FatTailMEDIA

ROCK STOCK INSIDER

A global network for mining fortunes

INSIDE THIS ISSUE

Buying into Weakness for Greater Upside...

This month's issue will cover a strategy that is aimed to help you make the biggest gains in your portfolio. You will read about my experience buying into dips in the last gold bear market and how that worked out. I will also unveil my latest stock recommendation where I hope to repeat what I did in the past. In my assessment, you could stand to make sizable gains if it goes our way.

Rick Rule talks about how the biggest gains in mining stocks often occur only after the stock has fallen as much as 70–80%. In fact, I personally made my biggest gains by buying into companies that tumbled, doubling down on them, and then watched them recover.

Let me recount my journey.

Back in mid-2013, the price of gold fell almost 30% in a matter of three months. Gold stocks formed about 30% of my portfolio back then. I was stung by the losses on my holdings as they exceeded the gains made in the rest of the portfolio.

You would not believe how much some of these stocks fell!

Newcrest Mining Ltd [ASX:NCM] was $22.25 on 1 March 2013. It fell to $9.87 on 28 June 2013.

Kingsgate Consolidated Ltd [ASX:KCN] was $3.55 on 1 March 2013. It fell to $1.26 on 28 June 2013.

Perseus Mining Ltd [ASX:PRU] was $1.52 on 1 March 2013. It fell to 43.5 cents on 28 June 2013.

The largest company plummeted by almost 55%. The smaller ones being crunched for more than 70%.

What would you do? Sell out and swear off these stocks forever? Hold on and hope for the best?

You would find it hard to justify buying more, right?

But I did just that. I decided to take this as the opportunity to literally replace the other stocks in my portfolio with gold stocks.

That sounds crazy, right?

Not when you listen to the right experts!

I was surfing the net trying to understand why the price of gold was dropping in mid-April 2013. That was when I stumbled onto a website called 'Bull Market Thinking'.

It was the start of my investment journey that has brought me here as your editor.

Tekoa Da Silva owned this website. His research insights opened my eyes into how to invest in gold and gold mining stocks.

He blogged about the fiat currency system, gold price suppression, the benefits of investing in gold mining companies, etc.

Many of his posts talked about using common sense to invest. For example, buying when prices are falling, how to find a good mining company, and the different ways of investing to take advantage of the lower price of gold.

He also conducted interviews with mining legends like Eric Sprott, Rick Rule, Peter Schiff, and many more. These experts talked about their personal experience in investing over the cycles for gold and silver.

A lot of what he said was very sensible. However, it went against what most investors would do because emotions cloud their judgment.

This site no longer exists though. It closed when Sprott Inc hired Tekoa to join their team in February 2014.

Let me share with you one of the many gems he had on his website.

Tekoa talked about buying stocks on a regular basis, which is known as 'dollar-cost averaging'. He showed how dollar-cost averaging investing works better when the stock price is falling and yields better gains than buying a stock that is rising in price.

You buy $2,000 of a mining stock for $1. You own 2,000 units.

And then it falls to 50 cents.

You spend $2,000 to buy 4,000 units. You now own 6,000 units. They are worth $3,000.

It falls to 20 cents.

You spend $2,000 again to buy 10,000 units. You now own 16,000 units. They are worth $3,200.

Now the price rises to 50 cents again.

You spend $2,000 again to buy 4,000 units. You now own 20,000 units. They are worth $10,000.

The price recovers to $1.

You spend $2,000 to buy 2,000 units. You own 22,000 units. They are worth $22,000.

Overall, you spent $10,000 to buy at an average price of 45.5 cents. The current price is $1, so your gain of 55 cents over 45 cents invested gives a 120% profit.

Consider an alternative situation where the stock price keeps rising and you adopt dollar-cost averaging.

You buy $2,000 of a mining stock for $1. You own 2,000 units.

The price rises to $1.25.

You spend $2,000 to buy 1,600 units. You own 3,600 units. They are worth $4,500.

The price rises to $1.60.

You spend $2,000 to buy 1,250 units. You own 4,850 units. They are now worth $7,760.

The price rises to $2.

You buy another 1,000 units. You own 5,850 units. They are now worth $11,700.

The price rises to $2.50.

You buy another 800 units. You own 6,650 units. They are now worth $16,625.

Overall, you spent $10,000 to buy at an average price of just over $1.50 to make a 66.3% profit.

