LionAnalyst

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One swallow does not a summer make

There is a growing body of evidence indicating that the market for miners is beginning to thaw, equivalent perhaps to several swallow sightings.

Sentiment has palpably improved from early 2014, although this is yet to flow through to the indices. Miners have begun to demonstrate cost discipline, mid-tier miners are acquiring projects, there is (scrip based, primarily) M&A taking place, and fund managers are once again taking meetings with miners. Equities over 2014 / 2015 have been weak, thanks to a dramatic collapse in iron ore and weakness in other metals prices. Despite this, select junior companies can now raise funds, and investor interest has clearly improved.

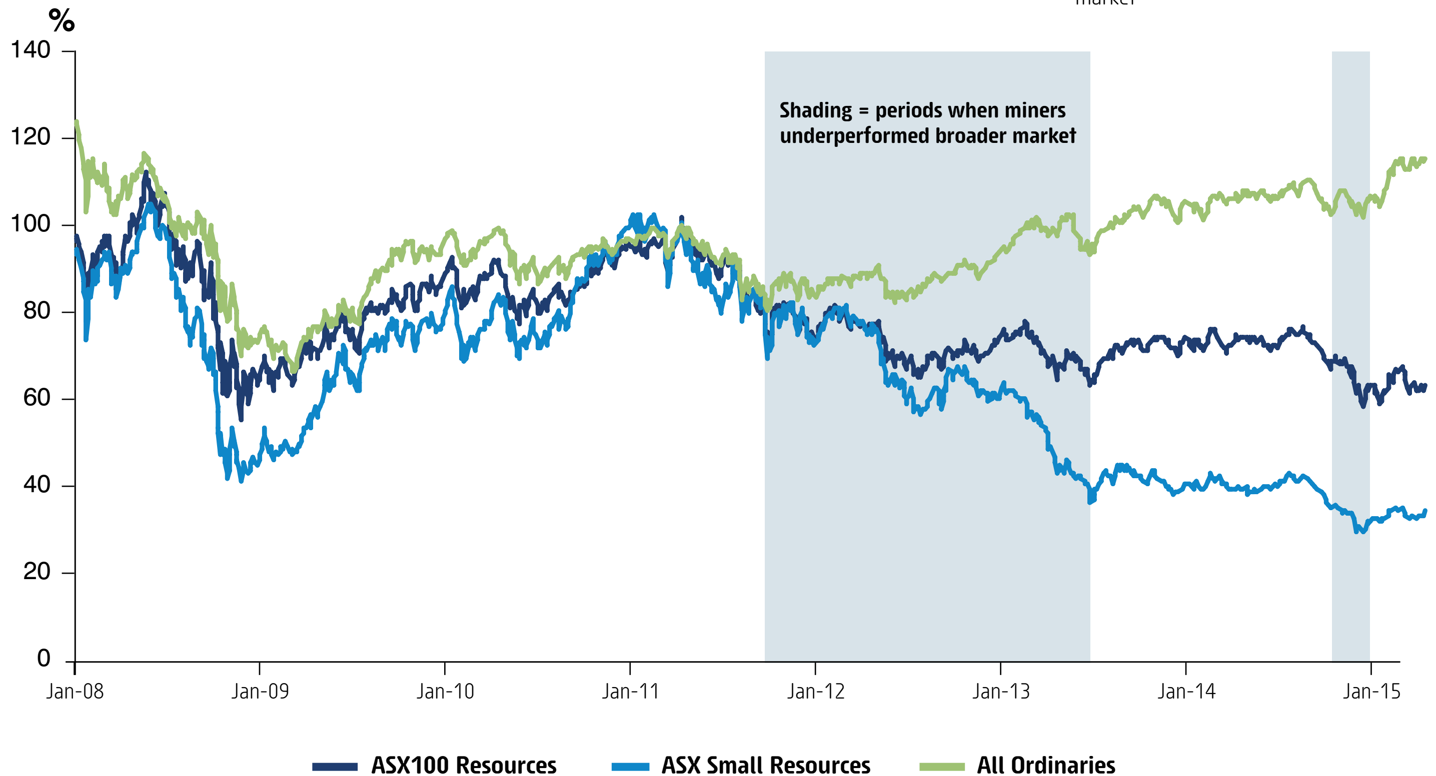
Valuations have been bouncing along the bottom and the majors are selling to pay down debt, so conditions are ideal for well-priced acquisitions, which is why we see the mid-tier acquiring. The less sophisticated broader market likely requires more of a catalyst to re-enter the mining space.

