

Miners at turning point

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Lion Clock has struck 5 o'clock

Are we there yet?

After five long years of share price weakness, the first quarter of 2016 has seen a reversal in investor sentiment towards miners – having only recently been regarded as 'risky' and 'irresponsible', this perception has changed to 'rational' and 'cheap'. The switch has been marked by a short and aggressive rally in both mining equities and mineral commodities.

Longevity of this rally is not of great importance, the central issue is that the rally occurred at all, as it is the first sustained period for more than five years of miners outperforming the rest of the market. The rally almost certainly reflects the unwinding of what had been a fairly confident trade – short resources – and the end of capitulation in mining stocks.

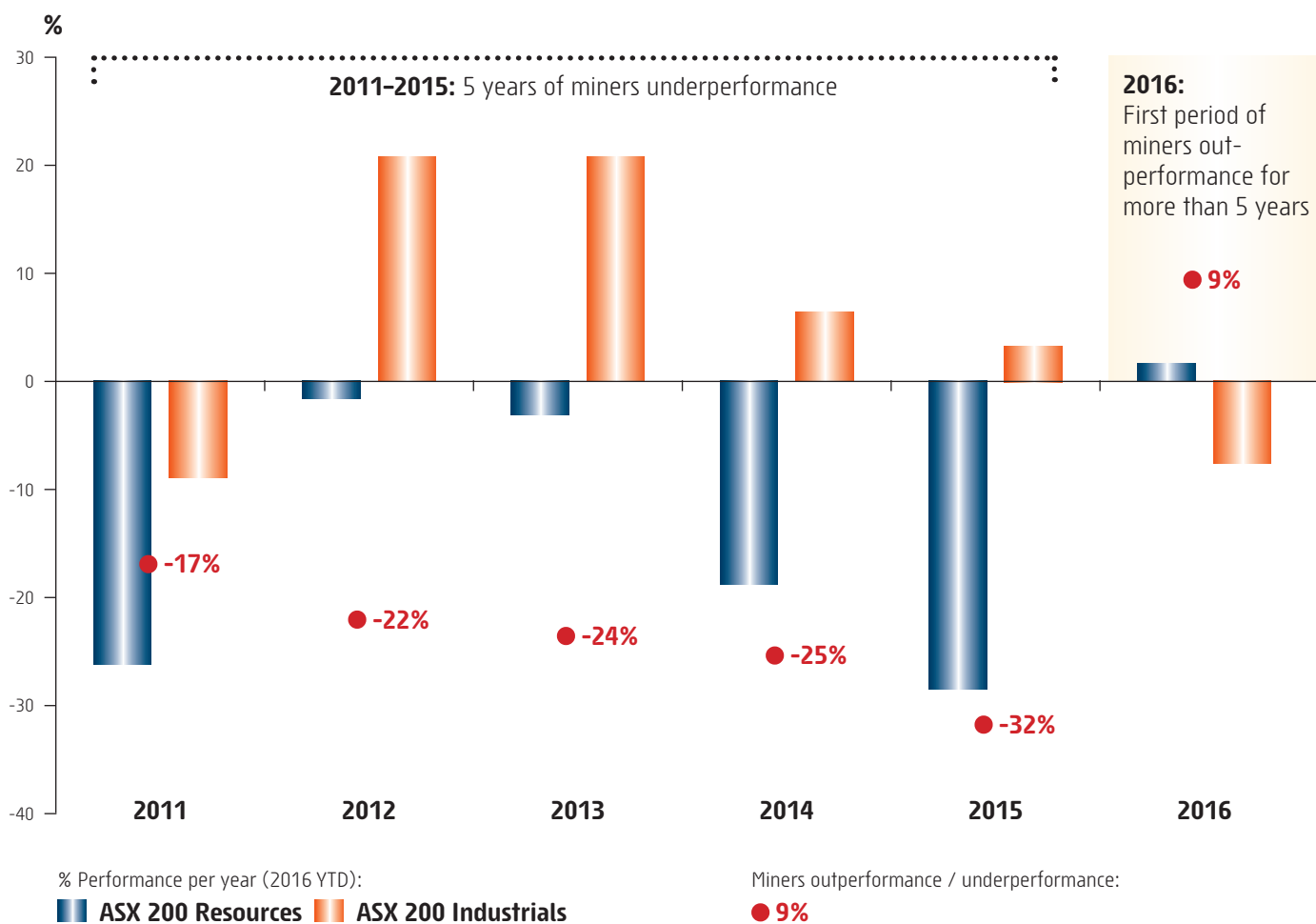
Picking turning points is notoriously difficult. Evidence of liquidity and sentiment toward miners is very compelling, however these can waver as the market changes direction. There is likely to be volatility as the market steadies, and upward movement across the broader mining market will only follow a period of consolidation.

