

The Investment case For Junior Mining Companies

By Eric Hommelberg
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Fundamental view - part II

On May 05 I published '[The Investment Case For Junior Mining Companies](#)' part I which had a strong focus on the technical set-up. Highlights of that article:

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- Gold correction most probably over (bottomed out at \$850)
- Junior sector just recovering from deepest over-sold condition since late 2002
- CDNX has started outperforming gold over the last few weeks
- Previous bottoms in CDNX/GOLD ratio were being characterized by sharp up-moves that lasted for many months
- CDNX/GOLD ratio charts leave plenty of room for a giant up-move that could last for more than a year
- Sentiment in junior sector has hit an all time low. This is a dream scenario from a contrarian perspective.

END.

I suggested a high probability for gold to have bottomed out at \$850 and elaborated more on that in my piece '[GOLD/HUI - Bottom Must be Near!](#)' last week. Well, lucky shot I guess but \$850 gold turned out to be the bottom indeed.

Now that gold finds itself in a new up-leg again we can finally be looking forward to some excitement in the junior gold shares coming months. As pointed out in part I the technical set-up leaves plenty of room for a giant up-move for the juniors that could last for more than a year. Please think about it, juniors bouncing off their most severe oversold condition in 8 years on the back of rising gold prices. This is the best technical set-up one could ever dream of. On top of that we could expect a wave of take-overs during the next two years since the major producers are hungry for new gold reserves. In other words, juniors with large proven resources will be hot!

Reasons why juniors will be watched (by major gold producers and investors):

- The industry is not replacing the reserves it is mining every year
- High grade mines are running out of ore.
- Even with gold at \$1000 / oz , it still takes four to seven years to open a mine.
- The industry isn't going to be able to respond immediately to higher gold prices.

- Reserves will be depleted in less than 10 years at current annual production rates
- The industry needs some major new finds desperately. Since 1999 only a very few world class gold deposits have been found.
- Majors are forced to acquire juniors because of the need for more reserves
- Juniors making discoveries are phenomenally profitable.

Now let's dig into each item listed above:

The industry is not replacing the reserves it is mining every year

The top 5 Gold producers are each pulling between 3.5 million and 7 million ounces out of the ground every year. In order to keep up with the current production rate the miners need to replace their mined-out reserves through exploration. But that's exactly the problem. In order to replace 3.5 - 7 million ounces of gold each year you'll have to find a major world class gold deposit (> 5 million ounce) each year which is highly unlikely. Of the 800+ discoveries listed of greater than 100,000 ounces (US Geological Survey's database), only about 6 percent contains 5 million ounces of gold or more. And even if a big discovery is made, it can take anywhere between three and 10 years to permit a mine in Canada or the United States, prospective areas where the major miners prefer to look for gold.

High grade mines are running out of ore.

Production rates are going down because the high-grade mines are running out of ore, which is forcing the producers to mine the low grade stuff. Since mill capacity doesn't change (mines are designed for a specific rate of production in tonnes mined and milled, not in ounces of gold produced) the output has nowhere to go but down. This has led to a dramatic production decline in South Africa the past decade and the end is nowhere in sight! Furthermore, many large gold mines, and particularly in South Africa, tend to close down with large ore resources still on the books.

The industry isn't going to be able to respond immediately to higher gold prices.

Even with gold at \$1000 / oz, it still takes four to seven years to open a typical mine. On top of that, rising gold prices lead to a falling gold production in short term. The reason for that is mentioned above since mine management will focus more on the low grade ore that was considered 'waste' at gold prices a few hundred dollars ago. With gold prices below \$600 the producers were forced to mine the 'high-grade' stuff since mining the low grade stuff wasn't economical. Now that a lot of the high grade ore is mined out, all that's left is the 'low-grade' stuff.. Since mines are designed for a specific rate of production in tonnes mined and milled the production rate of gold and silver metal will drop since ore head grades are dropping.

