



A Guide to Natural Resource Investing

By Rick Rule and
Sprott Global Resource Investments, Ltd.

A Note From Rick Rule, Founder and Chairman of Sprott Global Resource Investments, Ltd.



Dear Friends and Fellow Investors,

Thank you for your interest in natural resource investing and Sprott Global. I'm delighted to have this opportunity to share with you the collective experience and insights our organization and I have accumulated over the past 30 years of investing in the sector.

My primary responsibility at Sprott Global is to ensure that our organization acquires and analyzes as much information as possible on companies in the resource sectors. Our analysts and I spend our time interacting with company management teams, attending resource-related conferences globally, analyzing geological data, assessing myriad extraction-related risks, and personally visiting exploration and development sites around the world in order to identify opportunities for our clients.

It is my hope that this guide will arm you with some basic information to help in your own research, as well as give you some insight into our investment approach and philosophy. As you read this material, please call us with any questions or comments at **1.800.477.7853** or send us an e-mail at **contact@sprottglobal.com**. You can also visit our web site at **www.sprottglobal.com** where you will find more detailed information and links to recent media appearances by Sprott analysts.

Thank you again for your interest and for allowing us to provide you with this information.

Sincerely,

A handwritten signature in black ink, appearing to be 'RR' followed by a long, sweeping horizontal stroke.

Rick Rule

Fundamentals of Junior Resource Stock Analysis

Successful speculation in junior resource stocks* involves solving a fundamental riddle – how do you *anticipate* exploration success before the financial community *reacts* to the success. The current bear market in precious metals gives you one leg up, as out-of-favor investments tend to have fewer specialists involved in the analysis of the companies in the sector.

Another advantage is gained through *diversification*. Placing all of your eggs in one basket often breaks your basket. While diversification does not ensure a profit nor guarantee against a loss, we always prefer a *group* of intelligently selected speculations to one large bet, no matter how compelling the story. A contrarian, counter-cyclical orientation helps, as well – in other words, avoid, when possible, the “herd mentality” of buying during roaring bull markets and selling at the depth of bear markets.

In exploration and speculation, success has typically followed those who use the best tools with consistent discipline. In the following pages, you’ll find some of these tools. The answers to the following ten questions can help you decide if you want to bother following, much less buy, a specific stock.

1 – VALUE

“What is the current liquidation value of your company versus the market capitalization?”

Compare the company’s actual value if auctioned off tomorrow against the value the market places on all of its outstanding shares. If the market capitalization (‘cap’) is greater than the liquidation value, there may be a “rat in the feed bag.”

Speculation can’t stand on one leg alone. You have to forecast both the upside and downside. When promoters are trying to sell a stock, you’ll hear how precious metals will soon soar, how exploration will soon hit the Mother Lode, and how their promotion will boost the stock’s price. That’s all great, but we have to weigh all of that against the downside, and **value** is the scale we use to do so. Nothing reduces risk like plain old value. If a company is not in a viable business, there’s no reason to buy it.

A company is only worth what it owns. Add up all the current assets (such as cash), subtract the liabilities, and add the liquidation value of the company’s projects. Liquidation value is what the projects would bring, as-is, in a sale today.

What is the market cap? For a rough estimate, multiply outstanding shares by the current market price. With 10 million shares outstanding at \$2.50 per share, the market capitalization is \$25 million. If this company has \$5 million in cash and no debt, its net financial assets are 20 per cent of market cap.

For example, assume the company owns four exploration properties. With a cold and steely eye, assign each of them a value (this is where the analysis of a seasoned economic geologist comes in handy). Now, add them all up. We’ll say in this example the properties are worth an estimated \$12.5 million, so with the \$5 million in financial assets, a liquidation value of \$17.5 million, versus a market cap of \$25 million. If the management can answer the other questions well, this could be a sensible speculation. More often than not, however (especially in bull markets), we find market caps exceeding liquidation values by an uncomfortable amount.

2 – PERSONNEL

“Tell me about your management team and directors, especially their past success in mining and markets.”

Why do we need to understand the track record of the technical team, the directors, and the dominant shareholders? While *deposits* are discovered, a *mine* must be built. It takes *technical prowess* to turn a mineral deposit into a producing mine. It takes *financial prowess* to access the capital so crucial to mining, so the management team must include experienced and proven fundraisers.

Do their skills fit the job? If the team cut its teeth strip-mining oxide gold deposits in Nevada, it may break those teeth on an underground silver, lead, zinc sulfide deposit in Peru. We favor teams who stick to their areas of expertise: highly skilled

* A “junior resource stock,” for purposes of this discussion, refers to the stock of companies with market capitalization under \$500 million engaged primarily in exploration or pre-production activities in the extractive industries sector.

exploration teams that decide they are going to become mine-builders and operators concern us; we prefer they sell to experienced operators, instead. The reverse can hold true, as well: mine *operators* are often poor mine *finders*. The tasks do not resemble each other, and the mindset that is successful in one field is often unsuited to the other.

