Think Piece

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Soup to Nuts
Vertical (or quasi-vertical) integration in the mining/industrial space
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To vertically integrate or not?

+ A new Golden Age (to mix a metaphor) could be dawning for specialty metals with the spoiler effect of Chinese predatory pricing in retreat while rising demand from new technologies is making them into potentially higher value inputs in higher value products.

+ China narrowing down supply via various means has resulted in fairly unequivocal signals to the industrial users in the West that they should start looking for alternative supplies.

✖ The timely forewarning (after all the Chinese could have unilaterally chopped supply) has largely gone unheeded by Western industrialists who are thrall to Just In Time and vertical disintegration theories expounded by Wall Street and its imitators.

✖ This “deer-in-the-headlights” stance means that nothing much is going on except among the most savvy or iconoclastic industrial players

✖ In the Rare Earth space for example, industry (despite being very well-resourced particularly amongst the military suppliers) has been looking towards the government to spend taxpayers money to make a stockpile for their convenience and peace of mind

“Secure thy Upstream”

Talking to companies in the specialty metals space is a totally different dialogue to that in the precious metals or even base metals space. The precious metals markets, despite what some conspiracy theorists might venture, is a totally transparent marketplace with a myriad of buyers and sellers. The base metals markets range from many-to-many relationships (copper) to few-to-many (nickel) but with relatively liquid markets moving around the vast amount of product. The other bulk mining products like iron ore, manganese, met coal etc are also many-to-many or few-to-many but have less transparent pricing (at least until iron ore new spot price regime gets formalized in some way).

The specialty metals space is, at best, a story of few-to-few relationships, or one-to-few or rather nightmarishly (in light of Chinese threats to withhold supply in some metals) potentially none-to-few. This noose swinging in the breeze in front of industrial users has triggered different reactions from different quarters. In the Rare Earth space politicians in Washington have seized the nettle and started to campaign against the US dependence upon REE sourced from China (particularly as it pertains to military applications). In Japan and Korea there is a determined hunt to tie up sources of supply in lithium and vanadium before they fall into Japanese hands. In a few isolated examples in the West, industrial users are trying to cement relations with prospective producers to ensure they get right of first refusal over offtake (when it starts to flow). By and large though the major Western industrial users of specialty metals have eschewed getting their hands dirty in mining (or returning to mining as many at one time were vertically integrated in their supply chains).

In light of the scramble to replace Chinese supplies with something more reliable we find that the industrial customers in the West can’t get out of their own way. Trapped in outmoded ideas of who should supply them, the level of commitment that the user should make on long-term contracts on both
volume and price and the daunting fact that most miners are finding financing hard to do except with Asian-based offtakers, the Western industrial users are outclassed and bewildered.

To them we would say “Secure they upstream”.

**Wall Street's role**

Vertical disintegration (in both senses of the word) is the best term one can use to describe the failure of Western industrial enterprises to secure their supply chain in a wide range of metals, particularly specialty metals. Essentially many corporates in the Western World used to ensure their access to scarce inputs by owning the means of production i.e. securing their upstream supplies. Investment fashion in recent decades required that managements parsed their various activities down to the “nth” degree and identified how much of revenues and profits derived from all aspects of a manufacturing business. Where a mining operation was part of the supply chain it was very easy from the 1970s to make a case that the mine was unprofitable and a drag (in virtually every category of metals) and thus something better spun off, sold or closed down. RIP much of the US specials metals mining capability. Wall Street loathed conglomerates and the idea that a defense manufacturer or even an auto or electronics firm should have a division that did not “make a profit” but helped the rest of the firm do so didn’t fit with the management theories that required that every stone be squeezed dry of blood to contribute to the bottom-line and the Gods of EBITDA and P/E.

