

Understanding resource company lifecycles

KNOWING HOW TO INVEST IN RESOURCE STOCK IS A HIGHLY SPECIALIZED SKILL; HERE ARE THE BASICS

by Ron Hera

While stock traders buy and sell shares of companies that produce natural resources based on factors such as stock chart patterns, quarterly financial results, trading momentum and news releases, value investors buy shares with the expectation that, over time, stocks will rise in price as key milestones are achieved, when value is created and eventually reflected in financial results. Value is created when a company makes a mineral discovery, defines a resource or upgrades its resources from the inferred category to the measured or indicated category.

The efficient market hypothesis underlying Dow Theory presupposes that the market has, and can correctly interpret, all of the information about companies, but that is not exactly the case for junior resource companies.

Among other things, pre-production resource companies burn cash without having regular revenues and do not have balance sheets like those of profitable producers, thus ordinary securities analysis is of limited use. Geopolitical risks in certain regions, such as changes in national mining laws, natural disasters and industrial accidents in dangerous businesses, such as coal mining, are ever present wildcards that can wipe out small companies and dampen entire sectors, such as happened with uranium after the nuclear meltdowns in Fukushima, Japan.

Unlike trading stocks, investing in natural resource producers involves a great deal of research followed by a great deal of waiting. In general, the value of a resource company increases as it progresses through each developmental stage, and with each passing stage, certain risks are mitigated. The recognition of increased value in terms of the company's stock price, however, takes

time. Warren Buffett famously said, "I don't want to buy any stock, where if they close the New York Stock Exchange tomorrow for five years, I won't be happy owning it." If a company is truly a good investment, the financial results of the business will eventually speak for themselves but it may be several years before an early stage company begins producing resources, becomes profitable or eliminates its debts.

Since investments in resource companies can be easily broken down by company stage, a logical investment approach is to systematically deploy capital over companies producing different resources (precious metals, base metals, oil and gas, agriculture-related resources, such as phosphate and potash, green energy, etc.) and that are in different stages of development from exploration to major producer. The lifecycles of natural resource producers suggests a corresponding, cyclical investment strategy where asset allocation over resource types and company stages reflects the risk tolerance of the investor in a continuous process where gains from investments in companies that successfully reached more advanced stages are moved back into earlier stage companies. Of course, prudent investors deploy only a portion of their capital in one area, i.e., in natural resource producers.

The lifecycles of companies that produce natural resources are like a train where investors get on or off before and after well-defined stops along the track. Achieving any milestone along the track from resource discovery to production, such as good drill results, is usually a positive event for a company's share price. As a company makes progress, windows of opportunity open where business transactions, such as an acquisition, can take

place. The key is to buy a stock before a transition between developmental stages and, assuming that the company makes it to the next stage, sell the stock to take advantage of the additional value created by the company (and recognized in the stock market in terms of the stock price).

Each company stage involves different risks. The only thing that an investor can be certain of in the exploration category is that the company will spend all of the money that it raises in the stock market trying to find resources. For a production-oriented company that has a discovery or a resource, a decision must be made at each stage regarding moving to the next stage versus a non-production exit strategy, such as selling the company. An economic assessment, feasibility study, the permitting process and other factors can make or break a small, production-oriented resource company. Producing resources requires a supporting infrastructure that may be prohibitively expensive or that may depend on the cooperation of parties outside of the company's control, such as utility companies, regional governments, aboriginal concerns or neighbouring companies. Certain companies, such as power companies, face substantial costs in building facilities and project delays or cost overruns can cause a company to quickly run out of cash and force it to issue more shares or to accept unfavourable financing terms.

Junior resource companies sometimes seek option agreements or enter into joint ventures with established producers to defray the risks and costs of moving towards production. At any point, a junior company that has defined resources can be an acquisition target, and companies with complementary resources may choose to merge. Once a company is in production,

Exploration Stage Extreme Risk Objective: Speculation	Discovery Stage Extreme to High Risk Objective: Speculation	Development Stage High Risk Objective: Speculation or High Growth
Junior Producer High to Moderate Risk Objective: High Growth to Moderate Growth	Mid Tier Producer Moderate to Low Risk Objective: Moderate Growth	Major Producer Low Risk Objective: Wealth Preservation

it must steadily increase both its resource base and its output to maximize shareholder value, but, for a variety of reasons, either one or both of these objectives may not be possible.

There is always the possibility, in any business activity or arrangement, that things will not go as planned. The downside risks in exploration and development stage companies are very steep and not all business transactions are positive events for shareholders. The most common way of managing risk in the junior resource category is to avoid exploration and discovery stage companies entirely. After all, it is a complex area that is extraordinarily risky and requires specialized knowledge. Geologists, for example, are very likely to outperform seasoned stock traders. The second way to manage risk is to undertake detailed, fundamental research, which is the keystone of value investing.

The train ride from resource discovery to production can be visually represented as a flowchart where positive or negative outcomes of developmental milestones increase or decrease a company's value while changing the associated level of risk. Until they are in production, resource companies burn cash and often need to raise money, which can dilute the holdings of investors. At the same time, commodity prices fluctuate, which is why savvy investors focus on companies producing resources that are rising in price due to fundamental factors, such as supply and demand.

Owning shares in resource companies provides investors with leverage to the underlying commodity, but if the price of the commodity falls, the share prices of companies that produce it also fall. The shares of companies that are not yet producing tend to fall much more than the

shares of those that are in production. Conversely, a major producer's stock price can move more as a function of the prices of underlying commodities than due to other factors, thus it may be difficult to realize significant profits outside of exploration and development stage companies. Ironically, most natural resource producers are in liquidation from the moment they go into production; they are literally liquidating their assets. As a result, ongoing exploration is vitally important to long term success.

The largest potential gains in resource company stock prices tend to be in the high-risk exploration and discovery stages, but the vast majority of discovery efforts do not produce a viable resource, and many resources cannot be easily developed. Once a resource has been discovered, it must be quantified, e.g., by a National Instrument 43-101 (NI 43-101) estimate, and exploration usually continues while the company seeks to evaluate the economic feasibility of moving to production. If the price of the resource in question falls, a company may be unable to raise capital and could become insolvent. Pre-production companies tend to become oversold during a stock market correction, which means that they occasionally go on sale, providing investors with an opportunity to redeploy capital into companies in earlier stages of development.

Like any business, one of the critical transitions for a natural resource producer is achieving profitability because there is no substitute for a sound balance sheet. When a company becomes an established producer, traditional securities analysis comes into play and stock charts reflect business results more than speculation. The journey from discovery to established producer is long and dangerous, but

PROJECT GENERATORS

For junior resource companies, the major alternative to becoming a producer is the project generator business model where the company's business is exploration and development up to a point where a transaction can take place. This allows the company to aggregate royalties and shares in resource producers, i.e., shares received in consideration for resources sold to producers. Setting aside the fact that the project generator model is not well understood by most investors, project generators have irregular revenues outside of royalties and exploration is always a high risk activity.

SHARE PRICE MECHANICS

As the price of a resource, such as natural gas or copper, rises, the earnings of companies that produce it also rise and the price to earnings (P/E) ratios of their stocks become increasingly attractive as long as their production costs are contained. Low P/E ratios attract investors and demand for a company's shares causes the price to rise.

investors can take advantage of resource company lifecycles by balancing risks over different natural resources and over companies in different stages of development while exploiting the transitions between company stages in a continuous investment process. ■

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