LionAnalyst

Topics this edition

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Risk Money Rotation
Miners turn to shine?

Mining sentiment has undeniably turned. Starting in early 2016, the re-ratings for large cap miners, especially in gold, are now trickling down to many smaller producers and even non-producers, signalling strongly that the speculator has returned. Investors have decided that miners are cheap, especially given the advantages of a low cost environment, and junior companies are in many cases trading at a fraction of historical spend.

The risk taking dollar has begun moving back into mining investment after a long vacancy, but where has it been? It doesn't disappear – risk appetite looking for multiple returns always exists. But, like many fashions, sentiment pushes it from one hot sector to another.

One sector that shares many similarities with mining investment is technology, which has been a very hot investment space for the last few years, and shows many symptoms of being close to its cyclical peak. It may be time that risk money is beginning to move from tech across to mining.

Risk money

Risk money is the speculative dollar that chases substantial multiple returns, and consequently needs to take risks – often targeting businesses at an early stage of development, usually well before the stage when steady revenues are available.

The typical evolution of mining projects from exploration and discovery stage through to production lends itself well to risk investors, and so there is a high proportion active in the sector. A great deal of sophistication can be applied to analysing and managing risks of these style of investments, although broadly speaking risk money does not. So rather than valuation or other detailed analysis, the drivers of risk money are fairly simple:

- Greed – which draws investors toward sustained positive returns; and
- Fear – which drives investors out, typically after realisation of how far over valued a sector has become.

Tech and mining sectors typify boom / bust cyclicity, and have a great deal in common:

- Both sectors contain a high proportion of 'versatile' entrepreneurs, who are often not fussy about which high growth sector they are active within – just searching for easy money.
- Many businesses are built from scratch, on an idea, a previously unrecognised mineral abundance, or of demand for a product.
- Big multiple returns are possible on capital, often prior to achieving steady state earnings or dividends.
- Whilst spectacular success is possible, success rate is low, and there are high rates of imitation.
- Geographical clustering – Silicon Valley attracts tech workers and entrepreneurs in much the same way as West Perth or Kalgoorlie, with similar effects on basic living expenses.

Historic tech and mining equity cycles

Through recent history (~25 years), investment cycles of tech and mining have essentially inversely offset from each other, especially at their respective extremes, which is a strong indication that the risk money appetite that inflates each sector crowds into one sector or the other, but not both at once. This being the case, the relative behaviours of tech and mining indices is a useful indicator to watch, especially when close to cyclical turning points.

- The following chart shows the Philadelphia Gold and Silver Index and the NASDAQ, both US equity indices that are useful proxies of the mining and tech spaces respectively.
- The tech bubble of the late 1990s followed the mining bust of 1997/98. Mining equities didn't begin to recover until the tech bubble popped in 2001.
- Both spaces had positive performance during the bull market of the mid 2000's, and declined together in the GFC, but the NASDAQ accelerated and climbed to new highs after mining equities peaked in 2011, which was when investors began to abandon the mining sector.
- Equity growth in tech in the most recent phase has been much more sustained than in the late 1990's – a period regarded as an investment bubble and extreme cyclical peak.

Tech and mining sectors typify boom / bust cyclicity, and have a great deal in common

