Canadian Resource Stocks, Down But Not Out

Canada & US Index Returns

Zimtu Capital Corp. is a TSX Venture listed investment company focused on private, micro, and small-cap resource companies.
ARE CANADIAN EQUITY MARKETS UNDervalued?

Defining “fair value” for the broad Canadian equity market (the aggregate of individual public companies) is a difficult task, not to mention a legal quagmire. However, looking back into the equity market’s performance over the past thirty years helps to assess key market drivers, identify long-term trends, and permits the use of expected relative value. Our findings were then carried forward and applied to forecasts of Canada’s economic performance. In terms of domestic Canadian equity markets, there are two primary indices that we measured. The S&P/TSX composite index (TSX) is the primary index for measuring the performance of larger capitalization companies; and the TSX Venture Composite index (TSX-V), is the index for the junior companies with smaller capital structures and where growth is the main focus.

As a first step, historical semi-annual GDP data since December 1982 for Canada was regressed against the TSX. Not too surprisingly, the results show that the TSX market is highly correlated to domestic GDP growth with a coefficient of determination (R²) approaching 90% based on a sample size of 61 observations. A little less intuitive, we applied the model’s findings to derive current and forward estimates of the TSX index using IMF forecasts for Canadian GDP. The TSX current value of 12,129 as of Jun 28th is close to the relative value the model estimated of 12,865 points. It appears that if the Canadian economy grows slowly, as the IMF expects, then big Canadian stocks are on average about where you would expect them to be.

As a next step, the correlation between the daily index levels for the TSX and the S&P/TSX Venture Composite Index (TSX-V) was analysed. Since January 2003, there has been a positive correlation of 59% between the two indices, indicating a historically positive relationship exists.

Economically, this relationship is not surprising given how increasing wealth affects investor risk appetites and how positive economic performance increases capital flows through to the middle and large market entities. Strong economic expansion over most of the 30 year period – although not as of late – tends to push up asset prices making individuals feel wealthier and

“Bull-markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria.” – Sir John Templeton

In the long-run, GDP growth is the main driver of equity returns for large capitalization companies, as measured by the S&P/TSX Composite Index. We find the current value of the TSX to approximately equal the expected value generated from our model.

Historically, there exists positive correlation between the S&P/TSX Composite Index and the S&P/TSX Venture Composite Index. We find the current value of the TSX-V to be significantly below the expected value generated from our model.
thus, increases their risk appetite. An increased appetite for risk and a strong labour market serve to increase capital flows into the more leveraged smaller capitalized companies. At the same time, strong corporate earnings provides an incentive for companies with cash flow and ready access to capital markets to grow their asset base through acquisitions. Rio Tinto’s recent acquisition of Hathor Exploration is a good example of how liquidity restrained junior equities which have valuable assets under their control, can still be very attractive even in difficult times.

Current and forward estimates derived from a regression of the TSX-V against the TSX indicate the Venture exchange is in unexpected and unwelcome territory. Based on our model, the value of the TSX-V as of June 28th is at a discount to even the lower bound of a 95% confidence interval. Graphically, using log-normal index returns over the last ten plus years shows just how far the TSX-V has deviated from its expected trajectory (Graph 1). Relative to the large capital TSX and on a historical basis, the Venture market is at a significant discount to its expected value (Table 1).

The IMF and others are still positive on Canada’s economic prospects. So while value may be an ethereal concept in markets obsessed with momentum investing, the recent breakdown in the correlation between the two markets is intriguing. Arguably and at some point, the valuation gap will close and it appears that the Venture market has the potential to move higher, perhaps significantly higher.

### WHY THE LARGE DISCREPANCY IN RELATIVE PERFORMANCE BETWEEN THE TSX AND THE TSX-V?

Part of the discrepancy in the relative performance between the TSX and TSX-V is due to the individual sector weightings that make-up each index (Graph 2) as shown in year-end MiG reports from the TMX website. As of December 31st 2010, the mining, and oil & gas sectors (MOGS) represented 42% of the TSX, and 85% of the TSX-V, by market capitalization. Over a two year span ending December 31st 2012, the market capitalization of the TSX contracted by 2.6%; whereas, the TSX-V...
V contracted an astounding 43.2%. Mining was the worst performing sector, falling 26.8% within the TSX and 54.1% within the TSX-V. Though not as horrific, the oil & gas sector also performed poorly, contracting 14.5% and 35.0% within the TSX and TSX-V, respectively. Some of the greater volatility witnessed in the performance of individual sectors is to be expected due to the number of exploration and start-up companies listed on the TSX-V that rely on infusions of equity capital to fund project development without cash inflows from operations. The ability to raise funds by issuing new equity in turn relies on investor sentiment.