Look at the controlling shareholders' track record, as well. Have they made money for investors in previous deals? It is not enough to make a mine; we want to make *money*. Be picky here, too. Can the dominant entrepreneur transfer his or her experience to the project at hand? While past performance is never a guarantee of future results, we always favor teams and controlling investors who have a history of success.

Finally, but importantly, are the insiders at the company major shareholders? We want key executives who stand to get rich off the company's equity, not live well off a salary. Key executives need sufficient desire and drive to succeed, and should be focused on this company, not trying to run four different ones. We want the insiders to be just as keen as we are to see share prices increase.

We prefer to get to know management teams over time, and along the way, perform low-level background checks on their credibility, career background, personality wrinkles, etc. We also try to visit the corporate offices to gauge how cash is used on items that don't generate shareholder value.

3 – HOW AND WHEN

“How are you going to make me money on this deal, and when will I make it?”

This is the question the promoters want you to ask, but make sure you control the conversation so they actually answer it. I once heard a stockbroker explaining a venture capital investment in a technological process. One potential investor asked, “How does the process work?” The broker replied, “It works fine!” Beware of such answers.

Make the promoter explain in detail *how* the company's exploration activities will increase both shareholder value and stock price. Why these questions? We want to understand what sequence of events management believes will occur over time, and how that will affect share prices.

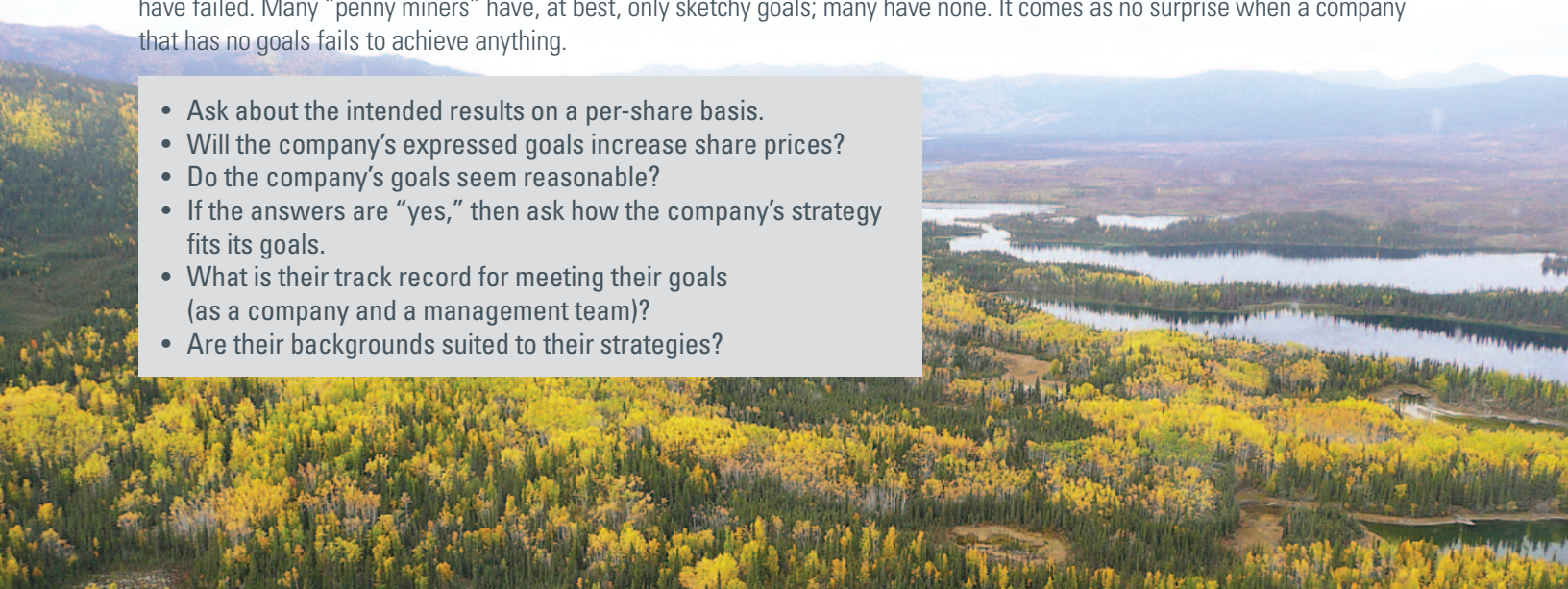
We must assign probabilities to the outcomes forecast and understand their timing and sensitivity. If management does not have a plan outlined, it is probably too early to buy. If the company refuses to keep us informed, or if they promise but do not deliver, we must consider selling the stock. If management does not have a geological theory with a plan to explore and prove it, it is probably too early to buy. If the financial or discovery results are below what we have been led to expect, we should sell the stock.

