Friday, July 6, 2018

HALLGARTEN & COMPANY

Portfolio Strategy

Editor: Christopher Ecclestone
cecclestone@hallgartenco.com

Model Mining Portfolio:

Early Onset Summer Doldrums

Performance Review – June 2018

Model Mining Portfolio

Early Onset Summer Doldrums

- **Nerves are on edge (in a good way) in the Uranium space in expectation of some pro-domestic industry initiatives from the Trump Administration**
- **Weed-induced euphoria is sucking the air out of the room for mining juniors in Canadian capital markets**
- **The Gold price has flirted with the dangerous $1,200 per oz mark and silver has been looking weak**
- **Exploration remains deeply out of favour with little money flowing towards this activity signaling a lack of resource pipeline down the track**
- **Base metals have rolled over badly in recent weeks with Zinc particularly badly hurt**
- **The gloom in the Lithium space deepens as it becomes clear that there is no need or rationale for three quarters of the players in the space**

Coking Coal – Lack of Pipeline is the Key

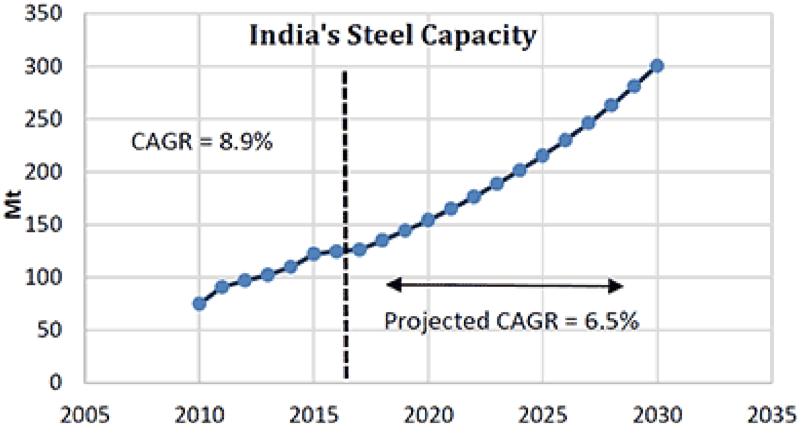
The lack of sophistication in investors being unable to differentiate between coking coal and thermal coal didn't much matter between 2011 and 2016 because both were out of favour. The key differentiator is that Thermal coal is largely burned for electricity, while coking coal is a key ingredient in steel production.

Since 2016 a resurgence in steel industry activity and some climatic events that effected supply (particularly out of Queensland) has meant that coking coal has had something of a rebound. This has not been reflected significantly in the prices of up and coming producers largely because of sweeping assertions by investors that "coal is dead" in the wake of the Paris Climate Accords. If coking coal is dead then most steel production will disappear.

The main motor of global coking coal growth has been China for well-nigh two decades now, however that may be about to change. At the moment China has about a 6.7% GDP growth rate, but is being outpaced by India, which is the rising steel star, pulling ahead with a 7.36% GDP growth. In addition to China and India, most of the coal from British Columbia is sold into other eastern Asian markets, although a significant amount is also sold into Europe.

The outlook is for the Chinese and the Indians to be short of coking coal going forward. India has bought coal out of northeast British Columbia during the current decade and quite a few coal companies are now looking at opening up markets through joint venture companies with Indian groups.

Projected Indian steel capacity from Metal Bulletin can be seen at the right.



India is not a name that is mentioned as much as it should be despite that its steel production is now estimated at 125mn tpa. While China and India produce some coking coal, India is only able to supply very limited amounts and not of a good quality. The forecast growth of Indian steel production could have a significant effect because, even if they don't take coking coal from British Columbia, the coal must originate from somewhere, thus displacing supply to other markets (such as South Korea), so the knock-on effect of greater Indian purchases is the factor to consider. The actual amount of seaborne coal shipped worldwide is about 240mn tonnes per year. The bulk of this originates from Australia. When one looks at the coking coal demand by 2030, India alone will need around 210mn tonnes, around 122mn tonnes more than currently.