2016 – Down then up

Year to date (11 April 2016) performance of the ASX200 Resources index is an individually unimpressive 2%,

but this conceals a fall from 1 January to 20 January of 16%, a subsequent appreciation of 30% to 7 March before a softening to date of 7%. The ASX200 Resources has outperformed the ASX200 Industrials by 9% year to date, and 21% since the resource market low on 20 January. This divergence is significant, as miners have constantly underperformed the rest of the market since 2011, and is indicative of two key changes:

- Investors are coming back into Resources. Not yet in droves – but buying interest that has been absent for years is clearly evident
- The sharpness of this rally smacks of an unwinding of short positions. The traders mantra is that "the trend is your friend" and now the short bet on miners is nowhere near as safe as it had been when the market was falling.



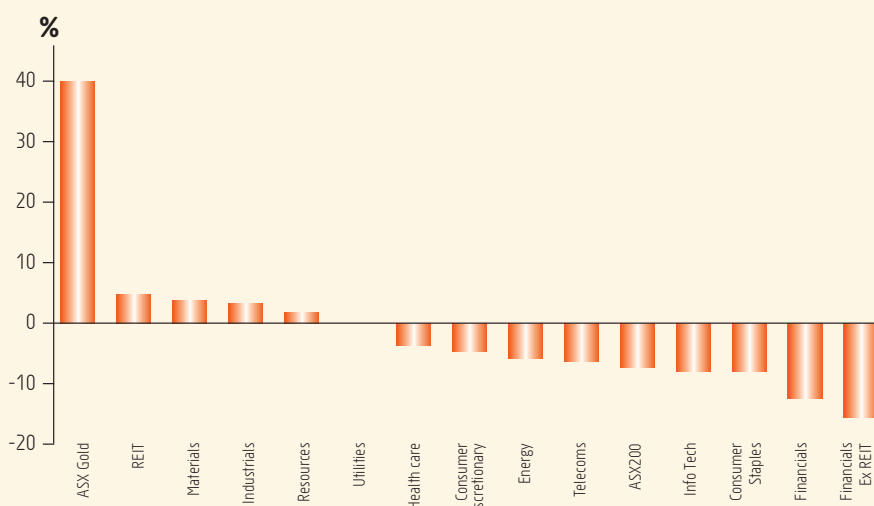
Source: IRESS data

All that has glittered is gold

The most significant recent performance of commodities has been gold, the drivers are well understood and have been widely discussed in the media.

A deferral of a tightening bias toward interest rates in the United States has fed fears of a prolonged period of low / negative real interest rates. There is a possibility of Britain leaving the European Union ("Brexit"), and Donald Trump might become the next president of the United States – a delicious concoction of uncertainty and fear. Consequently, gold stocks have been the stand out by a long way – the growth stories of a select number of companies had been a feature of 2013-2015, so there was a strong foundation. Nevertheless, Australian gold stocks are up 40% year to date – with performance like this, one can only conclude that investors have rediscovered gold miners in a big way.

ASX Sectors - % Performance 2016 YTD



Source: IRESS data

Investor interest in larger gold stocks, which are trading at generous levels for present earnings, is now cascading into smaller capitalisation gold miners. Valuations and share price performance of smaller gold companies are starting to mimic their larger peers. Of crucial importance is that investors are once again funding fresh raisings of small and micro-cap miners. This strongly suggests that there has been a complete change of heart – only a few months ago, small miners and especially non-producers were judged as too risky for most investors to bother, an undeniable indication of returning liquidity.

The cycle has bottomed

Capitulation is over – miners have become Rational and Cheap

The end of a bust in any cyclical investment space is characterised by a capitulation event, which itself culminates in the collective realisation by investors that the sector is too cheap to ignore any longer.

A great deal of commentary from investment analysts and press is around the price and value of miners and now reflects this sentiment. Having seemed to steady in early 2015, mining equities and commodities staged a substantial fall between March and the end of 2015. During this phase, investor concerns were about sustainability of miners' dividends (particularly in major miners) and balance sheet health. This sentiment

reversed as many major miners cut their dividends in late 2015 and early 2016, including BHP Billiton and Rio Tinto, who scrapped contentious progressive dividend policies. Despite the obvious negative implication for miners yield, these actions seem to have been the catalyst for investors to take a renewed interest, and the majors are now better able to afford M&A.