Notice that you actually have less in the second case than the first?

This is even though the stock in the second case rose 150%.

Sure, you have more in your balance in the second case than the first during much of the term of the investment.

You will say that this goes without saying, right? That is obvious!

But why do people tend to buy stocks as they go up? Because emotions drive them to do this. They follow the trend.

The essential condition to making big profits buying the dip is that the stock actually will recover after it has fallen.

If the stock does not recover, you're throwing good money into bad. You need to know when to cut your losses.

Now, how do you know whether a stock has the potential of recovering after it has tumbled?

This is where you need good insight into what you are investing.

The making of a company with huge profit potential

Mining is a cyclical sector. Commodity prices can fluctuate, and these cycles of ups and downs can last for several years. These prices may be driven by both supply and demand for the commodity in the market, as well as the digital contracts traded on the commodities exchange by investment banks and dealers.

The price of gold (and other precious metals) are especially prone to extremes. It can trade well above or below its reasonable range and remain there for a long time. This may put all the players in this industry through a tough test of endurance.

In the April monthly report, I introduced you to my *Valuation-to-Profit Margin* (VPM) approach that decides whether a gold stock is good value or not. You read about how I use the company's *Enterprise Value*, *Cost-Adjusted Production* and *Per-Unit Profit Margin* to come up with a VPM *multiple*. This multiple can be compared against other companies to see which is better value.

You may also recall that on top of the VPM multiple, we also consider the company's debt levels, ability to generate cash flows from their operations, and the amount of in-ground resources in their mines to support future production.

You look at these qualities to build confidence in the companies you own.

There are rare occasions where a company that ticks these boxes are on sale. The good news is that you can find companies that can yield big profit potential even if they don't tick all the boxes.

Let me give you an example.

Buying into a company during their hard times

A company going through a difficult period can offer tremendous opportunities for us. The difficulty may arise from their mines performing poorly for some time, or they have just raised capital to pay down their debt.

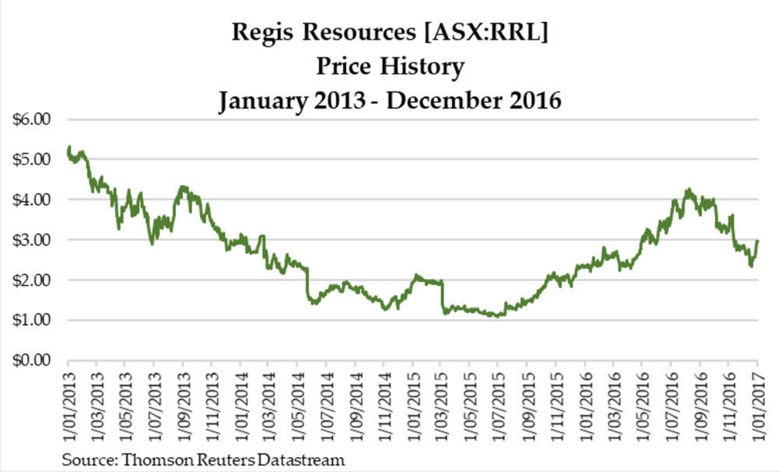
Investing in such a company is like setting up camp in a bush that just had a bushfire ravage the region recently. It's unlikely to burn again for some time.

The only investors still holding are the faithful or the badly burnt.

There is an exception though. Sometimes the fire is so bad nothing grows anymore. Then you just avoid the place altogether.

I first invested in **Regis Resources Ltd [ASX:RRL]** in mid-2013 as a safe haven gold stock. The company managed to stand its ground firmly when other gold stocks could not.

The price history for Regis Resources from January 2013 to December 2016 is given below:



Source: Thomson Reuters Datastream

It traded at $5.11 at the start of 2013. It fell to $2.89 at the end of June but recovered to $4.28 in late August.

Even **Northern Star Resources Ltd [ASX:NST]** fell from $1.23 at the start of 2013 to as low as 51 cents by end of June, before recovering to just over $1 in late August.

Regis Resources had a rough patch in early 2015 during the heavy rain that ravaged much of Australia.

The walls of one of the mines that Regis Resources owned collapsed. Production temporarily fell from an average of 85,000oz a quarter to just over 65,000oz in the third quarter.

Shareholders savaged the company and the price fell from $2 on 2 March 2015 to $1.19 on 10 March. The stock traded in the $1.10–1.30 range until mid-July.

