pope Francis has played a direct role in the crucial turning point has sent letters to both Obama and Castro during the summer, making explicit appeal to a resumption of bilateral relations between the two countries. The rapprochement process will take some time, but President Obama wants to the end of the embargo against Cuba to end before the end of his term in 2016. The shift toward Havana will also help improve Washington's relations with other Latin American countries and Venezuela in particular, perhaps helping to divert Caracas's highly ideologically driven course toward a more pragmatic and business friendly one (even if that openness will likely be in favor of selective partners such as Brazil and Argentina – first). Moreover, in strictly business terms, it will be far easier for US and Western companies to work in Cuba; until recently, all western companies have been subjected to US risks when conducting

business in Cuba.

I was reminded by fellow InvestorIntel contributors Christopher Ecclestone and Jack Lifton that Ian Delaney, former CEO and current chairman of Canada's Sherritt International Corporation, knows a thing or two about this. Under his direction, Sherritt invested successfully in Cuba's nickel and oil deposits in the 1990's becoming its main independent energy producer. Sherritt started dealing with Cuba in a key period, which fell between Cuba's loss of USSR support and before the 1996 Helms-Burton Act that barred domestic and foreign companies from dealing in former U.S. property in the island. Mr. Delaney has been barred from entering in the United States because of his dealings with Cuba. The former CEO and current Chairman of Sherritt's strategy in Cuba, which showed that Cuba can be good for business, could be vindicated shortly. Ultimately, Obama's shift in Cuba policy is part of a wider strategy to boost the influence of the United States in Latin America, a region that has seen considerable economic growth and political progress in the past decade.

Fidel Castro's uncertain health, Raul Castro's own advancing age and his decision to limit his presidency of the Cuban government to two five-year terms have raised speculation in to what post-Castro Cuba will look like. There are a few dynastic propositions, including Alejandro Castro, Raul's son, and a few other younger relatives, though family and communist legacy aside, the Cold War mentality of the Castro brothers (less so Raul) will be replaced. A Chinese version of Cuba, marked by economic openness and political repression, might follow. The United States might appreciate this line as it would ensure security, control the borders and prevent the island from falling prey to the Central American drug trade. If the current conditions will persist it is very likely that the U.S. will not disrupt their embargo against Cuba and that thanks to their pressure the island will remain excluded from

regional and international institutions such as the Organization of American States and the International Monetary Fund.

Twenty years after the end of the Cold War, Cuba remains an obsession for Washington even as the embargo has not capitulated the Communist government, which has sought friends in China and Venezuela. Cuba has faced a more uncertain political position since the end of the Cold War and is ready to begin a new chapter in its history. Cuba will retain a strong nationalist fiber but its economy will necessarily require foreign investment and expertise. Had President Obama not acted now, it would have left it open to other Latin American nations, Brazil in particular. Paradoxically, even China has complained about the slow pace of reform in Cuba even as Chinese cooperation has targeted the creation of industrial and entrepreneurial capacity in Havana. In Cuba then, Beijing and Washington have congruent goals. China could increase imports of sugar and nickel from Cuba, while helping to raise its oil production output at the refinery in Cienfuegos. Should Cuba opt to liberalize the economy more than its politics, the United States would still be able to craft a policy to manage closer ties just as it has for China. Oh, lest we forget, the US and Cuba have military ties though the presence of a US military base at Guantanamo, the object of a rather shameful report about CIA torture abuses.