Lion Selection Group

Investing in Exploration and Junior Mining Companies

Exploration and Junior Mining Companies

When early-stage mining companies are a success, they can provide outstanding investment returns. Value can be generated from new mineral deposit discovery, leverage to an appreciating commodity price, re-rating following successful project development, or takeover. But this is a cyclical and highly volatile sector and eventual success is a matter of successful execution combined with timing. Investors not only need to assess fluctuating commodity prices and the cycle of mining booms and busts, but also boil down a range of technical factors that relate to project quality.

Valuation

A mine can be simply valued for expected revenue, minus costs, over the life of mine. Share prices of miners usually reflect these fundamentals, with an adjustment for performance in relation to expectations, or the outlook of the commodity being produced. Share prices of aspiring miners are usually discounted to reflect the additional, unresolved challenges of funding mine development (which is likely to be the largest single expenditure ever made on a mining project) and any unresolved technical challenges, the most significant of which is building a new mine according to plan, on time and on budget.

There are far more exploration companies than there are established miners, and the investment market tends to treat exploration totally differently to mining operations from the perspective of what investors are prepared to pay to own shares in a miner or an explorer. It is not possible to value exploration because there is nothing tangible to put a value on – only an opportunity. The price (not value) of an exploration situation comes down to how effectively the elusive prize that is being sought is promoted, and the willingness and abundance of supporters to inject capital. There is an interesting human tendency which is an apparent willingness for people to pay more for something that they don't understand than something they do.

The difference between value and price and the influence of promotion can generate risks and opportunities for investors.

> "The price (not value) of an exploration situation comes down to how effectively the elusive prize that is being sought is promoted, and the willingness and abundance of supporters to inject capital."

Risks

There are a selection of key risks that characterise all early-stage mineral commodity companies:

Exploration risk

Exploration potential can be tantalising and is extremely common, valuable discoveries however are rare. Whilst it is logical to discount the risk of a discovery taking place because of the likelihoods involved, it is not unusual for the market to instead put a value on the tantalising potential instead. This builds an expectation which can be challenging to live up to, if a discovery is made.

Commodity price

The price of mineral commodities fluctuates according to supply and demand, and actual or perceived trends for commodities has a strong influence on investors' willingness to invest in explorers or miners. All mineral commodity projects are leveraged to a commodity price, because the margin after cost expands at a greater rate than the underlying commodity price. An appreciating commodity price can unlock value through leverage, likewise a decreasing commodity price can wipe it out.

Funding

Exploration companies are funded by investors, not revenues, and require constant follow-on investment. The greatest risk for shareholders in early-stage mineral commodity companies is shareholder value erosion via dilution. This leads to dilution for shareholders who cannot, or don't want to, follow their interests. And, owing to the uncertain amount of capital required and price at which it can be obtained, dilution is the largest unknown factor in assessing the value of a company. Shareholder returns can be influenced greatly by timing of fundraising.

In addition to the above, **political risk** affects all business sectors, it is not unique to miners or explorers but manifests in mineral resources businesses in a unique way. Some businesses can be established wherever the proprietor wishes to do business, but mineral deposits cannot be moved. Furthermore, owners of mineral projects are reliant on governments for permits to operate and often must negotiate a tax and royalty regime or outright project interest that can erode owners' value to the favour of the government or residents of the jurisdiction. Political risks are often underestimated by entrepreneurs.

Cycle timing

The share prices of miners and explorers fluctuate according to investor sentiment toward the sector, which is strongly influenced by the price and outlook for mineral commodities, recent performance within the sector and competition for investing capital from alternative sectors or markets.

For miners that can be valued, this sees investors sell shares at a discount during busts and buy them at a premium during booms. For explorers this is far more extreme – the lifeblood of explorers is raising fresh funds, which can be impossible at any price in busts, but available in abundance during booms.

The turning points of mining cycles are characterised by typical investor behaviours, which also manifest in activity within the mining sector. Even so, timing of turning points is notoriously uncertain – the only thing that is certain is that cycles do turn.

