Mining Journal

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This gold miner is different

Southern Gold chief executive Simon Mitchell says investors deserve a better deal as he points to his own shareholder-friendly approach to boosting returns.

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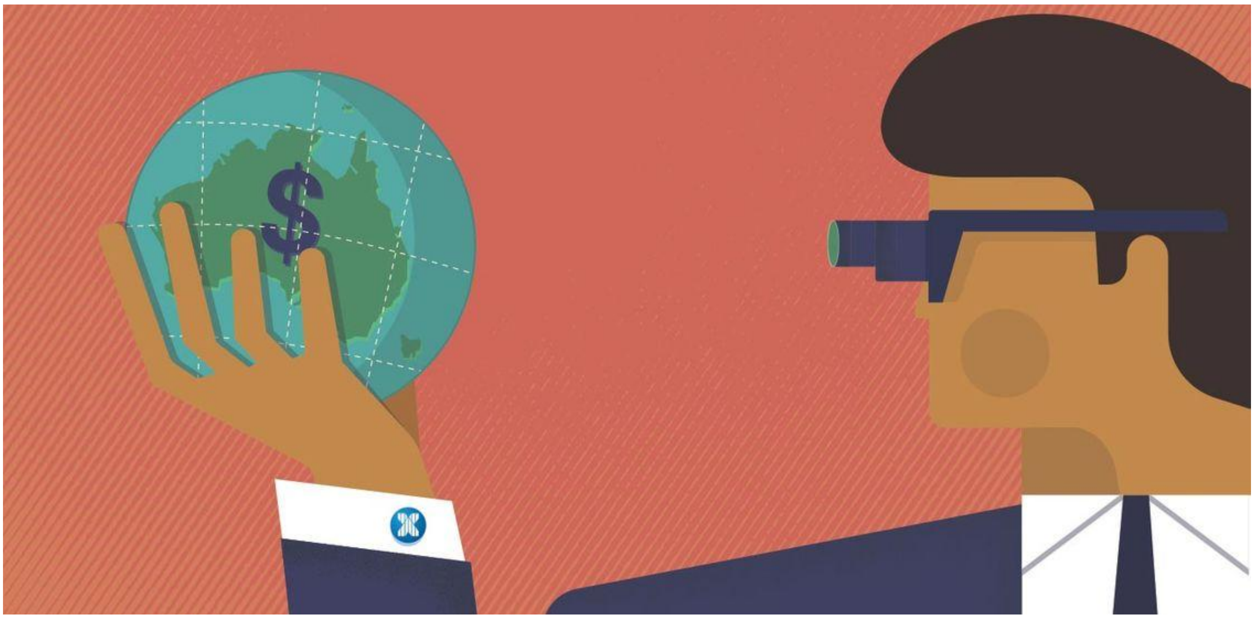

26 April 2018

In an era of constrained funding, the stereotypical gold industry investment model involves an initial scaled-back project with a low capital requirement and a speedy development path, followed by one or more larger and more capital intensive projects funded from the proceeds of the first.

Returns from the first project alone, executives frequently assert, justify the price for the entire company - meaning everything else, the 'blue sky', is foolishly being given no value.

The staged commitment around multiple projects reduces near-term capital needs and gets to production more quickly but neglects the risks behind completion of successive projects.

Let's assume, for example, that a company has three potential development ideas. The first is relatively straightforward with a high 60% chance of successfully producing an underlying value increment of A$50 million (US$38 million).

The value created by the first can be expended on a second more difficult project with a less likely 30% probability of success. A later third project comes with a 20% likelihood of success. If it can get over the third hurdle, let's say the company could create value of $500 million.

That is not an uncommon scenario presented by start-up miners often with a seemingly low market capitalisation of $10-20 million.

Directors will never confess - perhaps because they have never considered the possibility - that the overall chance of completing the three stages in the example outlined above is less than 4%.

If the company had planned to stop at the first stage, investors would have had a 60% chance of getting back $50 million. The usually preferred investment goal is a 3.6% chance of $500 million.

> **A one-off dividend does not make a business model**

Either is a legitimate investment at the right price. If company managers insist on withholding the value from the first stage to pursue the longer-term aim, risk-sensitive investors should be unwilling to pay more than $18 million, in this example.

Mitchell himself began and ended a recent presentation in Melbourne about his "organic exploration model" lamenting the lack of buyer interest for his $12 million market capitalisation company.

Having given Westgold Resources the right to mine its Cannon deposit in Western Australia, Southern Gold netted $13.65 million from the deal in a little over a year.

With underground mining potential at the deposit, the company exchanged a further five-year right to mine in January for an up-front payment of $1.5 million and a future profit share.

Unexpectedly, Northern Star Resources bought out the Westgold regional assets in March, including the right to mine at Cannon and is yet to confirm its mining intentions.

Under the agreement, which has carried over, the company would receive additional amounts of $160-210 per ounce, depending on the total quantity mined and the prevailing gold price, as its existing 23,000oz resource is mined in the year ahead. Exploration potential could add to the resource beyond the first year and contribute to a lengthier flow of funds.

In addition to the Cannon property, the company has regional exploration interests in the area east of Kalgoorlie boasting the presence of Northern Star, Silver Lake Resources and Barrick Mines.

The second and third development opportunities for Southern Gold are in Korea. Its Korean properties - now being developed in joint venture with London-listed Bluebird Merchant Ventures - have hosted historical gold-silver workings; some artisanal and others with more formal underground structures.

The Kochang prospect contains a high-grade gold and silver mineralised vein system with underground access. The company has disclosed historical average grades of 12g/t Au and 3-217g/t Ag with grades of more than 20g/t Au in narrow veins.

The company is seeking to define extensions of these systems for potential re-entry and quick development as a small-scale high-grade mining operation with a low initial capital requirement.

The Gubong property contains five historical underground mines along 5km of strike including the Gubong mine, which contains 120km of historical underground workings reaching a vertical depth of 1,500m.

Drilling to a depth of 500m has produced highly variable but economic grades at Gubong ranging from 1g/t Au to over 500g/t Au. The joint venture partners have also disclosed grades of more than 1g/t Au in waste rock stockpiles and tailings.

Going back to historical workings potentially shortens exploration horizons and lowers capital spending but may require modern miners to work around decades old, possibly inefficient and sometime dangerous mine plans.

An analysis defining the opportunity more clearly is expected in mid-2018.

In his recent presentations, Mitchell has held out the revenue streaming model of TSX-listed Franco-Nevada as a guidepost to the way he intends to manage his company's returns from these endeavours.

There are always good reasons to be sceptical about claims that ‘we are different' when the herding instincts are so evidently strong.

Franco-Nevada pursues a highly focussed financial intermediation model that largely eschews physical asset ownership. A bright idea aside, access to capital is its critical ingredient for success.

A portfolio of properties structured for yield straddling exploration, mine development, operations and asset trading, on the other hand, would be a more complex juggling act risking an unusually large number of dropped balls.

Southern Gold, though, has made a start. In June 2017, directors announced a special dividend, subject to reinvestment rights, equivalent to a cash yield of over 12%. The $1.4 million came from the proceeds to that point of the Cannon profit-sharing arrangement with Westgold Resources.

A one-off dividend does not make a business model. The test of whether Southern Gold really is different will come when it must regularly ration funds among multiple competing projects and expectant shareholders.

The evidence favouring scepticism abounds but Southern Gold deserves kudos for recognising a need to rebalance the risk-return profile for investors and, more than that, actually doing something about it.