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LUNDIN MINING: ENTERING SERBIA

Abstract: This report provides an investment analysis of the RTB Bor copper mine for the Canadian based Lundin Mining Corporation. The first section of this report examines Lundin's financial outlook. Strengths such as positive cash flow, low debt, and strong current ratios are presented as a solid financial foundation upon which Lundin can build. However, decreasing revenues and poor returns on assets and equity raise concerns that Lundin needs to address. The second section of the report analyzes the copper outlook and argues that since this industrial metal is quite correlated to the economy, demand will follow the economic recovery. The third section of the report analyzes the country risk of Serbia. It concludes that Serbia's political risk is comparable to similar European nations but points out that there are still economic uncertainties in the country that pose a risk to entering the market. Nevertheless, Serbia's strong GDP growth in the past decade and the fact that the country is on track to join the European Union in the coming years make the Serbian market an attractive investment opportunity. The next two sections examine in detail the Serbian market and the competition, risks and threats that Lundin would face. Arguments are made as to why RTB Bor is an attractive site for Lundin: low labor costs, underutilized mining capacities, and an increase in local demand for copper. The section discusses that the acquisition of RTB Bor would have to be completed through a joint venture with the Serbian government (a 40%-60% split) and analyzes the advantages and disadvantages of it. Competitors and risks are analyzed through the Porter's Five Forces model and a conclusion is made that there are currently several known and likely competitors to Lundin in Serbia. Furthermore, the paper argues that several substitute products for copper currently exist, which could impact future demand. The sixth and final section of the report outlines an action plan that Lundin could follow to acquire RTB Bor. The section begins by valuing a 40% stake in RTB Bor at approximately €450M. Given the low debt capacity of Lundin, the paper suggests that the acquisition be financed through the Canadian debt market and that a bid be made in the region of €100M-€200M. An action plan for the next three years is presented and contingent aspects of the proposed strategy and its related challenges are discussed. The paper concludes that adding RTB to an already strong mining portfolio would maximize shareholder value, diversify Lundin's operations geographically, and provide the Company with a much needed spark to get its financial performance back on track.

Key words: Mining, Serbia, Bor, Lundin Corporation

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Introduction in Lundin Mining Corporation

Lundin Mining Corporation (the Company) is a diversified base metals mining company. The Company currently has four mines in operation producing copper, cobalt, nickel, lead, and zinc. It is headquartered in Toronto, Ontario, is listed on the Toronto Stock Exchange (TSX: LUN), and is a part of the S&P/TSX 60 index. The Company also trades on the Swedish Nordic Exchange. Appendices 1A and 1B illustrate Lundin's recent stock performance and comparison to the S&P TSX. To be able to address the Company's desires going forward, it is imperative to review the Company's mission statement: "develop and constantly upgrade a base metal mineral resource and mining portfolio that provides leading returns". The statement specifically points out that the Company's core values are focused around the following points: (1) generating a steady stream of development opportunities, (2) having a high performance culture, (3) possessing a strong balance sheet, (4) maximizing the value of existing operations, (5) having an ethical and transparent environment, (6) being safe, productive, and healthy.

Lundin currently operates in Portugal, Spain, Sweden and Ireland, producing copper, nickel, lead, and zinc. The Company also owns a development project pipeline which includes expansion projects at its Swedish and Portuguese mines. Finally, Lundin has an equity stake in the "world class" Tenke Fungurume copper/cobalt project based in the Democratic Republic of Congo. The Company is significantly underleveraged indicating significant possible debt capacity. The Company has historically never had a Debt-Assets ratio greater than 25%. This supports the firm's mission of having a strong balance sheet and confirms that the Company is serious in meeting its targets. Furthermore, while cash flow from operations has decreased in each of the past three years, they are still positive and have been for the past five years indicating strong operations. Additionally, the Company has had a very stable current ratio of approximately 1.45 over the past four years. Finally, the Company exhibits a strong gross margin indicating Lundin's efficiency at turning their raw materials into income.

