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May 2014. Edition 6

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Road to Recovery

Last LionAnalyst we examined the condition of the mining cycle, which is driven by liquidity and sentiment, and concluded on the basis of liquidity conditions that mid 2013 was the bottom of the market for miners. Sentiment towards mining stocks however, especially juniors, remains very low. We now see many anecdotes that suggest the worst is behind us.

Early 2014 saw a flurry of capital raisings, mainly by mid-tier miners, with more money raised in the first two months of 2014 for miners on the Canadian exchanges than in all of 2013. This coincides with project acquisitions and company takeover activity. All are excellent signs, but don't alone herald better times.

Most investors in mining are dormant at present. Though the wall of selling has subsided, institutional investors are still reeling from several consecutive years of heavy losses and retail investors equally cautious. The most active and acquisitive investors are the Chinese and some mid-tier miners, whilst the risk money that was the marginal buyer of explorers is looking elsewhere.

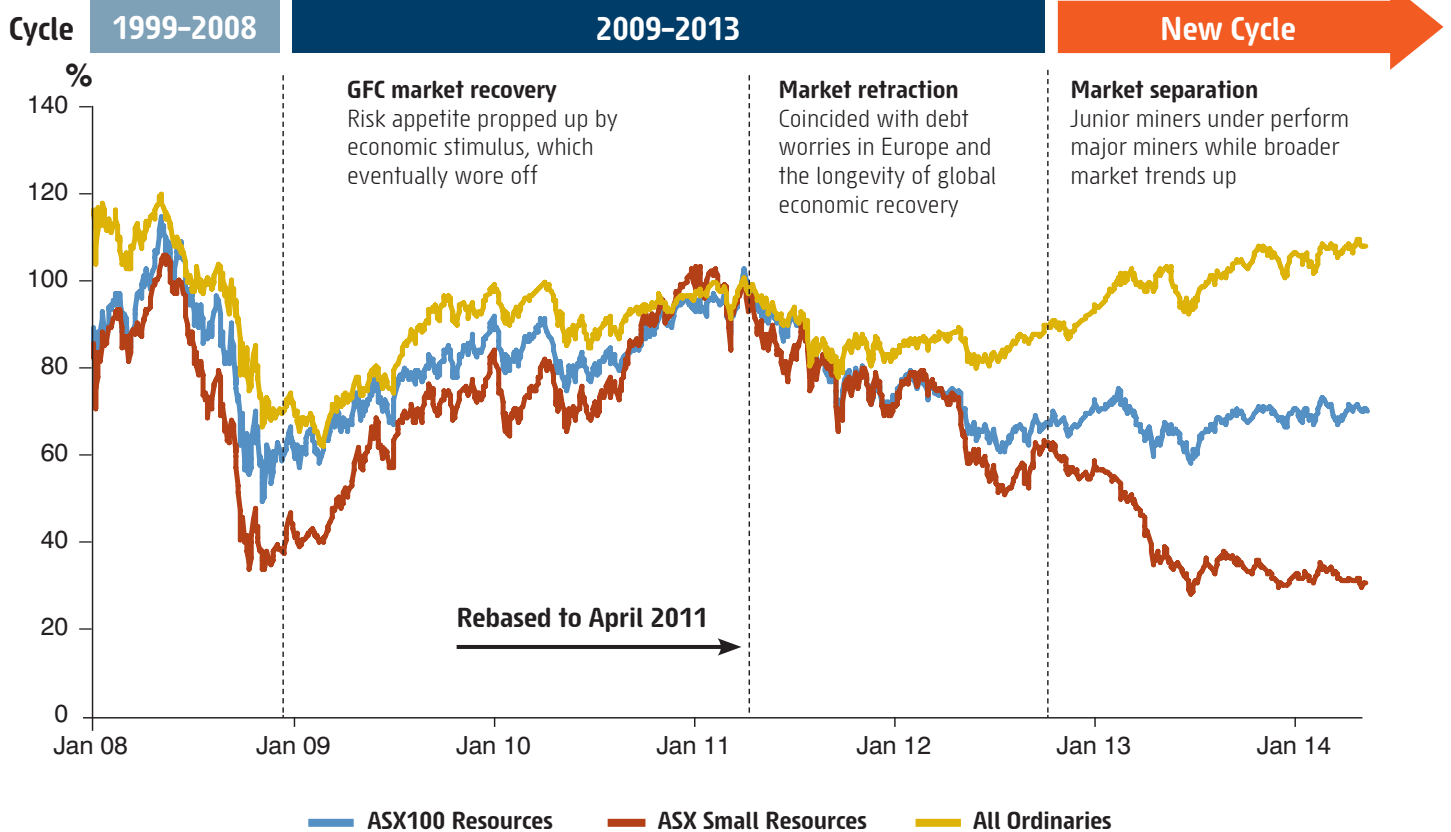
Being growth stocks without self-generating cash flows, mining and tech stocks are peas in a pod competing for the same investment dollar. Currently tech stocks appear to be absorbing a great deal of the available funding in this microcosm. This comes at the greatest expense to the junior miners. We believe

