LionAnalyst

Mining
Checking in on the BOOM

Topics this edition

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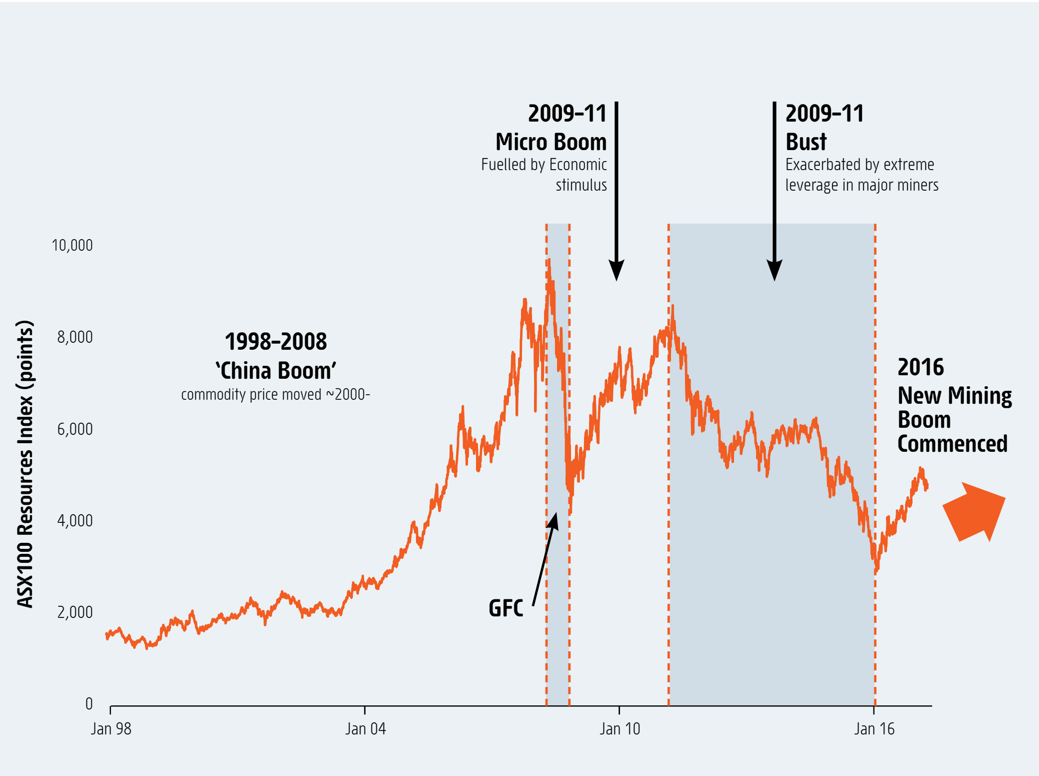
Market: Right on Average... but Wrong at Extremes

On average, the market is always right. The problem with this, and statistics, of course is that during the peaks and the troughs it can be very wrong, and neither rational nor efficient. The height of booms and nadir of the bust is where the market overshoots driven by extremes of sentiment. This manifests in poor capital allocation, via chronic under investment in the bust and overpaying or investing in the wrong areas in boom times.



It is arguable that the loftier the boom and the deeper the bust, the more extreme the market overshoots, and there are signs that this is the case at present. The "stronger for longer" mining boom from 1998-2008 was exacerbated by economic stimulus between 2009-2011, which along with weakening commodities led to a severe extended mining bust from 2011-2015. The bust in particular saw miners severely oversold to a weighting in the market well below previous busts, and the financial condition of major miners meant they have been slow to invest in the industry, which has historically been a key signal to investors of discounts on offer.

A strong rise in mining equity indices in early 2016 as investors sentiment swung back to miners was not the typical start of the early stages of a boom, and may reflect of the extent the market overshot on the bust as well as a bounce in some commodities in 2016. Booms generally start with gentle, extended rises, leading to strong returns as the boom heats up.

Recent Booms and Busts – Foundations of a deeply discounted market

Investors have been drawn towards mining equities as the tide rises, particularly in gold given the macro themes. Whilst there has been performance in headline indices, large parts of the market – particularly micro-cap and junior miners – still contain wonderful and discounted opportunities.