While operating earnings increased by $50.0M from $323M in 2008 to $373M in 2009, sales for the year were only $746M compared to $853M in 2008. Per the Company's 2009 financial statements, "cost improvements and favorable exchange rates offset the effect of lower sales volumes". However, the lower sales volume is quite alarming as revenues have consistently decreased since 2007. Additionally, the Company's return on assets and return on equity are quite low, despite the increases in 2009. In summary, Lundin's financial weaknesses appear to be decreasing sales volume, revenue, and returns on assets and equity.

Copper Outlook

Copper is a conductor of heat and electricity and is used for "heating, air conditioning, plumbing, roofing, adapters, computers, cards, mobile phones, wiring, electrical leads, transformers, motors and lightning units" (Boric, 2008). As stated in investment reports, copper is essentially used in nearly every major industry of the world: transportation, engineering, machinery and equipment, electrical, building, automotive, and computer. Consequently, copper prices follow the health of the economy. Copper prices have been on an upward trend since 2000 and the world production trend has been growing exponentially. The only decline in prices was experienced during the financial crisis period from early 2008 to early 2009 as production stalled and decreased. With the global recovery well on its way, the demand for copper is expected to get back to the strong trend that started in 2001. As of April 1st, 2010 "copper rose to a 20-month high on speculation that stronger manufacturing in China and the U.S., the world's largest consumers of the metal, will result in increased demand" (Chanjaroen and Mc Ferron, 2010).

Overall, macro-economic trends and projections indicate that the economic recovery is well on its way. This will boost the manufacturing industries such as machinery, equipment and automotives in leading copper consumption nations such as China and America, thereby increasing the demand for this industrial metal.

Serbia's Risk Assessment

Serbia, a parliamentary democratic republic, is located in Southeastern Europe. With a population of approximately seven million, it is the largest nation in the Western Balkans and an important political and economic figure in the surrounding area. Serbia is currently classified as an emerging economy by the International Monetary Fund and an upper-middle income economy by the World Bank. It regained its status as a sovereign nation in 2006 after the disintegration of the Union of Serbia and Montenegro (and previously, the Former Federal Republic of Yugoslavia). Serbia is a member of the United Nations, OSCE, Council of Europe, the Central-European Free Trade Agreement, and has applied in 2009 to join the European Union, with accession aimed to be in 2014 (Magnusson and Nenadovic, 2009).

Political Risks:

Serbia's political scene during the 1990's faced incredible challenges and hardships as the country battled through the Yugoslav Wars (in Croatia, Bosnia, and Serbian south province Kosovo). This secluded the country from

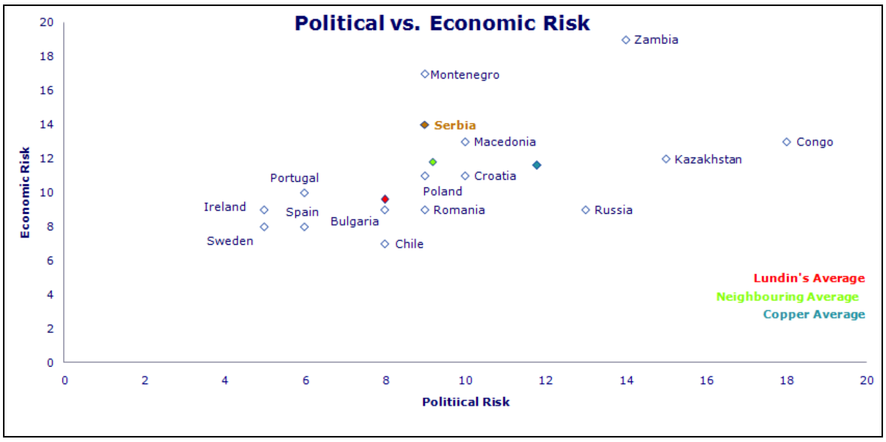
Europe's growth at the time and pushed it into both political and economic isolation. After the end of the Milosevic government in 2000, Serbia's political climate has very much stabilized. The country is currently ranked as one of the few "free" nations in the Balkans, is a militarily-neutral nation, has a high human development index, and holds numerous partnership and cooperation agreements with the European Union, Russia, and China.

