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HALLGARTEN & COMPANY

Portfolio Strategy

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Model Mining Portfolio:

Compounding the Recovery

Performance Review – June 2016

Model Mining Portfolio

Compounding the Recovery

- + Brexit fears propelled gold and silver higher, at least temporarily
- + Base metals prices scarcely missed a beat on the Brexit fears and Zinc has positioned itself for a run on the key $1 per lb hurdle
- + Gold stock prices continue to outrun the performance of physical gold
- + The oil price has stabilized
- + The financing environment is bubbling along with a healthy flow of deal
- + Takeovers continue at what feels like a rate of one per week as producers endeavor to lock in bargains while they are still to be had
- + The AUD and CAD have weakened again vis a vis the USD
- × The Lithium "boom" is taking a pause as too many companies are adding too many assets and not providing sufficient exploration results on what they already had
- × Undiscriminating investors have reappeared in the gold space. This may end in tears.

Brexit – A Brave New World

To those who ask what our standpoint on Brexit is, our response is to ask if you were on the Titanic would you rather be first to the lifeboat station or last? To continue the analogy Britain has been paying a First Class fare on the Ships of Dreams (or is it Fools?) and has yet been served only Third Class gruel and treated like Steerage. In good old Edwardian style whenever it has complained about its treatment it has been told it should hearken to its betters and stop complaining and "know its place". The betters are the self-appointed "betters" of Brussels and parts thereabouts. Inevitably the treatment with more sticks and very few carrots has worn thin and the inevitable pushback has occurred. The great fear for the "betters" is that more of the Third Class are going to want to make a dash for the boats (most notably the Danes and Swedes – with the Dutch looking on longingly).

The coming months will prove interesting watching. Gold bugs received a shot in the arm from the initial vote with it being enough of a shock to propel gold above the previously hard to breach $1,300 mark. We would humbly suggest though that the process of Britain extricating itself from the EU will probably not be enough in terms of rockiness to drive gold much higher. What might be needed is for more signs of the EU itself cracking up. The forces that might drive this would be a renewed Greek crisis, further trouble in the banking systems of some EU components (most notably Italy), refugee/immigration surges and wrangling over how the EU budget is handled once the large net contribution from Britain is withdrawn from the mix. Belt-tightening will be required and we would humbly suggest that it will be the EU's "taker" states rather than its "giver" states that will be needing to trim their sails. This is something that they have shown themselves unwilling to do in the past.

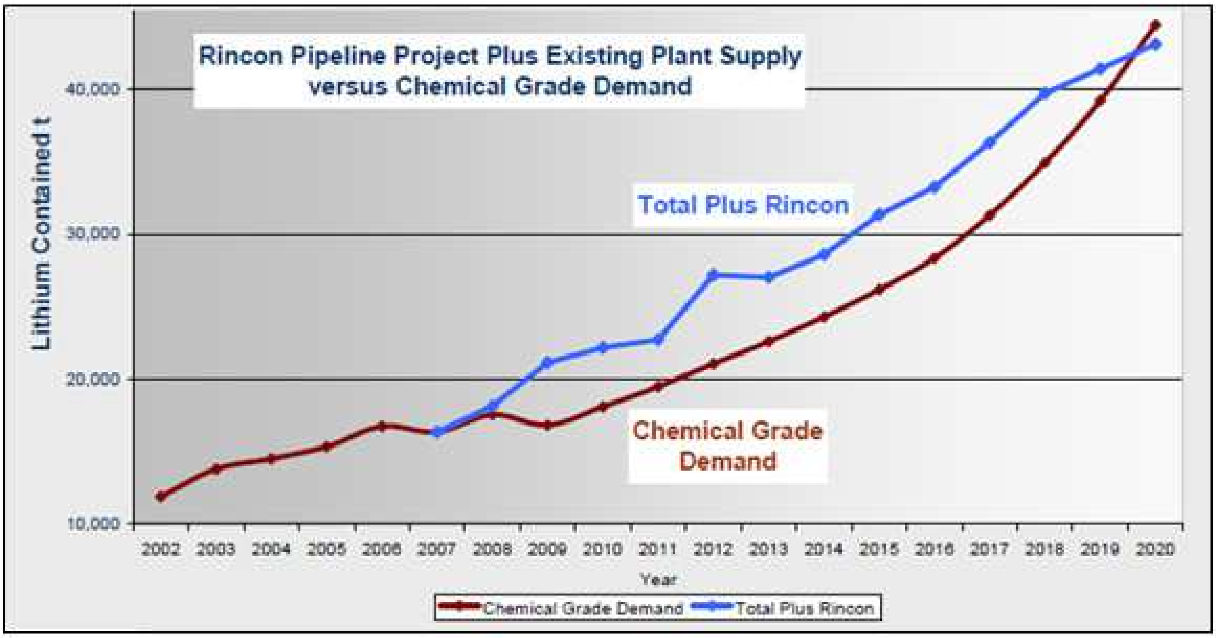
Beyond this anti-EU forces are now emboldened in many states. We suspect that if the Austrian presidential vote was held today rather than back in May then it would have turned out differently. The idea that voters will shy away from "unpopular" (or moreover unfashionable) stances must be cast into the dustbin of history. Voters are, to quote the old film Network, "as mad as hell and not gonna take it". Elites are on the run in Europe and the US with the populace pursuing them with sharpened pitchforks and that makes for exciting and unstable times. Elites may look like they have full control of the levers of power but when they become too arrogant and too isolated from the masses events like those of 1789 in France are set in train and much to the surprise of aristocrats, oligarchs and plebs alike, heads start to roll.