Bust periods create opportunity in two ways:

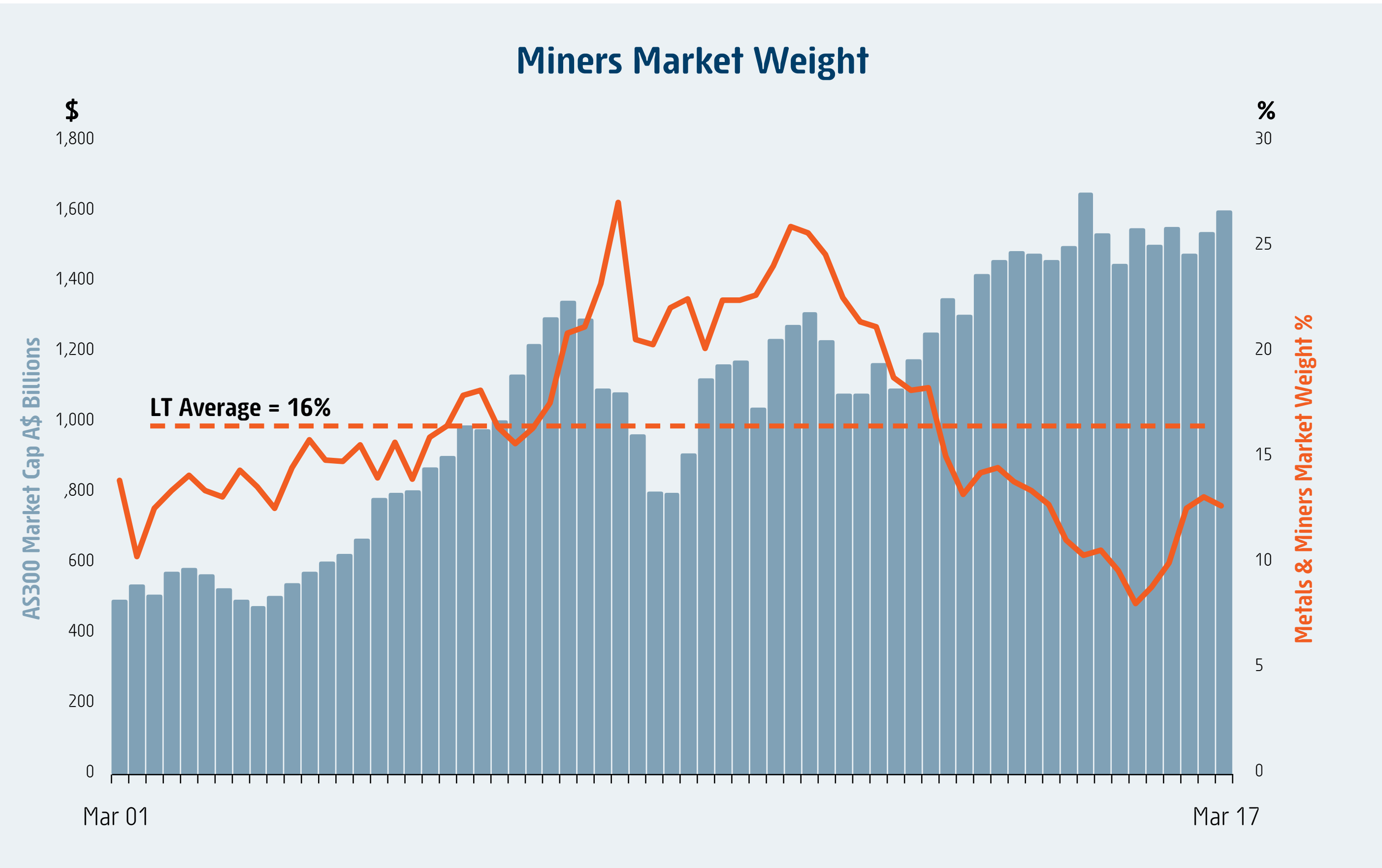
- Falling equity prices – everything becomes cheaper, and eventually discounts emerge. Long falls create deep discounts.
- Project development pipeline neglected as miners go on capital expenditure strike. Short busts create a short pause in project development, but big busts create a long gap – and development assets therefore become much more attractive later in the cycle

The 2011-2015 bust was so long and deep, both forms of opportunity are now on offer.

Why the bounce? – Miners market weight

Miners share of ASX300 sank as low as 8% in late 2015, which is well below the 10-12% level where busts have historically levelled out. Investors buying miners during 2016 and 2017 have increased miners market weight to 13%, which is consistent with normal early boom settings. The broader market backdrop during 2016 / 2017 has been one of low earnings growth and interest rates, so the sudden jump in miners can be justified as reduction of a discount to earnings, especially in major miners, without yet pricing much growth.

The long term average market weight of miners is 16% and recent peaks have been at 28% (2007 / 2011), so investors holdings of miners are still at the bottom end of the range that is generally experienced through a cycle, and suggests a lot of money is yet to move back into mining.



Major miners – Paying the price for poor allocation of capital

The recent bust is also significant for the condition and behaviour of major miners. Historically, major miners with best in industry costs could tap operational cash flows to take advantage of discounted opportunities. However, 2011-2015 saw the major miners collectively managing extreme leverage on their balance sheets to the extent they had to sell projects to pay down dangerous debt levels. Opportunistic acquisitions or investments by majors have historically provided liquidity into weakness at the bottom of the market, but this was absolutely absent and the majors themselves were being sold down aggressively due to their financial condition. So the bust went on longer and deeper than usual.