Economic Risks:

Serbia's economy remains quite risky. After being gravely impacted by UN economic sanctions from 1992-1995, the nation further endured an estimated $30 billion in damage from the NATO bombing in 1999 (Vujanovic, 2009). While the country has experienced strong growth in GDP since then, inflation remains high at approximately 6.5%, unemployment is 13%, there is a large trade deficit, and the country's bonds are still labeled as non-investment grade. While economic risk remains high, the country has made valiant efforts in trying to re-establish itself as a leading nation in the region. GDP growth rates for the past nine years have been 5.23% (annualized), which far surpasses any comparable nation. They are expected to return to this rate starting in 2011-2014 as the nation recovers from the financial crisis impact. Serbia is currently the only European country with free trade agreements with both the EU and Russia. Taking into account that the country is expected to join the European Union in the coming decade, it will be firmly positioned to be the connection point between Russia and the EU. In an attempt to attract foreign companies, Serbia lowered its corporate tax rate to 10%, making it the second lowest corporate tax rate in Europe behind Montenegro. Given these factors, Serbia's economic risks seems to be offset by the promising potential of growth and returns that the country is offering and its high assurance of future stability through partnership agreements with the EU.

Risk Analysis:

A detailed political and economic risk analysis was conducted to compare Serbia's respective risk to neighboring countries, countries of Lundin's current operations, and other countries worldwide that possess copper. Political factors considered were the democracy index, the human development index, degree of corruption, and ease of doing business. The economic factors considered were the countries' long term sovereign ratings, foreign direct investment, inflation, public debt (measured as a percent of gross domestic product) and the gross domestic product. The results are as follows:



Why Serbia?

Serbia's eastern town of Bor is the home to one of the largest copper mines in Europe, The Copper Mining and Smelting Complex RTB Bor (RTB). The site holds one of the oldest traces of mining in Europe and dates back to 4500 B.C. While the mines are "currently working below capacity" (Privatization Agency of Serbia, 2010), a significant increase in production has been achieved since 2008 due to the growing demand of copper in this area, indicating a "considerable upside for future production". RTB's current core operations include an "underground copper mine, three open pit mines, an undeveloped underground resource, three copper ore flotation plants, a copper smelter, a refinery, and other associated infrastructures". RTB's organizational structure has changed since the decomposition of the previous ownership and related privatizations of downstream entities that did not belong to the core mining operations. The remaining entities under RTB Bor L.L.C (the parent company) that have extraction and treatment of copper ore activities are:

- RBB – Copper Mine Bor d.o.o
- RBM – Copper Mine Majdanpek d.o.o
- TIR – Smelter and Refinery d.o.o

This connection has already begun: Serbia and Russia signed The South Stream Pipeline project in December 2008. This gas pipeline will transport Russian natural gas through Serbia into the EU.

On February 2009, the Privatization Agency of Serbia issued a public invitation to reputable copper producers and processors for a strategic partnership in relation to the privatization of RTB. The objective is "to attract strategic investors who can provide management and production know-how investments in technology and environment protect, and access to the local and export markets". The following sections provide an in depth analysis of how Lundin could benefit by acquiring RTB.

The mining industry in Serbia makes up the foundation of the domestic industry and the entire Serbian economy in general. Given that the country has experienced significant growth in the past decade and growth projections are predicted to continue the strong course, entering the mining industry in Serbia can provide a firm with many opportunities. Specifically, "investing in the Serbian metal/mechanical industry means acquiring some very important economical benefits such as low labor costs (especially medium skilled labor) and low transportation costs due to the geographic proximity of the [European Union] and Serbia" (Serbia Energy). As indicated by Serbia Energy, investing in Serbia "not only allows a company to access a fast growing local market with a strong and growing request for machineries but will also provide them with further access to various other markets holding preferential trade agreements with Serbia". Serbian metal processing workers are highly skilled as they are trained to meet the European Markets Standards. However, the manual labor costs are still quite low with respect to Western European nations.