I bought three times during June–July 2015. I acted a bit late because I was unsure when their mine would resume operating.

The company recovered over the second half of 2015 very quickly. It traded at $2.32 at the end of 2015 and $3.42 at the end of June 2016.

From February 2014 to end of June 2016, I had invested $37,500. My investment was worth $58,000 by the end of June 2016.

Not a bad outcome, right?

The good news is that I have a company to recommend with similar future potential.

Let's get to know more about this company. I will present my case for why this stock could present similar opportunities.

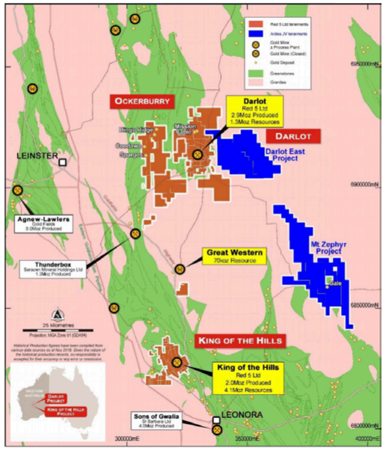
Red 5 Ltd [ASX:RED] — chequered past, bright future

Stock Price	$0.165
No. of Issued Stocks ('mil)	2,346.32
Market Capitalisation ($'mil)	$387.14
Net Cash ($'mil)	$147.80
Enterprise Value ($'mil)	$239.34
3-Month Average Stock Turnover	7,380,000

Source: Thomson Reuters Datastream
(price based on 31 May 2021 close of market)

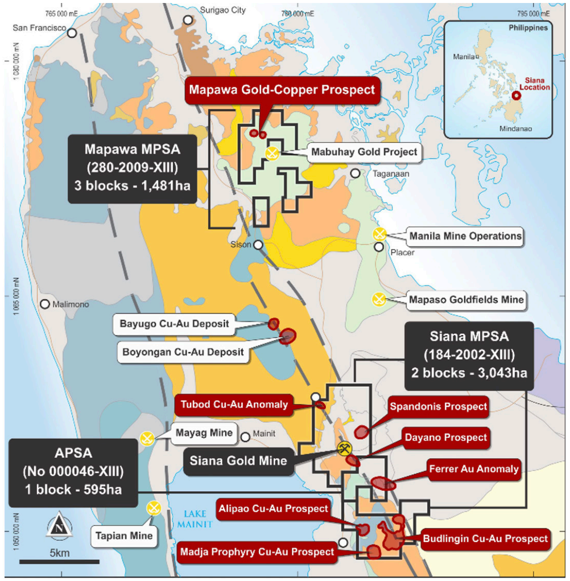
Red 5 Ltd [ASX:RED] is a junior gold producer that owns three mine properties, Darlot in the Eastern Goldfields and King of the Hills in Leonora (both in WA), and the Siana gold mine in the Philippines.

You can see the location of the two Australian mines in the map below:



Source: 2020 December Quarterly Report Presentation

The location of the Siana mine is shown below:



Source: Red 5 Ltd website

Red 5 built the Siana mine which started producing in early 2012. The company suspended operations from June 2013 to January 2015 as they made repairs to their facilities. Operations were suspended again in April 2017 as the Filipino government delayed in approving Red 5's plan to develop underground operations.

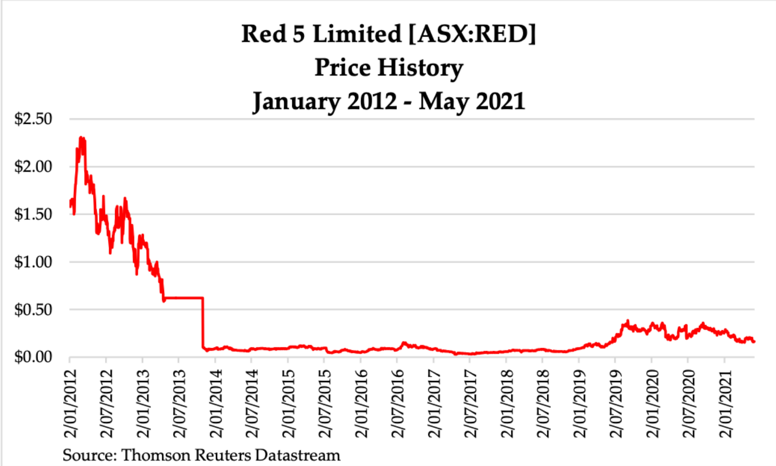
The Siana mine was delivering an annual production of around 60,000–70,000oz of gold and a similar amount of silver at an AISC of $1,000–1,100/oz prior to its suspension.