The example below tells it all:

A mine's operating structure is generally set at initial design, in that it has a rated mill capacity of 100, 1,000, or 10,000 tonnes per day. Its cost structure is likewise set by design in that a tonne of ore costs \$x to mine, \$y to process with \$z for G and A. Therefore, for example, a 1,000 tpd mine with the costs \$x+y+z equal to \$200 per tonne must process ore of that minimum value to break even. No operator will survive for long processing sub \$200 ore. At US\$660 per ounce and assuming a 90% recovery from the mill, the minimum profitable grade is close to 13 gpt (or near 1/3 of an ounce per tonne). As such, the operator will optimize by mining from various orebodies and stopes to mine as much as possible above the 13 gpt cut-off. Rock with grades of 8 gpt are waste. Daily production might be economic down to as low as 300 ounces per day (1,000 tpd at 1/3 per ounce x recovery).

As the gold price moves to say \$900+ per ounce, few of the mine's costs change, but now the revenue is 30% greater. Consequently, the Mine Manager's first priority is to

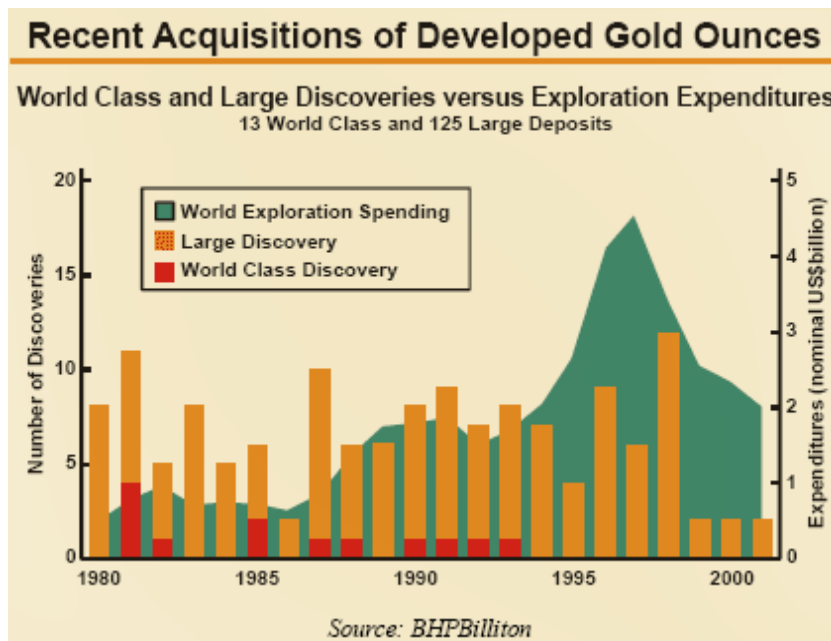
extract the extra ore that was a short time ago, waste. The cut-off or minimum grade mined goes from 13 gpt down to 9 or 10 gpt, so the mine's 1,000 tpd output now drops from 300 ounces per day to 280 ounces per day.

Most gold mines operate this way! So as the price of gold goes up, primary mine production drops. The higher the price of gold, the greater the drop in primary mine production.

END.

The industry needs some major new finds desperately. Since 1999 only a very few world class gold deposits have been found.

As mentioned above, the top 5 Gold producers are pulling each between 3.5 million and 7 million ounces out of the ground each year, which translates itself into the need for a world class gold discovery each year to replace the mined reserves. Well, that simple fact is that new world class gold discoveries are very rare and hard to find, by exploration or purchase. See chart below:



The chart is a bit dated but after 2003 only one huge world class gold discovery has been which was Aurelian's FDN project. Unfortunately it may take a while before those new discovered ounces (10+ million) will be accessible for production since the Ecuadorian government isn't exactly providing the support necessary to move things forward here. Two large gold deposits in nearby Venezuela also have just been denied production rights which isn't a big help either for future gold supply!

You get the picture? Wanted (desperately) several new world class gold discoveries each single year but (almost) no major world class gold discoveries announced over the last 10 years. Result? An inevitable, major decline in world gold production! The decline is already well underway since world gold production peaked in 2001 and has been in decline ever since.

Now some analysts argue that there isn't a problem at all since world gold reserves are estimated at about 30.000 tonnes so at current production rates we could easily produce a for another 10 years. What these analysts fail to recognize however is the simple fact that it becomes harder and harder to produce the remaining ounces left. Late in the life of mines, the typical case is that the mine shuts down early, with a large amount of "reserves" still showing on the "books". A good case in point was the Homestake Mine in South Dakota, which was shut down with a large base of ore "reserves" (millions of

ounces) still on the books. Anyhow, the proof the decline simply can't be ignored since world gold production peaked in 2001 and has been in decline ever since. The decline and closure of any existing big gold mines, such as in Nevada's mega-producer Carlin Trend, will exacerbate the supply problem dramatically.