The elites seem at this stage more intent on retaining their power than meeting the masses halfway. This augurs for more stresses and strife which holds within it the potential for fillips from time to time for the gold price. Thus for the rest of 2016 and into 2017 we would posit that it will be never a dull moment.

Lithium – What Went "Wrong"?

That most famous of Scottish poets, Robbie Burns, once uttered the lines: "the best laid schemes o' mice an' men/ gang aft agley". Well might this also be said of the Lithium space. Back in 2010 the Lithium boom peaked upon the realization that a handful of projects were all that was needed and most of these projects were well advanced and "dead certs" to fill the mid-decade demand deficit right through to 2020.

In one of our Lithium Reviews at the time we highlighted a particular chart that showed that, alone, the Rincon development in Argentina would plug the biggest gap and we could all sleep easy in bed.



Source: TRU Group

At the time we commented "Frankly, this chart shows that Rincon is enough to cover demand and produce excess supply. In this scenario, ALL other projects are surplus to requirements until 2020. Even under this Rincon scenario one must suspect that prices will come down because there will be oversupply in the interim. There is certainly not space for all the other wannabes to crowd into an already full lifeboat".

What Happpened?

The "dead certs" at the time were those projects that also threatened to upset the apple cart of the cartel (that is if the cartel did not embrace them in some sort of bearhug). These "guaranteed to get to production" projects were:

- Talison's Greenbushes (which was a reopening of an old mine)
- Galaxy's Mt Cattlin
- Sentient's Rincon *salar* in Argentina (which had initially been developed by Admiralty Resources)
- Canada Lithium's Quebec mine
- Orocobre's Olaroz *salar* also in Argentina

Well, the rest, as they say, is history. The presence of these five projects in a clearly more advanced stage preempted the evolution of the other players and most of the old Lithium universe (the Lithosphere.. as we termed it) faded away.

Talison was quickly taken over for a startling amount of over $700mn by Tanqi, and then was brought into the cartel's sphere by Rockwood (now Albemarle) elbowing into the picture and taking half of the deal. The cartel doesn't like loose ends. This asset is still churning out product.

Mt Cattlin made it to production and then rather swiftly shut down. Galaxy ditched its Chinese processing operation and was reasonably well paid to part with it and now is in the process of reviving the mine in league with General Mining (the latter holding the reins). So this was a case of an addition of production which six years out is still not a net addition due to the mothballing. This will be reversed shortly.