Market performance

After the global financial crisis, the market was quick to recover – starting in 2009, as major economies undertook economic stimulus measures and quantitative easing. Concerns about debt levels in Europe caused a correction in 2011, which was perpetuated for miners with economic headwinds in China and weakening commodity prices. Having performed in line with the market from 2008 to 2011, miners then underperformed until mid-2013. This marked somewhat of a turning point as the constant stream of selling reduced to a trickle. But for a period in late 2014, miners have maintained performance more or less in line with the broader market since.

Market for Miners: Global Financial Crisis to Present

Pre 2008	2008–2011	2011–2013	Mid 2013	Mid 2014
Miners (large and small) out perform market	First GFC collapse Then market recovery Miners move in line with market	Miners collapse, first alongside market, but then ~2 years of underperformance Steady deterioration in liquidity	Turning point for sentiment - Miners begin to keep pace with market	Iron ore collapse – another (brief) phase of miners underperformance

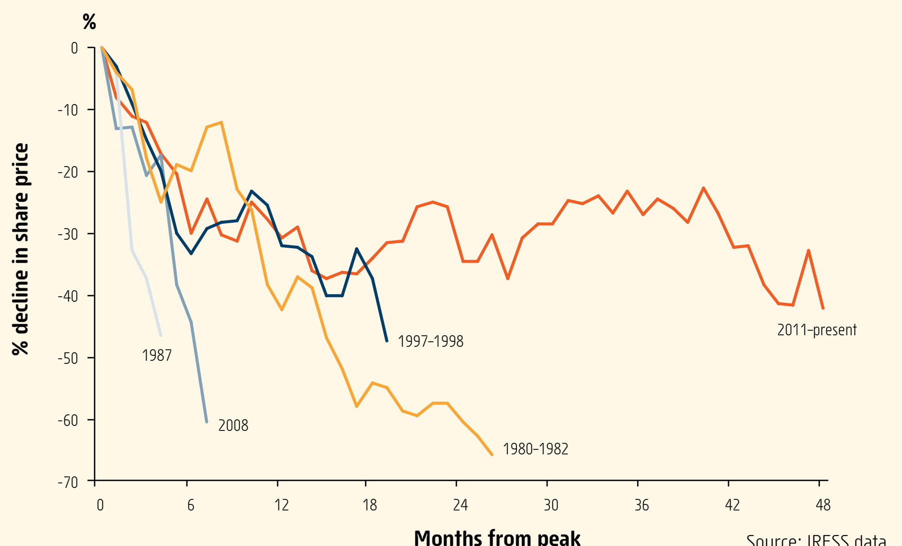


The reasons the market slowly and painfully sold down mining equities are well understood:

- Even given massive commodity price gains of the boom, the industry broadly made few returns to investors, because costs increased in line with commodity prices and margins were relatively static.
- When commodity prices weakened, the exuberance of the boom finally left the collective psyche of investors, who quickly lost patience with miners.
- In a low interest rate environment, stocks with even modest yields experienced better capital returns than miners, and for lower comparative risk.
- As there was no single catalyst the decline since 2011 was a slow death, unlike most busts which historically have been much more short lived.

The market continues to hit new lows, and the magnitude of the correction in miners since 2011 has now become the longest in the last 50 years.

Mining corrections of the last 50 years based on BHP share price



Investor Sentiment

Sentiment towards miners is now beginning to soften. The 'wall of selling' that drove equity price falls is now well behind us, and many generalist funds have sold down or right out. Market weights of miners are now at or below the levels of previous lulls. This suggests there is little stock left to sell in the hands of investors who have the ability to swing large amounts of money from sector to sector.

