THE (SOMETIMES ON) FRIDAY SHEET
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Camel butts under every tent
Lousy metal prices, but bound to head higher
Gold funds beating the Dow
Not enough discoveries to go around
RDU kills a camel
Equity vs. property dilution
SWG vs. GNM

"I'm not going to use a $10mil missile on a $10 tent in the desert and end up hitting some camel in the butt"…George W. Bush

There's a lot to be said for common sense. Although I never would have thought the wisdom of George W. would lead off a Friday Sheet, big events can change perceptions in unexpected ways.

In today's Sheet we're going to look at the business of minerals exploration and, minerals exploration as a business. Setting the guidelines right from the start, we'll assume that in any business the objective is to make money, and in the exploration business we're trying to find ore deposits economically. Metaphorically, we're hoping to find something worth more than a dead camel for less than it costs to blow up a whole bunch of tents in the desert. My thesis is that there are a lot more camel butts than ore deposits out there and common sense dictates that both a speculator's and a junior explorer's "get rich scheme" recognize and work within these limits.

First let's appraise the good and bad of this archaic industry today.

Metal prices are appalling and unlikely to improve, given that the macro-economic crystal ball foretells a global recession with the Chinese buying fewer washers and dryers and JDS Uniphase shareholders delaying that Mercedes purchase. As a result, major mining companies will be making far less money on their great mines and losing it on their marginal ones. The owners of one of the costliest mines to be put into production recently, Antimina, are not experiencing a particularly good first year, with zinc at $.36/lb and copper at $.64/lb. More layoffs and budget cuts are inevitable throughout the industry.

Gold and gold funds, on the other hand, look strong (5-11-01 Sheet) having outperformed all funds for the year with a 17% increase compared to a decrease of 29% for all US stock funds. The gold bug index (HUI) currently at ~71 began the year at 42. Even the seven stocks covered at the beginning of the year (1-5-01 Sheet) have put in respectable performances (particularly considering the high risk nature of these businesses, not one disaster!):

Southwestern Resources (SWG.T, C$2.72 on 1-5-01, currently C$2.75, high of C$4.00)
Virginia Gold (VIA.T, C$.62 on 1-5-01, currently C$.55, high of C$.80)
Anatolia (YMC/U.V, US$.24 on 1-5-01, currently US$.46, high of US$.65)
Rubicon (RMX.V, C$.35 on 1-5-01, currently C$.36, high of C$.53)
Francisco Gold (FGX.V, C$5.00 on 1-5-01, currently C$6.50, high of C$6.85)
European Goldfields (EGU.V, C$1.45 on 1-5-01, currently C$3.30, high of C$4.80)
Harmony Gold (HGMCY, US$4.50 on 1-5-01, currently US$5.43, high of US$6.43).

Despite the dreadful near term outlook for the mining industry, mineral production and reserve depletion continues at a fairly rapid pace. A study by Chris Bain (Explor. Mining Geol., V.9, 2000) into the past 50 years of minerals exploration and discovery points out that at current rates of production the industry's annual discovery requirements are roughly:

* Gold: Fifteen 5mil oz deposits assuming a $25/oz discovery cost, $50/oz development cost and sustainable production costs of under $150/oz production cost
* Copper: Two high-grade, world class porphyry deposits containing 5Mt of recoverable copper each equating to about 500Mt @ 1.3% Cu located near favorable infrastructure
* Silver: Ten deposits containing 60Mil oz each
* Diamonds: Six deposits containing 20Mcts

I've been watching, and even assuming this year's two promising large copper discoveries by Metallica/Noranda at La Fortuna (~400Mt @ 0.61% Cu, 0.56g/t Au resource), and Ivanhoe's Oyu Tolgio property in Mongolia prove economic, we're falling behind. Chris backs up this observation by noting that base metal discoveries peaked in the 60's and 70's and, gold discoveries in the late 80's to early 90's. This decreasing discovery success rate has occurred despite (until recently) increasing exploration expenditures over the 50-year period.

Why does it appear to be getting tougher to make grassroots discoveries?