The reasons behind coking coal staging a dramatic recovery are multifarious. During the past few years of low coking coal prices, production was cut back in all the main exporting countries. The old story of "taking out capacity spurs a price rally" is repeated. From 2011 to mid-2016 the coking coal market was driven by both the reality and the perceptions of the direction of the Chinese economy. On the supply side it has been substantially affected by what the Australian producers were doing. The Australian dollar came down and the Australians ramped up their production. Some have viewed this as a strategy to knock the Americans out of the market. Some US producers had started to think about shipping out of British Columbia ports to remain competitive in Asian markets. This proved largely to be futile and the US producers have been squeezed out of Asia by access issues and the overvalued US currency.

Price Trends

It was inevitable that, with the Commodities Supercycle being driven by the Chinese and the key underpinning of that Supercycle being steel, that coking coal should have been driven up by that economic phenomenon and then sucked back down as sentiment turned against bulk minerals and, indeed, all minerals after 2011.

According to World Steel Association, 70% of steel produced today uses coal, and China is the most important part of the puzzle as it produces half of the total crude steel in the world.

China's crude steel output reached 808 million tonnes in 2016 and Metal Bulletin Research estimated that production would set an official record of about 840 million tonnes in 2017. As China is the largest producer and consumer of metallurgical coal, this increased crude steel output has pulled coking coal prices higher as can been seen in this chart of coking coal prices from 2013 to 2017 below:

Source: Platts, Steel Business Briefing

Beyond the rising coking coal demand in China, there were new restrictions on the mining industry which reduced domestic supply and put further upward pressure on metallurgical coal prices since last year. Metal Bulletin reported that the Chinese government implemented a cap on the number of working days for miners, which curbed domestic production of metallurgical coal and helped push prices higher. Hence the dramatic "rising from the dead" of the coking coal price from mid-2016 that saw the price treble (something no other mineral, excepting Cobalt, has managed) which then prompted the inevitable pullback.

These impetuses from China coincided with interruptions in supply, notably in the world's largest producing region of metallurgical coal, Queensland in Australia. A trigger for the soaring prices in April of 2016 was a cyclone which broke down railway links transporting coal from the mines to the ports. After miners declared force majeure due to floods and landslides after the cyclone, Australian exports halved from March to below four million tonnes in April.

Steelmakers scrambled to find an alternative supply of coking coal and prices spiked. The shortfall led large buyers in China, Japan and India to increase their imports from Mongolia, Russia and Mozambique.

As the chart below shows prices have now stabilized at a more sustainable level at around twice their 2016 lows.

Source: INO/Platts

It is important to note that Canadian and Australian coking coal vendors are operating with a strong competitive currency advantage in comparison to US producers.

Colonial Coal – Cobbling Together an Empire

Over the last month we launched coverage of Colonial Coal and added a position to the Model Mining Portfolio. This is the first time we have ever had a coal position. Our thinking here is that underinvestment has left the voracious steel industry with little in the way of future pipeline of HCC assets and that the players have been exploiting the assets of the "last go around" without considering replacement. Colonial Coal was brought to life in 2005 and became a publicly-traded company on the TSX-V Exchange in late 2010 via an RTO, with a name change to Colonial Coal International Corp. It has two HCC assets in British Columbia, Huguenot and Flatbed.

The Huguenot Coal Project covers a total area of 9,531 ha and consists of one contiguous block of 17 coal licenses that encompass previously explored deposits. The property is located approximately 125 road-km from the currently idled Quintette mine load-out and 132 road-km south-southeast of the town of Tumbler Ridge, and is amenable to open pit and underground mining. The coal quality is reflective of a premium, hard coking coal (HCC) product.

In broad terms the game plan at Colonial Coal is to repeat the strategy that company's founder, David Austin, pursued at the two coal companies he had previously founded, Northern Energy & Mining and Western Canadian Coal. The latter company was sold to Walter Energy in late 2010 for $3.3 billion while in 2011 Anglo acquired the remaining 25% of PRC (held by NEMI and Hillsborough Resources) for $166mm ($664mn for 100%).

