Big brother exploration funding on the rise

Mining Journal – May 16, 2019
Finance > Capital-markets
David Upton

From a global perspective, Australia in 2019 looks like a good place for mineral explorers. Unlike Canada and the US, the junior exploration sector in Australia has not been ravaged by the flight of so-called hot money to cannabis start-ups.

And while sentiment among ASX investors towards junior explorers and developers has still not turned around from the dark days of 2015 and 2016, the amount of money being spent on exploration is on a clear upward trend.

Richard Schodde of MinEx Consulting, a Melbourne-based mineral economics firm with a global reputation, is all over the Australian numbers.

"I certainly wouldn't say the Australian exploration scene is in the doldrums. Exploration spend in the December 2018 quarter was A$577 million, which is up 90% from the low point of $303 million in June 2016 in real terms," Schodde said.

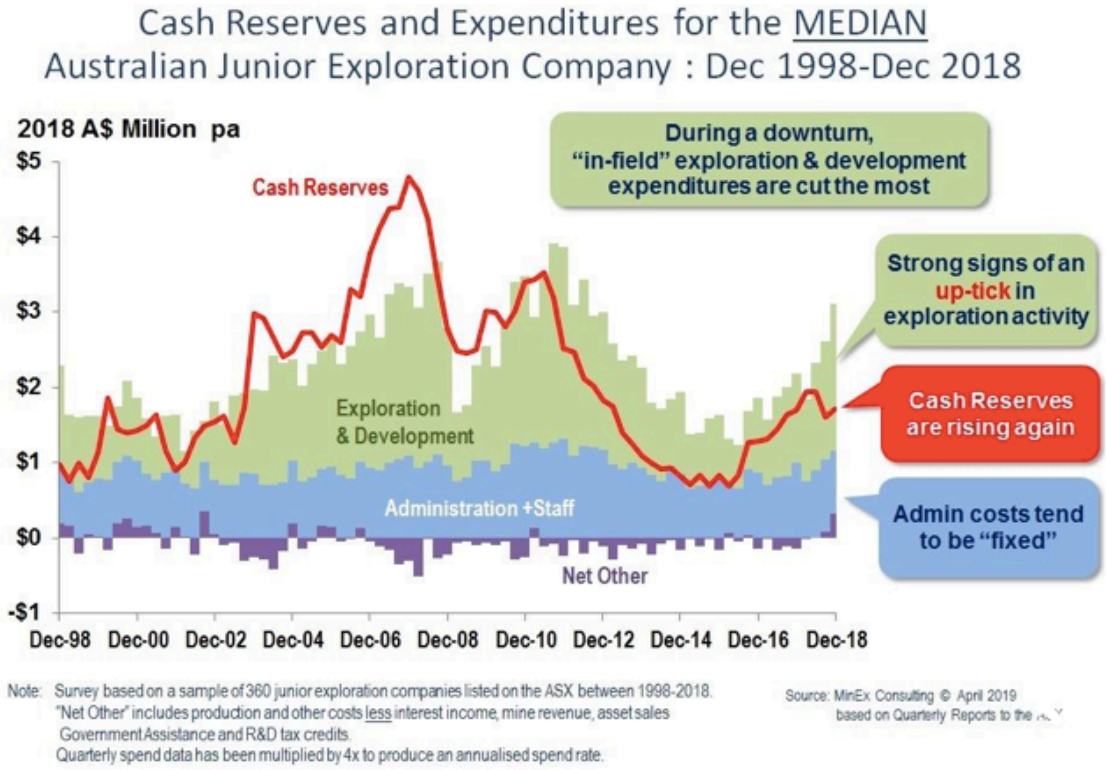
He said the December 2018 quarter was still well below the peak of about A$1,200 million a quarter in the heady days of 2012, but noted the boom-time numbers were pumped up by exploration for bulk minerals, mainly iron ore and coal.

"If you strip them out, the current level of spend on gold, base metals and other minerals is getting close to the levels incurred back in the boom years."

Schodde closely monitors the health of the junior sector by sampling the quarterly reports of the 600-plus junior explorers listed on the ASX. His data shows the average cash balance of ASX junior explorers has lifted from a low point of about A$700,000 in 2015 to between $1.5 million and $2 million.

"Juniors can still raise capital in Australia and on average have been able to refinance their business over the past three years. They whinge and complain, but I don't think the current situation is any more difficult than most of the normal periods that people have been operating."