The signal from the industry, when it came, was from opportunistic juniors who bought projects from stressed majors. These deals enabled several of the purchasers to grow into mid-tier companies.

A long bust also means there has been a long capital strike with chronic under investment. Many pre-production projects have stalled and the development pipeline has thinned right out. Most commodity prices sit below the incentive price for new projects to progress still – so reserve additions are being skewed strongly toward operating mines, which are depleting rapidly. For future projects to be developed to meet future commodity demand requires a combination of cost reduction and improved commodity prices. The pace project development remains slow and well below that required. When demand begins to bite, it will be significant because of the long break we have seen in developing replacement production, and development stage assets will become highly sought. The picture for majors, and in particular, BHP is further clouded by investor activism seeking accountability for the poor capital allocation decisions.

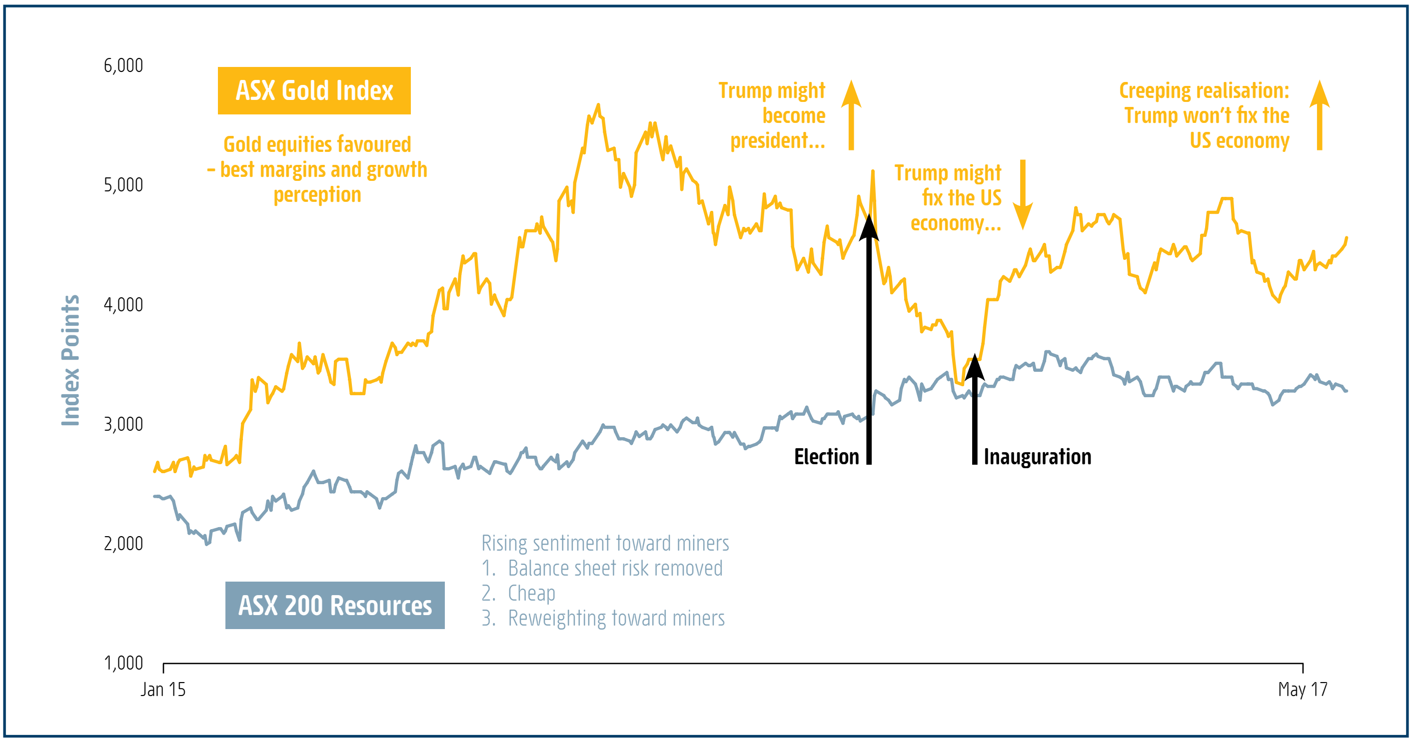
At this time of the mining cycle, we would expect an increasing realisation that the industry has under invested. PWC's recent Mine 2017 publication (7 June 2017) highlights that the top 40 miners 2016 exploration expenditure was around one third of exploration expenditure in 2012. An $100 million Australian Government initiative to encourage exploration was withdrawn, apparently partly due to lack of interest. Lead indicators are positive that the majors are getting more serious about exploration, with BHP committing to investing 20% of its capex in exploration, and major initiatives announced by Rio Tinto, MMG, and Newcrest – although these budgets can be quickly diverted to M&A growth!