that tech stocks are also showing signs of being cyclical. Importantly if this is the case, it appears the tech cycle could be divergent to the mining cycle, and implicitly the heat from the tech cycle may need to dissipate before risk money returns to junior mining.

Mining booms are always much slower to start than to end. In order for the mining cycle to move back towards a boom, sentiment must improve, and this will be a gradual process. It will take time for investors to become comfortable with miners cost discipline, the outlook for China and commodities and changes in regulation. This "healing" process could be accelerated by M&A by already active strategic buyers, or exploration successes – both of which could be rapidly positive for sentiment.

The worst is behind us Indices stabilised

Having collapsed throughout 2011 – 2013, mining equity indices now appear to have stabilised. Against the backdrop of a generally buoyant market, the indices for major miners (ASX100 Resources) stabilised mid-2012. The Small Resources index took longer and didn't stabilise until mid-2013 – both have since traded sideways. Whilst there is no index for non-producing juniors, these stocks continue to experience price weakness but are not facing nearly the downward pressure they had done prior to mid-2013. A major driving force of mining equity indices falls was redemption selling, which now appears to have abated.



Source: IRESS data

Valuations are low

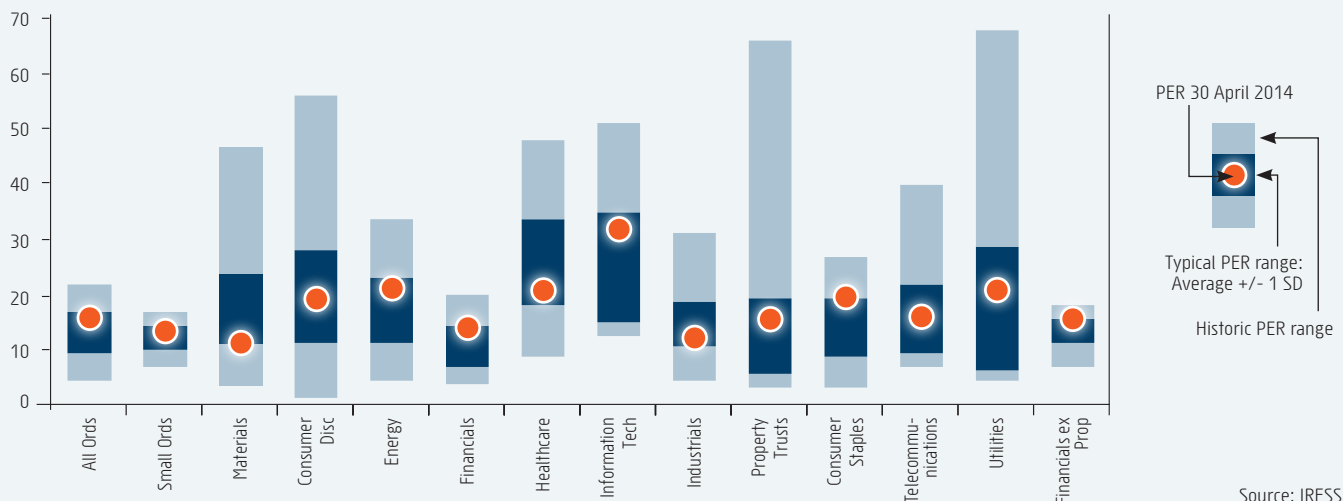
The chart below highlights historic Price to Earnings Ratio (PER) ranges of key Australian market sector indices. The materials sector, which is composed predominantly of mining companies, is currently trading at a multiple to earnings of 12.4x, which is almost 1 standard deviation below the average historic PER. This is in contrast with a fairly fully valued broader market, where many other sectors are trading at or above average historic PER.