The 50-year study points out that economic hurdles are becoming higher and higher due to steadily increasing real operating and capital costs and declining real metal prices plus, the sheer size of the deposits needed to replace production. Add to this the exploration maturity of most favourable geologic terrains with fewer explorers looking, and the answer becomes obvious. Exacerbating this "problem", I see the lack of determination and steady funding of exploration as detrimental to this already difficult scientific endeavor. Very little money is (or has been) available from the industry or equity markets recently, meaning new projects and ideas are becoming fewer and farther between just as deposits are becoming harder to find. Even flow-through funds in Canada are going begging, as there are so few "respectable" drill ready projects available. In Latin America the funding situation is worse, and if you're looking in Africa or the "whereverthefucistans", well you're on the wrong side of the tracks.

On the business side, the accountants and bankers running the mining companies have justly concluded that exploration is a money-losing proposition. Replacing production through acquisitions and expansions provides a much more quantifiable resolution than the uncertainties of paying a pack of degenerate geo's to run around in politically questionable environments. Fortunately, the apparent deficit in discoveries has, for the most part, been made up by "brownfield" discoveries at existing operations that were discovered by an older pack of degenerates. [As an aside, many of the mines currently in production would not be economic if discovered today.] However, there are geologic limits to how much ore these giant deposits can give, and we will ultimately see these limits reached. Looking forward, how many more Escondida copper deposits are still out there? One? Ten? Fifty? First Quantum (FM.T) has apparently done the math and is sitting tight in Zambia with an expectant and hopeful eye on the Congo.

Going back to Chris's study, he concludes that sooner or later, the scarcity in discoveries will become a force acting on real metal prices and that at that point, the trend in real price declines will reverse. This should then create a more favorable environment for investment in exploration. Shout hallelujah! But there's a big problem here, as we've discussed previously (2-9-01, 11-17-00). It is the few giant ore deposits that are the foundation of the major mining companies and these deposits are geologically unique beasts. Discovery is uncertain and difficult while development can take decades.

No doubt, dear reader, you appreciate and sympathize with the dilemma your favorite mining company executives will be facing in the future: Rising metal prices, declining mine lives, increasing production profiles, no new giant ore deposits or potential discoveries and ample evidence that your pack of degenerates has been wholly unsuccessful at anything but spending money. So how and where do the CEO's find the next giant ore deposit? More specifically, how do they find this given the rising economic threshold for mining operations, the increasing exploration maturity of the favored terrains, the escalating exploration costs and discovery risks due to the more "esoteric" techniques required to detect hidden mineralization and, they've canned almost everyone capable of finding anything anyway?

The answer, I believe, has to be the junior exploration company. The question, now becomes: How do we speculators and explorers best position ourselves to be in the way of the inevitable (but not necessarily imminent) big bucks from the next exploration BOOM?

The blatantly obvious and simple solution is to only explore properties that contain giant ore bodies and only invest in companies that are going to discover these big ore bodies. I should charge for this sage advice, eh!

During the last minerals exploration speculative boom (1994-1997) it seemed that easy. The following companies were sporting market capitalization's in the C$100's of millions and almost certain to make a discovery:

General Minerals (C$15.20, currently C$0.08)
Southwestern Gold (C$26.00, currently C$2.75)
Yamana (C$6.30, currently C$0.12) and
Corriente (C$18.70, currently C$0.75)

Obviously it wasn't that easy. The boom went bust and today we are faced with extremely low metal prices and almost no investor interest, despite the clear indications that the mining industry will become increasingly desperate for new discoveries.

Common sense dictates we recognize there's a camel in most tents. The minerals exploration business is fraught with environmental, political, cultural, technological and financial uncertainties. Admittedly, large discoveries, when made, are extremely profitable to the discoveree but the odds, costs and risks are exceptionally unfavorable. Any exploration business plan should acknowledge these facts.

For the few of us left in minerals exploration and speculation there are two basic paths to riches being followed by the junior exploration company. Either 1) funding is provided through equity dilution and it's an all or nothing game for shareholders or, 2) funding is provided through joint ventures and dilution occurs at the property level.