Features of the boom so far

Gold equities

Best-in-industry costs, commodity robustness rather than weakness and growth of new global scale mid-tier (Northern Star / Evolution / OceanaGold, etc) drew the attention of returning investors looking for places to invest money in mining, to gold. Gold producers were by far the most attractive on margin and balance sheet credentials, and so became a crowded trade. At one stage during 2016 (July), the ASX gold index was up by 115% on the year. Gold equity prices have come back, as sentiment "rubbed off" on other miners and the broader mining indices have risen.

Gold stocks have been volatile on top of the rising trend, with a creeping intrusion of political events. During late 2016, Donald Trump becoming the US President began to creep in likelihood, which provoked a creeping gold price on the basis Trump would be "good for uncertainty". When live poling during the election showed Trump taking a lead, gold spiked some $40/oz within 30 minutes. This was quickly reversed however when he made an acceptance speech that was highly conciliatory and sounded like he would be a responsible economic custodian, and gold weakened in response to a strengthening US dollar and outlook on interest rates. Come the inauguration, markets shifted once again, as it had become clear that the people who run the US were not going to let Trump run the US, stifling his policy outlook and with it the potential for short term economic recovery, US dollar strengthening and interest rates. Since then gold has been stronger – a trend gold equities have largely followed.



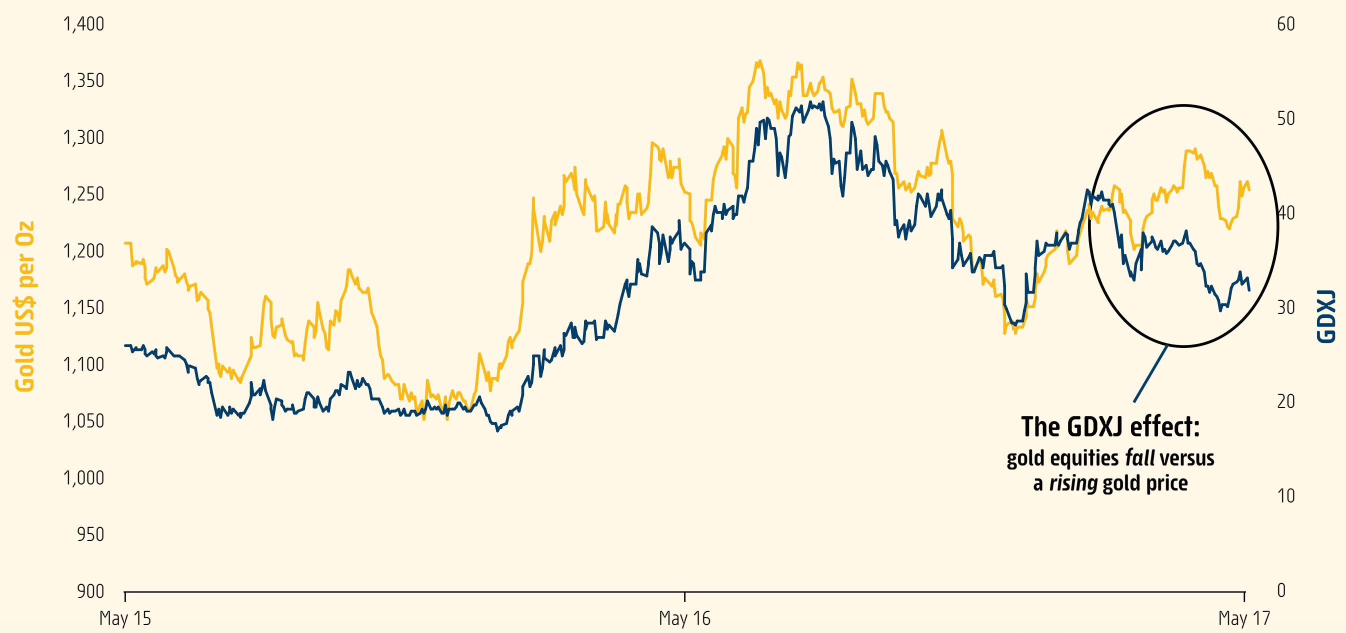
GDXJ effect

Gold equities historically have displayed a strong positive correlation to gold price, however there has been a major departure from this trend since March this year. The story has a perverse twist to it – because of growing investor interest in gold miners, Exchange Traded Fund (ETF) manager Van Eck has experienced substantial inflows to their gold miner ETFs the GDX (major gold miners) and GDXJ (junior gold miners). The bigger these ETFs get the more stock in their target universe of stocks they have to hold, and the GDXJ reached a point where it couldn't buy any more junior gold producer stocks for regulatory reasons (up against takeover thresholds). The solution has been to change the rules of what the GDXJ can hold to enable it to hold more, larger companies. This triggers a new problem – using the new reference index, the GDXJ was instantaneously skewed toward the smaller end of its universe, so the fund had to aggressively sell smaller stocks in order to reweight across the new universe.

