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SMALL CAP EQUITIES - INSIGHT

What we look for in miners & explorers

When it comes to assessing small cap mining and explorer stocks, IFM Investors looks for five key attributes: quality, liquidity, a pathway to rerating, ESG compliance and portfolio fit.

January 2020

LISTED EQUITIES

1 Quality: but ugly ducklings welcome

Naturally, everyone loves companies with long mine life, low cost, high quality assets with strong management teams in commodities with good fundamentals domiciled in tier one jurisdictions. These companies offer sustainable through-the-cycle advantages. Needless to say, they tend not to come cheap!

The more subtle part of our quality analysis is not what we see today, but what is likely to occur in the future. Using a football metaphor: you need to kick the ball not to where the player is, but to where they're going to be. It's important to identify economic sensitivities around grade and recovery rates, inflection points in strip ratios[1], where the funding pressure points are, and the timing of when assets flip from being cash consumers to cash generators (if ever!).

Sometimes the opportunities are not necessarily obvious. A great example is the Newmont/Buenaventura owned Yanacocha mine in Peru[2], with reserve grade of only ~1 gram per ton located at ~4000m altitude in the Andes – a pretty daunting prospect on paper. From 2000 to 2005, that mine averaged production of 2.6moz per year (peaking at 3.3moz in 2005) at cash costs of only ~US$100/oz! In those years Yanacocha had a strip ratio of less than 1:1 and achieved recoveries of ~70% from a heap leach[3]! Sometimes it's not just about grade.

Of course, things can change overnight in terms of exploration success. Our mandates do not require a company to have a Joint Ore Reserve Committee (JORC) compliant resource for us to invest and we can take a view on exploration upside and district potential.

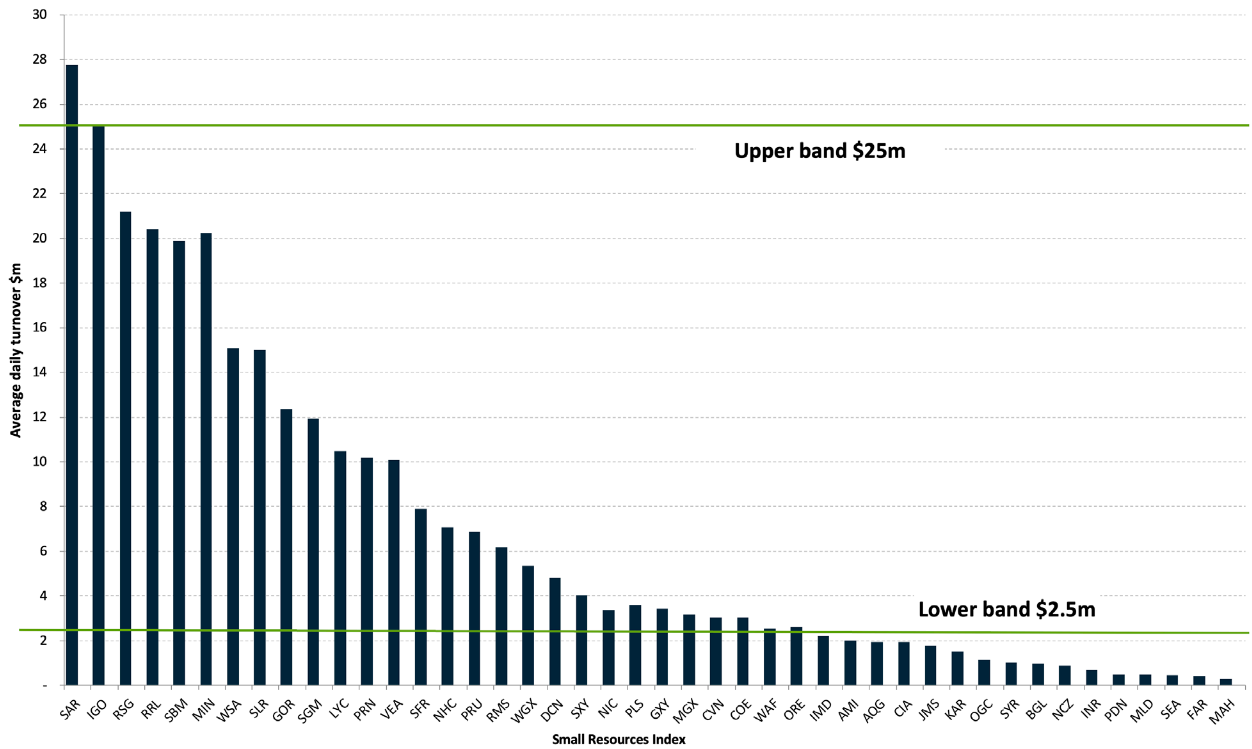
Finally, good management teams are key. Things don't always go to plan in mining (to put it mildly!), and it is worth paying a premium for companies to whom we can outsource those sleepless nights.