Majors are forced to acquire juniors because of the need for more reserves

So, the major gold producers can't replace their produced ounces of gold simply by means of exploration, so what are they supposed to do then? Well, the answer is simple, they simply have to open up their check-books and buy the ounces. In other words, the majors are simply forced to look to juniors in order to acquire the exploration opportunities that they themselves can't find. When you realize that one of the most important factors to increasing the odds of making a discovery is to have experienced and qualified geologists with a proven track record plus the fact that juniors continue to steal the top geologists of the major companies then it's easy to understand why 75% of all discoveries are made by juniors.

So, the major gold producers have to make new acquisitions to meet their growth targets, well, it seems that that's exactly what'll happen during the next two years:

Miners Looking For Take Overs

The Canadian Press

May 13, 2008 at 11:40 AM EDT

TORONTO - Nearly half of the large mining companies interviewed for a recent study by Ernst and Young said they need to make acquisitions to meet their aggressive growth targets and 90 per cent said they expected to make an acquisition in the next two years.

END.

Juniors making discoveries are phenomenally profitable.

History has always been very gracious to juniors making huge discoveries which has clearly been demonstrated in 1996 by Arequipa Resources that appreciated from 1 CAD\$ to 35 CAD\$ in 6 months time after making a world class gold discovery (7 million ounces) and more recently (2006) by Aurelian Resources that appreciated from 90 cents to \$40 on the back of a huge world class gold discovery (10+ million ounces). John Bridge, a senior gold analyst of JP-Morgan once said:

If you are lucky enough to buy into an exploration company that makes a discovery, you can effectively buy your own auto teller machine. Some of these things are just phenomenally profitable.

END.

Now sure enough statements like these are hard to swallow these days when most juniors are trading as if gold was at \$400, see [part I 'Technical view'](#). Now the question of course remains what caused the juniors to disappear completely from the investor's radar-screen during the last 8 months. Let's focus on some favourite bear-tunes that have been echoing in the junior arena for many months now:

- Juniors are being shorted by Hedge-funds as part of a spread they play in the gold mining shares. They go long senior gold shares, short juniors thereby depressing the juniors to unimaginable lows
- Juniors are facing difficulties in order to finance their exploration programs due to the on-going credit crisis. A junior that can't finance itself will bleed to death.

- Juniors are facing sky-rocketing exploration costs which in turn accelerates the burn-rate of the remaining cash and therefore accelerates their way towards bankruptcy
- Most juniors won't find anything since only one out of 2000 projects will make it to a mine. Trying to guess which projects could evolve into a mine will most probably lead to tremendous disappointments..
- There are so many new companies and promoters that money from the usual small mining cap investors is diluted
- The uranium boom and the ETFs are diverting plenty of money away from the (gold) juniors.

Juniors are facing difficulties in order to finance their exploration programs due to the on-going credit crisis. A junior that can't finance itself will bleed to death

This seems to be a no brainer but a recent study by Ernst & Young revealed that despite the sub-prime fall out most juniors did their financing in the latter half of 2007:

Even with the banks and investment banks in disarray because of the meltdown in the U.S. mortgage industry that hit last summer, Ernst & Young said it found nearly 60 per cent of 2007 loans to the mining sector were made in the second half of the year.

END.

Yes, without doubt the cost of debt has soared but as the study reveals there weren't any bankable transactions in the sector that haven't been completed because of debt availability issues.

As an investor I'm not worried about increasing exploration costs and cost of debt. I don't care if a junior pays up \$5 million for its exploration program or \$8 million, all I care is about a potential world class discovery that will catapult the company into a multi hundred dollar company.

Most juniors won't find anything since only one out of 2000 projects will make it to a mine. Trying to guess which projects could evolve into a mine will most probably lead to tremendous disappointments..

Absolutely true, that's why you have to spread your investment dollars, the professionals are doing exactly the same. Goldfield's CEO Ian Cockerill once said:

We invest in 10 juniors in the hope that one or two of them come up trumps, and the value you get off the table there will pay for the other eight that do not. But you are spreading your exploration dollars, It increases your chance of success.