Companies thus would be punished for “extraneous” activities. Mining of these metals, particularly once China started exporting these products at rock bottom prices after the mid-1970s, looked to be an indulgence if a Western manufacturer persisted in the practice. Interestingly the Japanese never suffered from such “market disciples” forcing it to divest mining because its companies were notoriously impervious to short-termism and market fetishism. However, because of lingering memories of the Greater East Asian Co-prosperity Sphere, particularly in Australia, it was the Japanese trading houses (C. Itoh, Marubeni, Mitsui, Mitsubishi, Sumitomo etc) who took strategic stakes in mines (and larger shares of the offtake) to ensure that the mothership in the Zaibatsu had sufficient raw materials to distribute to the hungry maw’s of group companies in Japan’s Great Leap Forward from 1949 until 1985.

Meanwhile the corporate West furiously disintegrated (again in both senses) while government’s were urged by budgetary zealots to offload strategic stockpiles. After all, selling down the strategic stockpiles, particularly in the US, meant that industry got the government to depress prices of metals and sell industry “cheap” raw inputs, often at a loss when one considered the accounting for the original purchase price of the product in the 1950s and 1960s, the financing cost, the storage cost and the opportunity cost for all those decades.

**Tungsten**

This super-hard, super-dense and super-slow to melt metal is ironically one of those other metals in which China has a 90% share of global supply. This fact has escaped most observers of the mining sector because there is no-one besides the sole listed stock that produces Tungsten in the West, the small Canadian company, Malaga (MLG.to). We produced a research note on this company some weeks ago.
Of course “Just in Time” is not heard all that much these days because it is now so embedded in corporate lifestyles that it goes without saying. The natural response for a peasant who decides to stop growing his own onions is to buy someone else’s and stash them away. Likewise the correct response to GE no longer owning stakes in Tungsten mines (to provide lightbulb filaments) would be to fill warehouses with enough Tungsten to ensure it could ride out price spikes and supply disruptions. Wall Street would chastise such a strategy as “excessive inventory build”. GE exited the lightbulb business as it was no longer sexy and the once mighty names of Osram and GTE Sylvania merged together into a new entity that goes by the name of GTP. While GTP does not produce Tungsten it has “gone Japanese” in the sense that it has done an interesting deal with Malaga to ensure that it can corral all the production it needs from the miner.

We might also note that the major Scandinavian tool company, Sandvik, which is a significant user of Tungsten for toughening tool steel took the rather retro (yet very canny) step of acquiring the Mittersell deposit in Australia to ensure its upstream.

Rare Earths

As we have noted in the past the REE supply situation is one where the alarms are being sounded on supply and yet nary a squeak is being heard from the end-users. The running in the US has been made mainly by politicians and the miners who stand most to benefit. The industrial users have remained quiet. Why? Well, when one considers that the industrial users include the very well-padded industrial-military complex the obvious retort to any complaints about the lack of alternative supply sources would be “well what are you doing about it?” and the answer is that the Raytheons of this world are waiting for someone else to deal with it.

At the moment ore is mined and concentrated at or near the mines but the biggest value-added in the process is at the quasi-manufacturing phase. This is a phase which Neometals (NEM.to) and Great Western (GWG.to) are exposed to but which the other explorers are not. Most of the budgets we have seen talk of $200mn plus CAPEX costs for the concentrating and separating process, largely at the mine. This leaves us wondering whether if prices go up significantly then miners might be best to get their mines going and sell ore to on-processors who would bear (or have borne already) the heaviest part of the capex.