2 Liquidity: a brutal reality

Liquidity is a primary investment consideration. In these volatile times, it is important to be able to tilt the portfolio, or indeed liquidate positions, as required, in a reasonable timeframe. For example, with 50 stocks in a $1 billion portfolio, the average position size is $20m. Taking into account position sizing and benchmark weights, portfolio positions can range from $5m (as a practical minimum) up to $50m. Assuming we trade 20% of the market, this implies a target average daily value »

[1] The strip ratio measures the volume of waste rock that needs to be mined to obtain a tonne of ore.
[2] IFM Investors does not hold shares in Newmont/Buenaventura.
[3] Heap leaching is a chemical process that is used in mining to extract metals (like gold) from other earth materials.

FIGURE 01 **SMALL ORDINARIES INDEX**



Source: IRESS, IFM Investors, 28 October 2019

traded of between $2.5m and $25m to trade a position in 10 business days. As Figure 1 shows, the majority of mining stocks in the Small Ordinaries Index are closer to the low end of this liquidity range.

3 Get the rerates, avoid the derates

Explorers and miners are familiar with the "Lassonde curve", the chart which conceptualises the risk and value proposition of an asset as it moves from a discovery to a mature producing mine. In practice though, Degrussa or Nova[4] type discoveries don't come along too often, and share prices rarely follow the script!

Diversifying from a single asset company to multi assets is a good way to rerate in our small cap universe. Northern Star Resources (NST) started with the Paulsens gold mine, whilst Evolution Mining (EVN, previously Conquest Mining) began with Mt Carlton gold and silver mine[5]. Both are now top 100 companies after numerous successful acquisitions.

Mt Carlton is particularly interesting. That project was stalled because of some tricky metallurgy requiring expensive processing options. Enter Jake Klein, whose experience with refractory ores and relationships with Chinese offtakers from his successful Sino Gold stewardship, brought the right thinking to deliver a cost effective solution and the rest is history.

On the flip side, St Barbara's Allied Gold deal in 2012 was a derating and a near fatal (for the company) event, but it was followed by an extraordinary rerating from 2015, driven by prodigious cash generation from Gwalia[6]. Getting ahead of these events is the holy grail of investing, although needless to say, it's easier said than done.

4 ESG is a journey to be embraced

Environmental considerations are clearly front of mind in the mining sector, given it is an emissions intensive industry, and we consider a broad range of Environmental, Social and Governance (ESG) themes in our investment due diligence. Whilst IFM small cap mandates currently do not exclude mining companies from the investment universe based on climate change concerns, we nonetheless actively engage with existing and potential investments on this issue.

Mining companies have always been aware of their environmental impact and the majority of those we invest in continue to improve their ESG practices and performance. Some examples include:

- the installation of solar farms to back up diesel fired power generation;
- technology to minimise underground emissions and improve ventilation;
- rehabilitation of land;
- providing employment opportunities for local and indigenous communities; and
- in developing economies, the provision of health, education, power and water to local communities and promoting sustainable business opportunities that survive the planned life of mine.

The ongoing focus on ESG issues from investment managers and within the mining industry is expected to result in further improvements over time.

We also engage with companies on social and governance issues, including human rights, labour relations, culture, corporate governance and executive

[4] IFM Investors does not currently hold shares in Independence Group (Nova) or Sandfire Resources (DeGrussa).
[5] IFM Investors does not currently hold shares in NST or EVN.
[6] IFM does hold shares in St Barbara at the time of writing.

remuneration that have increased significantly in importance. It's no longer adequate that companies only focus their attention on delivering financial benefits to their shareholders. In August this year, 181 CEOs of US companies, including JPMorgan Chase, Apple, Amazon and Walmart, signed a new "Statement on the Purpose of a Corporation", which affirms that companies have a "fundamental commitment" to all their stakeholders, putting employees, suppliers and communities on a pedestal previously occupied solely by the shareholder[7].