END.

Now if a major company with its well trained geologists is satisfied with two winners out of 10 juniors in which they have invested it should tell you something. It should tell you that investing in a very few juniors only is not the smartest thing to do. Diversify at least in 10 to 20 different junior plays. One winner easily compensates the losses made on others.

Juniors are being shorted by Hedge-funds as part of a spread they play in the gold mining shares. They go long senior gold shares, short juniors thereby depressing the juniors to unimaginable lows

Statements like these are heard very often these days but hard to verify. Without doubt this is happening here and there indeed but in the end all shorts will have to be covered at some point since no cover means no profit! It's as simple as that! In other words, a

short being implemented now is a guaranteed future buy. As long as sentiment remains bearish the junior short sellers will be able to push down the stocks even further but remember you can't manipulate against a primary trend. In other words, when sentiment reverses and the public starts accumulating en masse there's no way any-one can hold down the juniors for a much longer period of time, in contrary, shorts that have to cover will be adding fuel to the fire. *See more on this topic below...*

Current sentiment in juniors vs sentiment gold shares May 2004 and May 2005

To those of you who feel depressed about their junior investments please remember that we've been through such bad sentiment before. In May 2004 for example things looked so bad that many analysts declared the bull market in gold stocks over. Yes, sentiment back then was as bad as it can get and desperation was the tune of the day. A reader of James Sinclair back then wrote to Jim :

Jim, I simply cannot take the pain in gold shares. I have a lot of respect for your opinions. I still want to believe you that we are in a bull market for gold. But today I gave up. I sold all my gold mining stocks. There is only so much pain I can take.

END.

One year later in 2005 sentiment hit rock bottom again. The similarity was striking, a reader of Bill Murphy's LeMetropoleCafe wrote to Bill on April 28, 2005 :

Bill and Chris,

Well, I never thought I would say it. I'm whipped.
I'm getting out of PM across the board.
Please remove me from all mail lists and GATA and LeMetropole.
Cancel my membership.
I'm going elsewhere to try to make a decent buck.
Good luck in the future.
I'm trying something else.

Jim

END.

So that was May 2004 and May 2005 while the HUI was clocked down to 180. Yes, it came down from 250 but that's exactly my point, people tend to extrapolate a recent trend and can't believe things can reverse. But let me ask you, looking back wouldn't you be happy to have bought the senior gold shares back then at HUI 180 levels? What does it tell you? It tells you that the time to buy is when sentiment hits rock bottom. And yes this is clearly the case with the junior gold stocks these days, as most investors have thrown in the towel and sold their junior shares. It's my strong belief however that within 14 months from now (again pls see [part I, the technical view](#)) people will be looking back at this period and wonder how they could have been so stupid not to have seen this golden opportunity.

OK fine you'll say, but I'm hearing persistent rumors about Canadian investment banks shorting juniors since that's been paying off tremendously in the past year. The investment banks/brokers short the juniors and try to cover later on by participating in a private placement. In other words, those investment banks are working AGAINST the interest of the juniors, all they want is to force the juniors issuing more shares at the next financing. Does that really happen? Although I can't prove it, my bet is that it happens over and over again. All one has to do is to watch the trades going into the close in which many juniors are being submarined on low volumes. Sometimes a junior stock gets hit by 15% going into the close through a sale of a 1000 shares only. Sure enough the seller's objective is NOT to maximize a profitable trade but to paint the tape and bring the stock down.

Now why in your right mind would you be buying juniors if powerful investment banks

are working against the interest of the juniors?

Well, good question..As mentioned above it's my strong belief these fraudulent activities do take place but on the other hand they don't worry me too much. The thing is that all a major investment bank cares for is a profit. They don't care at all whether or not the profits will be achieved by means of (illegal) naked short selling. My point however is that the short selling won't be a profitable trade for ever since markets always do have turning points. The short sellers can push whatever they want but at some point the bargain hunters will be stepping in big time which will put a floor under the junior share prices. Watch-out what will happen next.