Historically, Serbia has been one of the leading copper producers in Europe. Prior to the economic and political turmoil in the Balkans, Serbia was producing more copper than Finland, France, Norway, Spain, and Sweden combined. As the country continues to recover, additional investments in copper sites such as RTB could increase efficiency and return copper output to previous high levels. Serbia has recently attracted several multinational companies, which could increase local demand for this industrial metal. A prime example of this is the acquisition of Zastava Automobiles (the Serbian automotive conglomerate) by the Fiat Group. Zastava, a once powerful player in the European automotive industry, suffered from the Balkan crises and was on the verge of bankruptcy. However, in July 2008, Fiat took control of Zastava, investing €700M in return for a 70% stake in the company. With this major investment, the company returned to its profitable ways generating $500M in revenues in 2009. Additionally, production is set to reach 200,000 units by 2010, a significant increase from the prior year. As copper is an essential metal used in the automotive industry, reviving RTB would allow it to meet the strong demand in a growing automotive area.

RTB fulfills several of Lundin's missions. Firstly, the mission of generating a steady stream of development opportunities and knowledge from having operations in other European nations such as Portugal, Spain, Sweden, and Ireland make it a prime candidate to provide management and production know-how to RTB. Secondly, the mission of having an ethical and transparent environment makes it an ideal candidate to offer environmental know-how to RTB. As a result, investing in RTB would help Lundin further meet its missions and would be in line with the Company's core values. Lundin's stock performance has significantly fallen in the past three years as revenues have been decreasing as a result of lower sales volume. Entering a joint-venture agreement with the Serbian government for the RTB complex would present the Company with a chance to explore and extract additional quantities of copper at a lower price due to significantly lower labour costs than in Western Europe. Furthermore, it could use the Serbian Government's close connections with Russia to access new markets and benefit from Fiat's investment in Zastava to acquire new customers. In summary, Lundin's rewards for entering the Serbian market include reinforcing its core values and missions, acquiring additional quantities of copper at lower labour costs, expanding its customer base through new markets in the Balkans and Russia, benefiting from the recent automotive resurgence in the area, and finally diversifying geographically by setting up operations in Southeastern Europe.

Serbia's Mining Market Structure

Serbia's mining market structure, especially the copper market, is fairly untapped. The government currently owns the majority of the sites. As of now, Serbia's mining market structure is essentially a monopoly run by the Serbian government. However, given the recent privatizations of former state-owned companies such as Zastava (acquired by Italy's Fiat), Mobtel (telecom giant acquired by Norway's Telenor), and the Petrolium Industry of Serbia (acquired by Russia's Gazprom), the country is headed for a monopolistic competition market structure. This is further indicated by the efforts that have been made by the Serbian government since 2007 to privatize RTB Bor. There is not much flexibility regarding the options for entering Serbia and acquiring RTB as the country has made the conditions very clear in the tender offering. Lundin's only option to enter Serbia and invest in RTB is to essentially enter the project as a joint venture alongside the Government of Serbia. The proporal made in this report is assuming a 40/60 joint venture. This percentage is based on the official tender offering made by the Privatization Agency of Serbia. Per the tender, the Government of Serbia has provided the following structure for the investment. Firstly, Lundin would have to set up a corporate subsidiary in Serbia. Secondly, a new legal entity would be created via merger of Lundin's Serbian subsidiary and the Government of Serbia. The transaction would be implemented in several phases. Finally, the structure would be such that Lundin's subsidiary would initially hold 40% of the investment while Serbia would control 60%. There exists an option for Lundin's subsidiary to acquire 67% of RTB in the future, providing certain conditions are met.

Threats, Competition, and Risks

To analyze the mining industry (with a focus on Serbia), Porter's Five Forces model will be utilized. This model will explain the threat of new entrants, the technological substitute threats, and any other competitive risks that Lundin might face in the copper industry going forward.

