LionAnalyst

CELEBRATING 20 YEARS OF LION

Greed has returned, speculation is growing it's 8 o'clock (and all is well)

Topics this edition

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Investor sentiment toward mining reversed in early 2016 from negative to positive, and the cycle slipped out of the bust and into the early stages of boom. Mining equities have performed aggressively during 2016 and 2017: putting on a strong absolute gain but also outperforming the rest of the market by a wide margin. Generally speaking, booms have been slow to start and early stages are usually characterised by a transition from negative performance to flat – as opposed to a rapid rebound.

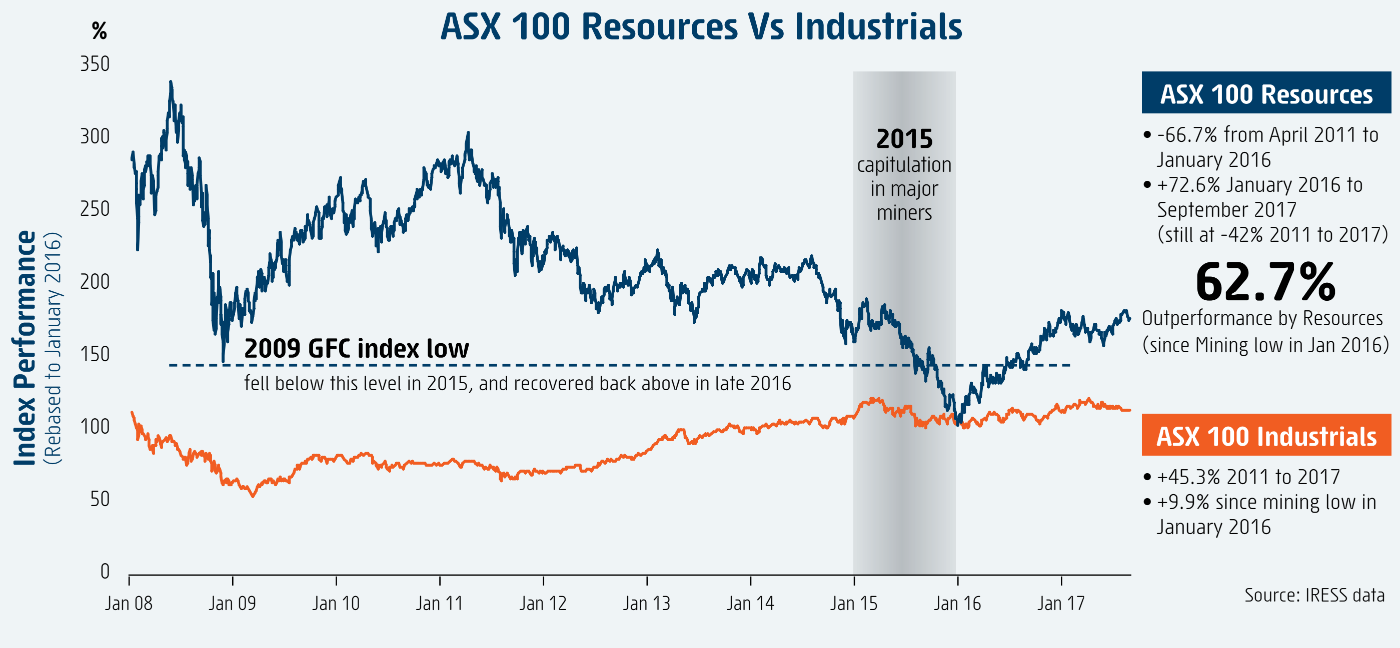
The strong rebound in investor interest in the sector has facilitated capital raising across the junior end, and a commensurate reinvigoration of exploration by all sizes of companies. Growth investment by the mining sector has re-started and investors are rewarding growth and ascribing value to upside again. This is a significant measure of evolution of the cycle – exploration spend does not begin to increase until enough appetite for speculative ventures has developed. Increasing exploration is the marker of 8 o'clock on the Lion Clock.

The Last Bust

The mining bust from 2011 to 2015 sets itself aside of historic busts on account of being the deepest and longest in living memory (and as far back as data can show), but also for the condition of major miners going into the bust.