Later that year, in November 2010, Western Canadian Coal was put in play when its key shareholder, Audley Capital, agreed to sell its 19.8% stake to Walter Energy of Florida. Walter Energy quickly tried to buy all of Western's shares, leading to the exclusive negotiations between the two parties. Eventually in December 2010 a takeover of Western by Walter Energy was agreed upon. Walter Energy was attracted to Western for easy access to Asian markets because of Western's operations in British Columbia. Walter eventually went into bankruptcy protection and, their wholly-owned northeast British Columbia coal assets were purchased by Conuma Coal Resources in 2016. Conuma re-opened the Brule and Perry Creek mines in 2017.

Possible Outcomes

It is useful to consider the similarities between now and when the previous Western Coal and NEMI deals were consummated. A number of years have gone by since the last fevered moment in the coking coal space but it is interesting to look at some differences between now and then:

- In 2010, coking coal was at US$140 per tonne and the US Dollar was at parity with the Canadian dollar
- In 2018 coking coal is at US180 per tonne and the US dollar is at $1.29 to the Canadian dollar

The move in price and currency juices up the valuations at which asset sales are likely to be transacted compensating for the absence of the euphoria that existed at the tail end of the Supercycle period when the last bout of transactions were undertaken.

It should also be remembered that back at the end of the last decade it was widely posited that the acquirers would be steel mills in Asia or at least big industrial mining groups, particularly from China while, in reality, the most aggressive bidders were Western mining groups bent on accumulation.

This time around it will be both the Western groups (needing to replace depleted reserves to remain in the game) and the end-users who will most likely slug it out to get positioned in new developments.

The measure that we would employ to assess the potential dollar value of a Huguenot sale would be a rough US$1 per tonne of HCC in the ground. This would give a valuation of USD$278mn to Huguenot on just the M&I resource and potentially another US$119mn when applying the same metric to the Inferred resources. With the current market cap around US$55mn this would imply that the stock is trading at one tenth of Huguenot's value alone using the very conservative $1 per in-situ tonne metric.

We have therefore classified Colonial Coal as a LONG and adding a position to the Model Mining Portfolio with a 12-month target price of CAD$1.10.

Portfolio Changes

There were three portfolio changes during June.

- Opened a Long position in Colonial Coal. Acquired 400,000 shares in CAD.v at CAD 35 cents per share on June 4th.
- Closed our Long position in Western Uranium. Sold 60,000 shares in WUC.to at CAD 83 cts per share on June 4th.
- Closed our Long position in Nyrstar. Sold 15,000 shares in NYR.br at Euros 4.95 per share on June 4th.

The Portfolio Move

Despite the strong performance of our Shorts, the early onset of summer doldrums caused the Model Mining Portfolio to retreat to $5.112mn from the $5.303mn registered at the end of May. Cash rose slightly from $1.49mn to $1.502mn.

Cobalt27 – Cornering Cobalt as a Strategy?

We found ourselves having to explain the Hunt Brothers' "silver corner" from the 1980s to investors the other day, which in itself was disturbing that they had never heard of it. The catalyst for this subject arising had been a presentation by Cobalt27 just shortly before at the Mining Journal Select conference held in London mid-month.

While the boosters for this stock refer to it as a "physical ETF" or a "stockpiler" we cannot help but seeing it as trying to push the price of Cobalt up by purporting to have removed supply from the market thus making a scarce metal scarcer. This is a logic that the Hunt Brothers would have felt comfortable with until it ceased to work. When we commented to listeners that this was reminiscent of Dacha Capital in the Rare Earth "boom" we also faced blank looks. That Dacha went the way of all things is known to those who followed it but it also serves as a lesson for the enthusiasts of Cobalt 27 who have piled in for bigger positions in the stock in recent weeks.

Personally we are feeling more comfortable with our Short position instituted at $12.43 now that the stock is trading nearly 30% lower.

The latest plunge has been promoted by a classic overreach in buying offtakes from Vale and others on Nickel-Cobalt mines to "fund" expansion of those mines. The companies with which Cobalt 27 has done these transactions could have funded expansion out of cashflow or at fine rates in the capital markets due to their sheer size of operations. So why do a deal with Cobalt 27? We suspect it's because the majors are neither Cobalt bulls nor can they resist the temptation to "take candy from babies". But what do they know?

To fund this gorging on offtakes, Cobalt 27 Capital launched a 30.8 mn share offering which produced an epic case of indigestion amongst its investors and sent the stock plunging. The company advised that the offering closed on June 27, 2018, for gross proceeds of $300.3mn, crystalising an instant and sizeable loss for all the players in the name.