Neo Material Technologies is an interesting example of a midstream company that is vulnerable in not having any upstream. It is a producer, processor and developer of neodymium-iron-boron magnetic powders, rare earths and zirconium-based engineered materials and applications, and other high value niche metals and their compounds. It is the most substantial dedicated mid-stream player (Rhodia is larger but much more diversified). The company is headquartered in Toronto and has around 1,400 employees in 19 locations across 10 countries. The company is not vertically integrated but may need to become so. Life was too easy just buying from an indiscriminate seller like the Chinese (which has necessitated NEM building plants in China with the attendant technology transfer dangers). Now that the Chinese could potentially make things more difficult for mid-stream players, this company needs to ponder diversifying supply via acquiring miners and/or funding their development of projects. With a market capitalization in excess of CAD$400mn it is the best positioned (in the absence of Molycorp) to hasten vertical integration in the REE space. A merger between NEM and an up-and-coming player like Arafura Resources (to dilute out the Chinese) or Great Western would make eminent sense.
Great Western is ironically perceived as an explorer but that is more theoretical than its real role as a mid-stream processor via its plant at Troy in Michigan and its Less Common Metals subsidiary in the UK, which is a key strategic playing piece (though one would not know it from the way GWG downplays and underappreciates this asset). In theory LCM is supposed to be fed with supplies from the Steenkampskraal mine (currently mothballed) in South Africa but GWG has not secured control of this asset and in its battered financial state would need a miracle to be able to raise the funds to secure and develop the mine. Curiously the company had Toyota as a JV partner on its Benjamin River property in Canada. Toyota obviously wanted the potential offtake from the mine and as is discussed later in relation to Lithium, Toyota are prepared to put their money where their mouth is. GWG totally misread the signs and spent virtually no money on expanding the Benjamin River resource sending a clear signal to Toyota that they had other fish to fry. Toyota got the hint and walked away from the JV a few months ago. With this level of haplessness GWG has set itself up to be taken out at a bargain basement price by another player with more wherewithal.

Then there is Molycorp. This has been sitting on the IPO launch pad for months now and has fallen victim to market woes. However, it should be dusted off again soon and sent on its way. This company has some quasi-industrial activities in that it has a Europium plant, amongst other things. It made a brief play for GWG or some part thereof in early 2009 but that went nowhere. Maybe it will be better luck next time when it is cashed up and goes prowling for victims. There are certainly more than a few beaten up REE stories that could do with finding a Big Brother with cash.

**Lithium**

It is interesting to note that the three major producers of lithium are all chemical companies and not miners. Investors rushing into the space seem to forget this fact as they search for lithium miners and only come up with juniors, when in fact the larger players are very large and entrenched. Maybe it is this reality that has forced the industrial players to get “up close and personal” in the lithium space and why the juniors are open to their blandishments.

The obvious parties needing to secure a good reliable source of lithium are the producers of hybrid autos, more than the makers of cellphone and laptop batteries.

The most advanced in the mating game between upstream and downstream is Orocobre (ORE.ax). Back in January 2010 it reached agreement to establish a joint venture with Toyota Tsusho (a parts manufacturer that is 22% owned by Toyota Automotive), to develop the Salar de Olaroz Project in Argentina. In the current feasibility study phase, Toyota will provide US$4.5 million to fund the completion of the Definitive Feasibility Study and other associated pre-development activities. This is expected to be completed in the third quarter of 2010. If all goes well then after finalisation of the terms of a joint venture operating agreement on completion of the Definitive Feasibility Study, Toyota will acquire a 25% equity interest in the joint venture at a cost based on the NPV estimated from the Definitive Feasibility Study. Additionally Toyota will be responsible for securing a Japanese government-guaranteed low-cost debt facility (probably through JOGMEC) for at least 60% of the project’s development costs. Thus Toyota chose Orocobre to be their lithium-mining vehicle. Toyota is the leading player by far in the hybrid auto space. They will have the full might of the Japanese government funding apparatus behind them so we foresee production as the inevitable next step after the DFS is out.
Canada Lithium pulled itself out of the “unlikely to move forward” basket with its cementing of an offtake agreement when, in April 2009, the company signed an exclusive Marketing Agreement with Mitsui Corp relating to the distribution of battery-grade lithium carbonate in Japan, China and Korea.

The key factor is going to be financing. The Japanese can finance whatever project they throw their weight behind, but two factors are key here. First is production costs per lb. Why would they back a project if the price of the output is too high vis-a-vis cheaper alternatives in LatAm? Secondly, if the production cost is OK, or absorbed by the producer (so a margin problem for Canada Lithium rather than Mitsui), then we might ask whether the capex is going to be of a magnitude to knock Canada Lithium’s plans out of the realms of reality. That would be highly prohibitive except with the Japanese funding the vast bulk of the project.