The problem with Rincon is much more obscure as it is away from the public light in the hands of its hedge fund masters on the Cayman Islands. Competitors mutter below their breath about processing problems, but if this was going to be the game-changer in the space with a potential flood of product it has not happened. It remains a wild card but not one that is taken seriously for now as a force that may mitigate Lithium price rises.

Canada Lithium's mine in Quebec got to production, the entity was taken over by the old crew from Red Back Mines and folded into RB Energy and then fell flat on its face in October 2014. This is another case of a Lithium production that reached the market (just) only to be found wanting and then was deducted from the future production equation. One year later the Lithium price had taken off and this asset would not have been thrown into limbo. RB Energy is currently in receivership. It will be interesting to see who ends up with this asset and how fast they can put it back into the producer category.

Orocobre looked like the most likely public company to add Argentine salar production to the global Lithium supply equation but has so far not been a force. It cleverly used the downtime in Lithium to snap up RTZ's borate operations in Argentina, but this did nothing to move forward its Olaroz project. Like Rincon the muttering classes all have their opinion of what has gone wrong, but the proof of the pudding is in the eating, and so far the hungry lithium market has not even caught sight of dessert let alone tasted it.

Supply/Demand Rules

Therefore, in light of all this is it any surprise that the Lithium market was caught with its pants down last year? A flock of "guaranteed" projects had failed to consistently deliver anything (aside from Talison). Late 2015 was the market's Wile E. Coyote moment when it woke up that not only few of the "sure thing" projects were going to ride to the rescue soon, but also that most of the "back-up" plans (excepting Neometals and Nemaska) had fallen victim to the long string of lean years.

This realization had spurred the remarkable surge in new players in recent times and made Lithium a hot space. Frankly one cannot beat some good old fashioned supply/demand dynamics to fire up a market. Indeed one need not even argue that Tesla's appearance on the scene has changed things, because it is scarcely even a consumer of Lithium at this stage. Therefore we would posit that Lithium's rise has been on supply disappointments rather than on demand excitement. Even if Tesla had not existed the market would have been driven higher in 2015-16 by the travails of the aforementioned projects whose production never made it to market.

The Portfolio Move

The Model Mining Portfolio continued on its upward trajectory. If anything it was held back by its preponderance to cash holdings. As not many new names excite us we suspect that we shall have double up some of our positions to utilize cash rather than conjuring with new names. The glaring absence is Zinc names where there is a severe paucity of choice. We were bitterly disappointed to see that Great Panther Silver let its option on Coricancha lapse. This alone was enough to spur us to remove our Long call on GPR. A very mistaken and shortsighted move.

The portfolio ended the month at $4.06mn. Cash holdings stood at $1.4mn up again due to the net disposals during the month.

Portfolio Changes

Some minor tweaking of the portfolio took place during the month. The upward movement in many stock prices gave us an opportunity to finally rejig the portfolio. These are the moves that were made on the 28th of June:

- Opened a Long position in General Mining. Bought 120,000 shares in GMM.ax at AUD 77 cts per share
- Initiated a Short position in Orocobre. Sold 20,000 shares in ORE.ax at AUD$4.61 per share

- Closed a Log Position in Chesapeake Gold. Sold 40,000 shares in CKG.v at CAD$5.32 per share

The Rationale

We closed our Long position in Chesapeake Gold as it had shot past our target price which was set as recently as March. There may indeed be fire behind the smoke but having made a good gain it was time to take profits and maybe await a pullback if a bidder does not appear.

While reviewing market caps in the overheated Lithium space it became clear that Orocobre, once one of our Long holdings, had clearly moved into the outer stratosphere with a market cap of nearly AUD$1bn being the highest in the space and significantly higher than the price Talsion was taken out for several years ago. Looking at undervalued situations General Mining seemed to be the best bargain in the space. Therefore we instituted a Pairs trade with a Short on Orocobre and a Long on General Mining (which is currently subject to a consolidation bid from Galaxy).

Teranga Strikes Again

The West African gold miner, Teranga Gold (TGZ.ax), has been in our portfolio since it acquired another long time holding of ours, Oromin (formerly OLE.to) back in 2013. It has clearly not abandoned its accumulative ways as in late June it announced that it had entered into a Scheme Implementation Agreement (SIA) with Gryphon Minerals (GRY.ax) pursuant to which Teranga will acquire all of the ordinary shares of Gryphon Gold.

