GLOBAL MINING OBSERVER

Issue 63 **INDEPENDENT COVERAGE OF THE MINING MARKETS** *November 2013*

Apportioning Risk in the Exploration Industry

The value of shares traded each month on Toronto's Venture Exchange, a proxy for exploration stocks globally, has dropped from $6bn in 2011 to $1.2 bn in October this year. The total market cap of all mining stocks listed on the exchange has meanwhile dropped from $37bn in 2011 to $11bn currently, shrinking the sector beyond its 2009 lows of $13.9bn.

Of the one hundred largest mining companies on the exchange, only three paid a dividend this year and one of those, Midway Gold, only to holders of preference shares. The data reflects a monumental failing by the exploration industry to deliver shareholder returns, with capital losses far exceeding any metal price decline. Gold and copper are both only 30 per cent from their all time highs.

The volatility of exploration stocks reflects the uncertainties of exploration itself and the long odds of converting an outcrop into a cash generative mine, but it also betrays the inadequacy of the market's mechanism for absorbing those odds in a way that fosters exploration capital. A buy and hold approach is rendered impossible, repelling long term minded investors and exacerbating the cycle.

"The starting point for me," says US-based investor Adrian Day, "is that mining at any stage is extremely high risk and exploration is especially high risk. To get from an initial anomaly to an actual mine obviously takes a lot of money, so the question is, how do you mitigate that risk?"

Vancouver's answer has been simply to pool it: repeatedly raising money for drilling, the exploration industry becomes a rolling dilution machine. Investors are invited to absorb the risk themselves by holding a portfolio of dicey stocks, in turn diluting the upside.

Alongside Sprott's Rick Rule, Day is the leading investor in prospect generators, companies that limit themselves to prospecting, using cash rich partners to fund high cost drilling. "It's a good way to participate in exploration while mitigating the risks," he says. "It enables a company to withstand failure and I think we have to recognise that failure is part of the process."

In Labrador and Quebec, the model has been pioneered by Altius Minerals and Virginia Mines, two of Day's largest holdings. Both are pure exploration stocks, but by apportioning risk ➤ differently to the bulk of the industry and by stripping the capital intensity out of exploration, both have emerged with cash and royalties in excess of their market caps and both have risen year to date.

Under a listed corporate umbrella, the model echoes an earlier approach to prospecting, whereby lone geologists would wander off into Canada's snow, turning up gold camps like Hemlo. Without capital for drilling, they would stake ground and option it on, retaining a royalty or minority stake.

In helicopters and high-viz jackets, Altius has the same approach, spending $13m on exploration in five years, vs. $60m in cash receipts and $91m in partner funded drilling. Retaining royalties and spinning discoveries into the market, Altius' market cap of C$301m ($289m) conceals cash of C$135m, equities trading at C$111m and a portfolio of royalties including 0.3 per cent of Vale's Voisey's Bay and 3 per cent of the giant Kami iron ore deposit.

"The beauty of Voisey's Bay," Day explains, "is that it pays their overhead, but the Kami royalty is more valuable." Backed by China's largest steel mill, Kami is expected to produce 8m tonnes per annum for 30 years from 2016.

At current prices, the figures imply royalty payments of $31m per annum, or as Day conservatively says, "$25m a year for 25 years." If the payments are paid out in dividends, Altius trades at an 11 per cent forward yield. "The revenue Altius will get from Kami will be far in excess of their needs," says Day. "That's also true of Eleonore."

Having discovered Eleonore on Quebec's James Bay frontier, Virginia sold the deposit to Goldcorp in 2006, retaining a 2.2 to 3.5 per cent royalty. From 2014, Goldcorp expects Eleonore to produce 600,000 ounces per annum for at least 15 years. Six diamond drill rigs are turning at 7,000m per month from its Andre Gaumond exploration shaft, named after Virginia's chief executive. "If he wanted," Day says, "he could pick up the phone and sell the Eleonore royalty within 20 minutes."

The biggest value in Virginia and Altius however is less in their royalties than in their low cost model and its potential for future discoveries. Fully funded for several decades, exploration success becomes more a question of time than chance or money. "For me," Day concludes, "when the hard assets add up to the market value and when the overhead is covered by a royalty, it's just a matter of being patient."

ANGLO AMERICAN has completed the sale of its Amapa mine in Brazil to Zamin Ferrous for $134m, plus up to $130m over 5 years subject to iron ore prices.

SANDSTORM GOLD has reported record quarterly gold sales of 9,570 ounces at operating margins of $894 per ounce, generating operating cash flow of $8.6m.