Since March 2017, the GDXJ has been opening a wider underperformance gap to spot gold, which it normally tracks faithfully. A performance gap is not unprecedented, however in this instance the index has gone down whilst the gold price has gone up – which is highly irregular. The whole reason an investor would invest in an ETF is that it tracks the behaviour of an underlying market – however in this case the ETF is responsible for negatively moving the market – the tail has wagged the dog.

This activity has not been contained to the population of small gold producers the GDXJ holds, there has also been a flow on effect – it has put a lot of larger, generalist investors off buying into any gold equities, and given there is a known weight of selling there has been an expansion in the short position outstanding against some gold names. Many traders use expressions which need no interpretation to the lay person, and in this situation the expression is "no one wants to stand in front of a moving train". So investors have not only avoided gold equities, they have been aggressively sold, as a result of Van Eck's short term need to rebalance its fund. The pervasive assumption seems to be that there will be consequent weakness in the market, affecting buying of stocks irrespective of their inclusion in the index or not, and this is likely to persist until the rebalance is obviously complete.

Tail wagging the dog



Battery commodities

In smaller capitalisation stocks, there has been an inescapable investor interest in companies that are exploring for or assessing projects that may produce commodities used in lithium ion battery manufacture. Battery technology has evolved substantially to the point where new generation batteries pose an affordable and efficient form of electricity storage that could transform power deployment and enable new forms of transport and generation. Manufacture of these batteries is expected to lead to additional demand for commodities such as lithium, graphite and cobalt, and the adapted use of batteries could lead to increased demand for copper and tin. Consequently, many companies with some claim to anomalism in such elements have increased massively in value, and no doubt this creation of shareholder wealth has played an important part in lighting the spark of investor interest again.

The surge of investor interest shares similarities to phases where investors rushed to become involved with the exploration and assessment for other new age commodities, such as Uranium in 2006/2007 and Rare Earth Elements (REEs) in 2010. Any geologist can attest that occurrences of minerals of all of these commodities are not at all rare, and once a flurry of exploration has taken place this becomes quite obvious. These deposits usually are metallurgically complex, which is to say extraction of a saleable mineral is tough and therefore costly. Marketing of the saleable product is a challenge as buyers often have quite specific requirements of the product, and no large or liquid global market exists. Reflecting on the uranium and REE episodes, the few projects developed into production have proven to be harder to operate and far less valuable than originally presumed. The market will always pay more for what it does not understand than what it does, and once reality sets in investor interest tends to wane.

In 2007, uranium stocks in the ASX300 accounted for 0.7% of the money tied up in miners in that index. In 2010, REE stocks accounted for 1.3% of the miners, and in 2016 combined graphite and lithium hopefuls accounted for 2.2% of the miners. Since mid 2016, the weighting of battery commodity hopefuls had declined, matching share price trends of most of those companies and their peers. At the same time, graphite and lithium companies have become some of the most short sold companies on ASX.