However, though the overall performance of resources stocks are significant to both indices, the TSX-V has and is dominated by natural resources listings. In contrast, the financial services sector was a major driver of support for the TSX over the time period in question, increasing its market capitalization by 7% to represent almost one quarter of the index. The TSX-V is without large financial institutions that can take advantage of historically low interest rates.

So, the recent divergence in performance between the TSX and TSX-V is also partly explained by investor preference to own perceived dividend paying safe-haven equities as quality rated fixed income yields have fallen. Large financial institutions, REITs, and established pipeline & utility companies, with access to low cost capital and the ability to pay healthy dividends have been the beneficiaries of this trend. However, this divergence cannot last indefinitely, as the performance of these sectors are inversely sensitive to movements in interest rates. A return to economic normalcy should again lead to increasing investment into cyclical industries where future demand growth is the focal point. Further, the responsibility of the financial service sector is to efficiently allocate capital by investing savings generated domestically and abroad into assets that are believed to offer the best risk adjusted returns. This is a value added proposition. The initial value creation is through the entrepreneurial endeavours of individuals, partnerships, and companies. The combination of an improving global economy and Canada’s strong banking system should equate to strong inflows of investment capital.³

³ Robertson, Grant, “Canada’s banks make grade in world standings”, Globe and Mail, May 9, 2011
WILL NATURAL RESOURCES REMAIN THE FOCUS OF INVESTMENT SPENDING IN CANADA?

The performance of the natural resources industry is an integral component to Canada’s well-being, and the demand for most commodities is tied to the health of the global economy. If the world isn’t growing, then it follows that much of what Canada has to offer – namely energy and materials – is of limited interest and value to the big investors who set the tone in the markets these days. The consequences of continued poor performance by energy and materials will eventually have pervasive negative impacts on other sectors in Canada such as real estate and financial services. Luckily, the IMF forecasts appear more optimistic. The median annual global growth rate over the ten year period preceding the GFC in 2008 was 4.1% The IMF forecasts global growth to increase to 3.8% in 2014 and remain above 4% through 2018 (Table 2). The materialization of this scenario is a potential catalyst for Canadian resource stocks over the medium-term.

Intuitively, sustained periods of investment spending should lead to job creation, and therefore significantly influence real GDP growth. In the case of Canada, YoY declines in investment spending have led to immediate increases in unemployment; while improvements in unemployment following a positive reversal in investment spending appears to lag. This is most likely due to cost control efforts by firms whereby, during an economic downturn variable costs such as labour are curbed. While during an initial upturn in the business cycle, firms will most likely invest in fixed capital to improve operational efficiencies from existing operating assets before hiring new labour. Therefore, the current national unemployment rate above 7% should not retard future growth and is more likely a lagging indicator (Table 3).

### TABLE 3: CANADIAN ANNUAL INVESTMENT TRENDS

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<tbody>
<tr>
<td>Real GDP growth (%)</td>
<td>4.21</td>
<td>5.17</td>
<td>5.12</td>
<td>1.74</td>
<td>2.82</td>
<td>1.99</td>
<td>3.17</td>
<td>3.11</td>
<td>2.65</td>
<td>2.09</td>
<td>1.10</td>
<td>2.80</td>
<td>3.17</td>
<td>2.57</td>
<td>1.84</td>
<td>1.46</td>
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<tr>
<td>Real Investment growth (%)</td>
<td>3.14</td>
<td>3.58</td>
<td>4.95</td>
<td>(2.86)</td>
<td>3.41</td>
<td>5.42</td>
<td>7.44</td>
<td>9.42</td>
<td>6.54</td>
<td>3.54</td>
<td>1.27</td>
<td>(11.94)</td>
<td>10.56</td>
<td>3.72</td>
<td>5.65</td>
<td>0.88</td>
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<tr>
<td>Unemployment (%)</td>
<td>8.29</td>
<td>7.57</td>
<td>6.83</td>
<td>7.27</td>
<td>7.67</td>
<td>7.58</td>
<td>7.18</td>
<td>6.76</td>
<td>6.30</td>
<td>6.08</td>
<td>6.15</td>
<td>8.29</td>
<td>7.99</td>
<td>7.47</td>
<td>7.29</td>
<td>7.26</td>
</tr>
<tr>
<td>YoY Commodity Price Index change (%)</td>
<td>(15.08)</td>
<td>8.80</td>
<td>26.56</td>
<td>(11.66)</td>
<td>(6.31)</td>
<td>19.49</td>
<td>20.94</td>
<td>26.19</td>
<td>5.76</td>
<td>7.22</td>
<td>21.83</td>
<td>(32.13)</td>
<td>22.83</td>
<td>16.66</td>
<td>(6.69)</td>
<td>2.02</td>
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Source: IMF, Bank of Canada, and Zimtu Capital estimates
Additionally, recent periods of strong economic growth in Canada have loosely overlapped rising international energy and industrial commodity prices, as witnessed in 1999-2000, 2003-07, and 2010-11 (Table 3). The outlier being the robust GDP growth experienced in 1998, which decoupled from the underwhelming commodity price performance. It follows, that we assume a significant portion of investment in Canada since 1998 was spent within the natural resources sector.