ASX100 Resources Index 1990–2021

Mining Booms and Busts

Mining Cycle and the Lion Clock

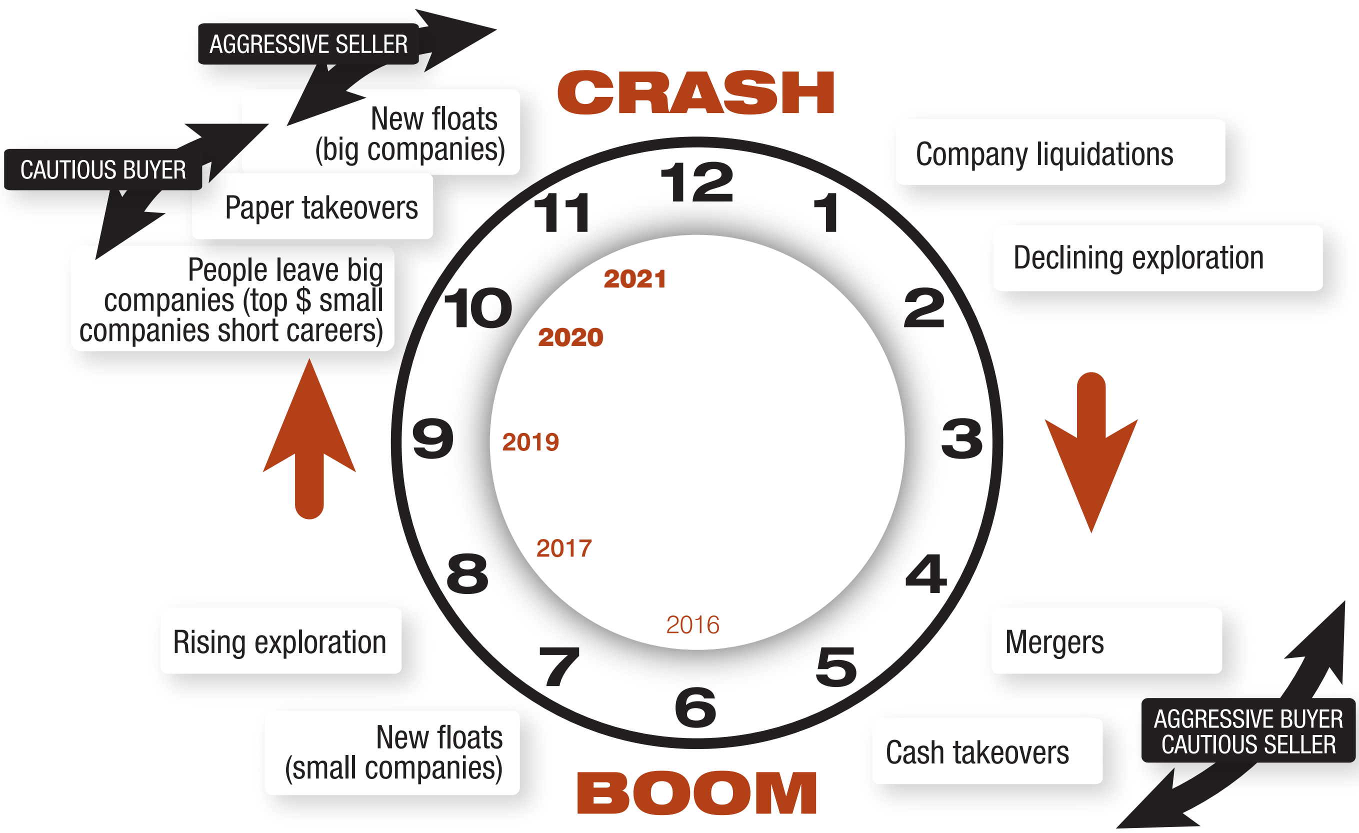
The Lion Clock depicts the mining cycle according to liquidity indicators that are diagnostic of the different stages of the cycle. Liquidity is the amount of investor dollars that are available to buy shares of miners and invest in equity fundraisings. When the cycle crashes it is 12 o'clock – midnight, equity prices of miners and explorers collapse as liquidity dries up. Most mining busts are comparatively short (compared with booms), and end when mining equities adopt a positive trend. The first to recover are the largest miners, and historically they have provided first liquidity to the sector in the early stages of a boom, either by investing in or taking over smaller peers that are trading at depressed or discounted prices.

The boom gathers pace as more and more investors return to the sector. Early indications are new exploration companies listing via initial public offerings – capital raisings are extremely challenging for explorers during a bust, which makes IPO's impossible. The tempo of exploration IPO's (number per year) grows through a boom. Exploration expenditure by the industry is typically slashed in a bust, and once funding becomes available for risky endeavours (either as cashflow recovers or investors provide it), exploration activity grows.