Management has been receiving offers to purchase this mine in the last two years. However, they have not provided specific details to the public.

Red 5 shareholders experienced a nightmare during 2012–17. They literally saw everything that could possibly happen in a mining business.

- The excitement of the company producing their first gold (commercial production declared in April 2012)...
- The entire gold mining industry seeing their prices plummet when the price of gold started falling in April 2013...
- The Filipino government requesting Red 5 cease production in June 2013...
- Dilutive capital raising in October 2013 to fund $62 million in expenses during the period when they had to suspend operations...
- Red 5 receiving government conditional approval to resume production in April 2014...
- Red 5 resuming production in January 2015 upon building a new facility...
- The price of gold rallying in 2016...
- Operations suspended once more at Siana in April 2017.

You can see the price history in the chart below:



Source: Thomson Reuters Datastream

Things started to turn around for the better in August 2017.

The company announced that they would purchase two mines, Darlot and King of the Hills, for $34.5 million. These two mines helped stabilise the company and provided them with the means to grow.

Darlot and King of the Hills: The turning point

The Darlot mine provided Red 5 with cash flows needed to build and expand their business. The one million tonne per annum (Mt pa) processing plant in Darlot crushes ore from the deposits at Darlot.

Until recently, this plant also processed underground ore extracted from the King of the Hills deposit. Trucks would transport the ore from King of the Hills to the Darlot plant. The distance by road between these two sites is just under 100kms.

The mine has produced at an annual rate of 70,000–102,000oz at an AISC of $1,480–1,800/oz since August 2017.

Total production since their purchase is just over 310,000oz at AISC of $1,746/oz. They sold their gold at an average of $1,944/oz.

You can see that the Darlot mine is only marginally profitable.

However, this year's production at Darlot is expected to be lower than the past due to labour shortage in Western Australia. The mine is expected to produce 74,000–78,000oz at AISC of $2,240–2,290/oz for the 2021 financial year.

There is a silver lining though.

Red 5 has expanded the Darlot operations since the purchase. It had 224,000oz of resources in October 2017. This has increased to 239,000oz of reserves and 1.3 million ounces of resources now.

Part of this spanned from exploration as well as purchases of satellite deposits. This included the 62,000oz Great Western deposit and the 185,000oz Cables and Mission deposits, which they paid $4.2 million for.

All three deposits are part of this year's mine plan. In fact, the Great Western deposit has begun to feed ore into the mill this February.

However, the real game changer here for Red 5 is the King of the Hills mine. Red 5 purchased it at the same time as Darlot. **St Barbara Mines Ltd [ASX:SBM]** owned and operated the King of the Hills mine until early 2015, when they sold it to **Saracen Mineral Holdings Ltd [ASX:SAR]**. Saracen undertook a minimal amount of exploration when they owned this mine before selling it to Red 5.

Red 5 picked up this deposit with only 402,000oz of resources. However, the company explored aggressively and found substantial shallow deposits to make plans for an open-pit mine.

This open-pit deposit at King of the Hills is huge! It now contains 2.4Moz of reserves and 4.07Moz of resources. The grade of the reserves is 1.2 grams of gold per tonne (g/t) of rock and the grade of the resources is 1.4g/t.

Recall that the Darlot plant only processes 1Mt pa and is more economical for higher-grade underground ore such as those exceeding 3g/t. It is only marginally profitable now.

The King of the Hills deposit contains large quantities of lower grade ore. Previously they were trucking higher grade underground ore (grades ranging 2–6g/t) to Darlot for processing. It is no longer feasible to truck large amounts of ore to a plant that is more suited to high-grade ore.

To this end, management sees the need to build a plant on-site at King of the Hills.