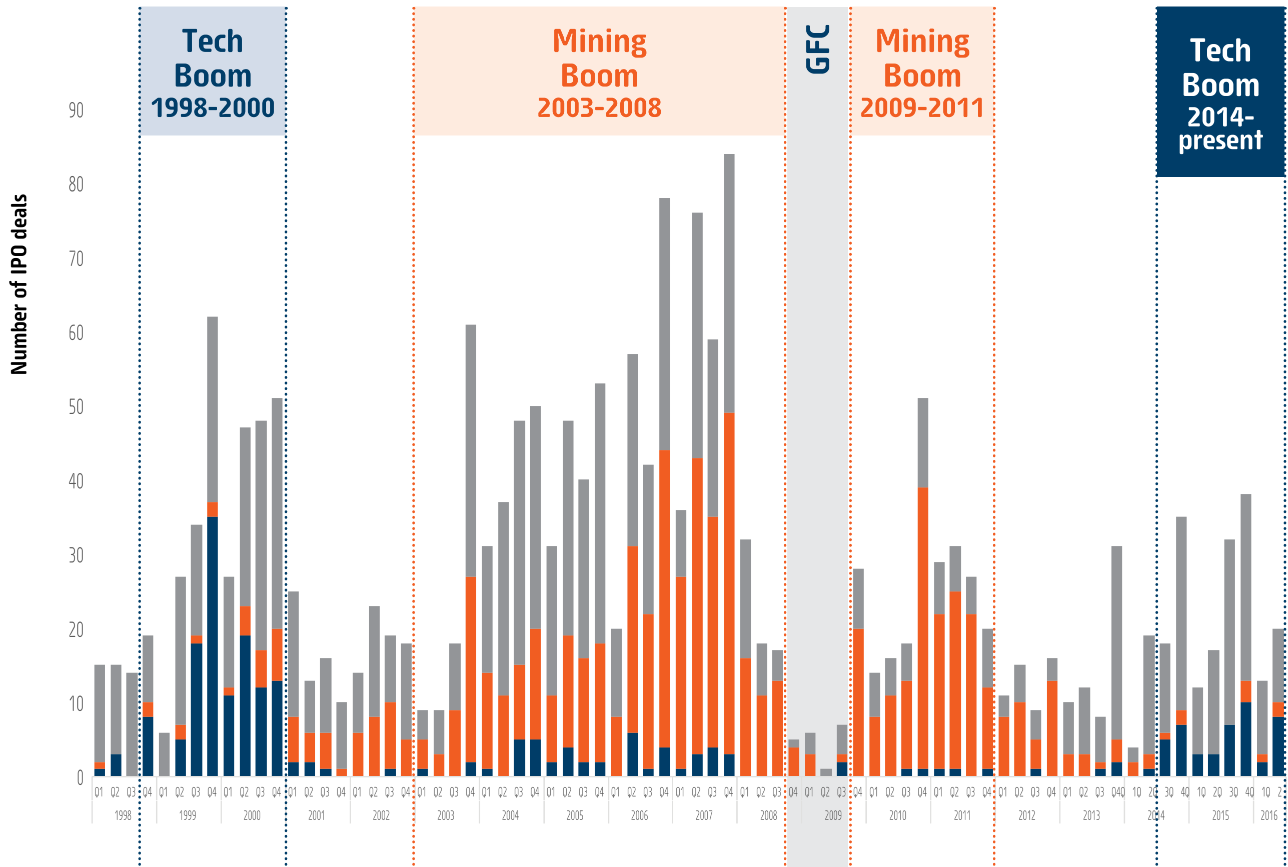
- Mining equities passed the bottom in January 2016, with an especially strong jump in gold miners. The NASDAQ has flattened and been volatile around its highs, which of itself is not an indicator of sentiment toward tech stocks turning. Earnings based valuations in the tech space remain high, and there are indications of dropping liquidity – there has been only one tech IPO in the US market in 2016 – signalling risk money has become more hesitant towards tech.
- Liquidity indicators mapping fresh capital inflows mimic the behaviours observed in equity prices, the following chart also shows ASX IPO numbers broken into mining and tech as a proxy.

Note that whilst ASX IPO's with US equities indices are not a direct comparison, there are few equity indices globally that provide as good a long term record of mining or tech, and ASX IPO data tends to mimic trends of other markets, albeit being a smaller market for tech.