This "offtake", and the financing for it, represented a transformation of the company from a stockpile above ground to one which also had a stockpile in the ground. But by admitting that a stockpile in the ground was there to be had it effectively shouted "Fire" in the crowded nightclub in which reveling investors were celebrating Cobalt's scarcity. If it was that easy to buy offtakes from majors then was Cobalt all that rare? Speculative investors did not want to hang around to find out and jammed the exits.

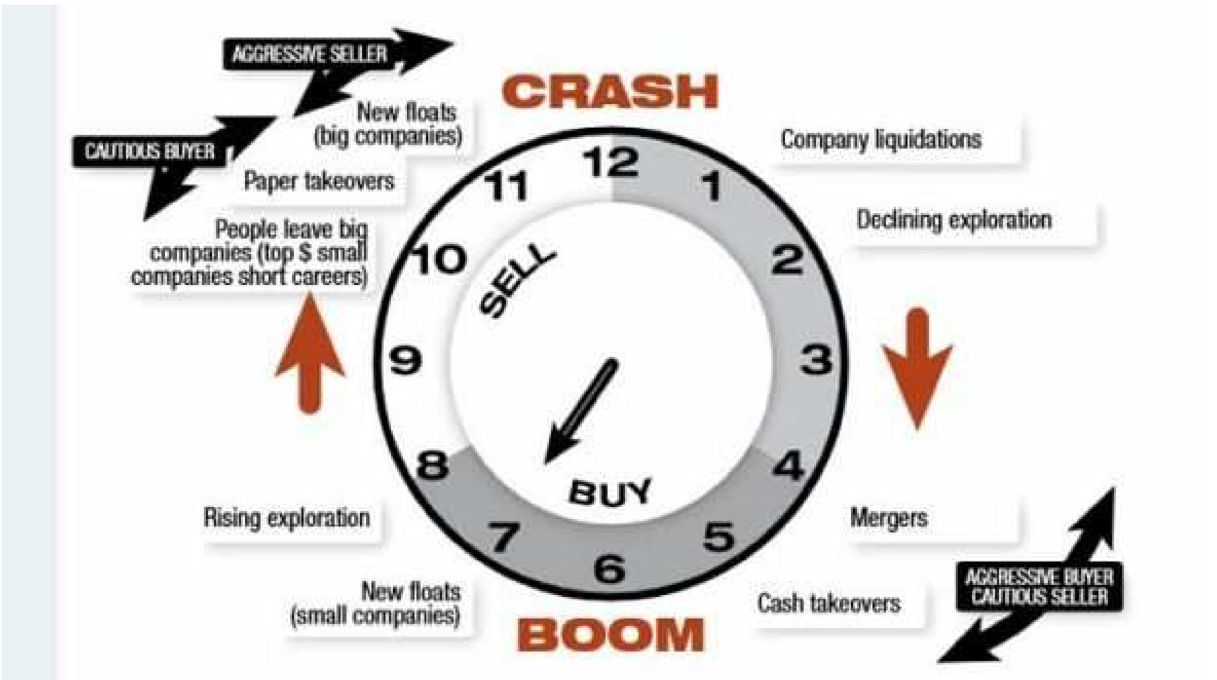
The charred remains of those who got in at $14 are now piled up on Bay Street and the fading rhythm of Disco Inferno can be heard in the distance.

The stock has shot past (to the downside) our Short closing target of $9 so we shall watch it closely in coming weeks with a view to closure.

Parting Shot

Julian Baring who died aged 64 in 2000 was described in his obituary in the Daily Telegraph as an "Ebullient scion of banking dynasty who became London's 'Gold Guru'". Despite coming from the Baring's banking family, he mainly made his name at the stockbrokers James Capel and later as manager of gold funds for Mercury Asset Management. In the view of many he was the City's most articulate and enthusiastic proponent of gold and gold-mining shares. His name comes up often in conversations in mining circles despite him now being long gone.

One of his inventions was something called the *Resource Clock*. This consisted of a clock face on which one would "mark the time" of the mining investment cycle and try and work out when to exit before it all came crashing down… as it so regularly does. Below can be seen a stylization of this clock and different firms in the financial space have adopted it and stuck their own names (and spin) on it.