Current sentiment of mining investors

The mining industry has performed poorly on a number of measures important to investors. Since the early 2000's, the sector generally pursued growth to increase exposure to historically high commodity prices, and this collective rush has massively increased costs. So far this century has also produced fewer and smaller exploration

discoveries than the 80's and 90's – no fault of the miners but the attraction of blue sky upside is diminished. Chasing scale and less mature geology has seen many companies misjudge risks. Overlain on company performance are themes of increasing regulation and resource nationalism, and wavering sentiment towards the health of China's economy, which is the key consumer of many commodities.

Historic Price to Earnings Ratio (PER) of key Australian market sector indices



Source: IRESS data

Retail Investors

Retail investors are of great importance to mining investment – especially for junior miners, as retail investors make up the majority of the spread of investors in exploration companies and generally are sticky, long term shareholders. Historically, many of the progenitor exchanges that came together to form the ASX were founded as exchanges to facilitate investment by retail investors in fledgling mining companies. Recently the market place for retail investors investing in junior mining has suffered systemic issues, and may actually have broken down.

Firstly, and probably foremost, retail investors may have lost their appetite for investing in juniors due to dismal share price performances. This is probably cyclic and history has shown this sentiment is usually ephemeral.

Secondly, the rise of the on-line broker has rewarded investors with lower brokerage costs, but at the cost of little or no investment advice. Full service brokers who historically did prepare research on miners including some juniors have suffered with lower corporate and brokerage income, which has meant cuts to research departments. Junior miners are now more under researched than ever.

The third change is increased ASX and ASIC scrutiny of junior miners and tighter regulation. ASIC notes that one of its key drivers in regulating juniors is to recognise how consumers make investment decisions and to educate investors to improve their understanding of the relevant concepts. Reading between the lines, it is possible that ASIC is trying to discourage retail investment in juniors to protect investors from themselves. This is manifest through new listing rule requirements and a stricter JORC Code 2012 that prevents junior mining companies from releasing scoping studies based on inferred resources.

Investing in junior miners is challenging for a range of reasons – sheer volume of opportunities, technical complexity and information transparency to name a few. To paraphrase Leigh Clifford (former CEO Rio Tinto), major miners can afford to “kiss a lot of frogs” in order to discover their prince. Juniors, without diversity of opportunity, might have to fall in love with the frog: Every junior must necessarily believe in their project. Often the focus of company promotion is on project attractions and upside, not the barriers to the project proceeding. Investors in junior miners have

to sort through promoter rhetoric to separate those companies with a prince from those merely courting a frog.

Institutional Investors

Institutional investors wear many stripes, but irrespective of their funding composition and mandate, are important to junior mining companies because of their ability to support larger equity raisings that are usually required to fund a project into production. Due to a range of challenges, institutional investors have largely left the junior mining space.

To be mandated, many institutional investors now need to have in house research capabilities (rather than relying on broker research), and opt to limit investment to larger companies for practical reasons and for higher liquidity.

Some institutional investors are managed funds – effectively a shop-front for their underlying investors. When those investors get cold feet and redeem their investment, it forces the fund to sell investments irrespective of liquidity in order to return cash to the investor. Generally, the best and most liquid investments get sold first. The selling pressure may diminish the value of remaining positions, which badly affects fund performance. This leads to more redemptions, and more selling. Redemption selling was like a death of one thousand cuts in 2012/2013, and was massively destructive of mining equities prices. This behaviour gives rise to an expression used by some traders “if you’re going to panic – panic early”.

Listed investment companies are apparently back in vogue as planners are now as likely to direct clients to LIC’s as to managed funds (no more trailing commissions). LIC’s have great merit in the junior mining space for contrarian investors, because this non-redeemable nature means underlying investor behaviours don’t influence the fund’s investment decisions. There have been several recent listings in this space of small cap focussed LIC’s seeking to take advantage of the lack of research of small caps.

