Understanding junio mining companie

A report from consultancy AIM Mining Research, 'Understanding Junior Miners', has filled gap in the market for analysis of early-stage mining companies, where the AIM market has seen exponential growth over the past three years

VALUATION issues – and hence share price drivers – in the sub-sector of early stage mining companies, depend very heavily on where the company is in its lifecycle. The illustration below is a graphic representation of a successful mining company, but if a company fails at the early stages of development, the value can in fact return to zero.

The performance of junior mining shares thus cannot be relied on as a consistent proxy for either the underlying commodity or a geared version of the major mining groups. The former tend to be driven much more by other factors: the internal flow of information on the development of the asset levels of liquidity; political risk shocks; investment stakes by a major; interest rate moves that affect the discounting of cash flows only expected somewhere in the future; and the scarcity value of the primary commodity exposure (for example, listed diamond equity plays are in significantly shorter supply than gold plays).

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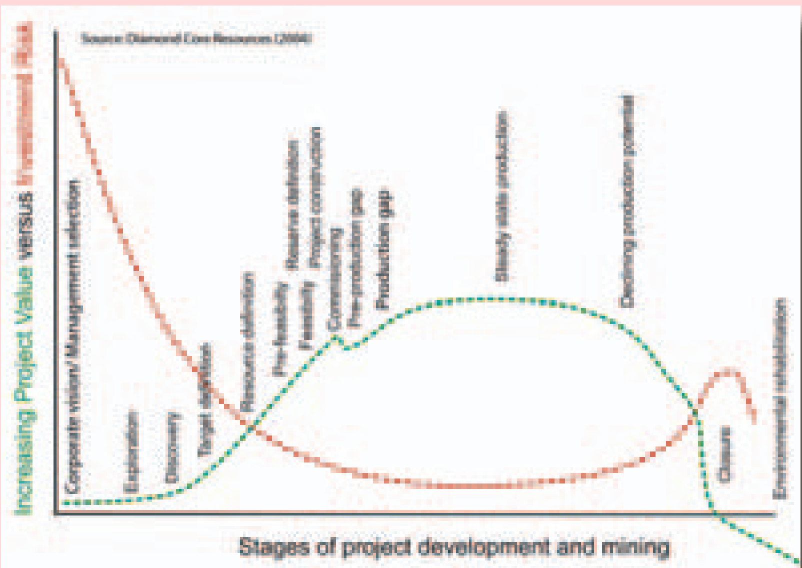
Consultancy AIM Mining Research says its report aims to provide investors with enough technical information, or the key questions to ask in order to interrogate and understand early stage exploration and development plays. It does not claim to be a comprehensive textbook, but has focused on areas where the 'panel' of writers possess considerable industry experience and knowledge.

One of the early sections provides information to hel investors with the questions to ask in order to assess the asse owned by early stage miners before they are in production. number of mining industry commentators blame the deart of significant new mineral discoveries over the last ten yea on the fall in exploration spend which occurred after the Bre- scandal of the mid-1990s – it was hailed as the biggest gol discovery in the world this century, worth more tha £13 billion, but turned out to be the largest mining scam of a time. At its heart was the doctoring of core samples supposed coming from the large "prospective" gold deposit in Indones



Coverage of three particular topics emphasises the subjective nature of the interpretation of early stage data emerging on potentially economically viable mineral deposits:

- There are a number of definitions of resources and reserve as defined by the most extensively used system of classification (JORC), and major differences exist in the Russia system (AIM currently has the highest percentage of Russian-listed junior miners versus other junior resource equity markets such Canada, the US and Australia).
- Even within a single commodity category, a range of different types of deposits occur, dependent on how the were originally formed. While the geological terms can sometimes be daunting, the reason for including these in some depth is that they will have implications for the future economic exploitation of the mineral deposits. Understanding some of the geological features can help investors start to benchmark new deposits against similar, producing mines for data to be used in valuation models.
- Monitoring the process of exploration and evaluation techniques used in the conversion of mineralisation into proven reserves is essential for giving investors confidence in the robustness of the final results. Share price moves ca often be considerable as more detailed information on the asset becomes available.