Source: Lion Selection

At midnight we have the darkest hour… though the darkest hour is supposedly just before the dawn. In this case midnight equals the Crash in market values. Then comes a grim aftermath of liquidations, asset sales, and bankruptcies. Then the gloom lifts, buyers gingerly appear, things improve, money flows in, capital is raised, new float occur, M&A, prices soar and then it all comes to grief again.

We were prompted to think of this recently when someone made the comment that the Australian mining market was moving into the last phase of the clock. Then we thought, “hang on.. most of the other markets are just entering the boom period” so how can the end be nigh? This then generated the thought that this clock may be useful for a high-level assessment but like the World Clocks that one sees the time is different in different markets (and in different metals).

We would posit that while Australia may be at 9 o’clock that London and Toronto are at 6 o’clock or earlier. Developmentally the Australian “boom” does not appear all that mature, even though valuations are rich. The equation there being that Super funds can put massive amounts of capital to work swiftly which feed into valuations faster than the boom can mature in terms of corresponding M&A or new listings or even new mines.

The Canadian market is not seeing any great wave of listings and several of its go-go sub-spaces such as Lithium and Cobalt are looking tattered. We are underwhelmed by the amount of money that has been raised and general agreement seems to be that cannabis and blockchain stories have been sucking the oxygen out of the market. Resource clocks should be made of sterner stuff (to mix some metaphors).

London also appears to be heathier for smaller stories but is not having major demands made upon it for big financings as so many of the large players have strong balance sheets, reasonable cashflows and manageable debt requirements. Without big financings it’s hard to tell whether this is an absence of supply or an absence of demand. Again though this is scarcely the stuff of which the last leg of the Resource Clock is made of.

So we have (resource) clocks in disconnect here and definitely we would say that averaging things out the clock has a long way to run unless this is going to be a feeble mining cycle indeed.