His data also shows the juniors are spending money much faster than in the past, but believes this reflects they are chasing good projects at the moment after being forced by the downturn of 2015 and 2016 to spend a lot of time on desk top studies.



While statistics suggest the junior sector is in reasonable shape and will be able to continue to draw on the ASX to fund exploration, one of the country's leading greenfield explorers and chairman of Australian Geoscience Council, Jon Hronsky, has a different view.

"The equity markets are currently very bad for junior explorers, and in fact, probably even worse for junior developers, despite the strong fundamentals for the metal sector around the battery thematic and other megatrends, and the decline of major mines.

"Even companies that are releasing unambiguously positive results often see their share price go backwards. Results have to be absolutely sensational to move the market in a positive way. The reason for this is that the capital for the junior sectors largely comes from the speculative, retail end of the market and this has largely lost interest. In terms of what happens next, I think we will see an increasing number of junior companies finally having to throw in the towel," Hronsky said.

He believes there will be "a lot less" funding of frontier exploration from the junior sector and less money spent trying to develop the smaller scale projects they usually focus on.

"At the same time, I think we are seeing a general increase in the emphasis on exploration among the mid-tier to major tier companies. It seems like senior management have finally started to realise that exploration success is an existential issue. The mining boom brought forward all those marginal resources sitting in the wings and now there is basically nothing left. This response has included both an expanded focus on their own exploration efforts by majors such as Rio Tinto and BHP and an increased effort to partner with selective juniors. I think this has been one of the more significant recent trends," Hronsky said.

He argues the increasing technical difficulty of exploration is also weighing against junior explorers, and that industry funding needs to change.

"As exploration becomes more technically challenging, junior companies need to improve their skills and also develop more of a longer-term, portfolio approach. A funding model based on multiple repeated capital raisings, each one typically at a discount and usually directly linked to a program with a binary outcome in the short term - because this is more or less the only thing that money can get raised for - is extremely poorly suited to the above requirements."

One of Australia's leading specialist resource investors, Hedley Widdup of Lion Selection Group, also believes there are tough challenges ahead for junior explorers that could see their numbers dwindle.

"At present, equity market funding is only very selectively flowing to juniors. This end of the market has been sporadic, at best, since the mining market ticked up in 2016. The difference in performance between majors, which are up by multiples, and juniors, most of which are at a lower price than they were in Jan 2016, is causing people to ask if something is broken in the market. I don't think that's the case, but I feel like the pitch of despondency about this is reaching a peak. So I'm wondering if we are close to a turning point for sentiment toward juniors."

Although juniors will be ecstatic if sentiment finally turns, Widdup believes the funding model is fundamentally mismatched with the challenges ahead for junior explorers in Australia.

He said exploration was an iterative, scientific process that rarely generates success at the first pass. "You need to approach the exercise knowing that follow on investment will be required. This works best where there is a suitable balance sheet/cash flow to fund a budget that is enough to do the work, and a close relationship between the CEO as the budget gate-keeper and the exploration leader. These two need to be able to communicate so the technical findings of exploring are understood and future budgets obtained. But juniors don't have the budget, and the CEO isn't the budget gatekeeper - the market is."