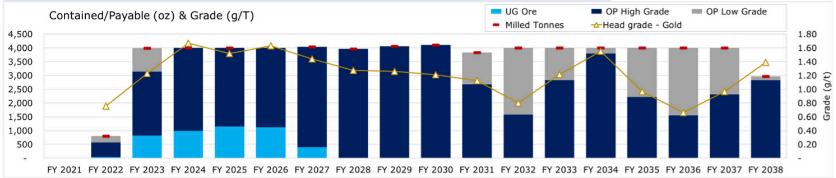
Australia's next big mine — top 10 in ore reserves, top 20 in resources

Last September, the company finalised its plans to develop the mine and build the plant. The expected cost is $226 million. The total budget approved is over $250 million to include a margin for risk and interest costs.

Construction is underway already and on schedule for completion in the 2022 June quarter.

The Final Feasibility Study released on 15 September 2020 shows the mine is initially expected to produce gold for 16 years. The first six years of production is expected to average 176,000oz at an AISC of $1,339/oz. The next 10 years of production is expected to be 146,000oz at an AISC of $1,415/oz.

You can see the production profile for this mine in the figure below:



Source: Red 5 King of the Hills Mine Final Feasibility Study 15 September 2020

The initial mine plan includes a 4Mt pa processing plant. The plant is designed such that it can be upgraded to being able to process up to 6Mt pa with minimal disruption to their operations.

You can see that the high-grade (based on their definition only) open-pit ore to be the dominant source of gold for this mine. A small proportion of underground ore will also be extracted and processed from 2023–27. Management expects that more underground ore may be found. This could increase the ore grade. This reduces production costs as each tonne yields more gold.

The company expects to generate over $750 million in after-tax-free cash flows based on the current mine plans. This makes it very compelling for a $250 million outlay.

Based on my experience, projections in feasibility studies are usually too optimistic. I do expect the average production in the first three years to be lower while AISC will be higher. This is because disruptions and cost overruns are unavoidable in the ramp-up phase.

Nonetheless, I think the odds are in our favour given the current price of Red 5, and the gold price.

I will revisit these figures and make adjustments to them later when we look at the valuation of Red 5.

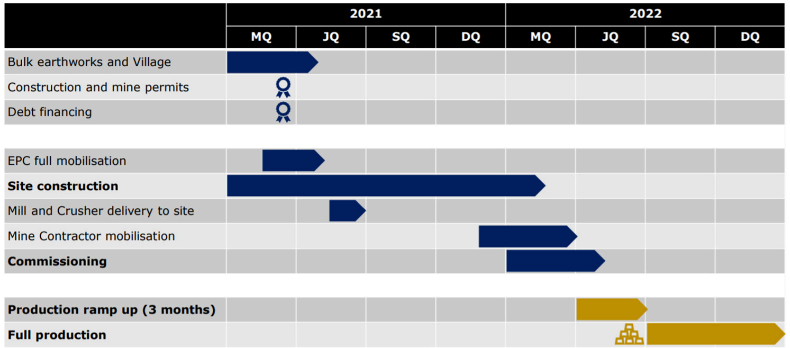
The mine plan currently expects 16 years of production for 2.5Moz of gold. This assumes mining 96% of the current reserves.

This mine is likely to last longer with the price of gold expected to rise. Currently uneconomical deposits may become viable in the future. Subsequent mining may target the remaining 1.6Moz of resources not included in this plan.

Management has plans to continue exploring this deposit and digging deeper. This can lead to more resource discovery and a prolonged mine life.

The latest update on the King of the Hills mine development came out on 12 May. They have finished the staff village, the bulk earthworks for the processing plant and the administration building.

The figure below shows the schedule of the mine development and their progress:



Source: 3 May 2021 Investor Presentation

The next eight months will see major construction happen in the site. Their cash balance will reduce substantially during this period.

Just as well they recently moved to raise capital to replenish their cash balance.

Cashed-up and secured debt finance

I have followed this company for many years and wrote my own valuation reports on it as far back as November 2018. I had written in May 2019 that the company will need to raise capital to fund the King of the Hills mine. You can get the full details in the report here.

Many who followed this company overestimated its ability to fund their substantial capital needed for the King of the Hills mine from operating cash flows. Even research houses such as Morgans and Canaccord Genuity were spruiking this company to be trading at over 50 cents in 2019–20.

I think Red 5 hosed down the chances for this to happen before the King of the Hills mine would be completed when they raised $125 million in mid-March 2020 at 18 cents.

The timing of this capital raising could be seen from two perspectives.

The first is that management was playing it safe given that Australia entered a nationwide lockdown arising from the virus outbreak. They wanted to secure funding in case things deteriorated.

