Timminco draws more aggressive short selling

2008-05-27 12:06 ET - Street Wire

by Lee M. Webb

Timminco Ltd., a star performer on the Toronto Stock Exchange (TSX) over the past year, continues to trade near its all-time high in spite of lingering questions about the company's secret proprietary technology to produce solar-grade silicon and aggressive short selling from both sides of the border.

As previously reported by Stockwatch, Timminco's stock price was languishing at approximately 30 cents per share a little more than a year ago, but that changed dramatically when the company, led by Heinz Schimmelbusch, piled into the hot solar silicon market.

The propellant for Timminco's meteoric rise to more than $25 per share was the claim that the company's subsidiary, which had been producing silicon metal for more than two decades, had developed a secret, relatively simple, low-cost way to upgrade metallurgical silicon into the much more valuable solar-grade silicon used in the booming solar cell industry.

In very basic terms, metallurgical silicon has a purity level of approximately 98 per cent and sells for approximately $1.50 per kilogram. Solar-grade silicon, the key component in photovoltaic cells that convert solar energy into electricity, is 99.999-per-cent pure and fetches approximately $65 per kilogram.

Using its secret proprietary technology to produce 99.999-per-cent pure upgraded metallurgical silicon at a projected cost of somewhere between $10 per kilogram and $15 per kilogram, Timminco is ramping up production at its recently completed 3,600-metric-ton facility in Becancour, Que.

Over the past year, boosterish analysts and bullish brokers have been tolling the virtues of Timminco while a Pavlovian pack of reporters chimed in with remarkably unskeptical coverage celebrating the soaring TSX solar play.

Perhaps not surprisingly, Timminco's rocketing stock price, the secret proprietary process that essentially makes Becancour a black-box project and the unusual share structure, in which the company's two largest shareholders control approximately 70 per cent of the stock, have combined to draw the attention of short sellers.

The fact that Timminco shipped 100 metric tons of its upgraded metallurgical silicon to reportedly satisfied customers during the first quarter ending March 31 has evidently done little to ward off the short sellers.

Short sellers were similarly undeterred by the fact that Q-Cells AG, a Timminco customer and the world's largest producer of solar cells, expressed considerable interest in the potential of upgraded metallurgical silicon during a May 14 conference call.

Apparently, a gushing May 14 "operational review report" by Timminco's paid-for solar booster Michael Rogol did not do much to convince short sellers that the company's secret proprietary technology is all that it has been cracked up to be, either.

Indeed, the short position increased substantially even as Timminco was heading to a new all-time high of $28.65 per share, pitting short sellers against those with long positions in what has become a high-stakes competition.

Canadian shorts

At the end of March, the short position in Timminco stood at a fairly modest 565,040 shares in Canada. Over the past six weeks, however, that position has increased significantly.

By April 15, the Canadian short position had more than doubled to approximately 1.18 million shares. It more than doubled again to approximately 3.06 million shares as of April 30.

According to the TSX's most recent short position report, there was an outstanding short position of more than 3.84 million Timminco shares as of May 15. At Timminco's current market price of more than $27.50 per share, the Canadian short position carries a value of approximately $106.3-million.

As it happens, the Canadian short position tells less than half of the story.

U.S. shorts

As previously reported by Stockwatch, Timminco changes hands in the grey market in the U.S. It does not have any market makers and there are no published quotes for the stock.

Compared with the active TSX trading in which millions of shares regularly change hands on a daily basis, the U.S. trading is relatively insignificant. In the last three months, the grey market daily trading volume only topped 100,000 shares once and sometimes only a few hundred shares change hands in an entire session.

While the trading volume south of the border is of little significance, the short position in the U.S. is actually quite substantial.

According to the latest available information as of April 30, broker-dealers in the U.S. reported total short positions in Timminco of more than 5.3 million shares.

Timminco also appears on the Financial Industry Regulatory Authority (FINRA) Rule 3210 threshold security list, which identifies issuers not subject to U.S. Securities and Exchange Commission reporting requirements that have aggregate fails to deliver of 10,000 shares or more valued at $50,000 or more for five consecutive days.

