EXPLORATION insights NEWSLETTER
JOE MAZUMDAR | BRENT COOK

2018 Precious Metals Summit Special

Sector capitulation feels like early 2000s

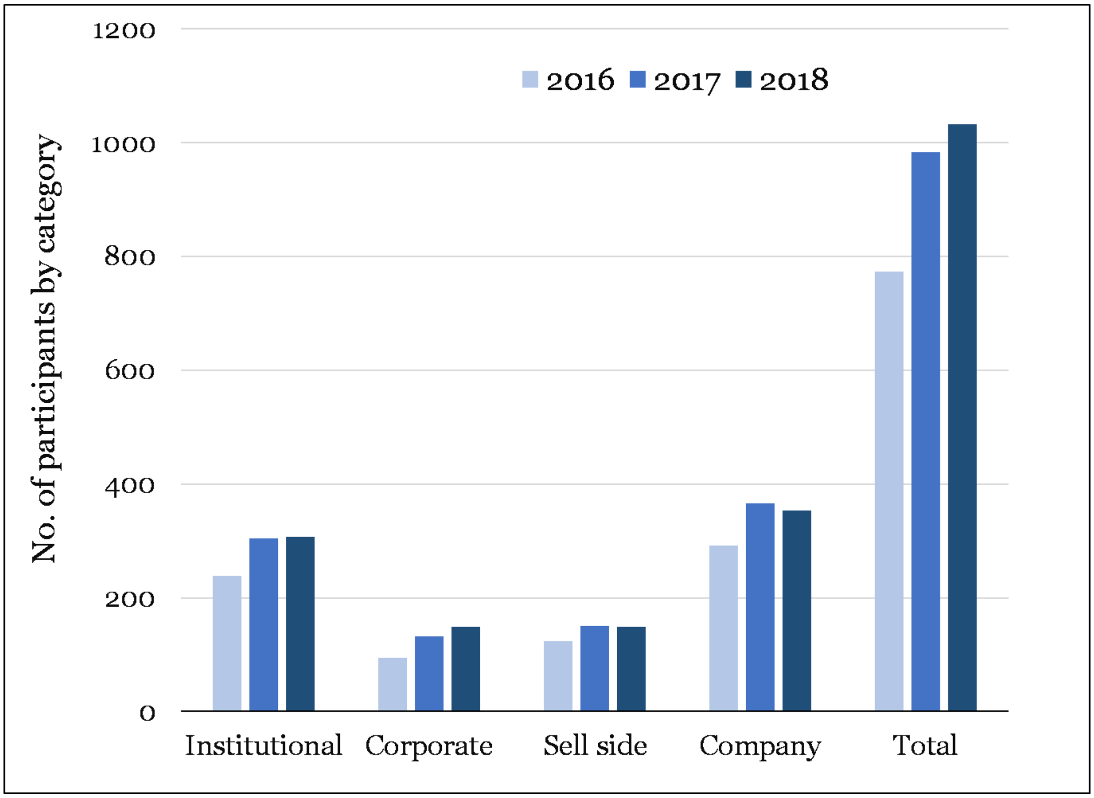
by Joe Mazumdar

The 8th Annual *Precious Metals Summit* held in Beaver Creek, Colorado, September 20-22, was the go-to mining conference of 2018 and, as in previous years, had a long waiting list of participants. The majority of the attendees continued to the Denver Gold Forum in Colorado Springs that kicked off right afterward.

Both Brent and I made our way to the Summit where we had the chance to mingle with other attendees and take the pulse of the junior mining sector in preparation for the last sprint to the end of the year.

(Greetings from the Precious Metals Summit at Beaver Creek, Colorado)

Our general views were captured by *Kitco News* in a couple of interviews found here and here. In its 8th year of hosting the Precious Metals Summit at Beaver Creek, the organizers hit a historic milestone by welcoming 1,060 attendees to the ski resort in the Rocky Mountains, (Fig. 1). This level of participation draws the event closer to the larger and longer running Denver Gold Forum (1,120 attendees).