IDENTIFYING RISK

In junior mining companies with particular skills sets in finding prospective assets, possibly the highest period of risk is associated with the actual development of the asset into a producing mine. A very wide range of factors will determine success or failure at this stage, most important of which are:

- Security of tenure, given the geographic spread of junior miners in the so called 'new frontier' regions with highe levels of political risk.
- Key characteristics of the ore body, particularly grade.
- Operating parameters of open pit versus underground mine development (the graphic right shows, by way of example, the implication of a steeply dipping ore body in open pit mining).
- Plant and metallurgy efficiencies (particularly in commodities that need to be separated out from by-products found in the same ore body, such as platinum group metals).
- Logistics, particularly when a mine is located in a remote 'new frontier' region.
- Management record in developing projects to production stage as opposed to finding new deposits – the two stage of the lifecycle of a mine project can require dramatically different skills
- Environmental issues that demand increasing amounts of company time and resource, covering not only the physical environment (where actual legislation will govern company requirements) but also the socio-cultural component (where local communities are capable of stalling potentially viable ventures if their concerns are not addressed).

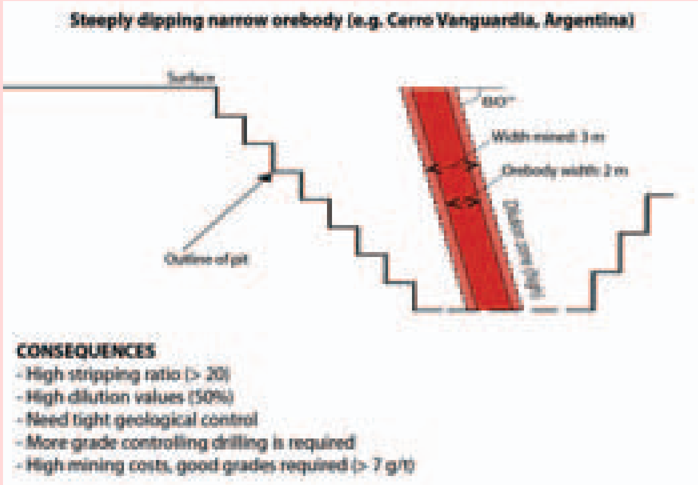
IN THE FINAL ANALYSIS

The final section of the report discusses the financial an valuation issues associated with understanding junior miners. It outlines accepted industry definitions for cash cost statistics plus further items that should be realistically added on top, given the nature of the junior mining company (such as essential capital expenditure required to ensure ongoing mining, and financing costs)

It points to areas of economic sensitivity that investor should probe: by-product credits; currency sensitivity (with all commodity revenues designated in US dollars) and cost escalation assumptions over the life of the mine, including possible change to royalty regimes.

Revenue projections for mining companies are clearly more complex than for UK-based industrial groups, as they will depend on commodity price forecasts (and within that, spot or long term), production forecasts (which may still be dependent on developmental timelines in early stage miners) and currency fluctuations.

It is essential for investors to interrogate company management on their assumptions underlying both the cost and revenue sides of the profitability equation as the robustness of this data will in turn affect the integrity of any valuation approaches adopted (ranging from the very blunt instrument of 'ounces in the ground' to net present value).



As the graph bottom left shows, the risk to investors is highest in early stage development of a mine, where data is anything but robust, and mispricing can occur.

Unfortunately, no 'holy grail' valuation methods exist to eliminate this risk, as interpretation of much of the early stage data is a specialist (and somewhat subjective) domain. But most standard methods can be enhanced by applying probability of outcome weightings to various factors. The content of AIM Mining Research's report aims to give investors the information and questions to ask, to enable them to assign their own probabilities to the successful outcome of a mining development.

The authors do, however, conclude that, in the final analysis, success and value creation by junior miners will depend overwhelmingly on:

- Large mineralisation and reserves, with potential 'blue sky'.
- Good convertibility of resources to reserves.
- Downstream technical and economic viability.
- Management team's ability and track record in operations.
- Security of tenure, taxation and other political and fiscal issues

The publication can be ordered at www.aim-mining.com. It draws on the experience and expertise of a team of writers: Dave Hodgson, ex-COO of AngloGold Ashanti, and three geologists with expertise in the three commodities that dominate the AIM mining sector: Peter Mellowship, previously at Implats (platinum group metals), Gordon Wylie, previously AngloGold Ashanti (gold exploration) and Jan-Marten Huizenga, a lecturer in geology (diamonds). The report is edited by Fiona Perrott-Humphrey, previously a rated mining analyst in the UK market, who also covers the market-related characteristics of Aim stocks.

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