The recent rally has already softened, however, it is evident that investors collectively have recognised (decided ?) that there is very little remaining downside in miners, and the changes to cost and capital management reassure investors that miners intend to manage their capital responsibly. This momentum will be very difficult to unwind without a substantial negative catalyst.

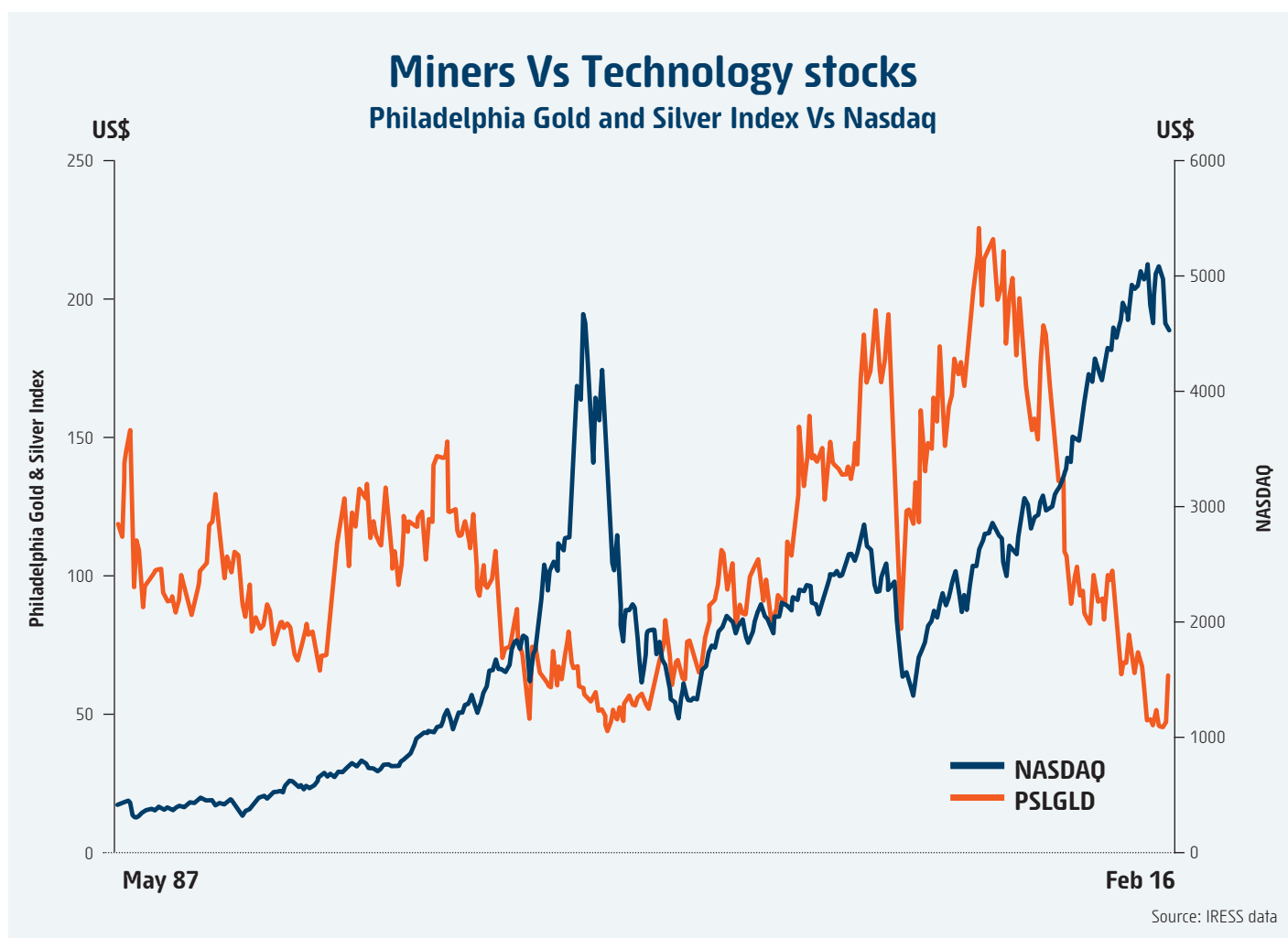
Liquidity returning from technology

The recent rally in miners corresponds closely with volatility in technology heavy markets such as the Nasdaq. This is significant,

because since the late 1990's technology and mining sectors have tended to trade in opposite directions.

The stand out of the technology sector is the extreme earnings multiples that many stocks trade at, as earnings growth has failed to match a sustained period of share price appreciation. The first quarter of 2016 saw no technology IPO's on US markets, during which time a number of listing hopefuls were stalled. This is hardly a harbinger of doom, but does indicate that funding of technology enterprises has stalled.