Galaxy Resources (GXY.ax) went the route of finding a strategic partner that ostensibly does not represent an offtaker. It has undertaken a pair of financings with Creat Group, an AIM-listed entity, holding 19.9% of Galaxy’s shares. Despite the London listing Creat actually represents Chinese interests. They have organized the financing for the mine buildout. Creat will provide Galaxy with 100% debt finance of approximately A$130 million for the purpose of developing both the Mt Cattlin and Jiangsu facilities. The loan is for a period of seven years at what the company calls “very attractive interest rates”. Creat also wins one non-executive board seat. Interestingly though there is no off-take agreement required. However with the processing plant being in China, we somehow doubt that finding a buyer will be an arduous task. The company announced as long ago as last April that it had offtake demand from Korean, Chinese and European customers for 130% of its planned production.

The tie-up with the Chinese is a smart move that virtually guarantees Chinese market penetration and moves the project forward. We are left wondering on some of the industry wannabes, particularly those in North America, whether they shall be able to secure the ideal scenario of a strategic investor that not only provides capital and underwrites production financing but also secures the offtake. All three factors must interact. While we are very benign towards governments blocking Chinese participation in “strategic” mine developments, the corollary has to be domestic users stepping up to the plate and committing to offtake and soft financings to make mines viable.

**Tellurium and Graphite**

At the risk of becoming exceedingly obscure we shall venture into a discussion of Tellurium and Graphite. Despite sounding obscure both are key parts of rising technologies, particularly Tellurium. The latter is a key component in the most common thin-film solar panels and thus important to alternative energy applications. The Chinese are trying to make the running in both wind turbines and solar panels as they grapple with their own energy problems. Prices for tellurium went from under $100 per kilogram in 2007 to over $200 per kilogram in 2008 and are now in excess of $150 again.

There is an ongoing debate on whether there is enough tellurium in the world to support the growing solar market, and how much costs would be added to the solar cell production if mines spend their resources to focus on tellurium production.
Tellurium though is typically a very small (by volume) by-product of gold and copper mining. Telluride gold deposits where the Te has a meaningful grade are rather rare but not unknown. The rising price of Tellurium does not justify a mine in itself but high gold prices plus high Te prices mean that a Telluride-Gold deposit should, all things being equal, be much more economic than a plain vanilla gold deposit. Moreover we can think now of a reason why an industrial enterprise should fund a gold mine if it means it can get access to the mine’s Te by-product flow. We are well acquainted with a particularly rich Telluride-Gold deposit that is held by a Canadian company. They have been having an uphill battle getting their project moving forward. Of course the major solar panel companies want the offtake but don’t want to put their money into a “gold mine”. JOGMEC (the Japanese mining sponsorship entity) spooks around knowing that Japanese industry needs the product but JOGMEC is curiously a funder of exploration not mine-building. The Korean entity, KORES though is more mine-oriented. None can seemingly get their brain around the funding of a gold mine to get the by-product.

Curiously, to ensure ample supply of tellurium, First Solar (FSLR) has been looking for suppliers who would focus on mining tellurium. Capital Mining (CMY.ax) in Australia announced in May 2008 that First Solar was sending a geologist to check out a newly discovered tellurium deposit. Although First Solar is the largest cadmium-telluride user, there are a host of startups hoping to replicate its success. Ironically the investment of a few tens of millions in securing its own supply of Te seems beyond First Solar with its multi-billion dollar market cap and thus it passes on the opportunity to put all other players at a disadvantage.

Graphite initially evokes images of the “lead” in pencils. However graphite is an excellent conductor of heat and electricity (hence its use in cathodes) and has the highest natural strength and stiffness of any material. It maintains its strength and stability to temperatures in excess of 3,600°C and is very resistant to chemical attack. At the same time it is one of the lightest of all reinforcing agents and has high natural lubricity. New applications include Lithium-ion batteries, fuel cells and pebble-bed nuclear reactors and solar power. While everyone has been getting hot and bothered over Lithium they failed to note that there is up to 20 times more graphite than lithium, in a Li-ion battery.

Graphite prices (see chart at right) have doubled since 2005 due to the ongoing industrialization of China, India and other emerging economies.

