Evaluating development stage mining companies

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Junior mining stocks now also part of conservative investment portfolios

Over the course of the past 12 to 18 months we have seen a widening interest of the investment community in "development stage" mining companies. Besides resource-focused specialty funds and retail "gold bugs", an increasing number of generalist funds and the general public have begun to add junior mining stocks even to the most conservative portfolios. This development has been driven by a strong commodity cycle which, according to many economic analysts, is projected to stay with us for a very long time.

Managing risk and opportunity

Shares of development stage mining companies are exposed to high volatility and require some research and industry familiarity for the prudent investor to adequately assess risks and opportunities. Most risk is associated with uncertainties related to the composition and size of the mineralization in the ground, metallurgical recovery rates, engineering, permitting and the company's abilities to finance the development of its projects. Ultimately, the assessment of and influence on these risk elements all heavily depend on the quality of management. Similar to venture capital financing for early stage technology businesses, prudent investors give strong consideration to the track record of management and how its experience relates to the specific stages of development of a project. Conveniently, this information is accessible to the public, since most mining companies are publicly listed on a stock exchange. While management quality may be the leading investment criteria it should be seen in addition to other general due diligence steps before deciding when to buy, hold or sell shares.

No significant upside potential with major mining companies

There is typically a strong correlation between the shares of producing mining companies and the price projections for the commodities they are producing. These commodity prices will be the key influence on the margins realized by a producer throughout the lifetime of a mine. Today, the upside potential for shares of most major mining producers is limited since, for the most part, the valuations of these companies have kept pace with increases in commodity prices and, therefore – assuming consistent commodity prices – already fully reflect the anticipated earnings potential.

"In situ" valuation

The valuation of any publicly listed mining company, as reflected in its market capitalization, can be translated backwards into a value of the minerals it has in the ground, e.g., on the basis of ounces of gold or pounds of copper. This valuation is referred to as "in situ" value. Often market analysts will maintain charts on average "in situ" valuation of mining companies at various stages of development. As, e.g., on February 21, 2006 the market was paying on average over US$ 50/oz for "in situ" gold "Resources" held by North American development stage companies, while US$ 190/oz was paid for gold "Resources" and US$ 270/oz for "Reserves" of North American gold producers.

Opportunities and timing

When searching for investment opportunities in development stage mining companies, a tool to determine whether a company has received full valuation would be to compare the "in situ" valuation of such a company in comparison to its peers. Then consider the level of awareness the public has for the company and the track record of management. Theoretically, the valuation of development stage mining companies should trend along a linear line towards the "in situ" valuations of mining companies in full production. While we do see a decline in the variance between the valuation of producers and that of development stage companies as the latter companies come nearer to production, the value increase is never reflected by a linear line. On the contrary, news on drill results, metallurgical testing (which indicates the percentage of mineralization in the ground that will convert into a sellable commodity), tangible IRR (internal rate of return) and NAV (net asset value) calculations as provided in pre-feasibility and feasibilities studies, independent analysts reports, financings and especially rumoured merger and joint venture interests sometimes cause significant shifts in valuation on development stage mining companies. Thankfully, claims made with respect to technical results are strictly regulated and corporate governance legislation has also significantly tightened the freedom of unsophisticated "promoters" that had tainted the reputation of the mining industry in the 80s and mid-90s.

Material transactions on the horizon

With demand for gold and copper at record highs, gold demand outpacing production by 5% annually and global copper inventories essentially fully depleted, all attention is being paid to major producers and how they can bring new additional reserves into production. However, due to the low commodity prices – especially in the late 90s – large mining companies shied away from new exploration projects and were driven by significant cost cutting objectives, causing widespread layoffs and divesting of earlier stage projects. This provided established exploration and development management teams with opportunities to selectively pursue undervalued projects, hire some of the best engineering talent in the industry and nurture such projects for market conditions as we are experiencing today. Now majors are looking to the later stage development companies, urgently seeking joint venture and acquisition opportunities. In fact, most major mining companies are in an interesting dilemma: having most recently reaped the benefits of high commodity prices and converting profits into multi-billion dollar cash positions, they now need to put that money to work or pay out special dividends to their shareholders.

Bewertung zukünftiger Edel- und Industriemetallproduzenten

Aktien zukünftiger Edel- und Industriemetallproduzenten finden zunehmend Einzug in konservative Investmentportfolios.

Neben spezialisierten Rohstoffonds und «Gold Bugs» haben aber auch immer mehr diversifizierte Fonds und Privatanleger Interesse an solchen Aktien. Diese Entwicklung ist in erster Linie auf das hohe Preisniveau an den Rohstoffmärkten zurückzuführen, welches langfristig anhalten dürfte. Aktien solcher Unternehmen können starken Kursschwankungen unterliegen. Dies erfordert Research und Know-how, um Risiken und Potentiale angemessen bewerten zu können. Letztendlich muss die Risikobewertung insbesondere in bezug auf Qualität und Erfahrungen des Managements gesehen werden.