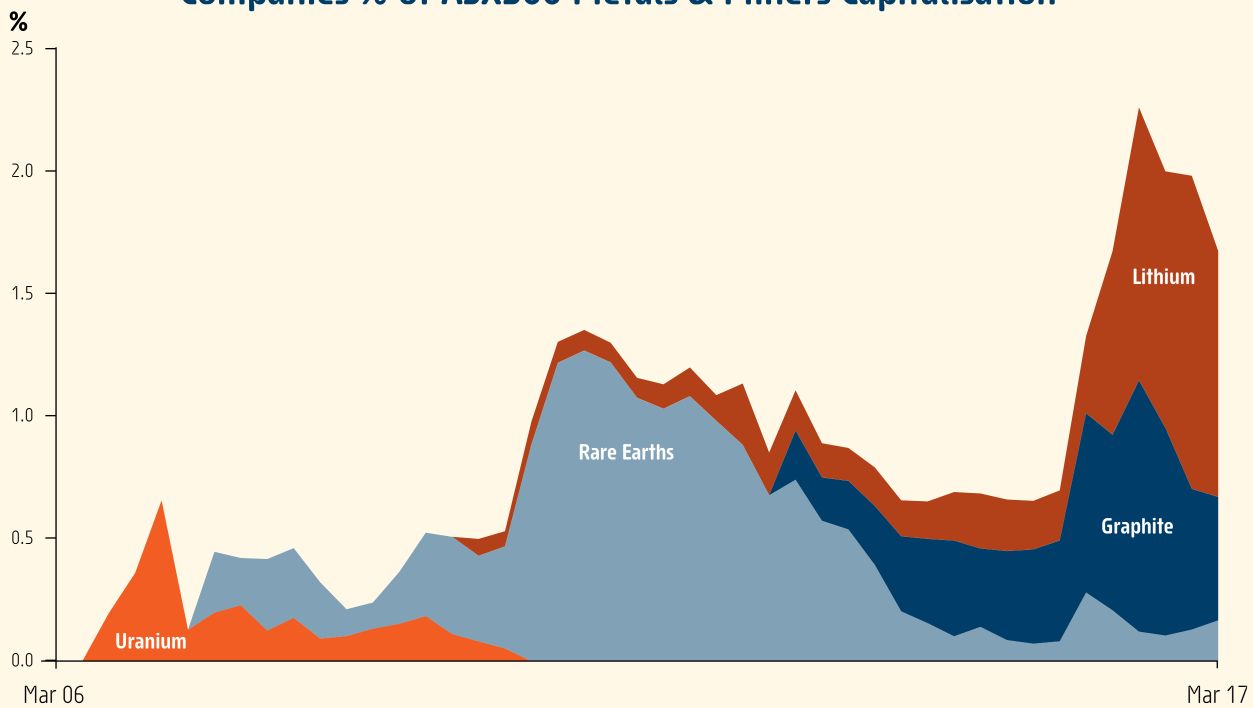
The fundamental for growth in battery use seems clear, however transferring this directly to the equities of potential producers discounts a broad range of risks encompassing funding, processing, marketing and commodity price.

IPO market re-opened

Liquidity equals price, and IPO volumes measure liquidity because they are highly discretionary – they just don't get away in a poor market, when investors may defend their existing investments or not participate at all. In 2016 the IPO market re-opened for miners, having seen only three mining IPO's in 2015 there were 10 in 2016. To date in 2017, there have been 12, and the year is less than half over with the pipeline of approaching IPO's apparently well stocked.

Early cycle IPO's tend to be successful through cycle. Being early in the cycle, there is a long runway of improving sentiment to build on. Because the market but especially the "gatekeepers" are discerning, only better quality deals are progressed, and those deals have to be done at a conservative valuation to ensure success, so investors are likely to perceive a good deal.

Companies % of ASX300 Metals & Miners Capitalisation



Outlook for the BOOM

Smallest guys fall the furthest, and slowest to get started again

Performance of companies through the bust was influenced by size. The Large cap (ASX100) Resources index fell 67%, whilst the ASX Small Resources fell 83%. Most of the ASX Small Resources are producing companies, and there is no index for microcaps that sit below these in value. Starved of liquidity, the collective capitalisation of microcaps fell by more than 90%.

When recovery begins, the first to move are the larger stocks. Outside of gold, a great deal of the benefit of the recovery so far has been seen by large capitalisation miners. Smaller stocks take longer to re-discover, and then usually play catch up later in the cycle.