Financial performance of many miners has improved. The majority of project development capex is now in the past, input costs have fallen by a significant amount (eg steel, fuel, labour) which is merciful as costs in 2011-2012 had reached a level that was certainly unsustainable. Improvements have not been universal though, weakening commodity prices have encroached on some high cost producers. Many producer currencies have also weakened, helping to inflate revenues despite flat to negative US$ commodity prices.

Most importantly, junior companies can raise money again. Access to funds is not universal – the pool of funding is closely guarded, and to reach out for it a company must demonstrate a tangible project, but also the willingness and capability to progress it. It is still very hard to fund highly speculative ventures. This phenomenon should see the population of juniors bifurcate – a minority will raise money, while many of the rest will wither and disappear, or be re-occupied as a shell.

There has also been highly encouraging evidence of market interest in two recent large sell downs by cornerstone investors in mid-tier companies. In late February, Newcrest sold down approximately 17.4% of gold miner Evolution Mining, which was a $106m stake. Then in early March Oz Minerals sold its 19.1% holding in copper miner Sandfire Resources, which was a $125m stake. Both sell downs were well above normal volume for these companies, and it is highly doubtful the market of 2012-2014 would have been liquid enough to absorb these lines of stock.

Market weights of Metals and Mining companies in ASX300

Average 2001–2004	June 2008 peak	March 2009 lull	March 2011 peak	March 2015 present
14%	27%	20%	24%	10%

Mergers and Acquisitions

Increasing M&A activity and deal flow is being driven by low asset valuations. Acquisitions in the mining space are primarily being made by the mid-tier, and scrip deals are outnumbering cash deals. Majors are predominantly sellers, and have been for over two years. Mid-tier miners are largely opportunistic acquirers, and their actions reinforce the view that valuations are at the base of the cycle.

Motivations to transact differ between majors and mid-tier miners. An acquisition of a cast off project from a major may be transformational for a mid-tier, so a deal is strategic. Major miners have been selling to reduce debt, and shedding higher cost / smaller output projects. This drives improvements in profitability per unit of production and also enables management to focus efforts on core business.

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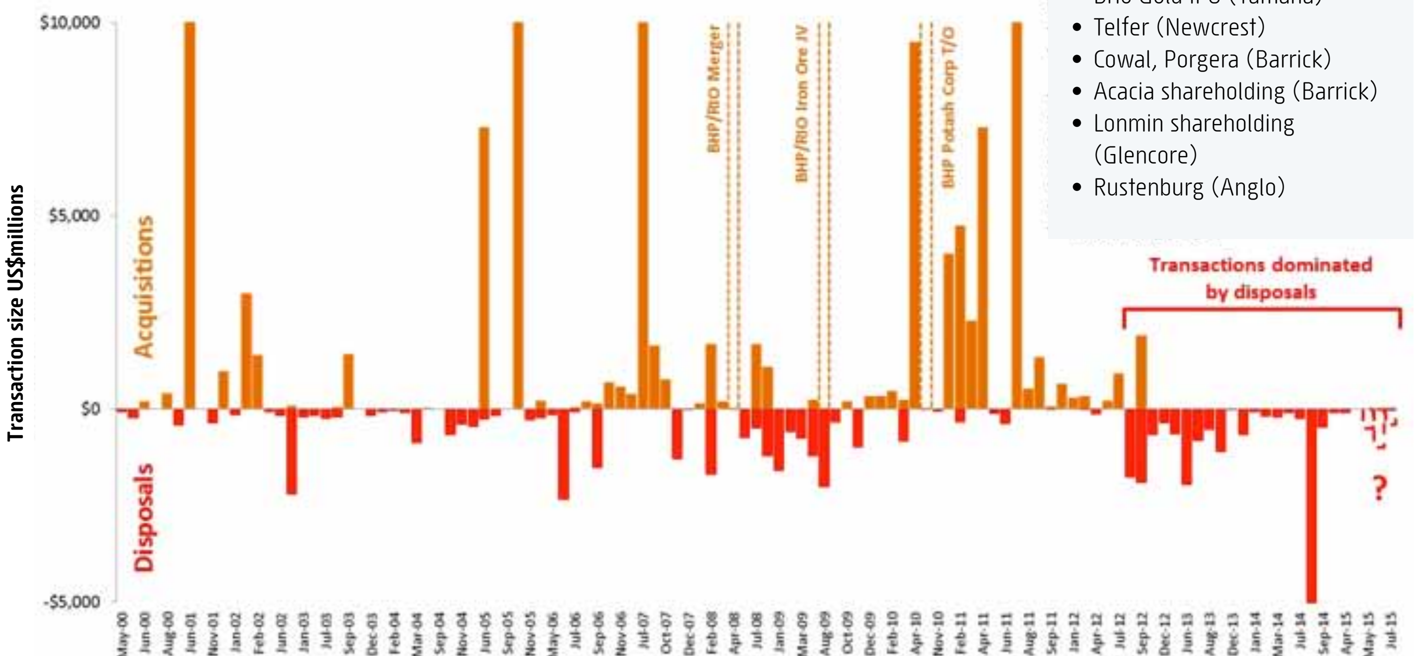
Future and potential divestments:

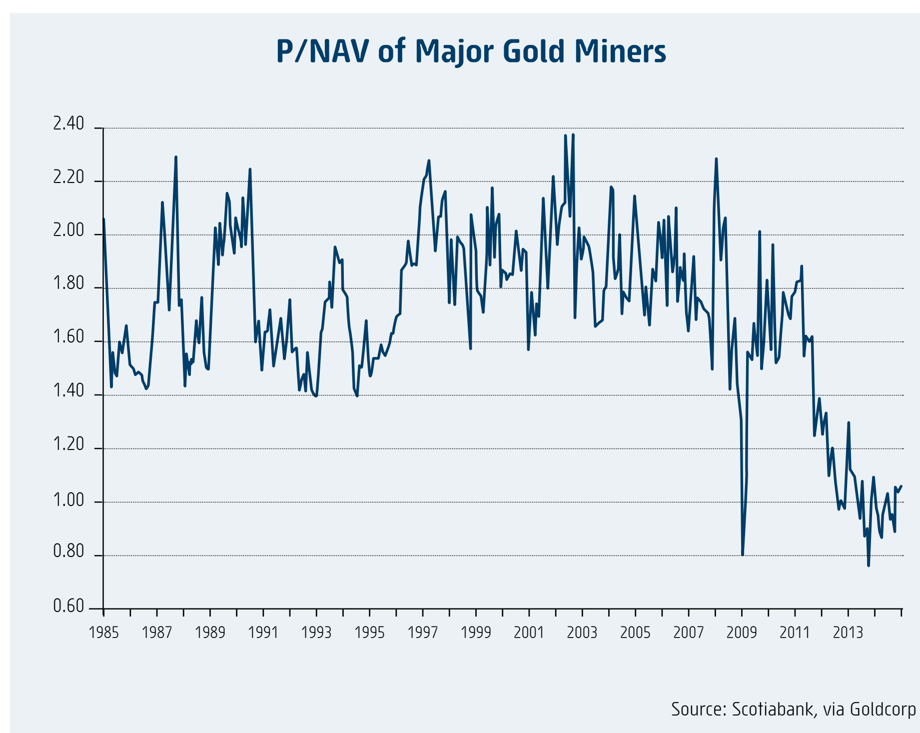
- Nickel West (BHP)
- Cripple Creek, Victor, Sadiola, Yatela (Anglogold)
- Base metals IPO (Vale)
- Brio Gold IPO (Yamana)
- Telfer (Newcrest)
- Cowal, Porgera (Barrick)
- Acacia shareholding (Barrick)
- Lonmin shareholding (Glencore)
- Rustenburg (Anglo)



Selected major miners only (BHP, Rio Tinto, Barrick, Newmont, Anglogold, Newcrest). Horizontal axis not to scale. Source: Company reports, newswires

Mechanism of divestments by majors is also indicative. Large divestments, such as the BHP spin off of South32, are via a distribution to shareholders which does not require a liquid market to raise fresh funds. Interestingly other major companies have slated divestments via potential IPO (Vale and Yamana) although the language used has been suitably ambiguous – historically the market has only supported large IPO's such as these at the height of a boom. There may be a strategy to advertise that the projects are on the market but not at fire sale prices.