The Lion team has observed many recent anecdotes of investors looking to recycle profits they have taken from technology investments into mining stocks. In Australia, the pace of technology ventures seeking a listing via IPO as well as RTO appear to have slowed. Combining all these factors suggests that some money is moving from technology back to mining.



Mining M&A – the stage is set

Australian gold producers have generated great cash margins over the last 12-24 months, which has strengthened balance sheets in the sector dramatically. Historically, miners have a poor track record of returning excess cash to investors, and usually such cash piles are eventually directed at growth – organically through exploration and development, and through acquisitions. The evolution from share funded deals that have dominated mining M&A recently to balance sheet funded deals is a clear demonstration of confidence within the sector and key indicator of improved liquidity. Appetite for growth can be highly contagious – if big is good, more must be better!

Activity is largely, but not exclusively in gold. Some of the highlights of recent balance sheet funded M&A activity:

- During 2015 Northern Star agreed to earn into Tanami Gold's Central Tanami project in the Northern Territory. Some shares were issued to Tanami as part consideration for an initial project stake, but most of the earn in is cash which is to bring the existing process plant back to commercial production.
- In November 2015 Canadian listed Kinross announced the purchase of the 50% of the

Round Mountain gold mine in Nevada that it didn't own from Barrick for US\$610m in cash, which was funded from cash holdings and existing liquidity (debt). The same month, Barrick also sold a 70% interest in two gold projects to a Private Equity outfit for US\$110m cash.

- Between May 2015 and April 2016, OceanaGold announced strategic investments (now holding 19.9% in both cases) in two separate junior companies with gold projects in Nevada.
- Bloomberg published a rumour on 10 March 2016 that Sumitomo were in talks with Gold Road about forming a joint venture to develop Gruyere in Western Australia.
- Rio Tinto advertised its interest in investing in new projects by supporting junior companies via an article published in the AusIMM Bulletin. BHP Billiton tied commentary on abandoning their progressive dividend policy to consideration of opportunistic acquisitions.

Miners are slashing costs

The most valid criticism of miners through the duration of the boom is that the industry collectively allowed costs to increase massively. There were unavoidable

elements, such as the cost of power, fuel and steel. Equally there have been increases that the industry should not be proud of, namely labour force cost and efficiency. Recently miners have been able to benefit from a drop in the price of oil, but driving savings on the cost of labour is a challenge and requires effort, this has taken time for the industry to grasp.

Labour cost reduction is a phrase that encompasses sacking people and reducing wages, and needs to be strongly led. A CEO cannot reduce wages across a work force but not accept a similar reduction in remuneration. After early resistance to taking the medicine, there is evidence measures are starting to bite. In time, these efforts will make marginal projects profitable again, even with no commodity price adjustment, and increasing profitability will drive competition for the investor dollar.

Investment markets in the past have been poor at forecasting cost reduction capacity, and often display disbelief at first reports. Investors will be reassured once initiatives have been shown to be sustainable. Cost savings have a long way to play out, but so far there does not appear to be any margin for this improvement built into sentiment.

Things worth knowing and remembering about mining booms

(that never get much air time)

Boom follows bust

The cycle has always repeated.

It's never different this time

Investors tend to judge the future based on the recent past. This tendency leads to the belief that the trend (whatever it is) will continue, and it creates a major blind spot in picking turning points, at the top and at the bottom. Turning points are obvious in hindsight, but that doesn't mean the next one won't arrive.

Most investors follow the majors

Major miners buy for strategic reasons, and in more recent history have made the biggest acquisitions when the cycle is close to its peak. An investors' mantra is to buy low and sell high, but in practice tend to mimic the behaviour of major miners, despite not being strategically motivated.

Peaks and Troughs

Irrespective of asset class (ie mining, technology, etc), turning point conditions are very similar.

- Peak: Stocks are too expensive with respect to earnings to sustain the price. Note this condition can persist for some time, even with a kind of acknowledgement from investors and sector participants.
- Trough: stocks are too cheap to ignore any longer, and probably can't go lower.



Lion Clock has struck 5 o'clock

Investors broadly have changed their view toward miners, and the realisations that miners are 1) cheap and 2) probably have very little downside on price, have now set in. The conclusion is not centred on the longevity of the recent rally – the rally is only an important piece of evidence. Capitulation is over, and strong cash generation and growth appetite in gold is likely to lead to more balance sheet funded M&A. Most importantly it has recently become possible again for small non-producing miners to raise funds, albeit quite selectively. The return of liquidity to mining equities is now well underway, and accordingly the Lion Clock has moved to 5 o'clock, which is just before the boom.