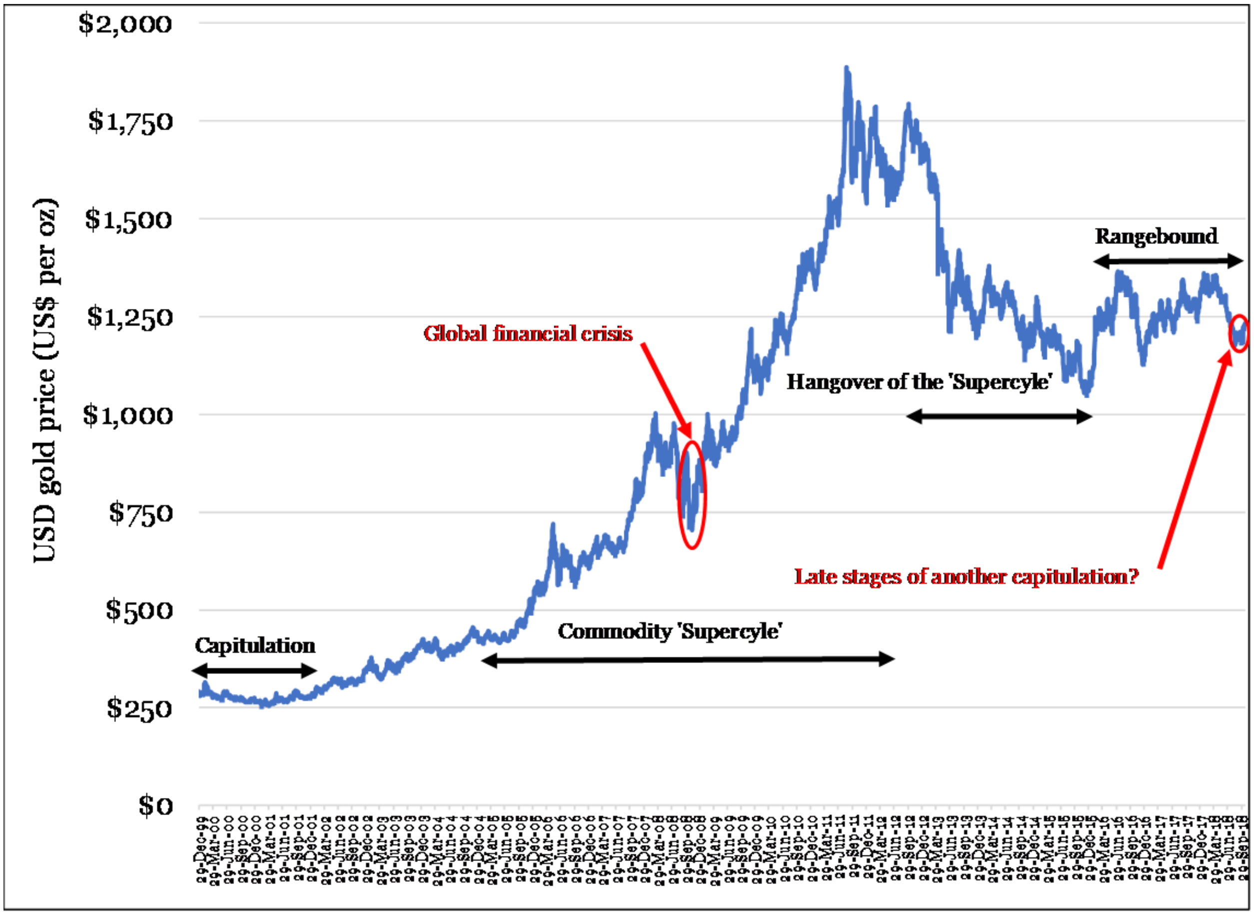
(Figure 1: Number of participants by category and totals attending the Precious Metals Summit in Beaver Creek over the past three years, *Source: Precious Metals Summit*)

The conference is sponsored by banks, brokerage firms, companies, and media outlets, and since its focus is on getting institutional investors in front of junior mining plays, the largest contingents are the presenting companies followed by funds. An increasingly conspicuous group is the corporate development teams of major and mid-tier producers which make their rounds "kicking the tires" of the predominantly non-cash flowing juniors. The increase in the number of 1-on-1 meetings was made obvious with the addition of an extra venue (outdoor tent). As for Brent and I, we had a packed schedule that included 1-on-1s as well as several interviews, as mentioned earlier.