The second is that management timed their capital raising poorly. Just six months prior, their stock price was over 35 cents. That would have been a better time to raise some cash while investors were enthusiastic about their prospects. After all, they had announced a significant upgrade to resources at the King of the Hills mine from 1.88Moz to 3.11Moz.

Nonetheless, the company needed at least $270 million of cash to see through the King of the Hills development. But they had $116 million in cash and $11.8 million in debt at the end of June 2020.

It didn't help that Darlot mine production was downgraded at least twice in the last year. This would not provide enough additional cash to fund the mine building.

As a result, the company again went to the market to raise $60 million in mid-March this year at 16 cents. This was to allow them to secure a $175 million loan with a group of banks.

This capital raising and debt placed Red 5 in a position where they are now fully funded for the King of Hills mine. Right now they have $147.8 million and $175 million of debt.

The two rounds of capital raising heavily diluted their capital. They had 1,243 million shares on issue prior to March 2020. Now they have 2,346 million.

So much for the price being 50 cents before the King of the Hills mine is completed. Even 30 cents is a stretch, unless the Darlot mine turns around in a big way.

Two steps back, how many steps forward?

You may ask now why I would recommend Red 5 given it is heavily diluted and the current operations look pretty bleak.

Good question.

The market literally hates this stock now.

I frequent stock discussion forums and read posts to gauge what the market thinks. But discussion forums are like your local pub. Everyone has a tall story and more fluff than fairy floss in an amusement park.

It's a different story when you have posters all unloading their bile on a stock.

Red 5 is one of them now.

The faithful spruikers have moved on. I recognised them by name. They used to say nasty things to anyone who did not shill the company. They did not like me because I was too conservative about the company in my analyses.

This is now a fertile ground to test out my thesis of how to make big profits buying companies that have had a rough patch.

Red 5 does not just have a story to feed people's daydreams. You have read about the King of the Hills mine and its potential. You also know they have the funds to see them through to their first gold pour next year.

Let us get down into the numbers. I will first use the numbers based on the 2021 guidance. The table below shows my calculations under the VPM approach:

Midpoint Production (oz p.a.)	76,000
Midpoint AISC ($/oz)	$2,265.00
Cost-Adjusted Production (oz p.a.)	33,554
Sales Price per oz	$2,400
EV/AISC-Adjusted Production ($/oz)	**$7,133.05**
Per-Unit Sales Margin	**$135.00**
Valuation-Profit Margin	**52.837**

Source: Red 5 announcements

The current valuation makes Red 5 stocks unattractive. The company is marginally profitable so the VPM multiple is 52.84.

You can forget you saw that.

The reason for buying Red 5 now is because we're expecting the company to perform better when the King of the Hills mine is producing. We're going to play the long game here, and hopefully reap significant rewards.

So in this case, we will look at the company's valuation based on its long-term production potential.

Here are my assumptions:

The Darlot mine will produce around 80,000–100,000oz pa at an AISC of $1,400–1,600/oz.

The King of the Hills mine will produce 140,000–180,000oz pa at an AISC of $1,250–1,500/oz.

Siana will produce nothing. It is a wild card.

So the expected long-term production will be 220,000–280,000oz at AISC of $1,300–1,540/oz. I anticipate that they will achieve this in two years' time.

The company currently has $147.8 million in cash. We will assume that the company will spend $273 million to complete the King of the Hills mine. This will involve using $113 million cash and $160 million in debt.

The company will have $36.8 million in cash and $160 million debt. This puts them in a Net Debt of $123.2 million so to *Enterprise Value* of $510.3 million.

I will assume they will sell their gold production at $2,400/oz. They have recently entered an arrangement to fix 25% of their sales of gold at $2,150–2,165/oz until 2026. So this puts a limit to what they make selling their gold even if the gold price rises.

Our valuation using these figures are given in the table below:

Midpoint Production (oz p.a.)	250,000
Midpoint AISC ($/oz)	$1,406.00
Cost-Adjusted Production (oz p.a.)	177,809
Sales Price per oz	$2,400
EV/AISC-Adjusted Production ($/oz)	**$2,870.17**
Per-Unit Sales Margin	**$994.00**
Valuation-Profit Margin	**2.887**

Source: 2020 Red 5 King of the Hills Feasibility Study, Australian Gold Fund estimates

On these assumptions, Red 5 could generate a profit of $994/oz. Its production-adjusted Enterprise Value (EV) is $2,870.17, giving a VPM multiple of 2.887.