Industry buying – Mergers & Acquisitions

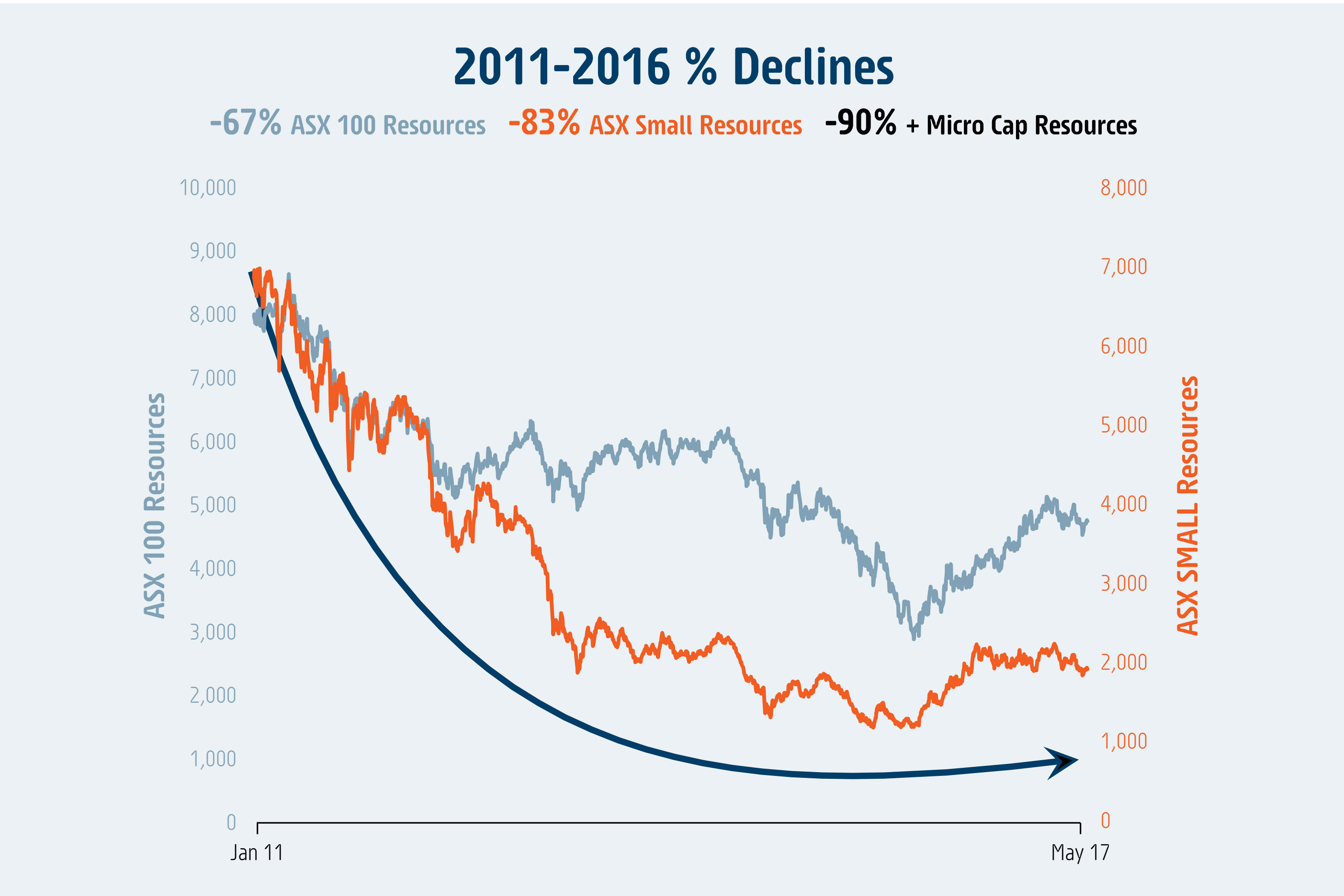
There was a flurry of gold M&A activity in 2013-2015 consisting mainly of junior companies buying projects from majors. Buyers mainly had to issue shares in the market in order to pay cash to the vendors. This developed a growth appetite amongst small to medium gold companies jostling for size, and many put on assessment teams or mandated banks for acquisitions or defence.

Buyer interest came to a hiatus in 2016 brought about by robust gold equities performance which had made most targets expensive on their market capitalisation. Softer conditions for gold companies in late 2016 and early 2017 brought on by the wavering of the Trump Trade and the GDXJ effect have created opportunities for strategic buyers.

Balance sheets – burning holes in pockets?

Owing to a long period of dropping exploration budgets there has been a lack of exploration activity and this translates directly into a lack of reserve growth across the industry. There is an adage that if you don't drill you don't find and if you don't find you don't mine, and taking the gold industry as a whole there is a growing need for reserve growth in many companies.

Whilst not exploring, balance sheets have been under repair and the net cash position of many gold producers is looking healthy again. The industry has a terrible history of returning excess cash to investors, and with the combined factors of available cash and dwindling production pipeline the stage is very much set for M&A, in the gold sector in the short term but the same dynamic is likely to play out across the broader industry. In April and May there were a number of deal announced whereby a large gold producer was investing in or proposing to take over a smaller peer in deals that were all funded by balance sheet cash, which is money generated by the company and not raised. The industry is buying again.



Conclusion

The Lion clock remains at 7 o'clock.

The IPO market has re-opened but we are still waiting for exploration to turn from a negative to positive trend.

Miners in early boom phase recovery so far is historically unusual, and reflects partial unwinding of extreme discounting of the bust.