This year, I also had the pleasure of moderating a *Keynote Investor Panel* that featured an excellent cross-section of the money that funds the mining sector. It included representatives of institutional active and passive funds (Joe Foster of Van Eck Associates, link here), private equity (Josh Parrill of Resource Capital Funds), and retail (Steve Todoruk of Sprott Global), (Fig. 2).

(Figure 2: Left to right: Panel of institutional equity [Van Eck, Joe Foster], private equity [Josh Parrill, RCF], and retail [Steve Todoruk, Sprott Global] investors moderated by yours truly with some colorful socks, *Source: @TrevAHall via Twitter*)

Joe Foster, who joined Van Eck in 1996 and is now Portfolio Manager of its flagship active fund, Van Eck International Investors Gold Fund (INIVX), has seen his share of commodity cycles. He is not bullish in the near-term for the gold market but feels that it is in the latter part of a major capitulation not dissimilar to the early 2000s, (Fig. 3).



(Figure 3: US dollar-denominated gold price from the start of the millennium. We note that although the absolute range of prices is much higher now due to higher prices, relative percent changes are similar to the early 2000s, *Source: Investing.com*)

His short-term pessimism is underpinned by the lack of investor interest in the sector, which is driven in part by the strength of the US economy and equity markets, low inflation rates, rising interest rates, and low volatility. Generalists, at this time, look at gold stocks as value traps that may remain undervalued. The fear of systemic risk—the risk of market collapse—is not high; therefore, the equity markets continue to benefit from inflows. Rising inflation rates in an environment of rate increases may trigger a slowdown in economic growth, which may support a rise in the gold price in the medium-term (>6 months).

Given that Van Eck is a long-term investor in precious metals, Mr. Foster pointed out that his current equity exposure is underweight major gold producers like Barrick Gold (ABX.T, ABX.NYSE), Newmont Mining (NEM.NYSE), and Goldcorp (G.T, GG.NYSE), but the lack of world-class deposits is thwarting growth for majors yielding over 4 million ounces of gold per year.

These companies should focus on cutting costs to generate returns, for instance, through the advancement of brownfields exploration projects like Barrick's in Nevada. During our recent site visit to the South Arturo joint venture between the major and **Premier Gold (PG.T, PIRGF.OTC)**, we got the impression that Barrick is keen on accelerating the development of the El Niño underground operation and the Phase 1 open pit, both of which are proximal to its Goldstrike operations, (Fig. 4).

(Figure 4: Looking northeast to the Betze-Post open pit gold mine and the Goldstrike plant facility in the Carlin Trend of Northern Nevada. The dark rocks are carbonaceous shales and silty limestones that host the fine grained disseminated gold mineralization, *Source: Exploration Insights*)

The INIVX fund is currently overweight companies such as Agnico Eagle (AEM.T, AEM.NYSE), mid-tier companies such as Kirkland Lake Gold (KL.T, KL.NYSE) and B2Gold (BTO.T, BTG.NYSE), and junior developers Continental Gold (CNL.T), Sabina Gold & Silver (SBB.T), and Cardinal Resources (CDV.T, CDV.ASX), among others. Mr. Foster's interest lies in a continuum of catalysts leading to incremental and accretive growth since the underlying value of a mining company is to turn a worthless piece of real estate into a cash flowing asset. We could not agree more.

Passive investing does not need a Fitbit

A note from CIBC from the middle of August highlighted that assets under management (AUM) invested in the gold sector by dedicated precious metals funds, like Van Eck, and passive funds, such as Van Eck's GDX and GDXJ, peaked at approximately US$54 billion in 2011, with a split of 94% active versus only 6% passive. Actively managed funds have fallen by ~80% to US$10 billion over the past six years and currently represent only 33% of the total AUM (~US$30 billion).

Mr. Foster provided support for the thesis from a unique perspective, (Table 1). Over the past several years, the ten US-based passive funds have added US$7.2 billion in AUM, and currently have a value of ~US$14 billion with the GDX and GDXJ controlling the lion's share (90%). On the other hand, the 18 US-based active funds control a smaller AUM (US$8.5 B) and have seen redemptions of US$1.0 billion over the same period.