This notion has already gathered significant momentum in Australia, with ESG an important and growing component of investment analysis. At IFM Investors, for instance, we are proactive supporters of the 30% Club, promoting, as a first step, 30% female representation on ASX200 Boards.

The consideration of ESG factors is now simply a ticket to the game (the listed market), and companies should be fully engaged with their ESG impacts and doing as much as they can to mitigate negative impacts, sooner rather than later if they want access to listed equity capital. Miners understand better than anyone that people need to go home safely after a day's work.

That said, we recognise that implementing strong ESG processes and meeting best practice governance standards, like majority Board independence and perfect remuneration policies, takes time, as companies navigate the perils of running a real business on limited resources. Hence, we will support companies that may not currently be complying with "ideal" standards of corporate governance but demonstrate a genuine commitment to achieving an appropriate balance and improving over time.

5 Portfolio construction: the whole is greater than the sum of the parts

Key portfolio construction measures include tracking error (risk) and liquidity (how long it takes to get in and get out of a position). Provided these are within prescribed bounds, there is a "risk budget" within the portfolio that enables us to introduce a limited number of less liquid, higher risk but higher return opportunities into the fund (of which there are plenty in resources). This may include a top tier asset in a geopolitically higher risk jurisdiction, or a pre Joint Ore Reserves Committee (JORC) resource exploration play. We use this risk budget very sparingly, but it does introduce some early stage opportunities. A current example is the Victorian explorer Staveley Resources (SVY).

CASE STUDY The rise of passive investing: Silver Lake Resources

Passive investing is becoming a much more significant force in the market. For example, Van Eck in the US runs two global gold equity Exchange Traded Funds (ETFs). The large cap ETF, GDX, was launched in May 2006, and currently has around US$11.4b held in 45 stocks. The small cap ETF, GDXJ, was launched in November 2009, and currently has around US$4.3b held in 73 stocks. The ETF has a 53bp management fee, and is designed to give investors globally diversified exposure to the gold mining sector without stock specific risk. Australian gold miner, Silver Lake Resources (SLR) is a member of the GDXJ. Van Eck's last substantial holdings filing with the ASX for SLR was in November 2018 at 6.0%.

SLR offers a good example of a fundamental rerating that was accentuated by passive investing. On 14 November 2018, SLR announced an agreed merger with Doray Minerals (DRM) for an effective nil premium. In our view, the merger made good fundamental sense. Apart from corporate synergies, comparable narrow vein underground assets and portfolio diversification, the merger brought cash to the well-operated but otherwise cash-constrained Deflector mine. As shown in Figure 2 on page 4, from the start of 2019, SLR strongly outperformed the A$ gold price, the US$ gold price and its peers in the Australian gold equity index, peaking 170% higher in July 2019 while the Australian gold peer group was up (only!) 50%. Note too, trading volume in the stock increased considerably compared to 12 months ago.

To be clear: we think this was a good deal for both parties. SLR has also performed exceptionally well at its combined operations in 2019, and a rerating relative to peers is fundamentally warranted.

DATE	EVENTS IN 2019	SHARES TO TRADE (M)	VALUE TO TRADE (A$M)	% OUTSTANDING TO TRADE
8-Mar-19	Announced inclusion into S&P/ASX300	8.6	6.2	1.7%
5-Apr-19	Completion of SLR/DRM merger - Index buying	2.0	1.7	0.6%
5-Apr-19	Completion of SLR/DRM merger - ETF buying	18.6	15.6	2.3%
6-Sep-19	Announced inclusion into S&P/ASX200	35.6	37.4	4.3%
	TOTAL	**64.8**	**60.9**	**9.3%**