Historically, the largest miners have had the benefit of industry best cost structures and free cash flow that could be used to purchase projects or peers after a fall. This liquidity from the industry usually provided the signal for other investors to start looking again in mining. This most recent bust however saw many major miners with unsustainable debt loads, accumulated from funding expensive top of the market acquisitions. To reduce debt, many chose or were forced to sell projects. As the bust wore on, not only were majors not buyers, they became sellers of projects and the market followed the lead strongly. This produced an especially aggressive sell down of the largest miners in 2015 – which is fairly clear was the long awaited capitulation event.

The sustained declines in mining equities during the long bust saw equity indices fall below the lows formed after the Global Financial Crisis in 2009. Despite recent strong positive performances of mining equities, indices have only just recovered to be once again above levels of the GFC lows, between mid-2016 and mid-2017.



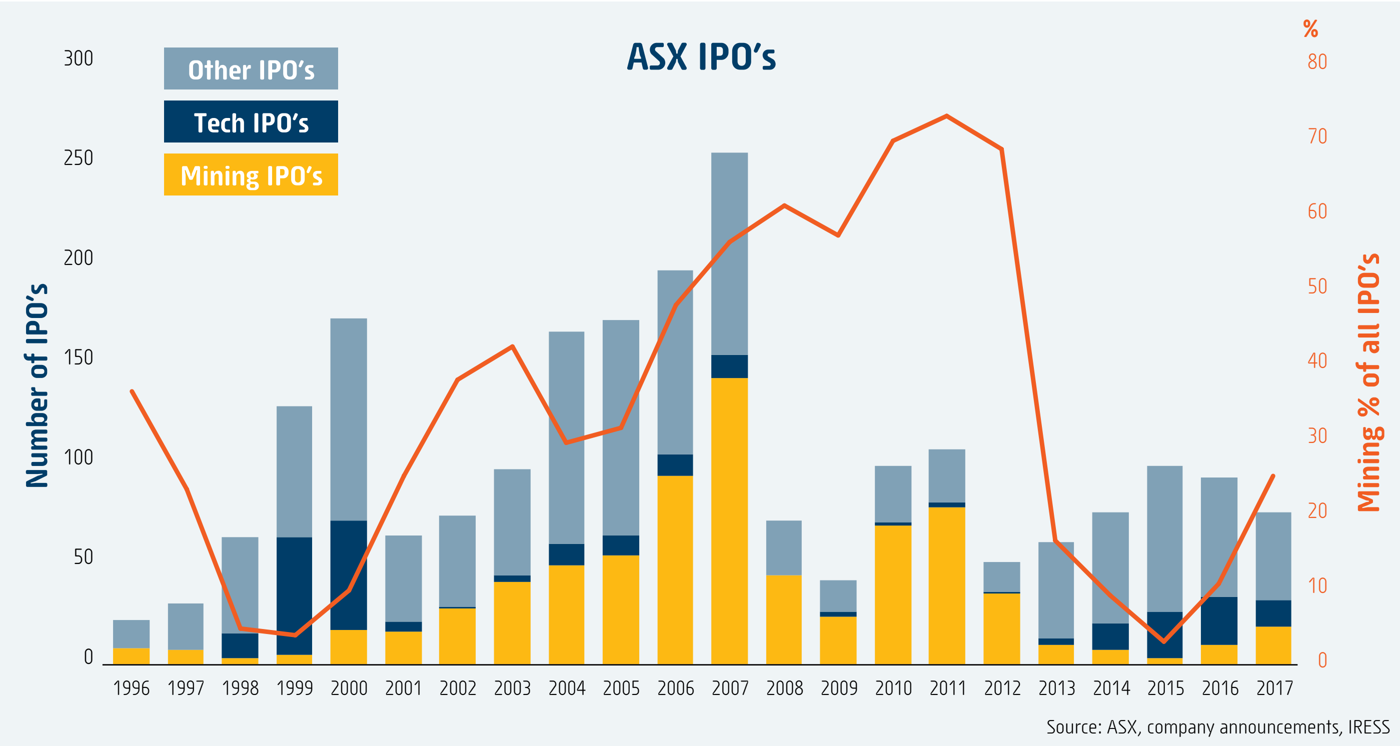
Mining IPO's

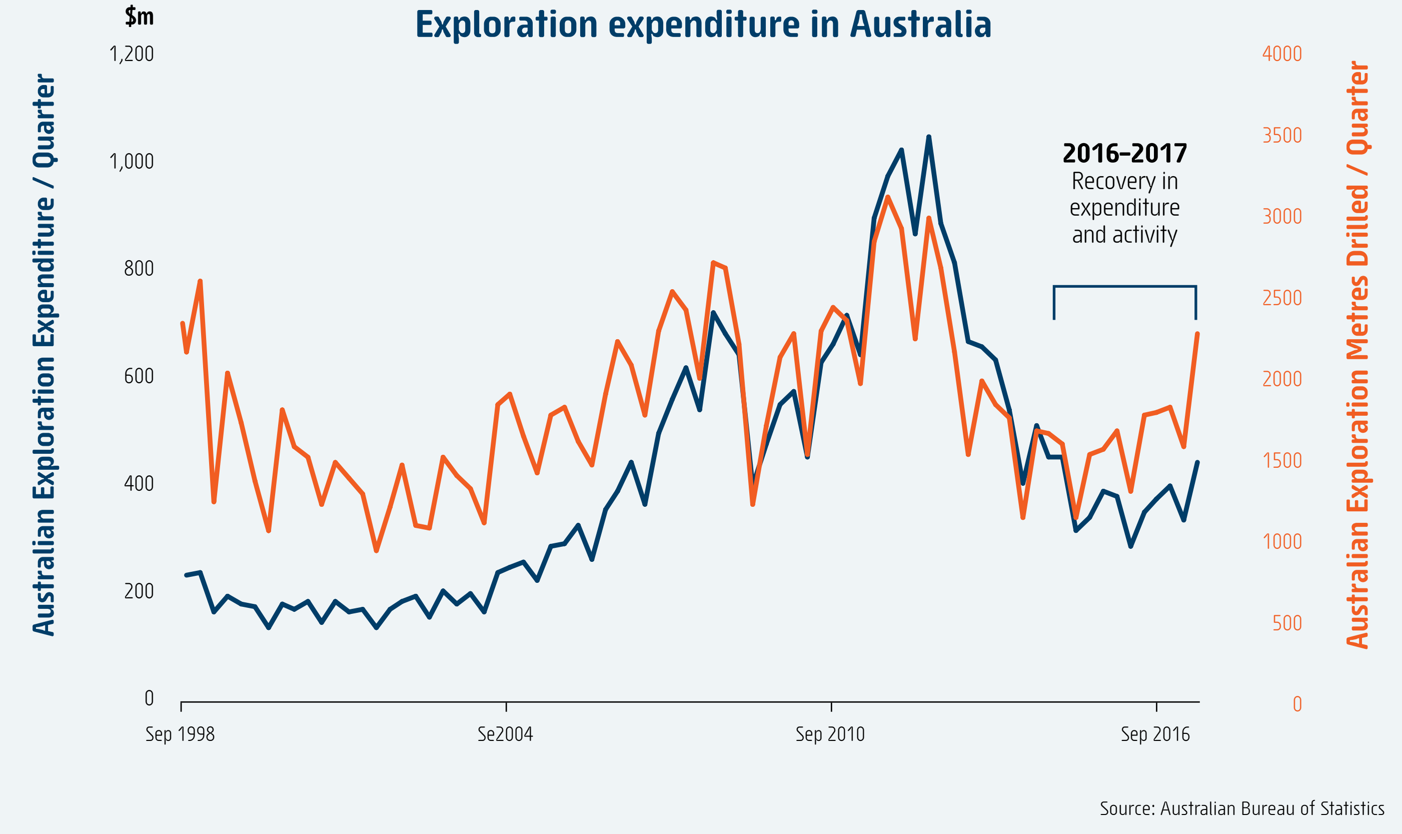
The number of Mining IPO's has increased each year since a low of 3 in 2015 (2016: 10, 2017 YTD 19). In addition, a number of the raisings associated with listings in 2016-2017 have been strongly over-subscribed. As well as an increasing volume trend, mining IPO's are capturing a larger share of the IPO market, particularly from tech IPO's – which are a competing sector for high risk growth capital in the equity market.