To majors there is an additional disincentive for acquisition. Major gold miners (for example) are trading at an average price to net asset value ratio (P/NAV) of less than 1, having maintained an industry average of about 1.8 for more than 30 years. When P/NAV >1 miners are valued at a premium, and this is an incentive to grow. However when P/NAV <1, projects are valued at a discount, and cash spent on growth is effectively de-rated.



Private Equity

Mining has not historically seen large scale participation from private equity (PE) funds, and generally speaking it is easy to understand why. Private equity money is generally unsuitable to mining investment – it tends to require a short term return, usually between 18 and 36 months, so is not suited to project development. The model usually involves acquiring control, aggressively cost cutting and restructuring then on-sale.

Despite these challenges, there now appears to be substantial funding accumulated under private equity management committed for mining investment purposes. A recent estimate of PE money ear marked for mining was US$60B (according to Ken Hoffman of Bloomberg), with a notable example being X2 (with commitments of US$5.6B, according to the X2 Resources website) – a vehicle headed by former Xstrata chief Mick Davis, which presents as a highly credible and motivated acquirer.

There has been very little reported PE investment in mining so far. In late April, Denham Capital announced a hostile cash bid for Mungana Goldmines valued at up to A$40m. Whilst small (with respect to the quantum of supposed funding), this is an encouraging sign of conviction in a PE outfit.

The collective interest in mining from PE is highly encouraging, as it further underlines value in the sector. With many other mining transactions being done for scrip, a large cash deal by a PE group would likely signal a major progression to the next stage of the cycle, and cause other would be acquirers to consider cash funded growth. This alone may be a reason for PE buyers to make their first deal carefully, as a market reaction might make it more difficult for them to deal at an attractive price the second time around. Temptation to act must be great, as valuations are very low, and committed cash could well begin to burn a hole in PE manager's pockets.

Financial condition of microcap miners

Junior resources companies that don't generate cash flow have struggled the most over the last three years. As a legacy of the boom there are a large number of junior companies, which makes it very difficult to stand out from the crowd and also makes for a large collective administration cost.

The additional challenges are that commodity price declines have made many projects uneconomic and the benchmarks for obtaining equity finance are higher due to scarcity, so only a small number of companies are now able to raise funds. Of the companies with a project that still look viable and is development ready, they are faced with an odd challenge. With interest rates at very low levels, debt is available either via banks or various lower documentation forms but accessing debt is dependent on raising some equity finance, which must be raised off market capitalisations that are somewhere between 1/10th and 1/20th of their peak (2011) valuations. The challenge is raising an equity amount which is a high percentage or multiple of their capitalisation.

After more than three years of trying to survive, the financial health of the junior mining sector is now at tipping point. Of the population of ASX listed, 'Materials – Metals and Mining' classified companies capitalised at less than A$100m (producers, service companies and recyclers removed):

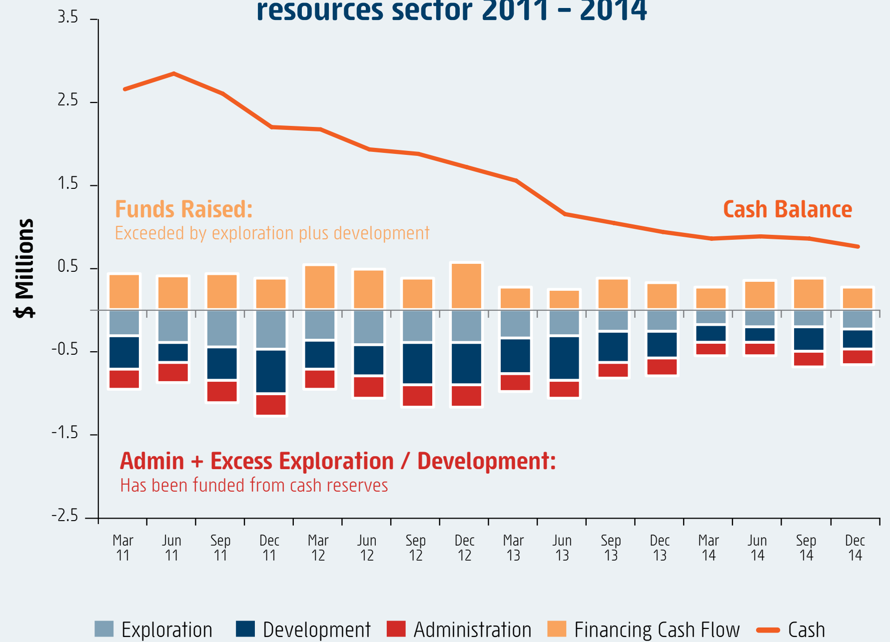
- The median cash balance of this group declined from A$2.9m in June 2011 to A$0.77m in December 2014 as companies have drawn upon reserves to fund exploration, development and administration.
- Annualised median administration spend sits at $0.8m, therefore "median co" has only enough cash for 12 months administration, and nothing for exploration or development.
- 58% of the companies in the population have less than A$1m cash.

