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Speculative Buy Firestone Diamonds

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Firestone Diamonds is a Very Simple Company Indeed
It has Two Mines in Production which are profitable
And Can Fund an Exciting Exploration Programme For Many Years
The Stock Has Been Hit By Political Concerns but
These Are Overcooked and at 52p it is a "speculative buy."

The Kenny family are an Irish dynasty with oil and mineral exploration experience going back decades. Their latest vehicle, Firestone Diamonds (FDI), was founded in 1994 and is chaired by father Jim and run by son Philip. The family own about a quarter of Firestone which is a very simple company indeed.

It currently operates two mines in South Africa - Avontuur and Oena. These two mines are profitable and generating enough cash to fund exploration activities at a number of other sites which could be seriously profitable. Clearly there are implicit risks in any exploration programme (it may find nothing) and in South Africa at present there is a perception of political risk. But on a risk/reward basis, Firestone looks like a very good bet indeed at 52p - a level which capitalises it at just £17.7 million.

The Two Producing Mines

Firestone's first mine was Avontuur which lies on South Africa's West Coast, approximately two thirds of the way from Cape Town to Namibia. It produces small diamonds at an average size of 0.22 carats per stone but it has produced enough of these stones to have been cashflow positive for the past three years. And it will continue to be so, assuming that current diamond prices hold. Indeed Avontuur generated enough cash to fund most of the development of the rather more significant mine at Oena up near the Orange river. The company say that this lease contains up to 270,000 carats with a gross value of £170 million but, even despite recent encouraging exploration news from the site, don't get carried away.
The opening of a new excavation (Sandberg) at Oena a couple of months ago certainly means that it will be increasingly profitable and cash generative but not sufficiently so to be a company maker. At current diamond prices the best that Oena and Avontuur together could do would be to generate around £1.5 million of cashflow per annum, albeit for a good many years.

The Upside

The cashflow generated by the two mines in production is being used to explore a number of properties in South Africa and in Botswana. Botswana is actually the world's largest producer of diamonds and unusually for an African country has a totally stable, political and fiscal regime and a decent infrastructure.
In Botswana, Kenny junior is very excited about the Mopipi area where Firestone has interests ranging from 50% to 100%. Mopipi is about 50 kilometres away from De Beers' giant Diamond mine at Orapa and Firestone has been exploring this area in some detail for over two years and has identified all the indicator mineral anomalies one would associate with a diamondiferous area (G10s, chrome diopside, etc). Detailed drilling at Mopipi should commence shortly.
Back in South Africa "aggressive exploration" will also start later this year at Groen River Valley - close to Avontuur - and the company is confident enough from the 5,000 metres or so that it has already drilled to state that it is "*close to identifying economic potential*." A site at Breektand, to the south of Groen River Valley is at the very early stages of exploration so although the area is known to be diamond rich there is no point speculating about it at this stage.
The potential is clear. Kenny's belief is that either Groen River or, more probably, Mopipi have the potential to be world class deposits with reserves that would dwarf those of Oena. If that faith is justified then clearly Firestone will be grossly undervalued. Its shares could treble and still look incredibly cheap.

The Risks

1. Firestone's exploration programme disappoints. It is more than possible that all of Firestone's acreage will yield just sand. In which case the company will generate enough cash from its existing mines to easily sustain its corporate overheads and to find other assets to exploit. Clearly in this case the shares would be valued on a modest cashflow multiple and in this scenario, I'd suspect that the downside risk is about 30-50%.
2. Conceivably Mopipi and or Groen River could end up as rather smaller mines. Rather like Oena or Avontuur they would generate some cash which would fund further exploration or asset development. Under this scenario, Firestone is probably fairly valued as a mere cash cow.

3. Diamond prices may fall. A slowdown in the global economy would in theory hurt diamond prices. However in the past De Beers has shown that if this happen it will simply reduce the amount of its stockpile that it releases in order to maintain supply/demand equilibrium, and hence prices. Over 20 years (or any longer timescale) diamonds have been a much better store if value than, say, gold. As it happens the De Beers stockpile is actually rather low and hence a number of commentators have suggested that diamond prices will, on a two to three year view actually rise. If that happens, Firestone's costs will not rise and hence operation gearing will kick in. A 30% increase in diamond prices could easily see at least a doubling of the cashflow generated by Oena and Avontuur in which case Firestone would probably be fairly valued simply on the basis of its current production.

4. Black Empowerment in South Africa might hurt mining groups. It is clear that the draft proposals leaked last month to hand between 30% and 50% of all mines to Black Empowerment groups have been scuppered. In any case the targets of activists anger are not small, usually benevolent foreign companies but companies such as Anglo American which were so closely associated with the Apartheid era. Obviously it would be preferable if Oena was nearer to Chipping Sodbury than to Cape Town but on a ten year view the political risks of South Africa are more than discounted in the share price.

5. Firestone might issue shares. Firestone has net cash of almost £2 million from a fund raising in November 2001. That, and the cash generated from its existing mines, is easily sufficient to fund its ongoing exploration programmer. Clearly if it unearths something exciting at Mopipi it will need funds to develop the project and it is unlikely that it could be completely project financed. But if it dies strike it lucky at Mopipi or Groen River any fund raising will be at a price significantly higher than 52p.

Firestone's shares have almost halved since May thanks to nervousness about South Africa. For a small company and an illiquid stock such as Firestone it needs very few sellers when the buyers are on strike - as they were during recent market upsets - to see the share price fall significantly. But meeting Kenny junior for lunch last week, it was apparent that nothing about Firestone has altered other than its production at Oena has increased significantly and that the signals from Mopipi have grown ever more positive.

This is a speculative investment. Any company depended on exploration activity has to be. If you want a more solid small cap growth stock to back, last night's recommendation (Merrydown) is your cup of tea. But if you are looking for an exciting risk reward punt then Firestone is rather more exciting. In a worst case scenario these shares could halve. But if Kenny's faith in Mopipi is justified then this stock could treble by Christmas. With a 60p limit buying price, Firestone is a "**speculative buy**."