	North American Funds	Assets under mgmt (USD$B)	Δ YTD	Δ 3 yrs
Active	18	$8.50	$0.55	$1.00
Passive	10	$14.00	$3.30	$7.20

(Table 1: Changes in assets under management of active versus passive funds over the past three years and year-to-date, *Source: Joe Foster, Van Eck Portfolio Manager*)

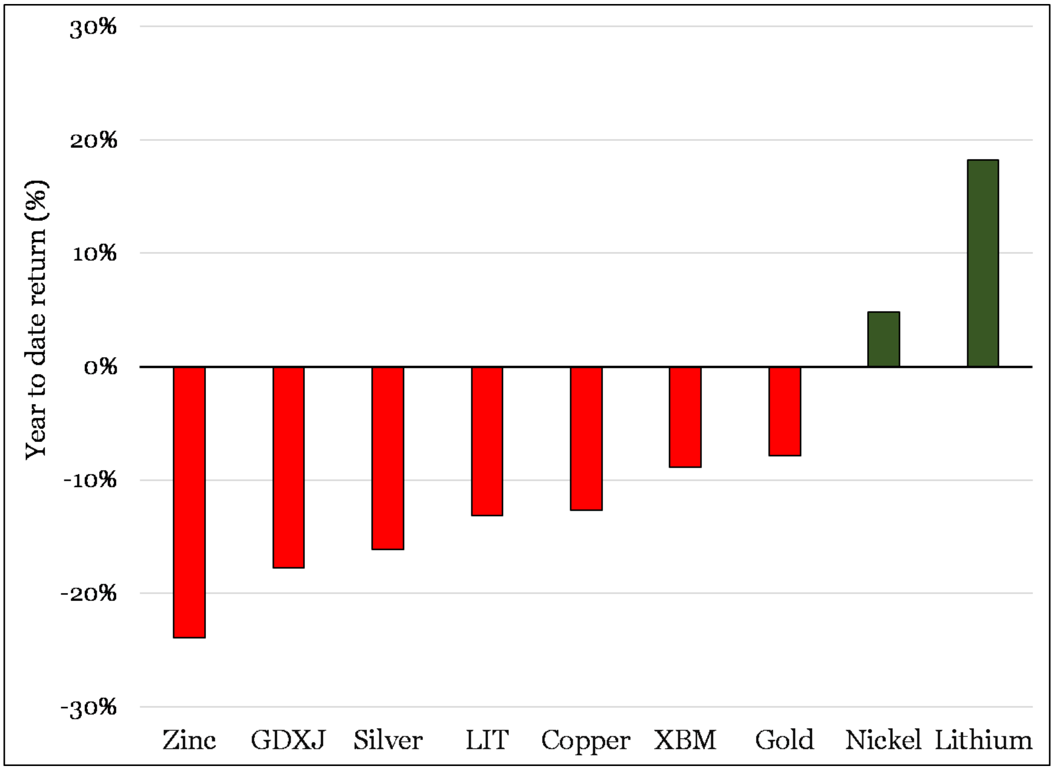
All this means that in the current market environment, new money prefers passive funds. The attraction for generalists focused on macroeconomic issues and technical tradings is the high liquidity, anonymity, and flexibility that comes with purchasing options and taking short positions.

ERRATUM 1: I take the opportunity *to apologize because during the panel discussion my striped socks caused me to reverse some of the figures*.

Time to deploy capital and not harvest it

Josh Parrill of Denver-based Resource Capital Funds (RCF, link here), a private equity firm with a multi-billion dollar mandate to invest specifically in the mining sector, thinks this is a unique time to "*deploy capital and not necessarily harvest it,*" and we concur with that opinion.

Private equity funds like RCF has a long-term investment cycle and can afford to be commodity agnostic as it has historically invested in over 30 different commodities. The firm employs a Chief Commodity Strategist to recommend commodity exposures, which currently include gold, copper, zinc, and nickel, (Fig. 5). The list parallels ours, however, our preferred exposure to the burgeoning electric vehicle penetration of the European and Chinese markets is lithium, not nickel.