Threshold securities may be subject to short sale delivery requirements and mandatory closeouts of fail to deliver positions, in other words forced buy-ins.

Interestingly, while the reported U.S. short position stood at more than 5.3 million shares at the end of April, over the preceding 12 months only approximately 2.8 million Timminco shares actually traded in the grey market south of the border. In other words, a significant portion of the U.S. short position was established in TSX trading.

In any event, the reported short position of more than 5.3 million Timminco shares in the U.S. as of April 30 carries a current market value of approximately $147-million.

Dreaded squeeze

As of the most recent reports, the combined short positions in Canada and the U.S. stand at more than 9.1 million shares valued at more than $253-million. While that is certainly not chump change, it does not necessarily reflect the full potential exposure facing short sellers.

At worst, investors holding long positions in a security can only lose 100 per cent of their money. As bad as that would certainly be, short sellers face the more unsettling possibility of being stung with even greater losses than that.

Theoretically, there is virtually no limit to what an investor could lose by being hung out on the wrong end of short sale.

While remarkably rare, a sustained "short squeeze" is the dreaded bane of investors who bet against a stock by selling short in the hope of profiting from a drop in the share price.

In simple terms, a short squeeze is precipitated by some event that drives short sellers to compete with one another to close out their positions in a rising market in order to cut their losses, with the frenzied buying triggering margin calls and buy-ins that push the stock price ever higher.

Many starry-eyed investors, perhaps particularly in the world of penny stocks, gleefully contemplate the prospect of wiping out short sellers in a devastating squeeze, but that rarely happens.

Among other things, with most public companies the share structure is not controlled tightly enough to sustain a significant short squeeze.

In a practical manifestation of the classic game theory dilemma of co-operate or defect, many of the shareholders in a loosely held stock, not trusting the other players in the context of the devil-take-the-hindmost dynamics of the market, will often dampen the impact of a potentially devastating short squeeze by attempting to bail out and unload their shares ahead of other investors.

Moreover, short sales are frequently made as part of a hedging strategy in which the short position is directly or indirectly backstopped by an existing long position or in-the-money warrants or options that can be exercised to close out the short position without driving up the market price of the shares.

Given Timminco's share structure and the stock's resilience in the face of some negative media coverage over the past month, short sellers might be experiencing a bit of apprehension about their positions, particularly if their exposure is not limited by some undetected hedging strategy.

As previously reported, Timminco's two largest stockholders, AMG Advanced Metallurgical Group N.V. and Sprott Asset Management, control approximately 52.6 million shares and 17.7 million shares, respectively, of the company's 104 million outstanding shares.

In addition to their lock on more than 70 million shares, AMG and Sprott might reasonably expect some support from the holdings of Timminco's officers and directors as well as some other funds, in the event push came to squeeze in a showdown with short sellers.

While short sellers may understandably have some concerns about their exposure, Timminco's major stakeholders possibly face their own set of challenges.

Long unwinding road

Timminco's controlling shareholder, AMG, which is also headed by Mr. Schimmelbusch, obtained the vast majority of its approximately 52.6 million shares in the company in March of last year by way of a transfer from Safeguard International Fund L.P., a private equity fund also headed by Mr. Schimmelbusch.

The reorganization of Safeguard's Timminco stake through a contribution to AMG, which was subsequently taken public in Europe and now trades on Amsterdam's Euronext exchange, was part of a clever strategy that allowed Safeguard to take some money off the table without impacting Timminco's share price.

As a selling shareholder in AMG's initial public offering in July of 2007 and through the subsequent sale of another 3.5 million AMG shares a few months later, Safeguard managed to pocket approximately $350-million.

When Safeguard unloaded its first tranche of AMG shares as part of the initial public offering last July, Timminco was trading at a relatively modest $6 per share. When the fund sold another 3.5 million AMG shares last October, Timminco was changing hands for $16 per share.