Derzeit ist das Aktienkurspotential der meisten bereits in Produktion befindlichen Edel- und Industriemetallproduzenten beschränkt, da ihre Aktienkursentwicklung überwiegend mit den Zuwächsen an den Rohstoffbörsen korreliert und, unter Annahme konstanter Rohstoffpreise, das zukünftige Ertragspotential bereits vollständig abbildet. Die Marktkapitalisierung eines zukünftigen Produzenten kann als Gegenwert seiner im Boden befindlichen Mineralienvorkommen definiert werden. Die Bewertung dieser Vorkommen nimmt zu, je näher sie der Produktion kommen, und sie werden als «In-Situ-Value» bezeichnet. Dieser Bewertungsansatz wird oft von Branchenanalysten auf kumulierter Basis als Branchendurchschnittswert dargestellt und bietet einen Ansatz, um Aktienkurspotentiale verschiedener Unternehmen zu vergleichen. Unternehmensnachrichten bezüglich Bohrresultaten, Ergebnissen metallurgischer Untersuchungen, Durchführbarkeitsstudien und Genehmigungen, aber auch Gerüchte über mögliche Joint Ventures oder Unternehmenszusammenschlüsse können starke Aktienkursbewegungen hervorrufen.

Wegen der niedrigen Edel- und Industriemetallpreise der späten 90er Jahre hatten alle namhaften Minengesellschaften radikalen Personalabbau betrieben und Explorationsprojekte eingestellt oder veräussert. Dies ermöglichte es antizyklisch denkenden mittelständischen Minengesellschaften, talentiertes Personal zu rekrutieren und selektiv Explorationsprojekte zu vorteilhaften Konditionen zu erwerben. Nun suchen die grossen etablierten Produzenten wieder nach produktionsnahen Projekten, an denen sie sich beteiligen oder die sie erwerben können. Wegen ihrer in letzter Zeit erzielten Rekordgewinne sind die Kassen voll.

Die Erfolgswahrscheinlichkeit eines jungen Explorationsunternehmens hängt stark von den Fähigkeiten des Managements ab. Talentiertes Management ist aber teuer und führt bei jungen Unternehmen oft zu Kompromissen bei Personalentscheidungen. Als Alternative bietet sich erfolgreiches Management mit erstklassigen Fachkräften unter einer Unternehmensgruppe an. Dies ist bei Hunter Dickinson Inc, einer Gesellschaft mit langjähriger Erfahrung im Management und der Entwicklung eines breiten Spektrums von Unternehmen, der Fall.

Optimizing shareholder value in development stage mining companies

Development stage mining companies are typically structured such that management holds a minority but significant ownership position. This ensures that the interests of shareholders and management are well aligned and material transactions such as mergers or joint ventures are considered by management on the same merits that every shareholder would like to see: maximum valuation and return on investment. In many cases, a large mining company is invited to "earn-in" to a project by financing the capital cost to bring a fully permitted project into production. In such cases, particular consideration is given to the technical expertise and capacities of the major and, in ideal scenarios, infrastructure that may already be in place at adjacent producing mines. In other cases, the offering by the major mining producer is so lucrative that it is in the best interest of shareholders to sell the project.

Portfolio of development stage companies under one management

As outlined above, the likelihood of success for young mining projects to reach this stage and/or come into production is significantly impacted by the quality of management on the technical engineering, project management and financial side. However, good management is expensive and, given the multi-year life cycle of mine development projects, in most cases not affordable for early stage projects. This forces many early stage projects to compromise and engage limited management capacities but also offers an alternative strategy, which is to bring together a best-of-breed management and engineering team and administrative infrastructure to support a portfolio of development companies and lead them to their full potential. In the case of Hunter Dickinson Inc.[1)], this process has led to the development of a range of now "late stage" development companies under management, most of which have recently appointed high profile presidents and CEOs to streamline the transition from development into production stage companies. ●

1) The directors of Hunter Dickinson Inc. were named Ernst & Young Entrepreneur of the Year 2004® Pacific in the Resource category.

A billion here, a billion there

	Cash & equivalence balances	Cash from operations
	as of June 30, 2005	6 months to June 30, 2005
Anglo American	US$ 2.8 billion	US$ 3.1 billion
Antofagasta	US$ 1.1 billion	US$ 0.8 billion
BHP Biliton	US$ 1.4 billion	US$ 10.6 billion
Rio Tinto	US$ 0.6 billion	US$ 2.9 billion
	as of Sep. 30, 2005	9 months to Sep. 30, 2005
Barrick	US$ 1.1 billion	US$ 232 million
Teck-Cominco	US$ 2.5 billion	US$ 405 million
Newmont	US$ 1.1 billion	US$ 437 million