Private equity has made the headlines recently with large amounts being set aside for investment. Most of this money is for later stage or production assets and tends to favour large projects, so is relatively inaccessible to most juniors.

Despite this bleak overview, anecdotes of institutional investor sentiment are positive. The market is awash with stories of (unidentified) investors wanting to “get

There is an old trader adage that if you’re going to panic, panic early.

set” – so clearly there is money available and poised, but needs to be catalysed into action. Waiting / watching is also much less price destructive than running away. On top of this, exploration companies on promotional road shows report increased interest from institutional investors and have meaningful interactions. In late 2013 there was apparently not even interest in meeting from institutional investors.

Chinese investors

The Chinese are a subset of mining investors that has grown enormously in importance since the early 2000’s. There is immense speculation about the commodity appetite of China as a whole, including mining investment appetite. The case for robust demand for commodities out of China remains clear, although we do not expect a repeat of the demand growth seen for most of the 2000’s. There is huge political will for continued economic expansion. Furthermore, as China matures to be a wealthy and developed country it will remain a key consumer of commodities. As a source of mining investment interest, China is already home to locally funded, internationally diverse mining companies, and may well join Western Europe, North America and Australia as an important international mining finance market.

Historically, Chinese investors of all classes have suffered combined challenges of being poorly advised (often by fee motivated advisers) and only seeing 2nd or 3rd tier opportunities. This has led to a level of mistrust of western vendors, and some notable poor investment experiences.

Many previous investments by Chinese entities have had a strongly strategic rationale. We don’t see this diminishing, and it is possible that some investment may be motivated by an attempt to engineer oversupply. More recently we have noted a change in investment approach. Investors are now seeking and conducting more technically oriented due diligence and there is a trend towards understanding value – possibly reflecting a value oriented approach to capital allocation.

continued over

Chinese investors continued

Mining businesses listed on Chinese exchanges tend to trade on a higher multiple to earnings than Australian / Canadian / London listed mining companies. There is an arbitrage opportunity available for Chinese investors with access to capital to acquire companies and list them on domestic exchanges, or for already listed companies to expand their multiple by making acquisitions.

In China high level approval is often required for acquisition funding, and we understand there has been a lack of new funding approvals as the new leaders have grown into their roles. Additionally, many Chinese business relationships have been renewed or reviewed since the leadership transition took place in late 2012, so there are some good reasons Chinese interest in mining investment has experienced a hiatus over this time.

Where is the risk money?

The market's appetite for risk varies over time, both for absolute magnitude and also type of risk. At present, risk appetite of the market is low, and what risk funding there is focussed elsewhere.

Technology investment

The chart below shows the Philadelphia Gold and Silver index versus the tech heavy NASDAQ. The late 1990's / early 2000's saw huge market interest in technology stocks, which led to the NASDAQ making record highs before crashing. This tech bubble

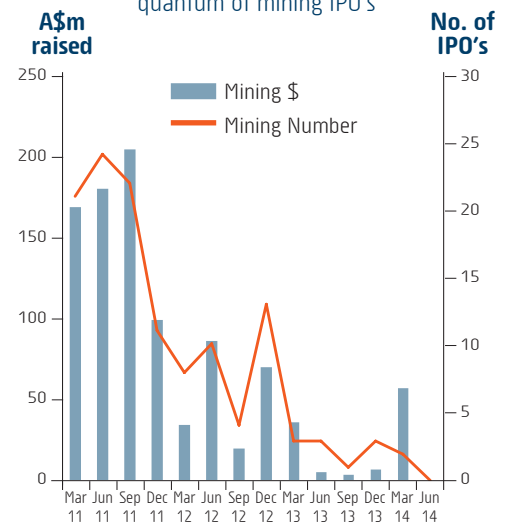
corresponds in time with an opposite trend in gold stocks – which looks very much like risk money through that period of time flowed into tech stocks at the expense of miners. More recently, there has been a similar separation between the same two indices as investment appetite for techs once again goes to fever pitch and the NASDAQ tests its all-time highs: two examples of a divergent cycle between mining and tech investment.