The rationale for retaining 100% of a property and funding through equity is best summarized by a reader who writes: "One question: Your sheet recommends junior companies who have jv'd their assets. Doesn't this remove, or at least reduce, their attractiveness as an investment? The junior company gives away the upside to a major by signing a jv that keeps dollars coming in but provides for transfer of 60% or 70% of the project if results are positive. My friends at Radius tell me that their shareholders would be up in arms if they were to sign such a deal. Comments? "

Not to belabor the point too much, but it appears the Radius (RDU.V) shareholders got themselves a dead camel under the tent, the whole thing, including the butt. The shareholders wanted and bought an all or nothing ticket in a high-risk business being run by an exceptionally competent team. They may not be up in arms, if only because they're holding on to their shorts.

We at Global have no problem with this approach to exploration and speculation, provided you recognize the odds. However, until metal prices rise and the money is easy, we prefer the odds of diluting our interest in the camel and maintaining our interest in the intelligent explorationist's ability to turn up more tents. Meaning, although we do get diluted out of a piece of what statistically will probably end up as charred camel butt, our stake ($) in the guys that we think are most likely to eventually find something goes as far as possible. Statistically, if we've got four shots at a 30% interest in a major discovery, we're ahead. I personally would not dilute in a property I thought had a very high chance of becoming a mine, it's just that they hardly ever come around.

Following this equity dilution vs. property dilution argument let's contrast two of the heavy hitters from the last boom: General Minerals and Southwestern Gold. Outwardly they appear very similar. Both are run by technically competent and respected industry people who choose to focus on high potential terrains in the Andean Cordilleran and China. Here's where they stand today.

General Minerals (GNM.T), 37.7mil shares outstanding, market cap ~C$3mil @ C$0.08, ~C$2.8mil working capital and burning ~C$400,000/Qtr. In 1996 GNM had in excess of C$35mil in the treasury and excellent prospects. Recently, Australian gold miner Ranger has taken down placements @ C$.25, some of which is funding Ta exploration in Bolivia (probably not what they had in mind). GNM's aspirations of proving the 263Mt @ 0.6% Cu resource at Vizcachitas to be economic through drilling and feasibility work seems to have been unsuccessful. Likewise, their drilling at Productora and Escalones, Chile does not appear to have resulted in an economic discovery. They have also been drilling gold veins at Towerbeck, China. In an effort to generate near term cash flow they originally planned to mine high-grade silver mineralization at Atocha. This plan seems to have been dropped in favor of small-scale tantalum opportunities in Bolivia. Although GNM pursued some joint ventures, when partners pulled out they continued to spend significant sums advancing the properties.

Southwestern Resources (SWG.T), 16 mil shares outstanding, market capitalization C$39mil @ C$2.75, ~C$13mil working capital and burning ~C$500,000/Qtr. In 1996, SWG's treasury was in excess of C$50mil. SWG also holds significant, but illiquid, equity positions in Canabrava Diamonds and Aurora Platinum with a current market value of ~C$11mil. These investments provide them with exposure to diamond and Ni-Cu-PGM exploration in the Canadian Shield. SWG controls base, precious and PGM properties in Peru, Chile, Argentina and China, ten of which are under joint venture to major or Peruvian mining companies. Resources have been defined at Accha, Peru (9Mt @ 9% Zn ox) and Poracotta, Peru (4.5Mt @ 2.6g/t Au). Past joint venture expenditures by almost 20 partners on SWG properties totals about US$15mil. To a large degree, the US$15mil in partner expenditures may represent the difference between a C$.08 stock and a C$2.75 stock.

Two companies, two business models, two very different market valuations. Which company or business model would you rather own today? How about next year? And when the next exploration boom kicks off?

My contention is that unless you are dead certain of a discovery, current market conditions favor speculation in companies that offset the heavy financial risks through joint ventures with companies capable of taking that financial risk. I understand this is controversial and the forum is now open for discussion. Email: bcook@gril.net mailto:bcook@gril.net

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