Mining Journal

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Five reasons to back exploration stocks

The exploration end of the mining industry is holding up better as an investment than the leading miners amid building anxiety about the prospects for global growth.

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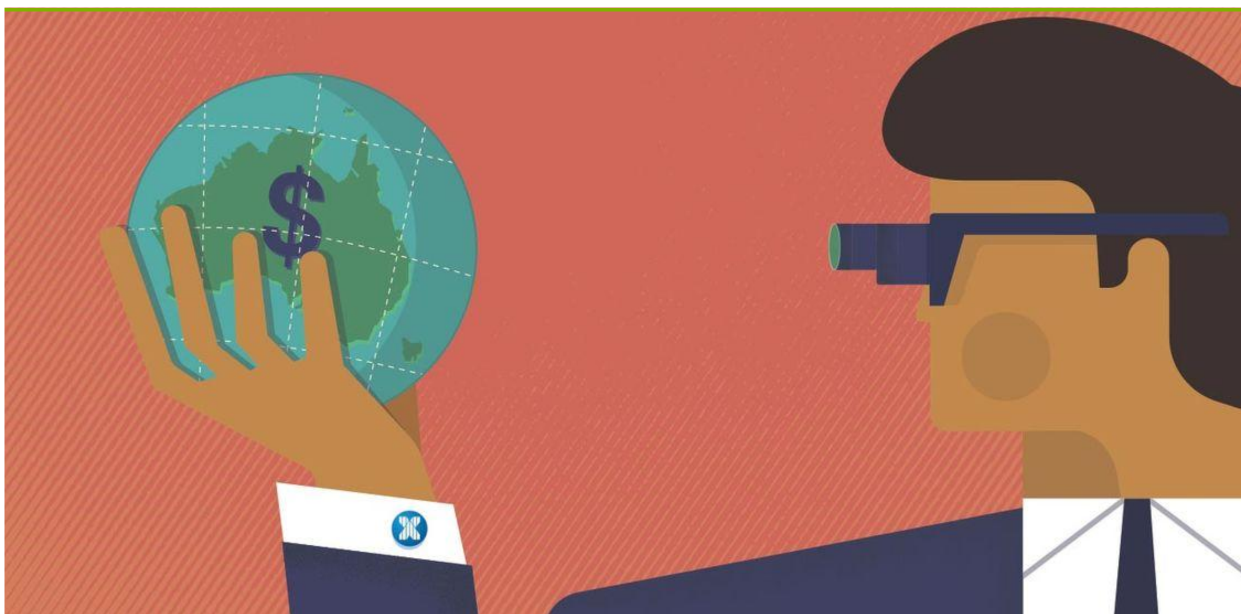

5 September 2019

In past cycles, investment returns among the smallest companies in the mining industry would have been among the most leveraged to an economic downturn. The balance sheets and asset lives of companies like BHP and Rio Tinto would have been promoted as buffers against cyclical headwinds.

Relative investment returns during July and August this year have run counter to this preconceived notion of sector risk. BHP and Rio Tinto have lost as much as 16% and 18%, respectively, in Australian dollar value.

The ASX small resources share price index - a measure of investment returns among the second-tier production companies - dropped just 2% at its worst and finished slightly ahead. My own index tracking ASX-listed exploration plays added 12%.

Several influences were pulling in different directions to produce these results. The initial reversal in the share price trend for the industry leaders coincided with a 6% decline in the S&P 500 after BHP and Rio Tinto had closely tracked the performance of that index through 2019.

Aggravating the wider equity price decline, iron ore prices tumbled 25% during August after briefly topping $120/tonne, for a net loss of 16% over the two months.

As the iron ore price was retreating from its supply-disrupted heights, the gold price was driven higher by a dramatic shift in bond prices.

Industry leaders, which dominate sector equity price indices, are heavily leveraged to changes in the iron ore price. Smaller companies are more geared to shifts in the gold

price. The latter would have also benefitted from a 4% decline in the Australian dollar against the US dollar.

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The apparent resilience of the smallest stocks in the sector was more than simply a gold price response.

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The median return for the universe of ASX-listed resources stocks over the past two months has been 3%, a highly creditable performance against an adverse market backdrop.

Of the 20 best-performing ASX-listed resources stocks, seven were oil and gas related. Most of those benefitted from new discoveries in the Perth Basin. Another seven benefitted from exploration successes or progress along development paths with exposures to a wide range of mine products including kaolin, rare earth elements, vanadium, base metals, lithium and tin.

Of the remaining five, two were boosted by higher silver prices. Investigator Resources was given a new lease of life from higher silver prices but it had also concluded a farm-in agreement in July with OZ Minerals covering a copper-gold development opportunity in South Australia.

Only three of the top performers were directly gold related. But even these were creating considerable value in any event.

Results of drilling at the Penny North deposit propelled the Spectrum Metals share price to a 378% gain. Capricorn Metals' 180% share-price gain came with announcements about progress along the development path at the company's Karlawinda gold project, a large equity raising and a hedging deal covering two years of gold production.

The pattern of investment results over the past two months suggest five ongoing reasons to retain or build an interest in the work of mineral explorers.

1. The exploration end of the mining sector has given up the cyclical gains made in 2017 before the weakening trend in economic activity commenced. Large numbers of companies in the sector are trading near all-time low prices. Bottom of the cycle leverage to exploration success or development progress is especially strong.

2. Slowing global growth and possibly weakening raw-material demand adds to the profit risk of the larger producing companies. The sector leaders are especially vulnerable to any failure by central banks to shore up asset prices or policy decisions adversely impacting global trade.

3. The sector has now been repriced to take account of falling discovery rates and consequently higher investment risks. Dashed expectations have taken their toll on pricing irrespective of the potential for eventual success. Across the board, valuations are now more realistically framed and, in many instances, overly pessimistic.

4. Industry activity rates are on the rise. Exploration spending has been picking up even against a largely unappealing market backdrop since the 2011 cyclical peak in conditions. The Australian Bureau of Statistics reported this week that exploration expenditure on new deposits had been rising since 2016 and, over the 12 months to June 2019, came within 16% of the peak spend in 2008 and within 25% of the record spend in 2011. The industry completed more drilling over the past year than in 2008 and came within 7% of the total completed in 2011.

5. Exploration is a long gestation exercise with many companies only now beginning to taste the fruits of work that might have commenced a decade ago during more buoyant market conditions. Lessons have been learned. The importance of technical skill as a marker of success has superseded bold claims about the imminence of higher metal prices as an investment driver. Nickel explorer St George Mining illustrates the extent to which investor patience has been tested for even a well-positioned explorer able to point to clear progress in building a project profile. The company has worked assiduously for nearly a decade with little investment

reward but is gradually building the evidence needed for eventual development success. The Western Australian explorer announced further high-grade nickel-copper-sulphide discoveries in the past week.

Many companies have found the going too hard and have moved on. Others, like St George Mining, have persevered to build the foundations of future investment success.

Those explorers that gave up on their first or second or even third attempts with little sign of success should still be eschewed. They made bad choices or did not have the requisite skills to take advantage of good choices. Imaginative strategic reinvention does not alter that diagnosis.

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