1. Bargaining Power of Suppliers

The bargaining power of suppliers in the mining industry does not exist as the mining companies extract the product and supply to the market.

2. Bargaining Power of Customers

The bargaining power of customers in the mining industry is very low as prices are fixed through market prices and through futures and forwards agreements.

3. Threat of New Entrants

The threat of new entrants in the mining industry is quite low for a number of reasons. Firstly, there are high initial capital expenditures for a company to establish themselves due to expensive but necessary machinery and equipment. Secondly, there are high barriers to entry due to the already established firms operating in the industry. Next, every country that possesses the desired resources will have restrictions and certain governmental and regulatory arrangements that must be met, making it harder to begin operations. Finally, there are high learning curves and absolute cost advantages as firms that have been mining for an extensive period of time have utilized best-practice methods to achieve efficient operations.

4. Threat of Substitute Products

The substitutes that can be used for copper are aluminum (for electrical equipment), optical fibre (for telecommunications), and plastic (for pipes). Copper has a higher conductivity than aluminum, is more ductile, and can be easily soldered. However, aluminum is lighter and less expensive. Optical fibre's practical bandwidth far exceeds that of copper cable. With bandwidth demand increasing due to high-speed internet usage, fibre optic cables will be in greater demand than copper. Finally, plastic is less expensive than copper however copper is much more durable. Overall, the threat of substitute products for copper is high.

5. Competitive Rivalry within Serbia's Mining Industry

There appear to be two existing and two likely competitors currently in Serbia that would pose a threat to Lundin.

There are several risks surrounding RTB and Serbia that should be considered. Firstly, the demand for copper is a critical factor. As outlined in Porter's model, there are several substitutes for copper that could impact its price forwarding the future. Secondly, Lundin would be entering an unknown market in which it has not previously operated. As Serbia is not part of the European Union, there are different regulations and business practices that could hinder estimated growth and sales. Thirdly, the various competitors outlined in the Porter model present a clear risk that Lundin might not have the competitive advantage in the area when dealing with copper purchasers. Next, there is the possibility of a conflict of interest as the Serbian government (being the initial 60% holder of the deal) would be desirous to sell the copper to certain, favored companies in the region. Their nature, operations, and degree of threat to Lundin are discussed below:

Competitor Name	**Description**	**Threat to Lundin (High, Low)**
Existing Competitor: Dundee Precious Metals	- Toronto-based international mining company engaged in the acquisition, exploration, development, and mining of precious metals. - Largest holder of exploration lincesnes in Serbia. - Sold the Timok gold project in Serbia to pursue new mine development opportunities in Bulgaria.	High -Company is similar to Lundin -Company has vast experience in Serbian market
Existing Competitor: Glencor International AG	- One of world's largest suppliers of a wide range of commodities and raw materials to industrial consumers. - Privately held company headquartered in Baar, Switzerland. - Started business of activation and exploitation of gold mine "Coka Marina 1", near Majdanpek.	High -Larger company than Lundin -Opereations close to Madjanpek, which is very close to Bor area -Has Serbian market knowledge as an advantage
Likely Competitor: Cuprom	- Leading copper company in Romania and one of largest in Eastern Europe - Won bid of RTB Bor in 2006 but failed to seal it due to lack of funds	High - Already attempted to enter Serbia - Geographically close
Likely Competitor: A-Tec Industries	- Vienna-based international industrial group with successful operations in drive systems, plant engineering, machine tools, and minerals and metals. - Won bid in 2008 for RTB Bor but credit crunch made them unable to meet second payment	High - Already attempted to enter Serbia - Currently employes around 11,900 around Europe (construction operations in Serbia)

Finally, given that the labor costs in Serbia are currently attractively low, there is a risk that with Serbia forecasted to enter the European Union in the coming years these costs will go up as the domestic costs stabilize with the rest of the Union.