Each Gryphon Share will be exchanged for 0.169 common shares of Teranga therefore, the transaction implies a value for Gryphon of approximately AUD$86 million. The number of Teranga Shares to be issued under the Transaction will be approximately 70.1 million.

Teranga owns and operates the Sabodala Gold mine, the only gold mine and mill in Senegal, West Africa. Located approximately 650km southeast of Dakar, the capital of Senegal, Sabodala has been in operation since 2009. As at 31 December 2015 Teranga's total proven and probable open pit reserves were 2.6 million ounces of gold, including measured and indicated open pit resources of 4.4 million ounces of gold and inferred open pit mineral resources of 0.94 million ounces of gold. The Sabodala Gold mine has a 13.5 year mine life based on current production and proven and probable reserves.

The plan is to leverage off Teranga's strong balance sheet and mining cash flows to help bring the 3.6 mn oz Banfora Gold Project into development and production in the near term. Adding Banfora to its low-cost Sabodala operation should position Teranga to produce around 300,000 oz per year with all-in sustaining cash costs below industry average, according to management. While Canadian investors have largely taken their eyes off the potential of West African gold to pursue more parochial interests closer to home, it is clear that Australian gold miners still see West Africa as an undiscovered frontier. This latest deal makes us think that an eventual combination of Teranga with a group like Endeavour might make sense.

Lynas – Barbarians at its Gate?

It's easy in all the euphoria currently swirling in the Lithium to forget that Rare Earths and Lithium were mentioned in the same breath as "no-hopers" only a few years ago. The factors that made Lithium what is was also held true for Rare Earths. Both bubbled to the surface as sexy new things in 2009-10. A lot of press ink was spilled and scores of new vehicles were created. As we have often sustained the appearance of REEs "saved" Lithium from a similar bubble to be burst. Lithium plays were probably around 30 in number (and only 20 of any real substance) when REEs burst on the scene and created 100/200/300 listed plays (depending on your calculations). If REEs had NOT stolen the spotlight when they did, then Lithium too would have been massively overpopulated. When it came down to it, there were two REE plays that got across the production line (Lynas and Molycorp) and only two new Lithium plays managed the same feat (Galaxy and Talison) and even in the case of Talison it was the reopening of an existing Lithium mine. Indeed, like REEs, there was attrition in the producers with Galaxy selling its plant in China and shutting its mine in Australia (Mt Cattlin). Sounds rather like Molycorp, except that Molycorp went bankrupt while Galaxy has lived to fight another day. And then there was one, Lynas in Rare Earths and Talison (bought in the meantime by Tanqi and Albemarle/Rockwood).

At the darkest hour the few score Lithium plays had shrunk to a mere handful (i.e. Nemaska, Neometals, Galaxy, Orocobre etc) while the REE space had shrivelled from hundreds to little more than ten still in contention (companies like Peak).

Then began the Lithium renaissance and the rest is history there. However, in the Rare Earth space the turn is yet to come. There remain around ten projects still plugging away and this is probably enough in terms of doable projects to create a viable Western REE industry without new talent appearing. Ironically Jack Lifton exhorted the industry to "right-size" its projects and yet it's been Darwinian forces beyond the industry's control that that "right-sized" the REE space down to the couple of handfuls we have today. It's like the Poseidon Adventure of the mining space. Only a few get to reach the light.

Who is the New What?

Virtually all the rest of the universe of REE wannabes require higher REE prices to trigger a start on their projects. Even if viable at current prices, they need the price to move higher to stimulate investors to fund them. But if one posits a rise in REE prices (which we do, excepting for Cerium) then the first mover will likely be Lynas, not Tin Pot Rare Earth Mines, because it will be Lynas that can send higher prices cascading from a more robust topline down to a healthier bottom line. Meanwhile Tin Pot Rare Earth Mines will only be able to dust off their begging bowl and set themselves up on a hot air vent on Bay Street to rattle it with gusto at the passing punters.