image: originator unknown

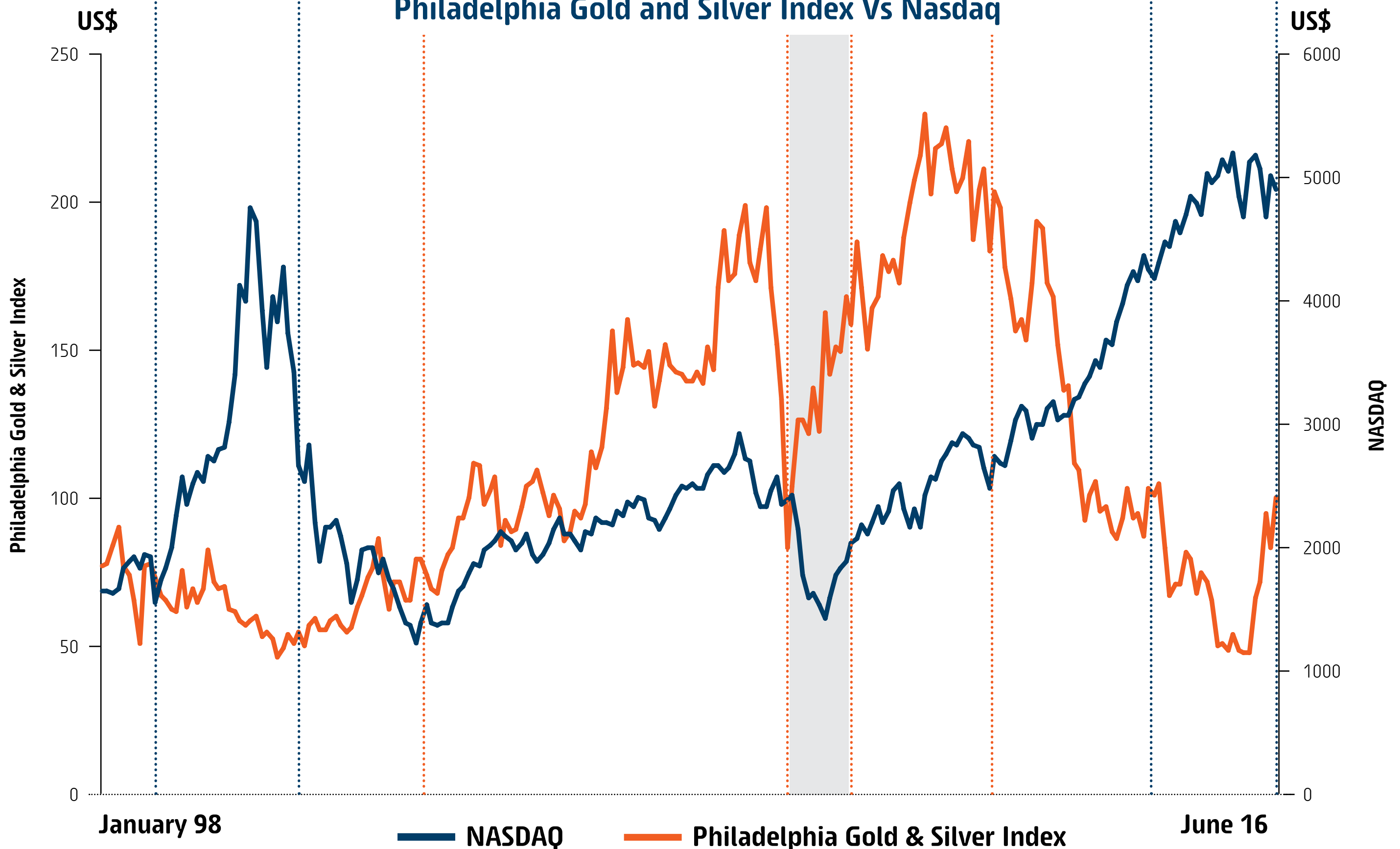
Historic tech and mining equity cycles

ASX IPO Flows



Miners Vs Technology stocks

Philadelphia Gold and Silver Index Vs Nasdaq



Source: IRESS data

Characteristics of cyclical extremes

- Peak: Stocks are too expensive with respect to earnings to sustain prices, although this condition can persist for some time, even with a sort of acknowledgement from investors and sector participants ('it's different this time').
- Trough: stocks are too cheap to ignore any longer, realisation of this is what turns the market.
- The largest IPO's occur at the peak, and IPO volume (number of deals) maps sentiment – if there is no appetite then there can be no IPO's.

	Mining	Tech
High valuation, even for early stage companies which may have low or no earnings	2008, 2011	2000, 2015
IPO volume	2007, 2011	1999, 2014
Largest IPO's	2007 (BoartLongyear) 2011 (Glencore)	2000 (Infineon) 2014 (Alibaba)

Mining IPO's

A very clear indicator that investor sentiment toward miners has returned is the mining IPO market has reopened. 2016 ASX mining IPO volume is already more than 2015, and more have been flagged for likely completion during 2016 (Lion Selection Group is supporting the listing of Egan Street Resources, and Gum Creek Resources being spun out from Panoramic). In addition, price performance of 2016 mining IPOs has been positive – an indication that investor interest has exceeded that required merely to achieve the initial fund raising.

Early cycle IPOs are often successful. Due to a long time waiting, quality has to be high to succeed in listing, and owners are conservative about pricing in a recovering market so price very fairly – providing likely uplift from a low valuation. Often appetite of the market will crowd a good deal when there are few around, which contributes to early aftermarket trading interest. Most importantly however, launching at the start of a cycle provides the longest possible time to be successful in the cycle.

Risk money is back

- Risk money is moving back into mining, much of it recycled tech trading profits.
- Mining IPO volume is increasing, tech IPO volume appears to have stalled.
- The tech market has not begun to fall, and may not for some time – markets require a catalyst to correct. The observation which is key is just that valuations in tech are high, and liquidity appears to be decreasing.
- The mining boom is still in its infancy, however increasing mining IPO's is a signal of the cycling moving on. The return of liquidity has enabled the IPO market to open, but IPO volumes will really increase as risk money gains a singular focus in mining.