This looks much more attractive. It is well below the 6–8 fair value range for mid-tier producers.

The fair value range for mid-tier producers implies a VPM multiple of 6–8. So Red 5 should trade in the range of 26–75 cents as it progresses towards production at King of the Hills. The median expected price is 47 cents.

This range seems wide because of the variation in the VPM multiple and the company's expected production (refer above). The lower end of the range assumes the worst-case scenario where Red 5 produces 220,000oz at an AISC of $1,540/oz. The higher end of the range assumes the best-case scenario where Red 5 produces 280,000oz at an AISC of $1,300/oz.

What are the risks?

You should now recognise this strategy comes with substantial risks. This company has been a heartbreaker for many investors in the past. This could happen again if they underperform and the stock price falls.

The company is currently building a mine and burning a lot of cash. There is a risk that the price continues to fall during this period as investors take a 'wait-and-see' approach.

The company could raise capital again and dilute your holdings. This could make it harder for the share price to recover.

It is possible that Red 5 turns out to be a value trap. This could mean missing out on other good opportunities.

The final risk is that the price of gold may fall. This can cause the price to fall due to investor sentiment. On top of that, the Darlot operations will be making losses too. This will place even more pressure on the price.

ACTION TO TAKE:

Buy **Red 5 Ltd [ASX:RED]** now. Do not pay more than 20 cents. Consider buying half your normal allocation now, and more if the share price falls on continuing poor sentiment (but not driven by bad news), or if the price starts to trend higher. Red 5 will go into the portfolio using tomorrow's closing price as the buy price.

God bless,

Brian Chu,
Editor, *Rock Stock Insider*

Rock Stock Insider Buy List

Stock	Ticker Symbol	Entry Date	Entry Price	Current Price	Gain%	Recommend	Buy up to
BELLEVUE GOLD	BGL.AX	21/10/2019	A$0.54	A$0.80	48.6%	Buy	$1.20 (5/5/2021)
West African Resources	WAF.AX	15/04/2021	A$1.02	A$1.03	0.98%	Buy	$1.40 (14/4/2021)
Gold Road Res	GOR.AX	21/10/2019	A$1.03	A$1.44	40.78%	Buy	$1.60 (28/5/2021)
Northern Star Resources	NST.AX	03/02/2021	A$12.51	A$10.91	-12.03%	Buy	$13.50 (21/5/2021)
Catalyst Metals	CYL.AX	29/10/2020	A$2.30	A$2.04	-11.3%	Hold	$2 (21/5/2021)
Silver Lake Res	SLR.AX	03/07/2020	A$2.16	A$1.73	-19.91%	Buy	$2, Sell at $2.60 (5/5/2021)
Westgold Resources	WGX.AX	18/03/2021	A$2.12	A$2.17	2.36%	Buy	$2.50 (28/5/2021)
SSR MINING	SSR.AX	14/05/2021	A$21.79	A$22.91	5.43%	Buy	$25 (14/5/2021)
Regis Resources	RRL.AX	31/05/2021	A$2.65	A$2.61	-1.51%	Buy	$4 (1/6/2021)
Evolution Min	EVN.AX	31/05/2021	A$5.41	A$5.02	-7.21%	Buy	$6 (1/6/2021)
Resolute Mining	RSG.AX	03/07/2020	A$1.17	A$0.00	-13.68%	Sell	CLOSED 10/9/2020
Chalice Mining	CHN.AX	24/12/2020	A$3.75	A$0.00	118.93%	Hold	CLOSED 18/5/2021
Anglogld Ashanti CUFS	AGG.AX	21/10/2019	A$6.03	A$6.10	3.66%	Buy	Fair value $5.60-$7.20 (5/5/2021)
De Grey Mining	DEG.AX	17/08/2020	A$0.77	A$1.44	87.58%	Hold	Sell at $2 (28/5/2020)
Wheaton Precious Metals	WPM	01/10/2020	$50.18	$48.37	-2.83%	Buy	US$55 (28/5/2021)
ETFS Phys Gold	GOLD.AX	21/10/2019	A$204.26	A$227.94	11.59%	Buy	

Last Updated: 04/06/2021

Note: Portfolio prices update daily. Generally, the 'current price' will reflect the closing price of the prior trading day.

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