(Figure 5: Preferred metals including Gold, Silver, Copper, Zinc, Nickel, and LCE [lithium carbonate equivalent] versus equity exchange traded funds [ETF] including GDXJ, LIT, and XBM. Note: we used the average quarterly sale prices from Orocobre [ORE.ASX, ORL.T] to generate our LCE prices, *Source: Investing.com*)

Mr. Parrill pointed out that traditional private equity funds tend to focus on late stage development assets to write the big checks, which can require time-consuming due diligence process. In contrast, firms like RCF and Orion Mine Finance offer a one-stop shop for mining companies by providing several layers of funding including debt, equity, and streaming alternatives. Many examples come to mind, including Pretium Gold (PVG.T, PVG.NYSE), Lydian Gold (LYD.T), and Red Eagle (R.T).

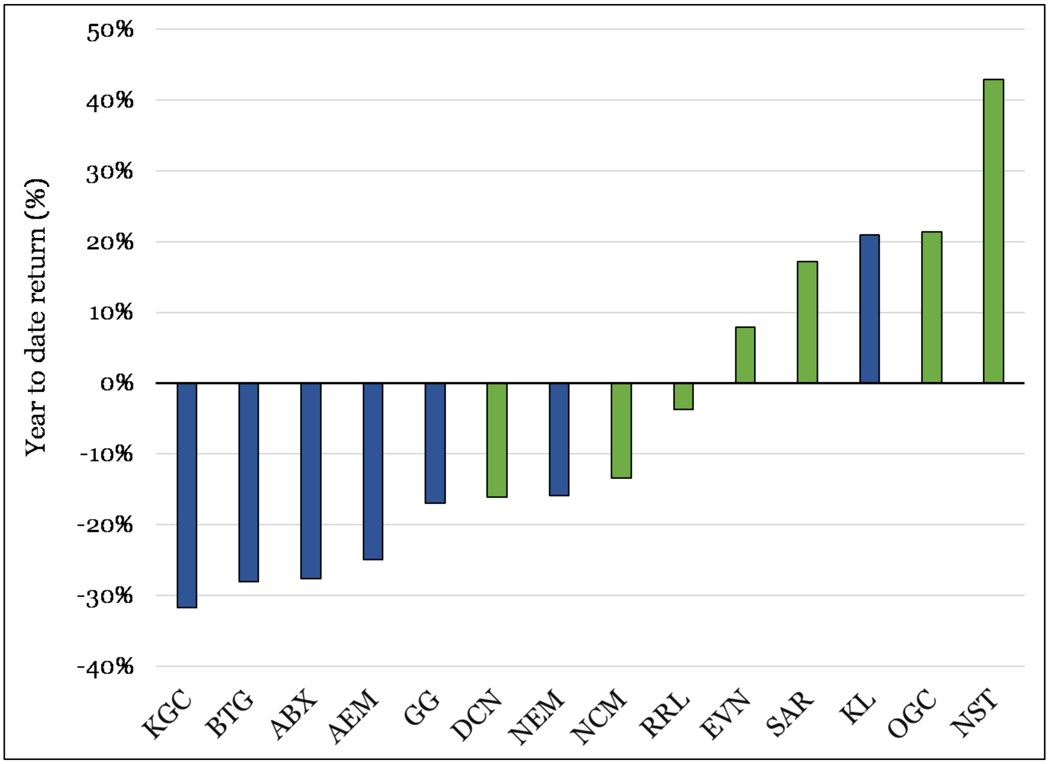
Although the financial equivalent of a 7-11 is convenient, it is not cheap. For example, Pretium's financials indicate that the cost of its US$350 million credit facility with Orion Mine Finance Group and Blackstone Tactical Opportunities is 15%.

To capture the value of earlier stage projects for its investors, RCF has created a second vehicle known as the Opportunities Fund to deploy funds to early stage exploration (C$1.0-1.5 million), de-risking stage (resource to feasibility study, C$3-5 million), and strategic options for M&A and market dislocations. The fund takes more significant risks but writes more and smaller checks.