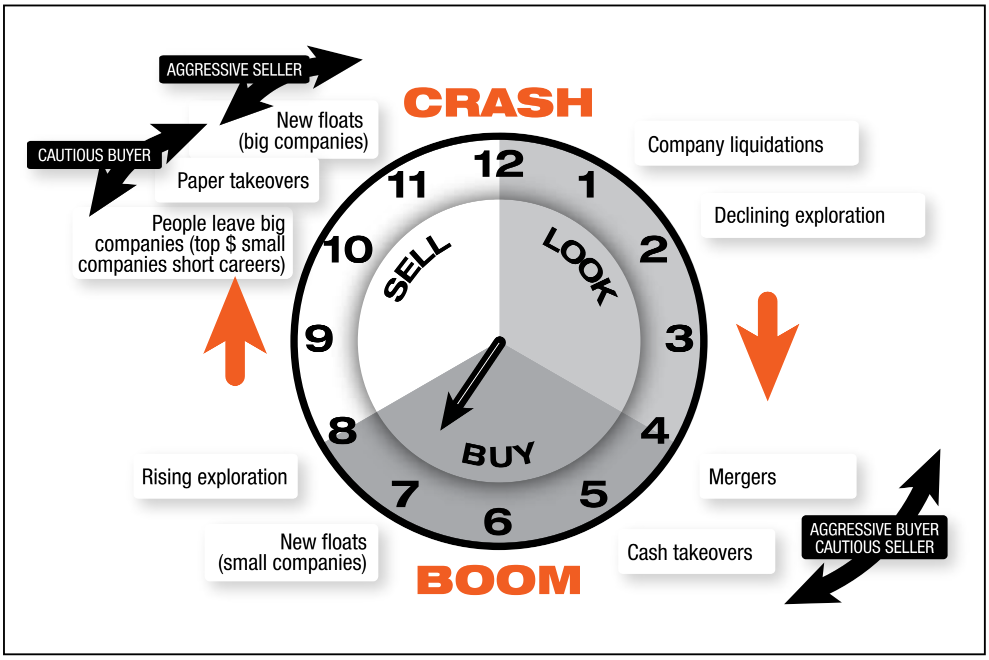
Potential for a robust boom there has been a long capital strike, which will result in supply demand imbalances and project development pipeline will be slow to restart.

Exploration

Restarting now
but not yet enough activity to push costs up.

Given time, will result in discoveries
which will have a stimulatory effect.

Risk: Mainly macro, not mining specific
The issues shaping investor concern are centred on monetary policy – interest rates have to increase, the big question is when. This will affect all equities, miners included, and miners comparative robustness will depend on commodity prices and industry cost structures when the adjustment takes place.



About Lion

Listed portfolio of junior miners (ASX:LSX)

Lion Selection Group is a listed investment company (LIC) focussed on junior and micro cap miners and explorers – the highest growth sector of mining. Lion offers a portfolio exposure to the junior mining space, managed by a team of mining investment professionals. Lion's aggregated investment capacity makes it possible to be a substantial shareholder in some situations, which brings about a relevance to company management that enhances Lion's ability to generate superior returns.

Lion was listed in 1997, and turns 20 years old in 2017. In this time, the fund has distributed to shareholders 97cps of dividends, 81cps as an off market buy back and a share in Evolution Mining, representing collective value of over $5/share including the present value of one Lion share. Total shareholder returns (TSR) are shown below assuming reinvestment of all distributions.

Total Shareholder Return: %pa to 30 April 2017

	Lion	ASX Small Resources	All Ordinaries
1 Year Return	57.7%	12.1%	16.6%
3 Year Return	-3.4%	-1.3%	7.4%
5 Year Return	-7.3%	-16.2%	10.6%
10 Year Return	7.9%	-8.4%	4.0%
15 Year Return	12.6%	3.8%	8.5%
Since Inception	9.3%	2.5%	8.5%

(please refer to notes below)

Breakdown of Lion's net tangible asset backing is announced to ASX every month.

Summary of Net Tangible Assets at 30 April 2017

One Asia	$10.9m	2x large gold projects, Indonesia. Unlisted. Nusantara Resources to be demerged and listed (ASX)
Erdene	$9.2m	High grade gold discovery, Mongolia. TSX listed
Roxgold	$7.8m	High grade gold miner, Burkina Faso. TSXV listed
EganStreet	$3.1m	High grade gold developer, WA. ASX Listed (RRS presenter)
Other & Cash	$13.8m	
	$44.8m	**NTA 42cps (vs 38-45cps share price)**

Notes on Investment Performance

1. Investment performance figures reflect the historic performance of Lion Selection Group Limited (ASX:LSG, 1997 – 2007), Lion Selection Limited (ASX:LST, 2007-2009), Lion Selection Group Limited (NSX:LGP, 2009-2013) and Lion Selection Group Limited (ASX:LSX, 2013-present)
2. Methodology for calculating total shareholder return is based on MorningStar (2006), which assumes reinvestment of distributions
3. Distributions made include cash dividends, shares distributed in specie as a dividend, proceeds from an off market buyback conducted in Dec 2008, and the distribution of shares in Catalpa Resources via the demerger of Lion Selection Limited in Dec 2009. Lion assume all distributions are reinvested, with all non-cash distributions sold and the proceeds reinvested on the distribution pay date.
4. Investment performance is pre-tax and ignores the potential value of franking credits on dividends that were partially or fully franked.
5. Past performance is not a guide to future performance.
6. Indices used for comparison are accumulation indices, which assume reinvestment of dividends.
7. Source: IRESS, Lion Manager