IPO's

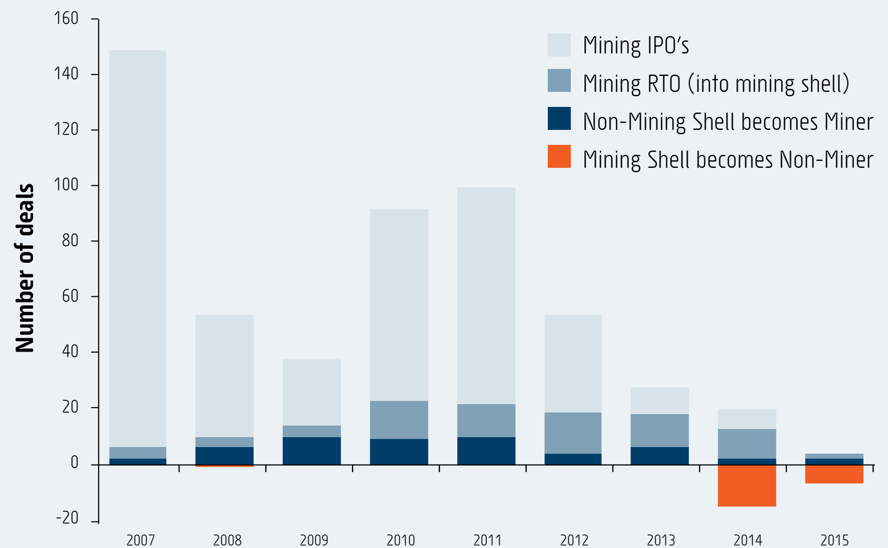
IPO's are an important indicator of liquidity, and at present the IPO market for miners is closed, suggesting liquidity is still very low. However, an artefact of the boom is a large population of failed junior companies which require a new project and capital to remain viable. Occupying a shell company via an RTO can be easier than conducting an IPO, and whilst IPO volumes are zero, RTO volumes for miners have been reasonably steady 2010-2014. 2015 figures are incomplete, but informal indications suggest there are several in preparation, and indicates that the market is not completely closed.

The gatekeepers to RTO's normally control a shell and are usually sophisticated and selective. Whilst there remains a prolificacy of listed shells, listing mechanisms are likely to continue to favour RTO's over IPO's. An RTO usually still requires a small capital raising, which now appear to be possible so there is a healthy indication of a future positive trend.

The RTO trend shows a recent phenomenon of readily available mining shells being used to list non-mining businesses (mainly technology). There may also be an element of professional capitulation – a further signal of the bottom of the market.