ATRUM COAL has closed a "heavily oversubscribed" $18.5m institutional placement, accelerating its 1.6bn tonne Groundhog anthracite deposit in British Columbia towards first coal late 2014.

MARKET REPORT

Highlands Pacific Jumps on Glencore's Flash Sale of Frieda River

AUSTRALIA: Highlands Pacific has risen 33 per cent on news that Glencore has sold its 80 per cent share in the 2bn tonne Frieda River copper-gold project, Papua New Guinea, to ASX-listed PanAust. Once valued by analysts at $2bn, PanAust will pay $25m upfront and $50m in December 2015, plus royalties capped at a further $50m.

For those brave to Papua New Guinea, the sale resembles the offloading by Rio Tinto of its Maules Creek coking coal deposit in Queensland in its cash raising efforts of 2008. Chinese regulators have told Glencore to sell down copper assets as part of its merger with Xstrata this year and the group is also keen to flatten its cap-ex pipeline.

Costs are estimated at up to $1.8bn, producing 100,000 copper tonnes and 160,000 gold ounces per annum for 18 years. The deal lifts Highlands Pacific, which holds 20 per cent of Frieda River, out of an acrimonious relationship with Xstrata, with PanAust waiving Xstrata's disputed claims.

CANADA: HudBay Minerals, up 7 per cent this week, has sold half the gold from its Constancia copper project in Peru to streaming group Silver Wheaton for $135m plus $400 per ounce.

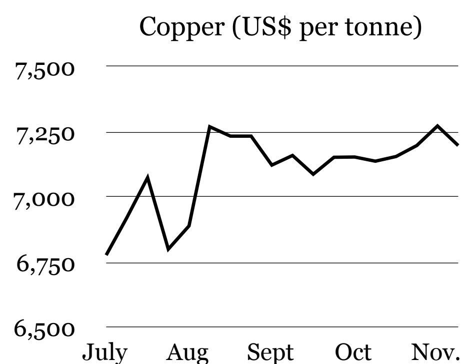
The agreement cushions HudBay's balance sheet against any overruns at the mine, projected to cost $1.5bn with full production in 2015. Silver Wheaton has already contributed $750m to Constancia in exchange for its silver and half of the gold from HudBay's 777 mine in Flin Flon.

LONDON: Gemfields, up 42 per cent in the last month to 34p, rose 7 per cent Tuesday on quarterly output figures. Grades rose 17 per cent to 302 carats per tonne at its Kagem emerald mine in Zambia, producing 6.5m carats in 3 months, whilst bulk sampling at its Montepuez ruby mine in Mozambique has yielded 4.6m carats to date.

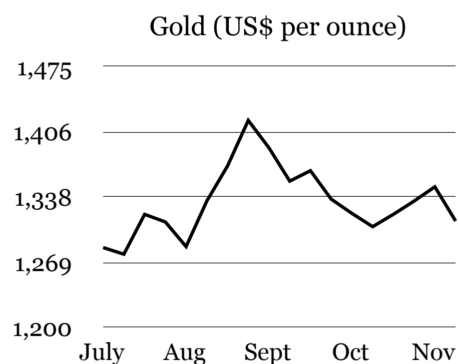
Record auction prices for the quarter of $54 to $58 per carat compare to per carat production costs of $0.66.

HUDBAY MINERALS installing a river diversion pipe at its Constancia mine, Peru. The company's first mine outside Canada, Constancia is due to produce 85,000 copper tonnes per annum for 15 years, dwarfing HudBay's current output of 40,000 tonnes in its last full year.

Copper (US$ per tonne)

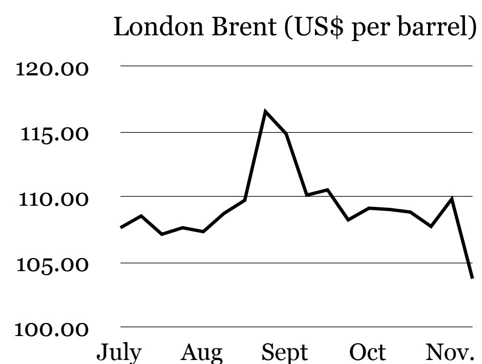


Gold (US$ per ounce)



COMMODITIES: Goldman Sachs, which deftly expanded into warehousing in 2010, has warned that changes to LME rules will increase price volatility. With queues for aluminium in Detroit of up to 460 days, the exchange confirmed changes today that will force warehouses to limit intakes once queues breach 50 days. Goldman is facing law-suits contending it has engineered queues by limiting load-out rates to profit from storage fees, but warned clients this week that efforts at "managing queues" would move metal off the exchange.

London Brent (US$ per barrel)



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