Tech companies appear to be rolling out the old mining mantra "it's different this time", using the same arguments to the last tech boom about old fashioned profit based valuation metrics not being relevant to them. The financial laws of gravity appear to be being defied by many tech stocks recently, some of which are making headlines for the magnitude of their valuations, particularly as they IPO. Despite rapid consumer uptake, many of these companies are yet to establish their revenue model, let alone make a profit.

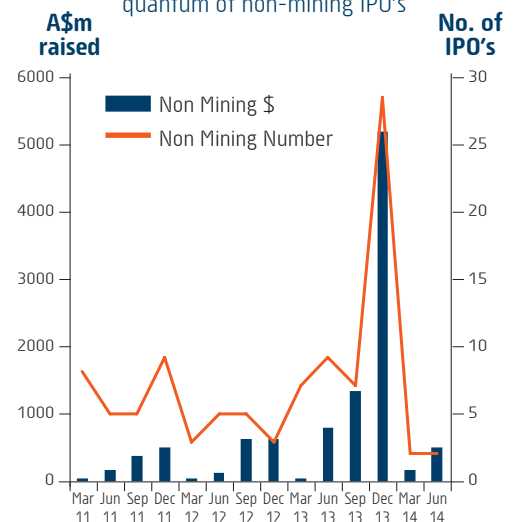
Non-Mining IPO's

Historically, mining IPO's by number constitute a majority of companies that list on ASX. Recently, despite a hiatus in mining IPO activity, IPO funding activity in the broader Australian market has reached record levels with a flurry of large new listings. The charts below show IPO activity (number and funding) of mining and non-mining IPO's onto ASX. There have been a number of poor performers, where financial projections or market appetite have not lived up to expectations, so clearly buying into these businesses is not without risk.

2011-2013 Strong decline in number and quantum of mining IPO's

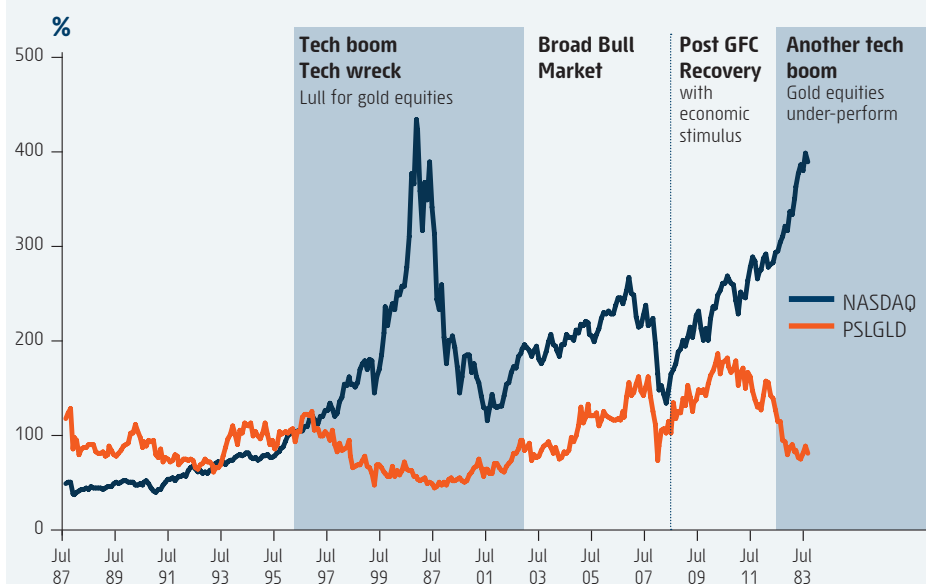


2011-2013 Corresponding increase in number and quantum of non-mining IPO's



Source: IRESS data, ASX, company announcements

Philadelphia Gold and Silver index vs Tech heavy NASDAQ



Source: IRESS data

Professional capitulation: Miners going dotcom

Just as investors oscillate between appetite for early stage mining risk and technology risk so do companies themselves. One example of many includes Minerals Corporation (ASX:MSC) that is in the process of changing its name and business to PRM Cloud Solutions. Interestingly this is not the first foray this company has made into tech – during the tech boom in 2000 the company made a short-lived move into telephony and internet services.