Source: IRESS data. All figures are MEDIAN of population, consisting of ASX listed Materials – Metals & Mining classified companies capitalised at less than $100m at 30 Oct 2014 (producers, service companies and metals recyclers removed)



(analysis based on changes in ASX listing codes, 2007-present. IRESS data)

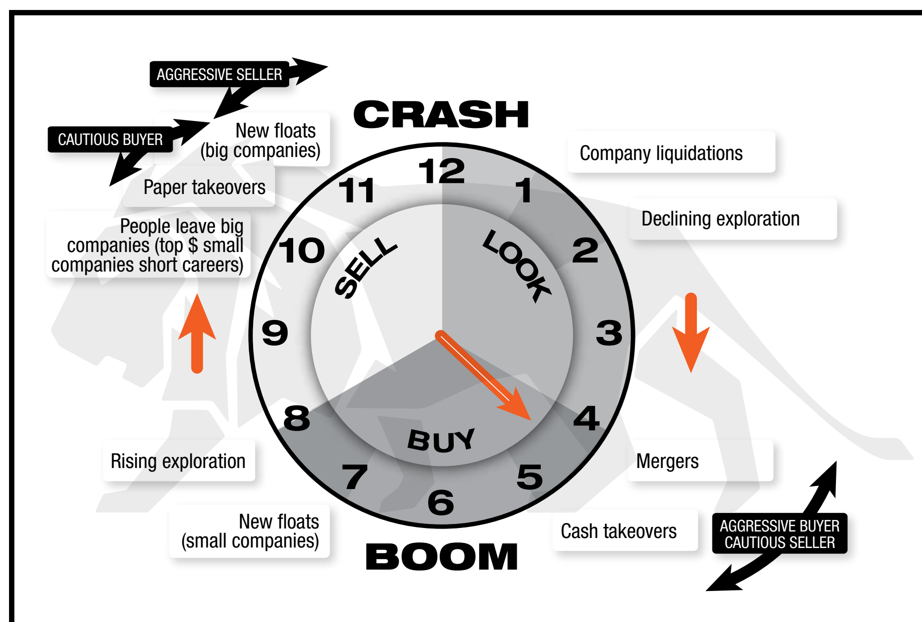
Catalysing interest back to mining

The conditions we are seeing now are the early stages of the next boom and we expect to see growing market interest in miners albeit only gradually. Whilst market weight of miners is at cyclical lows, juniors are able to raise money again, M&A looks to be gaining pace and there is a war chest of PE funds watching from the sidelines, so it seems there is a shared common belief by both miners and some seasoned investors that current valuations present an opportunity.

Institutions that manage large amounts of money are presently weighted away from mining, and this is the tide that needs to turn before there will be an improvement in miners trading valuations and mining equity indices. A number of conditions are expected to encourage institutions to begin increasing weighting towards miners:

- Sustained cost improvements / profitability by miners.
- A large cash acquisition by private equity buyers would be a strong signal to the market.
- Cyclical move out of tech (a competing risk space).
- In the broader market, an increase in interest rates would decrease the appeal of yield stocks.

The short term challenge for institutions, given many are close to fully invested, is determining what to sell to provide the funds to invest in mining. The latter presents the greater challenge, whilst the broader market is performing well there may be a sense of inertia towards exiting successful positions. Large cash takeovers such as the A$5B bid for Toll Holdings (announced 18 February 2015) may begin this task for portfolio managers. Any outperformance of miners could be self-perpetuating, as institutions look to cover their peers performance.



The improvement in sentiment is still young, and possibly fragile so there remains risk on the outlook. Recent mining equity performance has been closely related to falling commodity prices, many of which have fallen through their perceived marginal cost resistance levels, so further falls cannot be discounted. However, having now come well off of highs, any further falls in commodities cannot be as large and given the selling of the last three years, mining equities are now arguably pricing a degree of commodity price pessimism. No doubt there will be volatility due to commodities but the growing abundance of value oriented buyers may limit downside.

The bust that started in 2011 did not have as clear a catalyst as previous busts, and as described earlier previous busts have also been much more rapid – it may be possible that this bear market dies of exhaustion and extreme old age. Cycles turn more gradually from bust to boom than from boom into bust. It's likely for the upswing catalyst to be a combination of many smaller factors and one by one investors decide the worst has passed, assets are cheap, so they buy again. The swallows are on the move.

Sentiment has improved since May 2014 when the Lion clock was moved to 4 o'clock. In recognition of this progression, the clock is now at 4:30. It is worth noting that some sectors of the market may be out of synch with the clock which represents the market as a whole. For example – small iron ore miners are at more like 1 or 2 o'clock. Likewise though, PE buyers could be the first to think the market requires a cash deal (5 o'clock).