Looking forward, there are reasons to be optimistic on a further continuation of the global commodity bull market which Canada has been a beneficiary of. The IMF estimates the pull-back in real investment spending experienced by Canada in 2013 to be relatively mild compared to 2009, before increasing in 2014 (Table 3). The Bank of Canada’s Financial Conditions Index (FCI), a weighted average of different financial variables, is positive indicating a healthy financial system and should be associated with economic growth (Graph 3). Further, the US economy continues to stabilise and is expected to grow for the next several years; while non-OECD incomes are projected to continue their wealth convergence with their developed neighbours (Graph 4).

China has quickly become the marginal buyer of industrial and energy commodities, as can be seen by the increased volatility in the Bank of Canada’s commodity price index since the historic US-China trade deal known as the China Trade Relations Act was ratified late in 1999 – the precursor to China’s ascension to the World Trade Organization (WTO) on December 11, 2001. Much noise has been made of a possible Chinese economic slowdown. However, the projected annual real growth rate for the world’s second largest economy is 7.8% in 2013 and is expected to remain around 8% through 2018. Importantly, though the Chinese economy in aggregate is quickly catching up to the US, China is still substantially behind on a per capita basis. Therefore, strong Chinese economic growth could persist well into the future as Chinese leaders transition the economy away from mercantilism, instead focusing on growing domestic

The IMF, a well-respected global institution, is forecasting improved Canadian economic growth in 2014. The Canadian economy has significant exposure to commodities. It follows that improved economic performance will require a healthy natural resources industry.
consumption by targeting massive inequality and corruption – already a stated goal of the Chinese politbureau.

Furthermore, India which has lagged behind China in both aggregate economic size and in its ability to elevate its population into the world’s middle class is poised to overtake China in population as early as 2025 at current growth rates. Measured using a ratio of purchasing power parity (PPP) GDP per capita, an individual in India would be expected to have a relative wealth of only 1/13th that of their American counterpart, and approximately 2/5th that of their Chinese counterpart. Much further infrastructure development is needed if India is to catch up with China on the path of converge with OECD countries on a per capita basis - adding additional upside for Canadian natural resources. Therefore, the recent poor performance of Canadian commodity stocks coupled with continued growth in China and India (together representing nearly one-third of the global population) may have created an attractive entry point for investors with long-term horizons.

WHEN WILL CANADIAN COMMODITY STOCKS TURN?

An interesting survey undertaken at Societe Generale measured the strength of the relationship between quarterly European equity returns and bond yields since 1995. Somewhat surprisingly, the sector with the strongest positive relationship, with a beta of almost 0.5 and a multiple R² of 64%, was Metals & Mining. It follows that though mining can be a fairly capital intensive industry, mining sector stock returns appear more leveraged to top line growth rather than capital costs. A similar study was conducted in the US by William O’Neil & Co that found energy to be the best performing sector during periods of interest rate increases.7 Extending these relationships to the cyclical commodity sectors in Canada, it may be an encouraging sign for resource stocks if we observe a sustained gradual rise in bond yields.