We note that gaps in market valuations have led some private equity firms to take their assets private, the financial equivalent of taking one's toys away from the sandbox. Mr. Parrill commented that this is the case when the requirements for listing on public markets outweigh the benefits. To illustrate, in early September, Orion Mine Finance completed the acquisition of Dalradian Resources and then delisted the company (link here). The positive for investors owning equity in public companies is that private equity represents a legitimate suitor for assets along with producers and streamers.

I hear the bullroarer

Another group that is making an impact on the precious and base metal market in the Americas is Australian mid-tier producers. Breaking with traditional trading discounts, the weak Australian dollar has enabled ASX-listed companies to outperform their North America-listed peer group, (Fig. 6).



(Figure 6: Year-to-date performance of mid-tier to major gold producers listed in North America [US listing, dark **blue**] and Australia [ASX, **green**], *Source: Investing.com*)

As we noted after attending the Noosa Mining Conference in Queensland (link here), there is an obsession among junior ASX-listed companies to take their projects into production. This mission statement has created a number of growing mid-tier producers over the past several years.

Strong balance sheets and rising valuations combined with a lack of interest in acquiring assets in geopolitically compromised Asian countries like Indonesia and the Philippines, to name a few, have led Australian producers to branch out into the Americas.

As pointed out by the Precious Metals Summit Conferences' CEO Jessica Levental, the participation of Australian mining companies is up ~25% in 2018. Not unlike pilot fish following their source of food, there has also been an increase in registration by Australian investors and brokers.

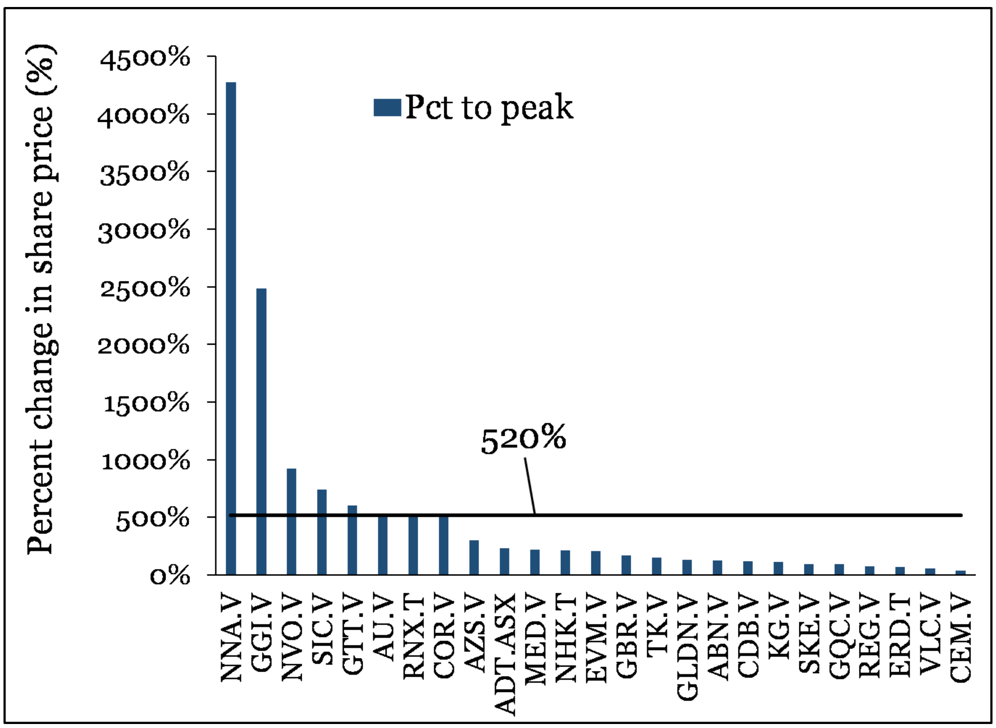
Oceanagold (OGC.T, OGC.ASX) probably got the ball rolling several years ago with its acquisition of the Haile gold project in South Carolina (link here). Newcrest Mining (NCM.ASX) has also been very active in private placements, earn-ins, and joint ventures with companies such as Solgold Plc. (SOLG.LSE, SOLG.T) in Ecuador (link here), **Mirasol Resources (MRZ.V)** in Chile (link here and here), and **Azucar Minerals (AZM.V)** in Mexico (link here), to name a few. More recently, Northern Star Resources (NST.ASX) purchased the high grade underground Pogo Mine in Alaska from Sumitomo Metal Mining (5713.TKY, SMMYY.OTC), (link here).