4 – GOALS AND STRATEGIES

“What are the company's goals and what strategies will it use to reach them?”

Thousands of public companies specializing in precious metals exploration litter the investment landscape. The vast majority have failed. Many “penny miners” have, at best, only sketchy goals; many have none. It comes as no surprise when a company that has no goals fails to achieve anything.

- Ask about the intended results on a per-share basis.
- Will the company's expressed goals increase share prices?
- Do the company's goals seem reasonable?
- If the answers are “yes,” then ask how the company's strategy fits its goals.
- What is their track record for meeting their goals (as a company and a management team)?
- Are their backgrounds suited to their strategies?



When a company expresses goals, make them get specific. Ask about intended results on a per-share basis. What do you care if cash flow doubles and issued shares increases tenfold? Will the company's expressed goals increase share prices? Some entrepreneurs simply seek to increase the assets they're managing to secure *their* own cash flow.

Do the company's goals seem reasonable? Will they raise share prices if they meet them? IF the answers are "yes," then ask if the company's strategy fits its goals. Many companies look like Don Quixote on his battle mule. Their goals sound grand but they have no clue how to reach them. Measure their goals against the backdrop of the people. What is their track record for meeting goals? Have they succeeded in similar endeavors? Are their backgrounds suited to their strategies?

5 – FINANCING

"How much money do you have, how much money do you need to succeed, and how are you going to get it?"

While no strategy or capital structure guarantees a successful outcome, mineral exploration and production is a capital-intensive business: *no capital, no business!*

Diligent investors will compare the amounts spent by the company on non-project overhead compared to exploration activities, and avoid those where the overhead spend is out of proportion to exploration expenditures.

Start with current assets: cash, stock of other issuers, treasuries, bank deposits, inventories, prepaid expenses, and the like. Then deduct current liabilities. This gives you a rough idea of the net working capital.

Get a detailed description of the monthly (or at least annual) "burn rate". What does it cost for rent, utilities, salaries, promotion, professional fees, listing expenses, etc.? Then superimpose projected exploration expenditures on a monthly basis. If the company has debt, add in debt service payments as well. Diligent investors will compare the amounts spent by the company on non-project overhead compared to exploration activities, and avoid those where the overhead spend is out of proportion to exploration expenditures.

Finally, where will they get the money they need? Years ago at a gold mining conference, I spoke to an erstwhile promoter who did not know my face. I asked him where he would solve his working capital problems and he informed me that a "hot" west coast broker named Rick Rule would raise all the money he needed at much higher share prices. Imagine his surprise when I identified myself and explained the likelihood of his imagined financing taking place.

Make sure management owns LOTS of stock and stands to get rich if they make you money. Self-interest is the market's sharpest spur.

When companies detail their financing plans, ask what conditions apply to the receipt of funds. Decide for yourself whether the companies will receive the necessary cash infusions and on what terms. If possible, get the names of their financing sources, and then contact those sources to verify that the capital is available. See if the preconditions and terms match the company's own understanding.



6 – OWNERSHIP

“Who owns this company? How much did they – or will they – pay for it, and when can they sell it?”

Make the company explain its capitalization history. If there were escrow or founders’ shares – shares issued for \$0.01 to early insiders – *who* got them for *what* service and *when* will they be free to trade them? Determine at what price every financing has taken place. Is the stock from those financings already freely trading, or can it hit the market later with the possibility of depressing share prices? How many options and warrants are outstanding? At what price can holders exercise them?

In other words, is the price asked now reasonable, given what others have paid? If the company recently issued shares at a price well *below* current market price, they made an unflattering public pronouncement about their opinions of the shares’ value. If insiders bought at prices well *above* current market, that might tell a different story.

Make sure management owns LOTS of stock and stands to get rich if they make you money. Self-interest is the market’s sharpest spur. Successful speculators back owners, not employees.

7 – PROMOTION

“Who else will you tell this story to, how will you tell them, and when?”

Promotion often makes the difference between success and failure. Promotion is crucial in capital-intensive businesses because it raises subsequent financing with less dilution and increases liquidity and share prices. Since exploration companies seldom pass out gold watches to 30-year shareholders, you want increasing share prices.