Should Lundin choose to proceed with the RTB acquisition, they should ensure that they hedge against all the foreseeable risks listed above. Firstly, Lundin should hedge the price of copper through derivatives to ensure that their selling price in the next few years is fixed. They should proceed to address this risk in a similar way that they do with all their other copper operations across the world. Secondly, Serbian consulting firms should be hired to prepare Lundin for business operations in the country. Companies such as Deloitte Serbia offer consulting with the aim to "combine [their] local expertise, business knowledge, and pragmatic approach to offer clients practical solutions in a complex world". Thirdly, Lundin should perform detailed analysis on the current competitors and strive to outperform them in terms of efficiency, customer relationships, and environmental considerations. Given that Lundin would be in a joint venture with the Serbian government, there is a risk that the government will influence RTB's (and consequently Lundin's) operations with respect to other local mining companies. However, to mitigate the risk of a possible conflict of interest with the Serbian government, Lundin should ensure that the contract provides clauses which prevent any favoured, predetermined sales and force a profit-oriented approach aimed at maximizing shareholder value.

Action Plan

This section presents the results of a quantitative analysis of the appropriate bid price, type of financing, and other acquisition-related discussions. A capitalized earnings valuation approach on RTB Bor was performed. A bid for 40% of RTB (adjusted for minority discounts) was estimated to be approximately €450M. However, a sensitivity analysis produced a range between €308M-€624M. Given that the minimum required bid for RTB Bor per the tender is €86M, I recommend that the Company offers the Serbian government between €100M and €200M. This would ensure that Lundin is achieving a good deal on RTB, while at the same time satisfying the tender's offer. The Company could finance the expansion by borrowing from the Canadian or foreign debt markets or issuing more stock through the Toronto Stock Exchange or the Swedish Nordic Exchange. Given the Company's Debt-Equity ratio of only 6%, I would recommend that the company borrow money from the Canadian market due to the fact that Lundin is a reputable Canadian company and many investors would be interested in providing debt to the Company. A calculation was performed to determine the additional debt that Lundin could shoulder while still maintaining a strong balance sheet debt-to-equity ratio of 25%. It was determined that the Company could borrow up to $609M CDN (approximately €446M). The strategy proposed in this paper is contingent upon many factors and each of these factors has related challenges. Firstly, RTB would have to meet the expectations of Lundin's shareholders and Board of Directors. Secondly, Lundin would have to satisfy the Serbian government and convince them that Lundin can return RTB to its profitable ways. Additionally, there is doubt as to how well the debt markets would perceive this project. Given that Serbia is part of an area that is currently (alongside Greece) experiencing much economic turmoil, there is a possibility that financing this project could prove to be difficult or infeasible. Lundin would have to quickly pass this project through many levels of management and have all the shareholders agree to begin proceeding with the offer. Lundin would have the option to increase its stake in RTB to 67%.

Lundin would have to make a bid that not only satisfies the valuation results, Board of Directors, and shareholders but also one that is favorable to the Serbian government and outperforms competitors. Given that Lundin does not have any previous business relationships with the Serbian government or Serbian economy, the risk exists that Lundin's bid would be rejected.

Conclusion and Recommendation

Lundin is currently struggling from decreasing sales and decreasing operating cash flow and is in dire need of revival. RTB Bor presents the Company with an opportunity to geographically diversify its operations, reap in the benefits after rebuilding this historically profitable and important mine, and to return Lundin's stock price to higher levels. While the political and economic risks of Serbia are higher with respect to Lundin's Western European operations, the outlook for Serbia (both politically and economically) is forecasted to be strong. This report suggests that the Company should make an offer to the Serbian government of approximately €150M for a 40% ownership in RTB. Given the low debt-to-equity ratio, the Company has the ability to increase their debt capacity. Accordingly, the bid should be financed through the Canadian debt markets. In a few years time, Lundin should reassess RTB's performance and, if satisfactory, increase its share in the Company to 67% to obtain controlling interest. This report has proven that adding RTB to an already strong mining portfolio would maximize shareholder value, diversify Lundin's operations geographically, and provide the Company with a much needed spark to get its financial performance back on track.

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