This trend is another positive for equity investors holding companies with quality assets in the Americas as it provides a new group of suitors to generate competitive tension to fill valuation gaps.

Drilling is an acceptable risk for a junior explorer

In his role as investment advisor for Sprott Global Resource Investors since 2003, Steve Todoruk's thesis is not unlike that of *Exploration Insights*. His focus is more on discovery and less on commodities while being wary of certain jurisdictions.

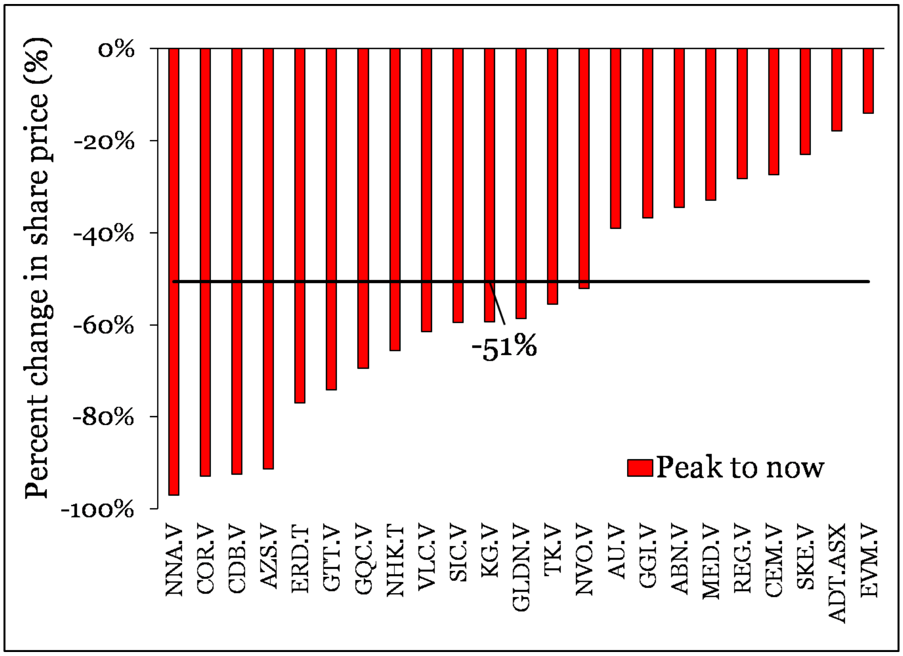
Our recent review of 25 junior exploration companies predominantly focused on gold and copper in Canada, USA, and Australia, with an average return of ~520% in just over two months *(ERRATUM 2: in this case, I said days not months in the Keynote Investor Panel)*, supports this premise, (Fig. 7).



(Figure 7: Percent change in share price—average of 520% over two months—after the release of a major catalyst such as a drillhole, *Source: Investing.com*)

Mr. Todoruk cited investments in Reservoir Minerals (delisted) and Mariana Resources (delisted). We did ok in those companies as well, (link here and here).

As the juniors fail to repeat the initial "stellar" results and meet the expectations of a rabid retail market, their share prices tend to give up some of their gains. Our research suggests that the same group of 25 companies lost on average half of their gains in 10 months or so from the first sign of a "discovery", (Fig. 8). The risk associated with drill hole results is significant as is the reward, and uncertainty related to the drill bit is a factor we anticipate; therefore, we don't recommend betting the house on them.