Safeguard still holds approximately 7.1 million AMG shares representing 26.6 per cent of the company's outstanding stock. With AMG currently trading at a converted value of approximately $98 per share, Safeguard's stake in the Amsterdam-based company is worth approximately $697-million.

Meanwhile, at current market prices, AMG's majority stake in high-flying Timminco is valued at a whopping $1.45-billion. There is nothing to suggest that AMG has any intention of trying to unwind its position in Timminco, something that would undoubtedly have a significant impact on the TSX solar player's stock price.

Interestingly, however, AMG's largest shareholder, Safeguard, is slated to be dissolved and its assets distributed to its limited partners within the next 10 months. In addition to Safeguard's stake in AMG, those assets include claims on another hefty chunk of Timminco stock.

Through its subsidiary ALD International LLC, Safeguard holds what is unabashedly described in AMG promotional material as "deeply in-the-money convertible notes representing approximately 17.4 million new Timminco shares."

Timminco pegs the number of shares reserved for issuance in satisfaction of the convertible notes held by ALD International at a slightly more modest 17.26 million shares.

Nonetheless, those convertible notes covering a relatively insignificant $7.1-million worth of loans are indeed deeply in the money, given that 17.26 million Timminco shares would carry a current market value of approximately $478-million.

Safeguard's controlled subsidiary ALD International, which has the right to convert the $7.1-million worth of notes at any time into shares at prices ranging from 40 cents per share to 42 cents per share, has thus far exercised remarkable restraint with respect to cashing in on its lucrative loans to Timminco.

As it happens, AMG has entered into a call option agreement with Safeguard's ALD International with respect to the convertible notes. Under the agreement, ALD International can call upon AMG to ante up the prevailing market price for Timminco shares in return for any shares issued upon conversion of all or part of its $7.1-million worth of loans to the TSX solar play.

AMG does not have enough cash to meet a full call under that agreement and any attempt to unload a substantial portion of 17.26 million Timminco shares in the market would undoubtedly put significant pressure on the share price.

It is not clear just what will become of the call option agreement between AMG and ALD International when Safeguard is wound up and its assets distributed to its stakeholders by March 31, 2009.

At some point, of course, even the most patient investors will want to cash out; and with an entry point topping out at 42 cents per share, ALD International's position of 17.26 million Timminco shares could withstand a great deal of downward price pressure. Indeed, barring a complete collapse in Timminco's stock price, Safeguard's subsidiary will likely make out quite handsomely however it manages to unwind its position.

Timminco's second-largest stakeholder, Sprott, which was taken public earlier this month by its market-savvy namesake Eric Sprott, may also face some challenges when it decides to unwind some or all of its funds' positions in Timminco.

As previously noted, Sprott controls approximately 17.7 million Timminco shares, reportedly acquired at an average price of $6 per share. At Timminco's current market price of more than $27.50 per share, Sprott's stake is worth approximately $490-million.

Given its $6 per share cost basis, Sprott could certainly weather some downward pressure on Timminco's stock price, too, in the event the firm decides to unload a significant portion of its shares, but any substantial disposition might trigger a ripple effect among other investors keeping an eye on its holdings.

It is unlikely, of course, that Mr. Sprott, who has decades of experience and a reputation as a sharp trader who keeps his finger on the pulse of the market, will implement some crude strategy that might spark a wild stampede to the exits.

In any event, it will be interesting to see how Sprott attempts to finesse its disposition of Timminco shares when the time comes.

Meanwhile, with the U.S. celebrating the Memorial Day long weekend, there was no trading in the grey market south of the border on Monday.

In something of a surprise, Timminco registered its lowest TSX trading volume in more than a year as a comparatively modest 230,897 shares changed hands and the stock gained 15 cents to close at $27.70 on May 26.

Comments regarding this article may be sent to lwebb@stockwatch.com.

(More information regarding Timminco Ltd. is available in Stockwatch articles published on May 14 and 16, 2008.)