The TMX group estimated that 70% of all global equity financing for the mining industry in 2012 occurred in Canada.8 However, the US has the most liquid bond market in the world and yield movements there should impact Canadian bond yields all else

7. William O’Neil & Co., Table: “Energy and Materials Show Most Outperformance During Rate Increase Period”
held constant. Therefore, we estimate US market expectations for future interest rate levels and apply as a directional proxy for bond yield changes in North America. The expectation being rising Canadian bond yields will move in tandem with rising US yields. We derive monthly forward US yield curves with one year terms to maturity using average monthly interest rate swaps published by the Federal Reserve and compare the results with trends since 2001. Spot rates appear to be bottoming while forward one year rates appear to be in the early stages of an upward trend since hitting a low in November 2012 (Table 4). As well, US corporate spreads continue to narrow, and as of January 2013 fell below their monthly median average since 1919 of 96 basis points, indicating investors perceive reduced market risk. Assuming forward rates are market expectations of future spot rates, their increase toward a historic median level combined with improving economies would indicate both greater market optimism, and incentivise firms to front load planned business investment in an effort to avoid higher future costs of capital. In fact, the 10-year US Treasury yield has stabilised back above 2% as many market participants project the curtailing of the Federal Reserve's quantitative easing program in the third quarter.\(^9\) The fact that the US economy has rebounded enough since the Great Recession for the market to contemplate an eventual exit by the Federal Reserve from credit markets is telling, and is potentially a bullish scenario for the Canadian natural resources sector.

Prior to PDAC 2013, Bloomberg reported the average junior mining company had enough cash at the start of March to meet only 5.7 months' of obligations. So unless, these junior mining companies that were surveyed are able to find financing and/or significantly reduce their cash burn ratio, many will have to sell equity or assets at discounts to their net present value. Unfortunately, in the current market environment, middle and large market companies have been loath to spend money and acquire new assets. This may be due to recent large write-downs on previous acquisitions, and cost overruns on what were anticipated to be flag ship assets. Overpriced acquisitions have forced the departure of two high-profile mining CEOs - BHP Billiton's Marius Kloppers, and Rio Tinto's Tom Albanese. Kloppers resigned after a 58% fall in second half-year 2012

A bullish scenario for cyclical commodity stocks can be envisioned as early as Q4 2013, leading to positive performance for the TSX-V in 2014.

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operating profits and billions in write-downs. While Rio Tinto’s Tom Albanese departed after approximately 70% of his infamous $38 billion purchase of Alcan was written off.\textsuperscript{10} Perhaps even more troubling has been the inability of large mining and energy companies to control cost inflation. For example, major cost overruns forced the departure of Anglo America’s Cynthia Carroll and caused large scale planned projects to be abandoned, including Australian Woodside Petroleum’s $45 billion offshore LNG project and Canadian Suncor Energy’s C$11.6 billion Voyageur oil project.\textsuperscript{11} The industry is currently going through a transition period for both newly installed and existing senior management teams alike to redefine and refocus their core business operations.

However, many of these companies still have substantial cash flows and access to low cost financing. Once senior management teams at these various mining conglomerates have settled in, the combination of potential excess cash positions and depressed asset prices could create a buyers’ market as early as the fourth quarter of 2013; lifting Canadian commodity stocks and the TSX-V.

Market participants who are eager to invest should first do their due diligence and look for companies with:

1. Proven management and technical teams
2. Economically attractive projects in politically safe jurisdictions
3. Appropriate share structures, and
4. Adequate cash balances

The current value of the TSX-V is now less than 30% of its 2007 high and could decline further. However, a stabilising global economy and improving consumer optimism could provide a floor for the TSX-V. A popular investor saying, “buy low, sell high” may soon come back into vogue.

Derek Hamill
Research & Communications


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**Zimtu will issue research on each of the following major holdings:**

**TSX: WPX – Western Potash Corp.**
- Full feasibility study completed and all mining permits granted on Milestone deposit. AMEC America’s Ltd. Estimates a $2.44BN NPV and IRR of 18.6%.
- Zimtu Capital holding: 2.7MM shares and 2.7MM warrants.
- Total exposure per 1000 ZC shares: 503

**TSXv: CCE – Commerce Resources Corp.**
- Positive PEA on two separate assets; Blue River Tantalum/Niobium Project in British Columbia and Ashram Rare Earth Project in Quebec.
- Zimtu Capital holding: 3.8MM shares.
- Total exposure per 1000 ZC shares: 328

**TSXv: LK – Lakeland Resources Ltd.**
- Newly formed uranium Exploration Company focused on the Athabasca Basin.
- Management and technical team with successful track record.
- Zimtu Capital holding: 4.4MM shares.
- Total exposure per 1000 ZC shares: 383

**TSXv: PF – Prima Fluorspar Corp.**
- Exploring and advancing the Liard Fluorspar Project in British Columbia.
- Recently became publicly traded.
- Zimtu Capital holding: 7.2MM shares.
- Total exposure per 1000 ZC: 656

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Coming Soon….
Questions? Contact Us.

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