As we can see from the chart on the following page, Lynas has been essentially flatlining since the start of 2015, surely there should have been at least some uplift in the price for the changed perceptions in the marketplace of the prospects of the specialty metals sector.

Back to Basics

There is now nothing to compare Lynas to in the REE space, with the demise of Molycorp. Indeed it could be said that Lynas's financials are unique and incomparable. Below we offer the latest earnings statements for perusal. The more recent quarters are missing a lot of the detail that would make informed decisions easier.

Lynas Corp

AUD$ mn	FY10	FY11	FY12	FY13	FY14	FY15	1Q16	2Q16
Revenue	9.13	10.006		0.95	64.6	144.6	46.2	49.5
Cost of Sales				0.95	77.7	168.3		
Gross Profit	9.13	10.006	0.0	0.0	-13.1	-23.7	46.2	49.5
GS&A	16.422	28.97	74.124	125.124	125.1	40.9		
Depreciation & Amortisation	1.158	1.22						
Interest expense & finance costs		0.775	7.8	12.6	27.4	37.3		
Other Expenses	9.159	27.015						
Forex Loss (Gain)	-2.337	8.613						
Impairments					-196.4	-16.8		
Other financial charges	27.769	0.701						
Pre-tax result	-43.041	-57.288	-81.924	-141.014	-345.4	-118.6		
Tax		1.798	-10.109	2.541				
Post-tax result	-43.041	-59.086	-71.815	-143.555				

It's evident from this that sales are on an upward track even without REE prices having staged a rebound. It the price rises rather than the volumes increases that will put Lynas back in investors' good books. But when it happens it will certainly take by surprise all those who have taken their eyes off this ball.

Predator or Prey

The mistakes that Molycorp made could fill a book, but one of the key ones for us was not to have developed a second mine. There were plenty of down and out juniors that could have been snapped up for a song (indeed for MCP stock) and yet it remained wedded to a pit that could never in a million years have provided it with enough of the REE mix that the market wanted.

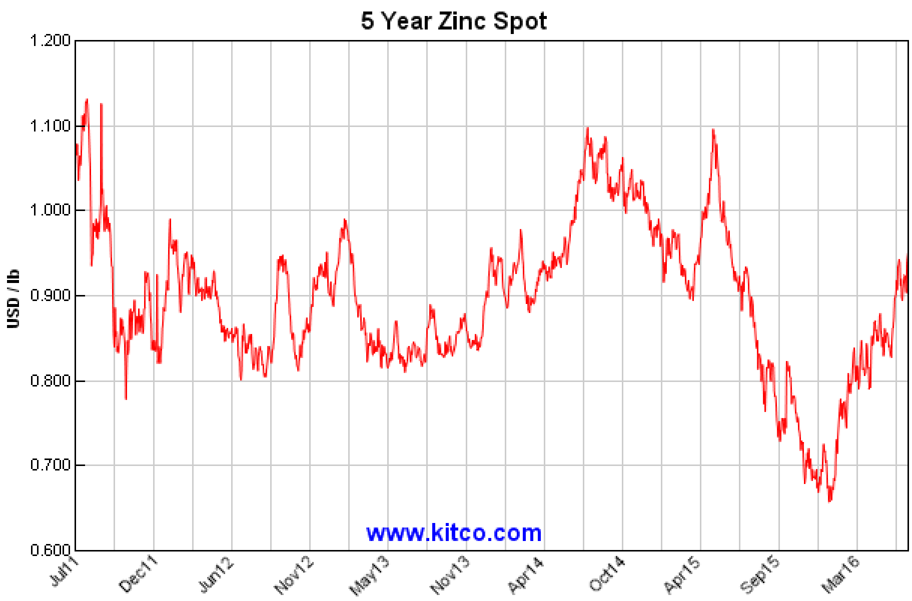
It will be interesting to see whether Lynas uses an early resurgence in REE prices to add another mine to its harem. Names to conjure with are those with “sightlines” to Malaysia. This would include the likes of Northern Minerals (NTU.ax), Peak Resources (PEK.ax) or Mkango Resources (MKA.v). Maybe even Arafura might be considered

Then there is the issue of whether Lynas itself might be a target. Certainly a PE fund might make a run. Even at a hefty premium to its current market cap it would still be quite a lot cheaper than that what Magris paid for the Niobec asset of Iamgold, for example. The Chinese would definitely NOT be allowed near it, but a respectable buyer from Japan or South Korea would not be totally inconceivable.