China produces 80% of the world’s graphite and is seeing production and export growth leveling off and export taxes and a licensing system have been instituted. In any case Chinese producers do not have the most desirable material (“large-flake” graphite). The major North American graphite mine is in Quebec and has a remaining lifespan of only a few years. With limited worldwide exploration and few potential development projects on the horizon, the potential is there for continued improvement in graphite demand and prices. Curiously enough two graphite projects have come to us over the last 12 months looking to finance efforts to step into the shoes of the expiring Quebec property. Both also have Canadian properties and one has two past producing properties in Africa. One of these companies Northern Graphite, is a private Canadian company that is 55% owned by Industrial Minerals Inc. (IDSM:OTCBB) and 45% owned by a number of investors. The company undertook a financing a few months back and despite scaling it back in size the
task was almost Sisyphean as investors had to be educated in graphite from scratch. Ironically the key takeaway for us was the ratio of usage vis-a-vis lithium in Lithium Ion batteries which meant that wrapping one’s brain around the graphite story was in some ways easier than lithium with its multifarious extraction techniques and gobbledygook techobabble. The other company had an even more cogent plan with an existing industrial processing plant thrown into the mix. It resolved to avoid the “Great Unwashed” of the public markets altogether and went for private equity financing.

The main takeaway we got though was that there were scores of users across North America and Europe and that all were concerned about potential supply and yet none were concerned enough to put $3-4mn on the table to secure themselves a seat at the decision-making table.

**Cobalt**

Outokumpu Oy is scarcely the word on everyone’s lips. In fact it is scarcely the word on anyone’s lips and yet twenty years ago this Finnish mining group was one anyone’s list of the top 20 miners in the world. What fate befell it? We cannot blame Wall Street in this case as, back then, it was not one of the stocks under coverage of the already shrinking band of Bulge Bracket mining analysts. In this case we can blame reigning orthodoxy in the generalized investment analysis world. What caused Outokumpu to go from a position at mining’s High Table to “eating in the kitchen”? We might blame it on being heavily exposed to zinc but many other mining majors went through the Valley of Death in zinc and lived to tell the tale. At least the company was not taken over as befell many of its peers.

The only operational mine left in the company is the Kemi ferrochrome ore mine in Finland. Some would argue that as an industrial company now, Outokumpu is a great success, we would tend to believe that it shed various mining assets at exactly the right time and cleverly positioned itself to miss the mining boom and be left instead as a second tier metals processor. For instance the zinc branch was merged in 2005 with the Swedish company Boliden, then later in 2005 it sold all its Boliden shares. This was perfectly timed to miss the zinc boom that began almost straight after this time.

From the vertical “disintegration” (in all senses of the word) view the company shed two other divisions that have gone on to do more interesting things than the erstwhile parent. These are Outotec, the highly sophisticated mining equipment/technology company (spun off in June 2006), and OM Group, the US based processor of Cobalt and other heavy metals. The latter was created in the early 1990s when Outokumpu decided to spin off its “peripheral” cobalt operations. In 1991, Mooney Chemicals, Inc., was acquired for about $50 million and merged with Outokumpu’s Kokkola Chemicals Oy and Vasset, S.A. (in France). Renamed Outokumpu Metals Group, the reformed company operated as a subsidiary of the Finnish giant until 1993, when the parent company spun off its 96% share to the public as OM Group.

Despite the seemingly “chemical” origins of OM Group, in December 2001 it acquired the mineral rights along with the chemical processing capabilities of Cawse, a nickel/cobalt Laterite project in Western Australia. The acquisition was touted as supporting OMG’s vertical integration strategy. Output from Cawse was destined to supply 8,000 TPA of feedstock to OMG’s Nickel refinery and 800 TPA of feedstock to OMG’s Cobalt refinery. Then in a *volete face* in 2007 OM Group significantly altered its business with the sale of its nickel operations, which had accounted for about half of its annual sales, to global nickel giant Norilsk Nickel. This was a curious move coming in the midst of the nickel bull market.
Earlier in 2001 the company made a play for Degussa Metals Catalysts Cerdec AG (dmc2), a precious metals and metals management concern. The $1.08 billion deal was finalized in the fall of that year and significantly expanded OM’s operations. In another brilliantly timed move OMG sold its precious metal refining business (to Umicore) for $814mn in 2003 on the eve the great bull run in gold and silver.