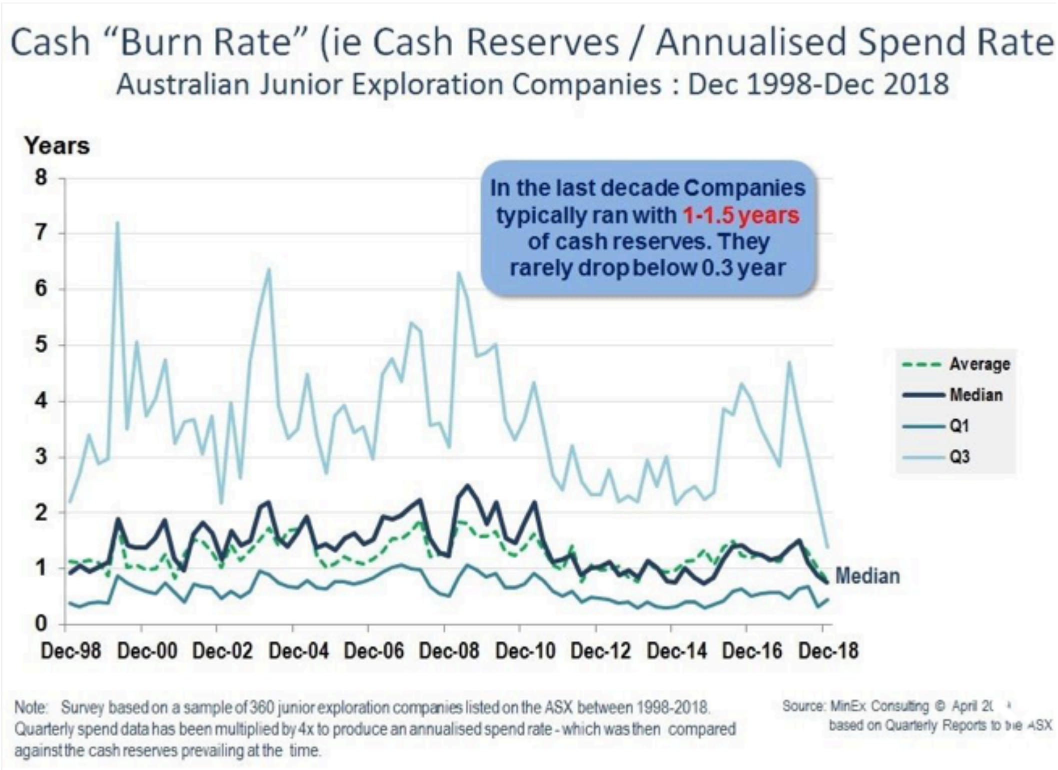
Widdup also argues junior explorers are getting offside with investors by not shouldering a fair share of exploration risk.

"The junior model has a lot of romantic appeal - an entrepreneur taking a risk on a concept and potentially reaping a reward if they are successful, alongside their backers. But the reality doesn't work like that - as we all know, entrepreneurs who take the same risk as investors are few and far between, and the norm is wages and other compliance costs consuming a large amount of funding that is raised. If these inefficiencies can't be rectified, then the market will be hesitant to provide funding."

"I can see the number of juniors withering as a result, but reinvention or disappearance is a slow process - it takes a very long time for a company to keel over even after it is essentially out of money."

So what does the future look like for junior exploration funding in Australia?

Schodde said juniors with quality projects would not necessarily need to change. He said juniors who were serious explorers with quality projects would always be able to raise funds through the ASX, although he agreed these companies were also more likely to get their funding support from mid-tier and major companies. "The majors have woken up to the fact they have to be involved in the junior sector, and are on the lookout for quality projects."



Hronsky believes we will see more of what he calls the "project generator" model. This is where the junior identifies the early stage opportunities and then JVs them with a mid-major in a deal structure that sees them end up with 20-30%.

Recent examples of this include Encounter Resources, which has a group of five joint ventures with Newcrest Mining in the Tanami and West Arunta provinces of Western Australia and the Northern Territory. The joint venture was initially on a 50:50 basis, but Newcrest has stepped up its involvement by sole funding expenditure to earn up to 80%.

OZ Minerals has also been actively expanding its joint ventures with project generators over the past 18 months. The most recent is a "Greenfield Discovery Alliance" with Red Metal, which is a set of option and joint venture deals over six projects. The deal set a new benchmark for joint venture relations between mid-tiers and juniors by allowing Red Metal to retain the right to contribute at 49% even after OZ Minerals has spent up to A$15 million.

Hronsky said another possibility was that of a private equity-style fund managed by technically savvy investors, which selectively invested in early stage juniors but also brought technical clout and rigorous decision making. Hronsky and a group of former Fortescue Metal Group executives have gone down this path by setting up Ibaera Capital, which has about A$100 million at its disposal and West Africa gold explorer Azumah Resources as its flagship investment.

Widdup sees the future bringing even greater investment in juniors and their projects by mid-tier and major companies.

"I believe interest in juniors by those companies is above historical levels. I think this is because this is a rapid way to become active on potential growth avenues without taking a massive leap. And I think we will see more. It is an efficient way to manage a portfolio of exploration without having it all in house, and suits the way that particularly the majors seem to operate - like investment banks with mining assets.

"Ultimately, it will lead to big miners buying little ones. Not every investment they make will lead to M&A outcomes, but this must be in their mind as a possible outcome at the outset.

Like exploration success, equity market will enjoy this and speculate on who is next, which is another stimulant for market sentiment."

He also argues that juniors should rethink what it takes to obtain capital for the risky business of exploration, and follow the lead of entrepreneurs in other high-risk industries.

"I think there is a requirement for juniors to regain an entrepreneurial initiative.

"This could be done by adjusting their remuneration expectation from a cash-based salary towards higher risk/higher reward for genuine success."