Mining Journal

Viewpoint > From-the-capital

Industry ducks strategy choices

'Returns or size?' is a question commonly brushed aside when companies take strategic decisions about exploration and mine development. Rarely is it put to a vote.

John Robertson*

The greatest rewards come from exploration

01 FEBRUARY 2018

A recent 'From the Capital' column about the strategic choices confronting Crusader Resources touched on an acrimonious debate last year between shareholders of AIM-listed gold explorer Stratex International and its directors.

The two sides were at odds over the strategic direction of the company after Stratex directors initiated a merger with Brazilian-based gold mine developer Crusader. The move on the more advanced South American assets was aimed at creating a quicker path to production and cash flows.

A group of disaffected shareholders wanting to stay close to the company's exploration roots opposed the plan arguing, among other points, that "the most significant uplift in economic value is achieved through early-stage resource identification". The bloc opposed to the Crusader transaction requisitioned a general meeting to put its case.

The response from Stratex directors - "that the greatest growth in market value is exhibited by companies turning an exploration asset into a development and then producing asset" - was directly at odds with the dissidents' reading of how markets value mineral assets.

Exploration companies currently trade at a median enterprise value (EV) per ounce of gold resource of around US$15 whereas, the directors said in supporting their decision, production companies currently trade at a median EV/Resource multiple nearer $44.

Averages, by definition, abstract from the existence of unusual outcomes but both groups could not have been right in their disparate generalisations of how markets value mineral assets.

Surprisingly, because it happens so rarely, the renegade shareholders won the day, despatched the chief executive and scuppered the merger.

> **The exploration transaction model has become more difficult to implement**

The Stratex disagreement is noteworthy because, more often than not, debate about where investment value arises along the development path is entirely avoided as successful explorers try to morph unquestioningly into mine developers and operators.

In presenting their case, Stratex directors seemed to hold out a valuation magic wand. They could choose between selling an ounce of gold resource today at $15 or $44, based simply on a statement of strategic intent.

Explorers may be able to sell today at $15. But any sale at $44 will occur only after years of development effort and the contribution of additional capital to facilitate progress toward production. They are hardly contemporaneous alternatives.

Mineral economist and principal of MinEx Consulting, Richard Schodde, estimated in a report in October 2017 ('Long-term forecast of Australia's mineral production and revenue') that the average time from discovery to development of a mineral deposit had stretched to 13 years.

The value principal put forward by the Stratex board implied investors are better off with three dollars 13 years from now than they are from getting one dollar today.

Over 13 years, the change in what investors might be prepared to pay for a mineral resource, based on the Stratex numbers, represents an annual return of about 8.5%. This is a premium over US government bond yields of just six percentage points in the fanciful event that no additional capital is needed.

Analysts might debate whether exploration and development assets are both too cheap but, as they stand, compensation for investment retention is inadequate.

Returns can be improved by minimising the time between exploration success and production but there are practical limits to this happening. Stratex could opportunistically contemplate three years to production after buying into Crusader only because of the previous efforts of others.

At the end of the day, the approach recommended by the Stratex board was implicitly more concerned with building size than returns on invested funds.

The additional $29/oz of resource garnered through a development strategy depends on the contribution of sufficient capital.

A company with a 1 million ounce resource may have a market value of $15 million but even a modest capital requirement of $75 million will mean having to forgo $90 million in total to get $44 million. Not a good deal. Scaled up, the result could be far worse.

A strongly growing EV is no guarantee of similar investment returns.

In current market conditions, satisfactory returns for shareholders supporting development are the exception requiring a highly unusual combination of attributes, not the norm.

In recent weeks, two of Australia's most prospective explorers - St George Mining and Stavely Resources

- made announcements validating expectations about their discovery potential. Their share prices rose fourfold in the immediate aftermath (even without any lithium or cobalt content to fuel investor interest).

In both instances, the companies' EVs will almost certainly be higher in future years after possibly hundreds of millions of dollars are invested in development of their mineral resources.

St George and Stavely will create additional value from further exploration. Yet, however great the eventual aggregate market values of these companies, they may never replicate the returns investors have already reaped as a result of their discoveries.

Acting in the interests of shareholders, companies should consider selling their equivalent of a US$15/oz asset once resource definition has largely run its course. Repeating similar transactions over the time it would have otherwise taken to get production underway from the initial deposit may leave companies smaller but with better investment outcomes.

This is, admittedly, easier said than done. Such asset transactions require well-funded ready buyers with mining skills to take projects to the next stage. They also need a pipeline of similar quality exploration assets to sustain the business model.

The exploration transaction model has become more difficult to implement especially within the Australian mining industry. Having lost mid-sized companies such as Western Mining, MIM Holdings and Norths, buyers of mineral resources for mine development are harder to find.

A hollowed out industry is now headed by a few uninterested global giants and populated by a very long tail of relative minnows. Today's industry structure is forcing small companies with strong exploration credentials, but ill-suited to mine development, to take uneconomic development decisions.

**John Robertson is the chief investment strategist for PortfolioDirect, an Australia-based equity research and resource stock rating group. He has worked as a policy economist, business strategist and investment professional for nearly 30 years, after starting his career as a federal treasury economist in Canberra, Australia*