Growth Investment is Back

The whole mining industry cut costs between 2011 and 2015, and this involved curtailment of investment in growth projects (green fields exploration, project assessment and development) as well as deferral of a great deal of required sustaining investment. The end result has been a growth pipeline for the industry which has stalled – which is a contrast against investors renewed desire for growth.

Given the long duration of the mining bust, the pause in assessments and developments has been much longer than previous busts. There are strong indications now that the industry has reinvigorated growth projects, but there are impediments that are likely to make for slow progress. Whole teams were lost and exploration ground dropped as work programs were ceased, so internal capabilities have to be rebuilt. A number of larger companies have supplemented internal growth options with investment into junior companies – a strong indication of growth via M&A to come. Whilst the boom conditions that existed between 2000-2011 were driven by emerging Chinese demand, it is quite possible that the current boom is driven by lack of supply to meet demand, with a commensurate scramble for control of growth assets. That penny appears to be dropping now.



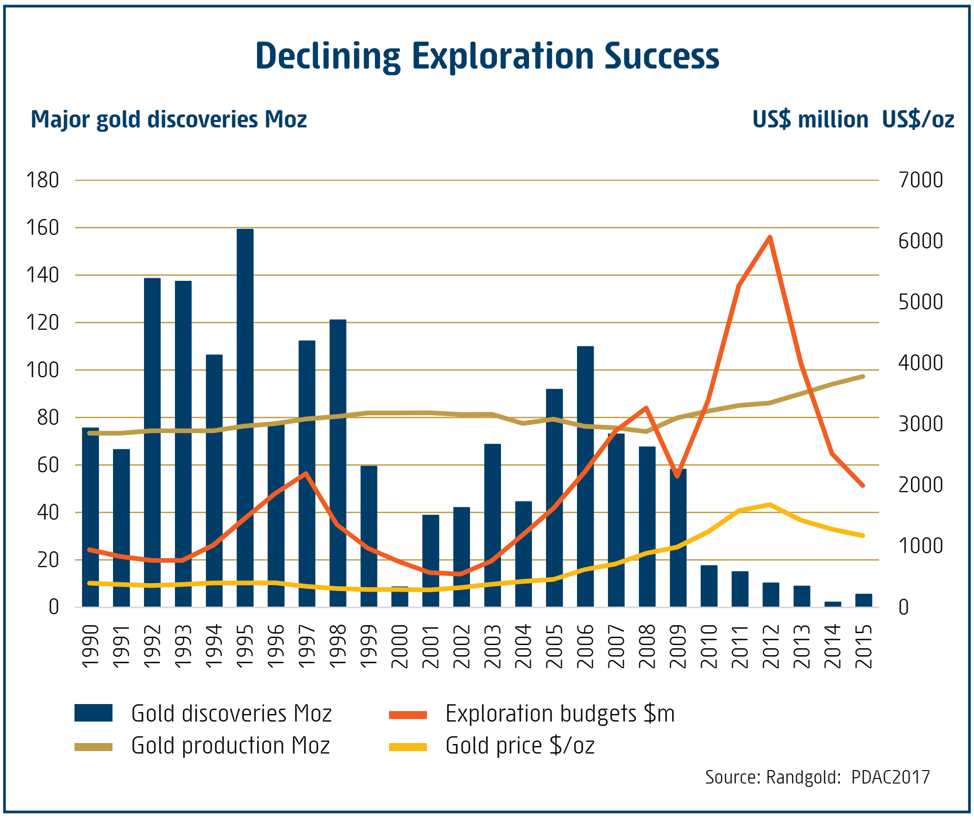


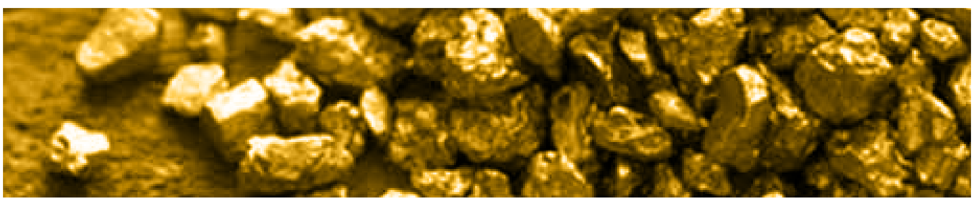
Exploration – Trending Up Again

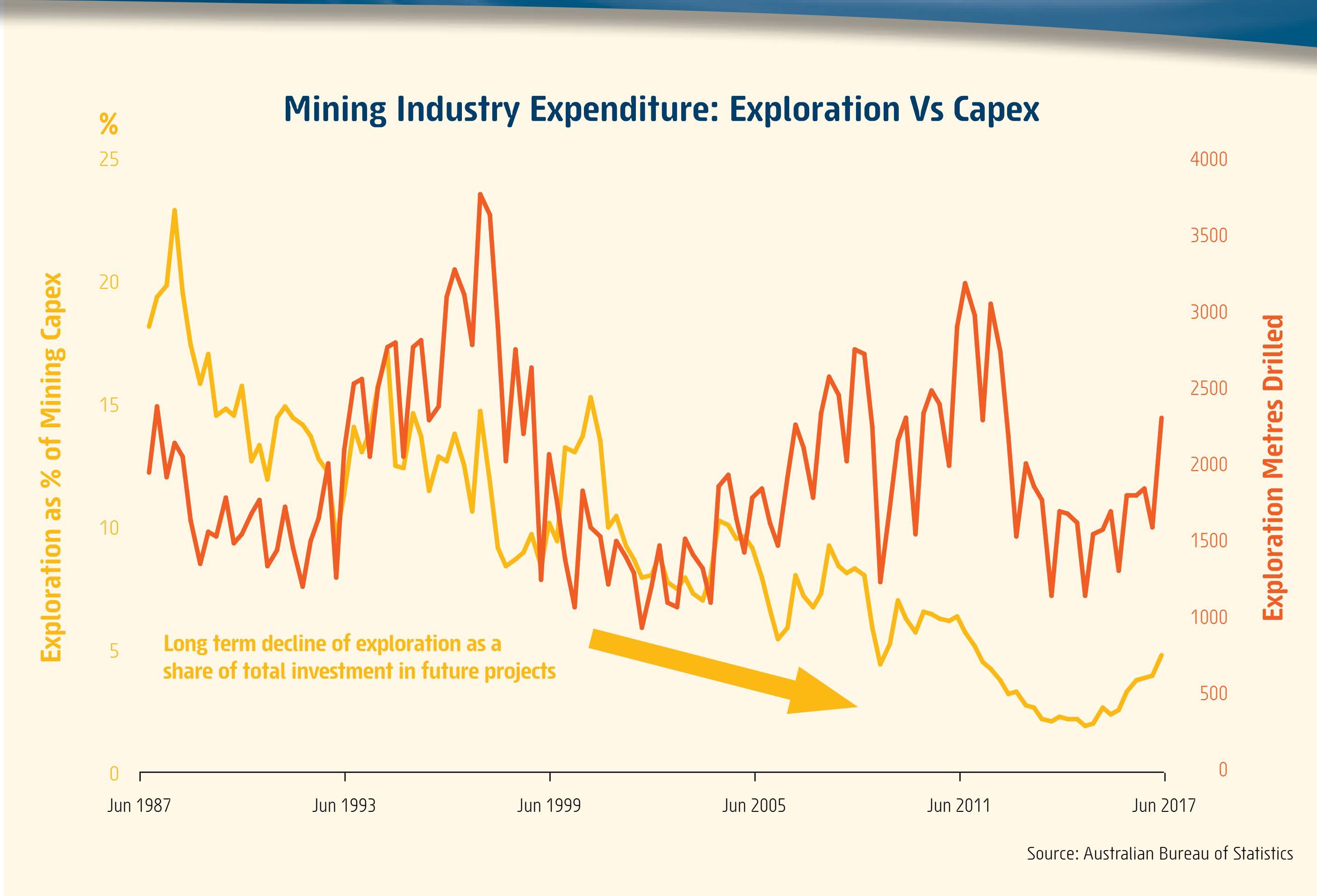
Figures from the Australian Bureau of Statistics show exploration expenditure in Australia has broken out of negative trends in expenditure and activity (meters drilled) that existed from 2012 through to March 2016. Exploration spend maps the availability of risk dollars to the industry – these budgets are first to be cut, and in many companies budgets need to be raised from the market.

