FROM THE CAPITAL

Highfield Resources faces return hiatus

Exploration results no longer excite market

John Robertson*

Highfield Resources, one of the best returning stocks on the Australian market since listing nearly three years ago, is about to enter the investment no man's land between successful exploration and running a mine.

This is where investment returns for even some of the best managed companies seem to disappear.

ASX-listed Highfield is seeking to develop potash properties in northern Spain. Its tenements are located in an area of historic production and, since its first acquisition in mid-2012, the company has been able to define a resource of 268Mt. By most standards, the exploration risk is now exceptionally low.

In May 2014, the company released the details of a pre-feasibility study that described a 20-year mine life capable of producing a US$234 million EBITDA in 2018 after spending US$308 million in pre-production capital.

On my reckoning, a A$2.20-A$2.80/share target by 2020, without any material change in market conditions and with the company comfortably in production, should not be out of the question based on what Highfield has told the market about its intentions and subject to further fine tuning of its development plans.

If realised, this would be equivalent to an annual return as high as 30%, making Highfield one of the potentially most attractive investment propositions on offer presently. Investors seem to agree. Highfield has produced investment returns since listing among the top 5% of those available in the sector.

In theory, the underlying value of the company should continue to rise from this point through the decision to build and for several years after production has started. This is the carrot to entice an investor into buying now and retaining a position into the early years of production.

In practice, investment life is less accommodating. The transition in the corporate life cycle from successful explorer brimful of exciting new prospects to the more dour project development phase is often a value trap for investors.

During this time, companies have typically passed the point at which they can generate sufficient positive surprise from exploration or resource sourcing to force a reassessment of market value.

Highfield is looking to develop potash properties in northern Spain

At the same time, they may not yet have made a full commitment to development or may display insufficiently convincing project economics for investors to assume future development.

There is a risk of this positioning extending beyond a reasonable investment time horizon. In some extreme cases, the transition may never be completed.

Venture Minerals is an example of one of these extreme cases.

Its funded and permitted Riley iron-ore mine in Tasmania has been stymied in the courts by environmental activists trying to prevent development in Tasmania's Tarkine wilderness.

Meanwhile, whatever the result of court action this month, the delay could prove fatal as changing iron-ore market conditions have blocked its development prospects.

This value trap, sometimes well beyond the control of company executives, is sufficiently common for investors to act instinctively to its imminence.

In the context of the Highfield example, there are already some hints of a transition in attitude. Gone are the robust responses to announcements about resource size.

The Highfield share price has fallen in the few days after the company has released updated exploration results recently. This telltale sign of market fatigue has occurred on all four occasions since the beginning of August on which the company has announced "good news" relating to the geology of its project.

Orocobre is illustrative of what a mine developer typically faces. It is exiting the tunnel Highfield is about to enter. It is scheduled to start full-scale production at its lithium plant in Argentina during November after beginning to drill its resource in the fourth quarter of 2008.

The history of the Orocobre investment return can be divided into three phases. The first phase involved a fivefold rise in prices relative to the broader market between early 2009 and early 2010. This was the period when the dimensions of the project were first becoming evident.

In the second phase, there was no net change in the Orocobre relative share price from early 2010 until early 2013 – even while the company was, in a real sense, adding value.

Its relative share price rose 150% in the third phase, during the balance of 2013, after it had officially started construction and as the company was reporting frequently on the progress of its new plant. Now, there should be a fourth phase in which profitability and operational outcomes will drive market value.

Until the middle of 2014 and abstracting from broader market moves by using relative price movements as the indicator of investment returns, there were only two short periods in over five years during which an investment in Orocobre would have added value to a portfolio. And this is one of the most successful development stories of recent years.

Contrary to popular belief, the risk profiles of investments in the sector do not decline monotonically from the exploration stage until production.

Opinions are also formed early about scale and development potential. They do not rely on the definitive production plans produced later.

Against this background, investors cannot count on early stage investment returns driven by exploration success and the disclosure of new project parameters continuing. Investors face the potential of dead money possibly for several years once the scale and quality of projects has been outlined.

At this point, a buyer of Highfield shares may reasonably conclude that the eventual return will be enough to compensate for any likely nearer-term opportunity costs.

Alternatively, a current buyer could be grappling with whether the company is sufficiently different that it can avoid the return hiatus faced by the likes of Orocobre.

Depending on that judgement, it might make sense to delay an investment until further into the gestation period for the project.

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