Where to from here? Drivers and catalysts

The aim of long-only investing is to buy low and sell high. Retail and institutional investors alike are asking themselves

“why should I invest today when I can buy cheaper tomorrow?”

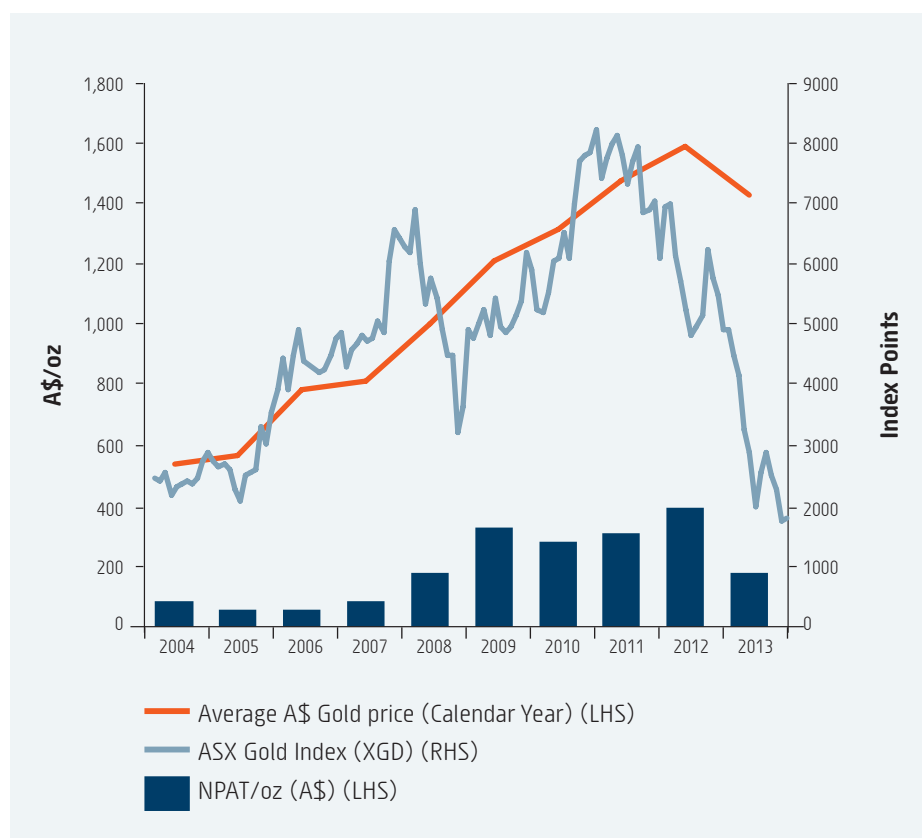
First – cost management

Many miners have started down the path of reducing costs, having previously (largely) disregarded profitability for a focus on growth. During a 10 year bull market miners forgot how to manage costs, but now the realisation has set in that rising prices can no longer be depended on.

The chart below shows normalised NPAT/oz of production for a collection of Australian listed gold producers¹ versus the annual average gold price and the ASX gold index. As commodity prices rallied from 2001 through 2007, producers scrambled to expose themselves to rising price by increasing output, but did so at the expense of margin – targeting growth acquisitions and mining lower grade ores. This occurred across all mining, not just gold, and was facilitated by a low cost of capital. The consequent increase in costs is illustrated by NPAT/oz remaining relatively static despite material increase in gold price.

Cutting costs is easier said than done. A mining project can attempt to mine higher grade ores to increase product output for the same fixed cost, but this involves reserve and schedule changes – not a quick fix. Reducing headcounts is effective but often creates morale issues within the workforce and may not be sustainable. We have seen some major companies sell higher cost and / or mature assets, which reduces their output but increases their margins. The junior miners that buy the projects have leaner overhead cost structures, and can often extract operating efficiencies not possible for more cumbersome majors.

Since 2011, equity prices have declined more substantially than the reduction in profitability. This is explained by abnormal, and supposedly once off items including some large write downs for assets devalued due to the fall in commodity prices. These write-downs have turned profit into loss in many cases, but as they are not a cash amount they don't reflect the expense of producing gold in a particular year. Importantly the mining companies are still producing profitably even at these reduced gold prices. Accordingly continuing profitable production and low current PE ratios delivers the backdrop to mining equities re-rating, provided of course that the gold price doesn't fall further and the 'once off' items don't repeat themselves.