(Figure 8: Percent change in share price for various junior companies from the peak after the release of a major catalyst to their current share price, *Source: Investing.com*)

Summary

Below are our main takeaways from this year's *Keynote Investor Panel* at the *Precious Metal Summit* in Colorado:

- We may be at the tail end of a protracted capitulation reminiscent of the early 2000s that requires some catalyst to reignite the fear of a systemic or market risk that would trigger exposure to the gold sector.
- The growth of passive ETFs is a financial phenomenon not isolated to the precious metals sector. Generalists that trade on macroeconomic indicators require liquidity, anonymity, and a range of alternatives (options), which is why they prefer to invest in passive funds rather than active ones.
- Private equity continues to be an important, but expensive, source of funding for single asset development companies. Firms like RCF are also partaking in the opportunity to invest in illiquid, early-stage exploration mining companies with smaller placements (<C$3 M) rather than writing big checks.
- Fickle markets generate dislocations in valuation that may lead private equity firms to take some of their investments private, which adds to the list of suitors for assets and is a positive for the industry.

- Australian miners, reluctant to add to their portfolios with assets from their hemisphere, are taking advantage of their premium valuations by growing their presence in the Americas. Again, this trend adds to the list of suitors for assets and is also a positive.

- Our review of 25 junior exploration companies since 2017, predominantly focused on gold and copper in Canada, USA, and Australia revealed a ~520% return in just over two months. The high returns represent both the opportunity to invest in the junior mining sector and the risk of losing half one's gains or more in several months if the next round of drill results fail to make the grade. We concur with Steve Todoruk that the risk of exploration through the drill bit is one we are willing to take as we swing for the fences.

While traveling through Reno during my site visit to Nevada, a subscriber asked if I had more luck on the slot machines than with junior mining stocks. Although I'm not fond of slot-machines, the reality is the rewards in both cases can be similar. But at Exploration Insights we strive to add value to our picks before purchasing them by seeking out fatal flaws that would prevent the companies from being acquired by a producer, (link here). Overall, we think it is more fun investing in the junior mining sector than surrendering our money to a one-armed bandit.

(Vintage slot machine from Reno, *Source: sherrylkingmantaymah.gq*)

That's the way we see it,

Joe Mazumdar and Brent Cook

Disclosures

Of the companies mentioned in this week's letter, Exploration Insights own shares of Azucar Minerals, Mirasol Resources and Premier Gold.

[Note that our trading activity is based on our investment thesis, which can be short- (tactical) or long-term (strategic), but the timing will not always be perfect due to market

volatility and share price liquidity. As a subscriber, you may want to purchase/sell a stock sooner or later than we do. As we need to justify our purchases and sales while allowing our subscribers to trade with us, we, unfortunately, cannot always act as quickly as we would like. We also want to remind all our subscribers that they have access to the open and closed positions in the EI Portfolio via the website. As soon as we execute a trade, we update the price and date of the open and closed positions, depending on whether the position was purchased or sold. There can be delays due to the illiquidity of some of the junior mining stocks and the time needed to link a new stock to our website. Our site visit expenses are covered by the company.]

Disclaimer

This letter/article is not intended to meet your specific individual investment needs, and it is not tailored to your personal financial situation. Nothing contained herein constitutes, is intended, or deemed to be--either implied or otherwise--investment advice. This letter/article reflects the personal views and opinions of Brent Cook and Joe Mazumdar, and that is all it purports to be. While the information herein is believed to be accurate and reliable, it is not guaranteed or implied to be so. The information herein may not be complete or correct; it is provided in good faith but without any legal responsibility or obligation to provide future updates. Research that was commissioned and paid for by private, institutional clients is deemed to be outside the scope of the newsletter, and certain companies that may be discussed in the newsletter could have been the subject of such private research projects done on behalf of private institutional clients. Neither Brent Cook, nor Joe Mazumdar, nor anyone else, accepts any responsibility, or assumes any liability, whatsoever, for any direct, indirect or consequential loss arising from the use of the information in this letter/article. The information contained herein is subject to change without notice, may become outdated, and may not be updated. The opinions are both time and market sensitive. Brent Cook, Joe Mazumdar, and the entities that they control, family, friends, employees, associates, and others, may have positions in securities mentioned, or discussed, in this letter/article. While every attempt is made to avoid conflicts of interest, such conflicts do arise from time to time. Whenever a conflict of interest arises, every attempt is made to resolve such conflict in the best possible interest of all parties, but you should not assume that your interest would be placed ahead of anyone else's interest in the event of a conflict of interest.