Long term trends in exploration (on the other hand) contain features that tend to support increasing scarcity of developable projects.

- Exploration success is declining. The example here is for gold (extracted from the keynote presentation by Randgold at PDAC 2017), but shades of the same are evident in many other commodities. Discoveries are becoming less frequent and abundant, and production has not declined (in fact in most cases, increased) – the pipeline of future inventories is not being re-stocked as rapidly as it needs to be.







Exploration – Trending Up Again *continued*

- Over the long term (30 years), the amount of expenditure on exploration as a proportion of capital spent elsewhere in mining has decreased dramatically: in the late 1980's exploration was equal to 15-20% of mining capex, but in the last five years had dropped to a level of 2-5%. In the same period of time, exploration physical activity (ie meters drilled) has exhibited cyclical volatility but within a range that does not appear to be declining. Either more projects are being built or project development has become more expensive. Probably a bit of both is true, which means the inventory of potential production projects is being emptied faster than before in relation to the effort being made to re-stock it.
- Research by Richard Schodde (2017) has shown that of the discoveries taking place these are increasingly being discovered by junior companies.

Collectively, fewer discoveries which are more likely to be in the hands of a junior are suggestive that future M&A by major companies will become more necessary.

Exploration is Valuable Again

A modern day gold rush is taking place in the Pilbara region of Western Australia. The target that is being promoted has immense potential – gold nuggets have been extracted from a conglomerate unit at surface, which offers up the geological analogy of the South African Witwatersrand. Whilst the surface nugget occurrences appear rich, so far there are no drill hole results to support sub-surface distribution of gold.

The equity market typically rewards explorers for a discovery as it takes place – drilling results add fuel to the speculative fire with each fresh batch of numbers making the find bigger. What makes the Pilbara rush quite enigmatic is the collective capitalisation that has been ascribed to the key players prior to any drilling taking place – now more than A$1.6B. As a rough comparison, that capitalisation exceeds the market value of medium sized local producers Saracen and St Barbara. Applying a broad 'market rate' of $70/Resource ounce – this capitalisation is pricing a discovery in the region of around 23Moz.

Quite irrespective of the risk of this capitalisation for such an early stage and speculative endeavour, the value so far ascribed by the market provides a very clear indication of the prevailing level of risk appetite. Explorers of all kinds are variously experiencing somewhat similar (albeit not to such lofty valuations) market response to exploration news, which is a marked reversal of conditions between 2011-2015.

Investors will often pay far more for something they don't understand than what they do, and exploration provides a prime opportunity for imaginations to exceed reality. Generally speaking, this enthusiasm is a symptom of a market having collective greed – it does not happen during a bust! The conclusion that is immediately evident is that risk appetite has returned to mining, which is essential for the boom to progress. We have not seen conditions so supportive of highly speculative exploration concepts for many years.

References

Key note presentation given by Mark Bristow for Randgold at the Prospectors and Developers Association of Canada conference – March 2017: http://www.randgoldresources.com/sites/randgoldresources/files/PDAC%202017%20KEY%20NOTE%20Mark%20Bristow.pdf

Presentation 'Recent Trends and Outlook for Global Exploration' given by Richard Schodde for MinEx Consulting at the Prospectors and Developers Association of Canada conference – March 2017: http://www.minexconsulting.com/publications/Exploration%20Trends%20and%20Outlook%20-%20PDAC%20Presentation.pdf

Lion Clock

The Lion Clock depicts the mining cycle according to liquidity indicators that are diagnostic of the different stages of the cycle. The clock moved to 6 o'clock in early 2016, after the sense of sentiment toward miners turned positive. It became 7 o'clock later in 2016 when the EganStreet Resources IPO was under preparation, as all indications were that the IPO market was opening and investor appetite had commensurately increased.

There has been a sustained increase in exploration expenditure trend over 15 months now, which is well supported by the volume of expenditure and activity being indicated by listed junior companies in their cash flow reporting. Recent capital raising success positions the sector well to fund continued work, and furthermore, investors' supportive response to positive exploration results indicates that the positive trend of expenditure is more likely to continue than not.

This is a clear signal of progressed sentiment in the sector – and so the time is now 8 o'clock.