In part I, the technical view, I made a case for the CDNX/GOLD ratio to have bottomed out, which translates itself into the simple fact that we've seen the extremes to the down-side and further down-side risk seems to be limited. Yes, they can try to push the junior sector further into oblivion but it will be increasingly difficult to do so. Pushing the extreme undervaluation of the junior shares into even lower extremes is like pushing a car up-hill by hand on a road getting steeper every single foot. Needless to say that resistance will increase with every single step and at some point you'll reach the limits of your muscle power and have to give up thereby surrendering the car to natural forces (gravity). This will guarantee a spectacular down-hill ride for the car. The car starts rolling down gaining speed and momentum. Nobody in his right mind is going to step in front of this rolling car in order to halt it. People willing to push the car by hand again will wait until its speed and momentum are reduced to zero. The same analogy can be applied to our beloved junior stocks. The short sellers can push the undervaluation of the juniors into oversold extremes but resistance will grow. At some point the short sellers will be overwhelmed by bargain hunters (new longs) and have to capitulate. Now the price starts to rise and will attract more new longs. The short sellers won't think twice and starts to cover their established short positions in order to guarantee their profits. God help them if the shorted company makes a discovery while all this happens! The shorts themselves are adding fuel now to the rise in the depressed shares thereby attracting even more fresh buyers (momentum players). Now this whole thing is gaining momentum and no short seller on the side line will get it in his right mind to step in front of these new long-players in order to halt the rise. No, the short seller patiently waits until upward momentum fades away before attacking again. The trend has reversed itself and the very same investment banks who were making money on the short side of the trade will be happy to be making money on the long side now as well, and will most likely be pushing the juniors into extreme over-valuations within a few years from now.

The set-up for the juniors from both a technical and a fundamental perspective is as good as it can get. We find ourselves in the deepest over-sold territories for juniors in 8 years, while majors will be forced to go after them within the next two years.

Now does it mean you have to go out and start buying juniors like crazy?

No, of course not. The thing is that juniors can be accumulated at bargain levels here but sentiment won't be changing overnight. History isn't exactly pointing towards the upcoming summer period as the best time of the year to buy gold stocks, and who knows if we will be facing another short term correction in gold.

The bottom line however is:

Junior gold stocks are dirt cheap these days and junior share holders are likely to benefit within 14 months from now.

NOTE: At the time of writing gold has plunged almost \$30 in two trading sessions to well below the \$900 mark. We've seen this pattern over and over again going into an option expiry only to see it popping back up after the expiry. The reason for this is quite obvious since the commercial dealers will do all they can to make sure the options they've written will expire worthless. I expect this correction to be short lived.

Now what are we supposed to do from here on?

Well, if you are a true believer in gold's future then these are the times to add to your existing gold positions since higher gold prices the years ahead will lift the entire gold share sector. The most rewarding will be those juniors making new discoveries since

new discoveries. Yes, the juniors do find themselves in challenging times and yes, many of them won't even survive but those juniors who do have the fire power (cash) to do the exploration they want and poised for discovery will be the big winners in the end. At golddrivers we hunt for such companies.

Highlights:

- Junior sector just recovering from deepest over-sold condition since late 2002
- CDNX has started outperforming gold over the last few weeks
- Previous bottoms in CDNX/GOLD ratio were being characterized by sharp up-moves that lasted for many months
- CDNX/GOLD ratio charts leave plenty of room for a giant up-move that could last for more than a year
- Sentiment in junior sector has hit an all time low. This is a dream scenario from a contrarian perspective.
- The industry is not replacing the reserves it is mining every year
- High grade mines are running out of ore.
- Even with gold at \$1000 / oz , it still takes four to seven years to open a mine.
- The industry isn't going to be able to respond immediately to higher gold prices.
- Reserves will be depleted in less than 10 years at current annual production rates
- The industry needs some major new finds desperately. Since 1999 only a very few world class gold deposits have been found.
- Majors are forced to acquire juniors because of the need for more reserves
- Sentiment in juniors now similar like sentiment gold shares in May 2004 and May 2005
- History says the time to buy is when sentiment hits rock bottom
- Buying gold shares in May 2004 and May 2005 has paid off tremendously
- Buying juniors now will be paying off most likely within 14 months from now
- The junior short sellers will be having hard times pushing the sector into even lower extremes.
- Short sellers must give up when extremes have reached their limits
- As mentioned in point #1, it seems we've reached the extremes to the down-side
- The extremes to the down-side open a window of BUY opportunities

Please feel free to drop your comments at: ehommelberg@golddrivers.com

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The Gold Drivers Report
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