Pin down the promoter:

- Who is the audience?
- What is the message?
- Who is the messenger?
- Do the three mix?
- What is the promotional budget?
- Is that sufficient?
- How will the promoter raise additional capital?
- At what price and from whom?



Make the company, preferably its promoter, detail its promotional plan. Who is the audience? What is the message? Who is the messenger? Do the three mix? What is the promotional budget? Is that sufficient? How will the promoter raise additional capital? At what price, and from whom?

Exploration companies need to adequately fund their promotional budget. They need to schedule at least two management “road shows” that include Toronto, New York or London. They should also organize at least one annual tour of the company’s focus properties for analysts. North American companies that do not appear at the major “gold shows” or large natural resource conferences are at a great disadvantage when it comes to promoting themselves.

Promotion is crucial in capital-intensive businesses because it raises subsequent financing with less dilution and increases liquidity and share prices.

Institutional investors finance exploration, but *retail* investors provide market liquidity. Promoting to only one constituency is a flawed strategy. Retail promotion strategies need to take into account that Canada has 35 million residents while the US has 315 million. Does the company spend their promotion dollars in markets that have the money?

Many Canadian companies know little about US securities regulations. Certain types of promotion may violate US regulations, which have historically become more restrictive each year. Make sure the promoter understands and complies with federal and state laws. If a promoter is not aware of the regulations and/or does not have concrete plans for compliance, forget about their stock.

8 – RISKS

“What can go wrong, how will I know what is going wrong and what will you do if it goes wrong?”

If company management cannot name at least three things that could go wrong, they have not thought through their enterprise. Make them describe their three worst fears for you.

Ask the promoter to describe specifically how you as a shareholder will get negative information and warnings. Ask what signs you should look for and how you will get information that will help you keep tabs on and assess these risks on an ongoing basis.

9 – RELATIONSHIPS

“Who’s buying the beer?”

If a company has answered these questions reasonably well, get to know the promoter personally. No company will ever answer every question perfectly, but candor and reasonable responses will tell you who to spend more time with. As you build a bond with the promoter, get him or her to tell the *real* story. Since your interrogation took control of the promoter’s spiel, you have helped order his or her thoughts about the company. Now, let the promoter lapse into “streams of consciousness,” and listen carefully for tidbits of information you would never get from the canned presentation.

10 – WHERE’S THE DOPE?

“Where can I learn more?”

If you are still interested, this could be a great company. Retrieve their annual and quarterly reports. All public Canadian companies’ reports and filings can be found at www.sedar.com. Read what they hoped to accomplish and compare that to their actual accomplishments. Find analyst and newsletter write-ups on-line, as well as the company’s press releases. *One final trick:* Summarize your understandings in writing and see if you can get the promoters to accept your summary as accurate. Make them accountable for their representations.

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FINAL NOTE

Many of you will read this section and decide that all of this interrogation and research is more work than you want to spend on each opportunity that interests you. You may be delighted to delegate the work to a broker or portfolio manager with a technical and financial background in the resource sector. Others will be up for the challenge and will put in the required effort to become self-educated about their potential investments.

One definition of luck is: *when preparation meets opportunity*. If you (or your broker) prepare yourself with the information discussed above, you will be in a much better position to pursue opportunities that arise in the resource sector.

For those who decide to utilize a broker to get answers to these questions on your behalf, remember that it is this type of individualized service that differentiates a full-service broker from an on-line, discount broker.

Happy Hunting!





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Generally, natural resources investments are more volatile on a daily basis and have higher headline risk than other sectors as they tend to be more sensitive to economic data, political and regulatory events as well as underlying commodity prices. Natural resource investments are influenced by the price of underlying commodities like oil, gas, metals, coal, etc., several of which trade on various exchanges and have price fluctuations based on short-term dynamics partly driven by demand/supply and nowadays also by investment flows. Natural resource investments tend to react more sensitively to global events and economic data than other sectors, whether it is a natural disaster like an earthquake, international political upheaval or release of employment data in the U.S. Low priced securities can be very risky and may result in the loss of part or all of your investment. Because of significant volatility, large dealer spreads and very limited market liquidity, typically you will not be able to sell a low priced security immediately back to the dealer at the same price it sold the stock to you. In some cases, the stock may fall quickly in value. Investing in foreign markets entails greater risks than those normally associated with domestic markets, such as political, currency, economic and market risks. You should carefully consider whether trading in low priced and international securities is suitable for you in light of your circumstances and financial resources. Past performance is not a guarantee of future performance. Spratt Global, entities that it controls, family, friends, employees, associates, and others may hold positions in the securities it recommends to clients, and may sell the same at any time. © 2014 Spratt Global Resource Investments Ltd.