The peak of the boom coincides with exuberance within the sector – high salaries paid by junior companies that are market funded, record capital expenditure, large and premium priced takeover deals and successful explorers trading on market capitalisations commensurate with cash producing miners. The liquidity necessary to list large mining companies is only available close to the peak of the cycle. So IPO's of large miners (eg Glencore in 2011, Franco Nevada, BoartLongyear and Eurasian Natural Resources in 2007) are an undeniable litmus test of the progression of mining cycle.

A crash usually results from a catalyst which is most obvious in hindsight, that causes investors to sell mining equities. Historically catalysts have included general equity market crashes (eg 1987, and the Global Financial Crisis in 2007), commodity price weakening (2011) or investors becoming disenfranchised with the profitability of miners (as occurred between 1997–1998, and 2011–2015).

The clock does not move at a steady pace, and the time between hours on the clock are not uniform.



Investment universe

Exploration and small mining companies form one of the largest groups of investable companies (by number) in the global equity market. In early 2021, there were around 900 mineral resource focussed companies listed on the TSX-V (Canada) and a further approximately 600 listed on ASX (Australia), with several hundred more accounted for by the unlisted space or listed on other equity exchanges.

The global universe of early-stage mineral resource companies is extremely broad both in absolute number (over 2000 companies globally as at early 2021) and abundance within the key equity markets: as at early 2021, over 60% of the companies listed on the TSX-V, and over 30% of the companies listed on ASX were mineral commodity focussed miners or explorers.

From time to time, Lion has seeded concepts to form new companies where a unique and compelling opportunity is presented without prior commercial form.

Lion Selection Group – a Simple Way to Invest in High Growth Minerals Companies

Investing in exploration and junior mining companies is not just a question of which companies to invest in, but when to buy and eventually when to sell. These decisions incorporate a technical assessment of company and project stage and quality, an appreciation for the price and outlook for the underlying commodity, and a sense for where the market for miners and explorers is positioned with respect to boom or bust.

Specialist Early-Stage Mining Investor

Lion Selection Group combines specialist knowledge and hands-on mining experience to select situations with attractive risk and value attributes, with an ability to take a long-term view and follow-on investment to allow for the time to unlock project value, within an overall portfolio approach to reduce the impact of situation specific risks.

Lion's Investment Philosophy

Provide funding at an early stage when price is likely to reflect the best discount to value and opportunities are generally poorly understood or appreciated by other investors, and assist companies along the development curve which is expected to coincide with project de-risking and value appreciation. Typically, investment exits are planned to coincide with trading liquidity after project development and considerations of the timing of the investment cycle.

- Investments are selected from a global universe of listed and unlisted opportunities with particular regard to value and risk
- Value: seeking multiples, 5-10x re-rating potential within the expected holding period
- Risk: project progression pathway must be defensible – not reliant on speculation
- Backing and work closely with people who think like owners is highly desirable
- 3–5 year investment horizon: corresponds with the expected time frame within which project derisking and development may be reflected in price.