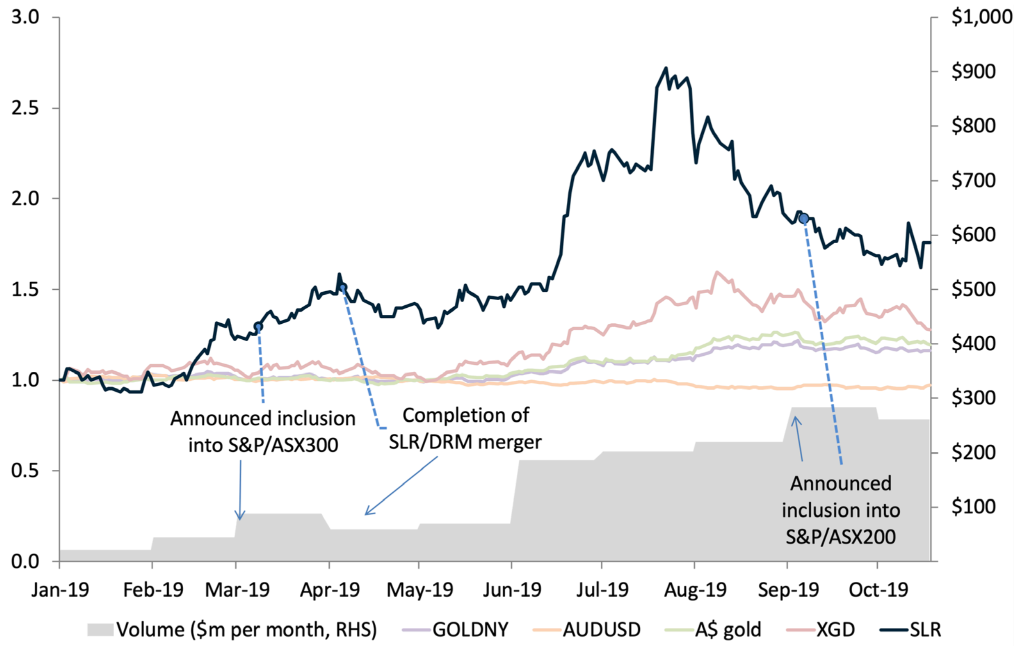
Source: IRESS, IFM Investors, 28 October 2019

Past performance does not guarantee future results, which may vary.

[7] Source: https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans

CASE STUDY CONTINUED

FIGURE 02 SLR VOLUME



Source: IRESS, IFM Investors, October 2019

However, in our estimation, the rerating was accentuated by net buying of around 65m shares from passive investors, which represented around $60m of value or 9.3% of shares outstanding (on a weighted average basis). This is summarised in the table below. In this analysis, we have only assumed passive buying from ASX indices, and the Van Eck gold ETF. We have assumed that inclusion in the ASX300 generates circa 1.5-2% of the register in new demand, and inclusion in the ASX200 equates to a further 4.5-5% of the register in additional demand. Furthermore, according to Morgan Stanley data, since March 2007, inclusions in the ASX200 outperformed the market by +7.1% for the period from 20 days prior to announcement up to implementation.

This obviously works in reverse too - if a company disappoints, then passive buying usually turns into passive selling. Van Eck substantial holdings filings (>5%) in the Australian miners since the fund's inception, have been almost as high as 20% of the register which is takeover territory. So, the ETF impact on share prices and liquidity can be profound. The resulting volatility has created significant opportunities for active investors to make money.

Benchmark inclusion has another benefit, aside from passive investing – it puts a company on the radar for active managers. Fund managers typically have an index based benchmark, requiring them to be a bit more deliberate about not owning a particular company in the index. Unlike a non-index stock, it can hurt their relative performance if it goes up, particularly if it carries a large weighting.

Fundamentals remain as important as ever

Rapid growth in passive and quant investing in all its forms has led to changes in equity markets. For active managers, it has added volatility, and widened the gap in valuation between the large and small miners/explorers. But the move into passive investing is perfectly rational as it is an effective way to deploy large and ever increasing amounts of capital into equity markets while diversifying risk at competitive fees. It helps our clients to get equity linked returns, while also lowering their Management Expense Ratios. So it fulfils a role and is here to stay.

But passive investment doesn't deliver alpha. It also doesn't provide funding for mines and exploration. Active and fundamental investing not only provides the capital required to build mines of the future, but, done well, it offers potential alpha for those investors participating in that end of the market. So, we believe active investing is necessary to ensure the integrity of market valuations... and keep the machines honest!

For the time being, riskier asset valuations are suffering from global forces, like trade wars and slowing growth. This is a cyclical phenomenon, and part and parcel of ordinary mining cycles. At this point in the cycle, there tends to be money available for those cash generating companies that don't need it, but not much for the aspiring developers and explorers who do. Since markets are cyclical, the pendulum will swing back, and our job is ultimately to ensure that money goes to the right projects to generate the "best" returns.

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