Mining Model Portfolio as at: 6-Jul-18

	Security	Initiated	Currency	Price Avg.	Current	Portfolio Weighting	Increase in Value	Target
Long Equities								
Various Large/Mid-Cap	Teck Resources (TECK.B)	5/29/2009	CAD	22.46	32.53	9.7%	44.8%	$38.00
	NevSun (NSU)	3/23/2012	CAD	3.45	4.35	5.0%	26.1%	$5.00
	Sherritt International (S.to)	7/11/2013	CAD	1.78	1.11	3.8%	-37.6%	$2.50
	Metals X (MLX.ax)	29/5/2014	AUD	0.98	0.73	2.2%	-25.4%	$1.00
Trading House	Noble Group (CGP.SG)	15/11/2017	SGD	0.20	0.06	0.9%	-69.8%	$0.30
Uranium	Uranium Participation Corp (U.to)	10/20/2010	CAD	7.01	4.15	2.4%	-40.8%	$6.00
	GoviEx (GXU.v)	6/29/2015	CAD	0.08	0.22	6.0%	167.7%	$0.50
Zinc/Lead Plays	Zinc ETF (Zinc.L)	1/15/2010	USD	7.04	7.89	2.4%	12.1%	$11.00
	Canadian Zinc (CZN.to)	12/9/2011	CAD	0.82	0.14	0.4%	-82.9%	$0.70
	Ascendant Resources (ASND.v)	10/31/2016	CAD	0.49	1.00	6.7%	104.5%	$1.70
	Telson Mining (TSN.V)	3/19/2018	CAD	0.79	0.77	6.1%	-2.5%	$2.00
	Southern Silver Exploration (SSV.v)	8/25/2016	CAD	0.27	0.485	2.8%	79.6%	$0.94
Gold Producers	Para Resources (PBR.v)	2/17/2017	CAD	0.23	0.19	2.2%	-17.4%	€ 0.58
	Westgold (WGX.ax)	12/6/2016	AUD	2.01	1.74	3.5%	-13.4%	$2.40
Copper Producer	Coro Mining (COP.to)	2/23/2015	CAD	0.03	0.11	2.5%	266.7%	$0.30
	RNC Minerals (RNX.to)	11/17/2016	CAD	0.33	0.11	0.8%	-66.7%	$0.60
Coking Coal	Colonial Coal (CAD.v)	6/4/2018	CAD	0.35	0.34	3.1%	-2.9%	$1.10
Royalty Trust	Abitibi Royalty (RZZ.v)	5/31/2017	CAD	9.10	9.94	2.5%	9.2%	$18.00
Beryllium	IBC Advanced Alloys (IB.v)	4/29/2016	CAD	0.30	0.33	0.8%	10.0%	$1.40
Driller	Cabo Drilling (CBE.v)	9/28/2016	CAD	0.03	0.01	0.5%	-60.0%	$0.08
Tungsten Producer	Almonty Industries (AII.v)	7/31/2015	CAD	0.36	0.95	10.9%	162.1%	$1.00
Copper Explorer	Asiamet Resources (ARS.v)	4/28/2016	CAD	0.05	0.1	3.5%	103.0%	$0.12
	Panoro Minerals (PML.v)	1/22/2018	CAD	0.28	0.37	2.5%	30.4%	$0.65
	Western Copper & Gold (WRN.to)	4/25/2017	CAD	1.57	1.08	2.5%	-31.2%	$2.74
Lithium	Neometals (NMT.ax)	7/31/2014	AUD	0.04	0.31	3.4%	737.8%	$0.45
	Lithium Power Intl (LPI.ax)	10/25/2017	AUD	0.44	0.27	1.8%	-38.6%	$1.38
Scandium Explorer	Scandium International (SCY.to)	8/23/2016	CAD	0.14	0.14	1.9%	0.0%	$1.00
Gold Explorer	Banyan Gold (BYN.v)	11/14/2017	CAD	0.07	0.07	2.1%	0.0%	$0.25
Graphite Producer	Elcora Resources (ERA.v)	29/5/2014	CAD	0.20	0.22	2.5%	10.0%	$0.64
Graphite Developer	Talga Resources (TLG.ax)	8/25/2016	AUD	0.27	0.64	3.6%	141.5%	$0.90
REE Explorer	Northern Minerals (NTU.ax)	6/9/2011	AUD	0.23	0.09	1.3%	-61.6%	$0.28
	NET CASH					1,502,397		
Short Equities						**Weighting**		
Shorts	Bacanora (BCN.L)	12/4/2015	GBP	0.83	0.899	25.80%	-8.90%	£0.60
	Lithium Americas (LAC.to)	10/25/2017	CAD	10.10	6.84	26.6%	32.3%	$5.00
	Cobalt27 (KBLT.v)	4/6/2018	CAD	12.43	8.77	29.2%	29.4%	$9.00
	Galane Gold (GG.v)	4/28/2016	CAD	0.06	0.06	18.30%	0.00%	$0.03

Current Cash Position	**1,502,397**
Current Liability on Shorts Not Covered	**274,775**
Net Cash	**1,777,172**
Current Value of Bonds	**0**
Current Value of Long Equities	**3,335,820**
TOTAL VALUE OF PORTFOLIO	**5,112,992**

Important disclosures

I, Christopher Ecclestone, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

Hallgarten's Equity Research rating system consists of LONG, SHORT and NEUTRAL recommendations. LONG suggests capital appreciation to our target price during the next twelve months, while SHORT suggests capital depreciation to our target price during the next twelve months. NEUTRAL denotes a stock that is not likely to provide outstanding performance in either direction during the next twelve months, or it is a stock that we do not wish to place a rating on at the present time. Information contained herein is based on sources that we believe to be reliable, but we do not guarantee their accuracy. Prices and opinions concerning the composition of market sectors included in this report reflect the judgments of this date and are subject to change without notice. This report is for information purposes only and is not intended as an offer to sell or as a solicitation to buy securities.

Hallgarten & Company or persons associated do not own securities of the securities described herein and may not make purchases or sales within one month, before or after, the publication of this report. Hallgarten policy does not permit any analyst to own shares in any company that he/she covers. Additional information is available upon request.

Hallgarten & Company acts as a strategic consultant to Northern Minerals, Para Resources, Colonial Coal, Panoro Minerals, Telson Mining and Lithium Power International and as such is compensated for those services, but does not hold any stock in those companies, nor has the right to hold any stock in the future.

Web access at:

Research: www.hallgartenco.com