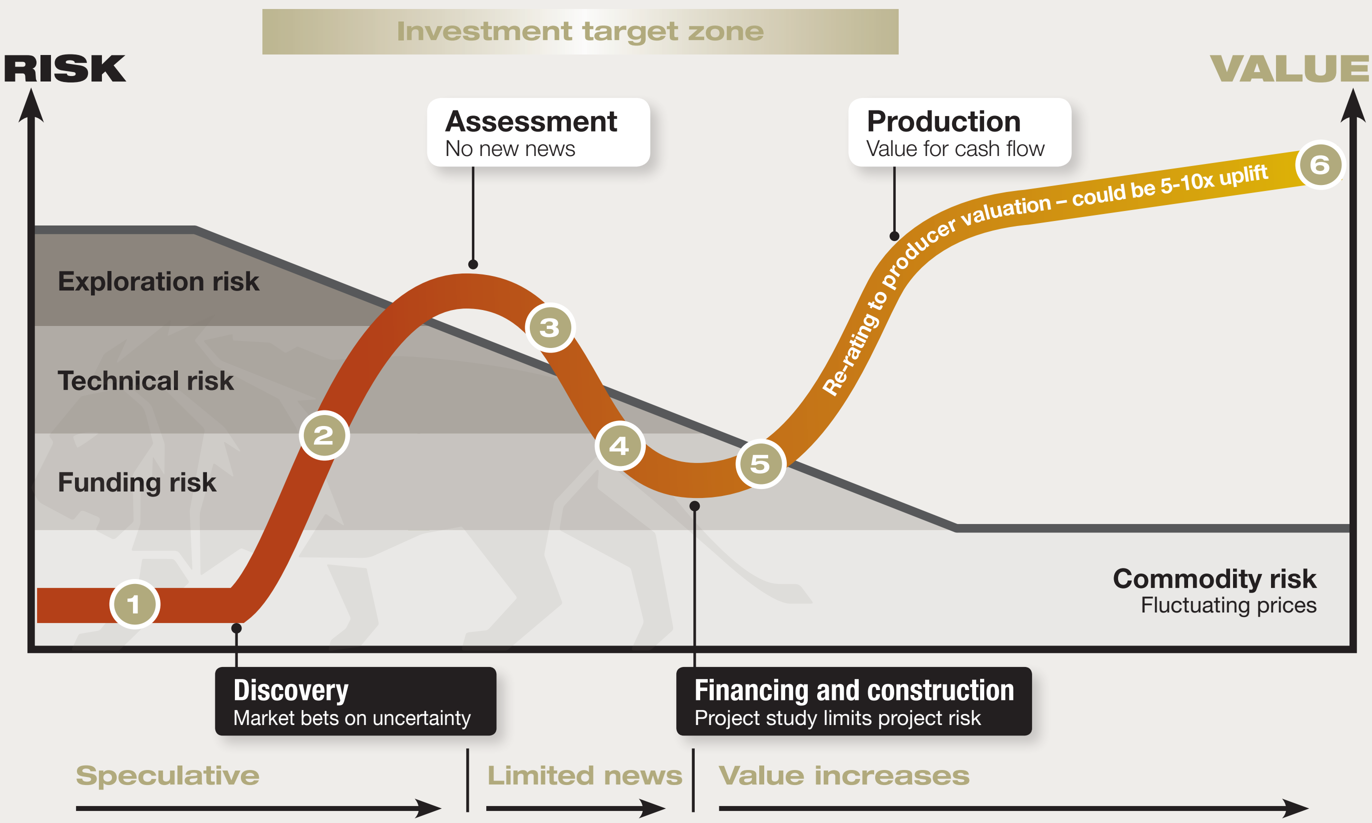
Resource company evolution and the development curve

Resource company evolution

The value of a resource company reflects its ability to generate future cashflow from its projects. However, price can differ from value because of a discount for risk or market sentiment related to the sector, a commodity or the project itself.

Stages of the typical evolution of the market value of a mineral exploration company, and evolution of risk over time is shown in the chart below:

1. Typically, exploration stage companies trade on a low valuation reflecting the key risk – will their exploration activities find a deposit? (And will the deposit, in turn, be economic?)
2. It is not unusual for the value of a company to run ahead of what the facts justify and to be highly reactive to newsflow, as the market speculates on further positive developments.
3. Market trading during the economic assessment phase is often more subdued, as newsflow tends to deal with reducing technical risk of the project rather than hinting at it becoming larger.
4. Generally, the largest fundraising a company undertakes is to sponsor development of its project. Until this is complete, a company is subject to the risk that it may not secure adequate or acceptable finance.
5. Once funding is secured the company can build the project, but the risk remains can it be built on time and to budget?
6. Once in production, the main risk becomes the effect that fluctuating commodity prices have on revenues.



Commodity risks

Not all commodities are equal with respect to risk, and this has an enormous impact on the proposition of being able to fund project development capital. Commodity related risk derives either from the technical difficulty associated with extracting a saleable product from the ore, or the relative ease of marketing / transporting / selling the product once separated.

Lion has historically invested a large proportion of its available funds into gold opportunities. This has been as much by design as circumstance, rather than a particular view on the commodity. Gold, by its nature, is generally relatively easy to separate from its host rock; once concentrated into doré, minimal infrastructure is required to transport it, and it can be readily sold. The relative simplicity of gold projects positions them as lowest risk amongst mineral commodity opportunities.

Most other mineral commodities feature increased technical risk related to the way that they occur as ores, the expense and added permitting issues of required transportation infrastructure and the transparency, size or concentration of the market into which the products are sold.