After this series of faux pas it is no surprise that the company is no longer vertically integrated. But one cannot blame the concept of vertical integration when the management of the company was so abysmally hapless in its execution. In our view it is time for OM Group to jump back into the water. If the Chinese are nervous about their potential sources of Cobalt supply then OM Group should be VERY nervous. We note with bemusement that the company has two cobalt refineries (one in Finland and one in the DRC). Try as one might to find mention in the company’s website of these activities, there is virtually nothing except ancient history press releases that refer to them. “Don’t ask, don’t tell” seems to be the attitude with relation to unfashionable activities. As the refineries (and Cobalt) are a key part of OM Group’s supply chain then to hide the importance of the metal (and vulnerability to supply SNAFUs) is a tad disingenuous. Frankly if Cobalt supplies have a major breakdown then OM Group is a first order victim of such an event (one might say eventuality). Forewarned is forearmed and while Wall Street’s analysts may not like it (and the company only has sparse coverage anyway) we cannot think of a more timely tie-up than OM Group connecting up with Geovic (GMC.to), with its property in Cameroon. Geovic is well cashed up with over $50mn in cash and so is more in need of an industrial rationale (read offtaker) than a funder. OM is clearly not thinking outside the box (which may be their coffin) at this time.

**Conclusion**

One of the classic scenes of the Seinfeld series was the so-called Soup Nazi and his cavalier treatment of his customers with the blunt “No soup for you!” as the ultimate brush-off. We can’t help but think of that with regards to the Chinese and specialty metals users. After decades in which the Chinese distorted global specialty metals prices, and supplies, with predatory pricing, they have now gone Soup Nazi on these hapless users and told them that the product is now off the menu for the likes of them.

The Chinese however have not totally cut of supplies totally but slightly closed the spigot. The signals are pretty clear though. In fact the Chinese are sending out a handy forewarning. Any company that starts complaining several years from now that they weren’t warned will find their woes falling on deaf ears. It would appear that there is more than adequate time for an industrial user to position itself as a guaranteed off-taker from one or more miners in whatever the strategic metal might be. The Asians have got it, the Westerners have not. The feckless plea for the government to start a stockpile of whatever metal is just a shallow attempt to move stock control from the user to the taxpayer. Let the company get a warehouse and borrow money and fill it with metal for future use. The taxpayer has “been there done that” and when the pendulum swung away from that approach in the 1980s the public took the loss and the miners were driven out of business. The industrialists got cheap supplies as the government destocked (the devastation of the uranium mining industry in the US being even more poignant than that of the REE space).

When one looks at most of the juniors miners one can see that it is no surprise that their projects find it tough to get financed considering the lowly market capitalisations of the companies and their stretched finances. However, it sticks in the craw somewhat that the end users are frequently some of the best-
resourced companies on the planet. We wonder if First Solar has a corporate jet in its inventory and whether its value might be more than the amount needed to kickstart a Tellurium mine or whether the paperclip budget of United Technologies isn’t higher than the market capitalisations of some REE names vainly calling out for financing.

As we noted in our comments on the GAO’s report on Rare Earth supplies to the military, politicians should not be joining the chorus calling for reactivating stockpiling but rather demanding that all military contracts have a stipulation that the contractor’s CEO certifies (a la SarbOx) that the company can guarantee that it has reliable sources of supply of whatever strategic input and that the ultimate source is NOT China. That would create a scramble to fund projects unseen since the war mobilization of 1942. If there is one sector of the economy with the wherewithal to fund such a push, it is the industrial-military complex.

As for the rest of the industrial users of specialty metals they should really be considering something along the same lines. If there is one mantra that industrial companies in the West should start repeating to themselves ad nauseam, “Secure thy upstream!”.
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