The market can remain irrational longer than you can remain solvent.

John Maynard Keynes

M&A

Merger and Acquisition activity within the mining sector is subdued at present. There have been transactions, notably project acquisitions from majors by Chinese buyers and junior cum mid-tier miners, and there are several live takeover bids mainly from Chinese acquirers. However, there is a disconnect between the value seen by these strategic buyers and the broader market.

The junior space in particular is ripe for consolidation. In mid-2014 there were 611 non-producing junior mining companies² with a market capitalisation of less than \$100m. Of those, 426 companies (70%) had a cash balance of less than \$2m. In the current depressed market, it's impossible to see all of these companies getting the equity funding support they require to continue working. Chatter from junior companies suggests there is growing discussion amongst junior companies about potential business consolidation, but this will test the pragmatism of company directors. Some boards will see consolidation as a way for shareholders to maintain a secure exposure to the company's projects. Others may see it as the end of a pay cheque, or simply lack the foresight to engage with potential suitors before they run out of funds.

Major companies are relatively well cashed up to be acquirers, however scale is unlikely to be an acceptable justification for most companies whilst the market remains focussed on margins and costs. Over time, as strategic buyers make acquisitions there is sure to be a flow through to the broader market as investors see the opportunity for value uplift into a transaction.

NOTES

1. Miners chosen if they were in production for the period 2004-2013. Includes NCM, LGL, EQI, KCN, DOM, RSG, SBM, TRY. Production is gold equivalent ounces. Source: IRESS data, company reports.
2. The universe of junior companies used here are companies with GICS classification "materials", with services and manufacturing companies removed.

Exploration success

Exploration discoveries can ignite speculative bubbles of liquidity, and importantly can occur at any time in the cycle. Despite the declining trend of success in exploration globally, new frontiers remain and improvements in exploration technology are constantly taking place. There are historical precedents to think a substantial discovery has the potential to ignite market sentiment and break the malaise.

In the mid 1990's gold premiums were driven largely by exploration success. One of the more notable was the Bre-X 'discovery' in Indonesia, and whilst this emerged as a fraud, the initial excitement in the market of what was touted as an 80moz discovery led to wide spread enthusiasm for gold exploration. The key factor in the 1990's was not a single discovery, but a number of discoveries, made by different companies.

An example of how a cluster of discoveries that could ignite the market might take place is the Albany-Fraser belt, in the South of Western Australia. Due to overlying cover,

the basement rocks were never prospected during historic gold rush times, and has been poorly explored to date. Conventional geological thought had all but written the region off due to high metamorphic grade and lack of prospective host rocks. This was proven incorrect in 2005 with the discovery of the Tropicana gold deposit. In 2012 Sirius Resources found a nickel-copper deposit which resulted in a 87x re-rating of Sirius' share price. Enthusiasm for the find was contagious – companies with ground in the same belt and neighbouring Sirius' find have experienced volatile prices as speculators jostle for position in case other deposits can be identified. Almost two years later, Sirius continues to explore the region and a number of others, mainly juniors, have done grass roots work to develop targets of their own which are now being drilled. The importance of the region is immense – totally unexplored until recently, now proven to be fertile and therefore massively prospective, and now seeing a wave of exploration. Another discovery would confirm the potential of the region, and more than one could well tempt the speculative dollar back toward exploration.

Conclusion

- Anecdotal evidence and liquidity indicators suggest the worst is behind us.
- A new boom will only get underway gradually, with bumps along the way. Investors need to find their way back as many are focussed elsewhere. M&A activity or exploration discoveries could accelerate this, but equally it may be a case of waiting for the heat to come out of other "hot" sectors, such as technology.
- The Lion view is mining equities, especially the juniors, are cheap and there are attractive opportunities on offer. It is unlikely this opportunity will pass quickly – in the past recoveries after a crash have taken years not months, before small companies could raise funds again.
- The key risk for junior miners at the moment is funding: accessing funds and making them last, but still being effective.
- Given a tangible change in conditions since October 2013, principally the emergence of merger and acquisition activity for projects and companies, the Lion Clock is now at four o'clock.