Therefore, we would not discount that Lynas may either become an aggressor or a target itself with the very near future. Its days as a bargain buy may soon be numbered.

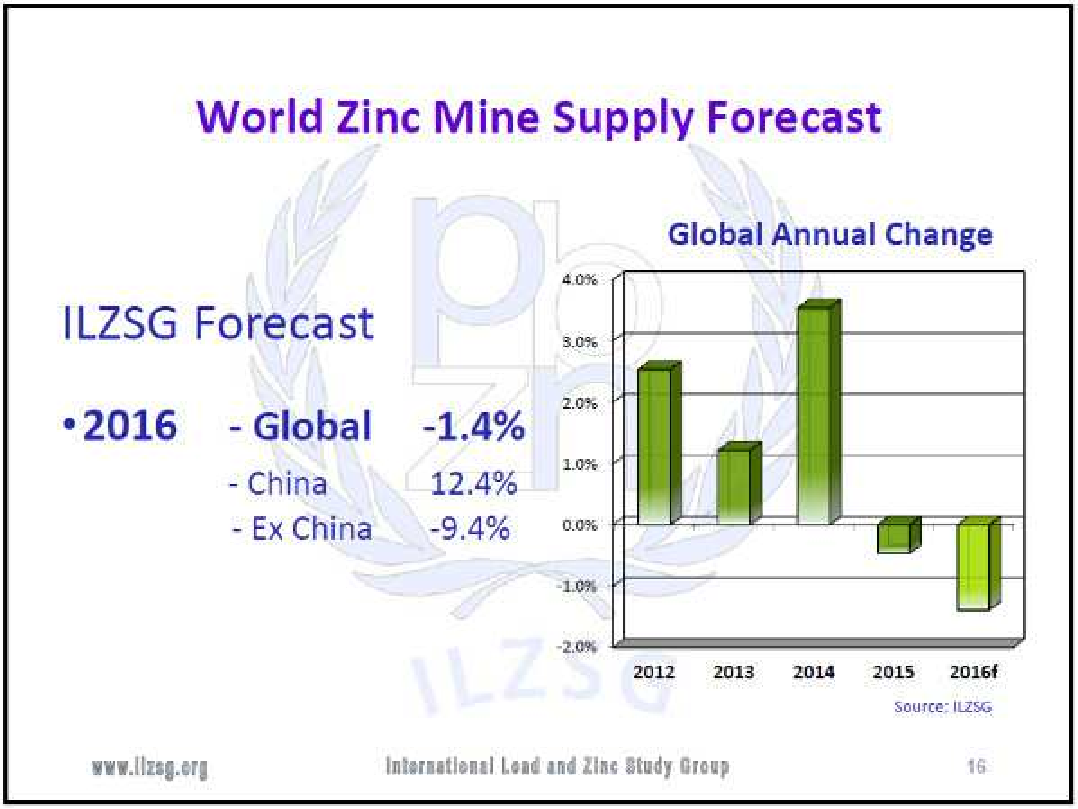
Parting Arrow

We have long been unalloyed (pardon the bad pun) fans of Zinc and its recuperation prospects. It seems but a distant memory, but last October the obituaries were being written for Glencore, the world’s largest Zinc trade with over 60% of global traded volumes. Now those fears are well in the past and Glencore, like Zinc, has arisen from its grave.



At this point in time we are looking at a nearly 50% uplift in the price in a period of a mere nine months. There is no other major metal, precious or base, that has managed such a rise in such a short amount of time in recent memory. If anything the pace has picked up in recent times. The rises are starting to look almost symmetrical with the diabolical fall from the middle of last year.

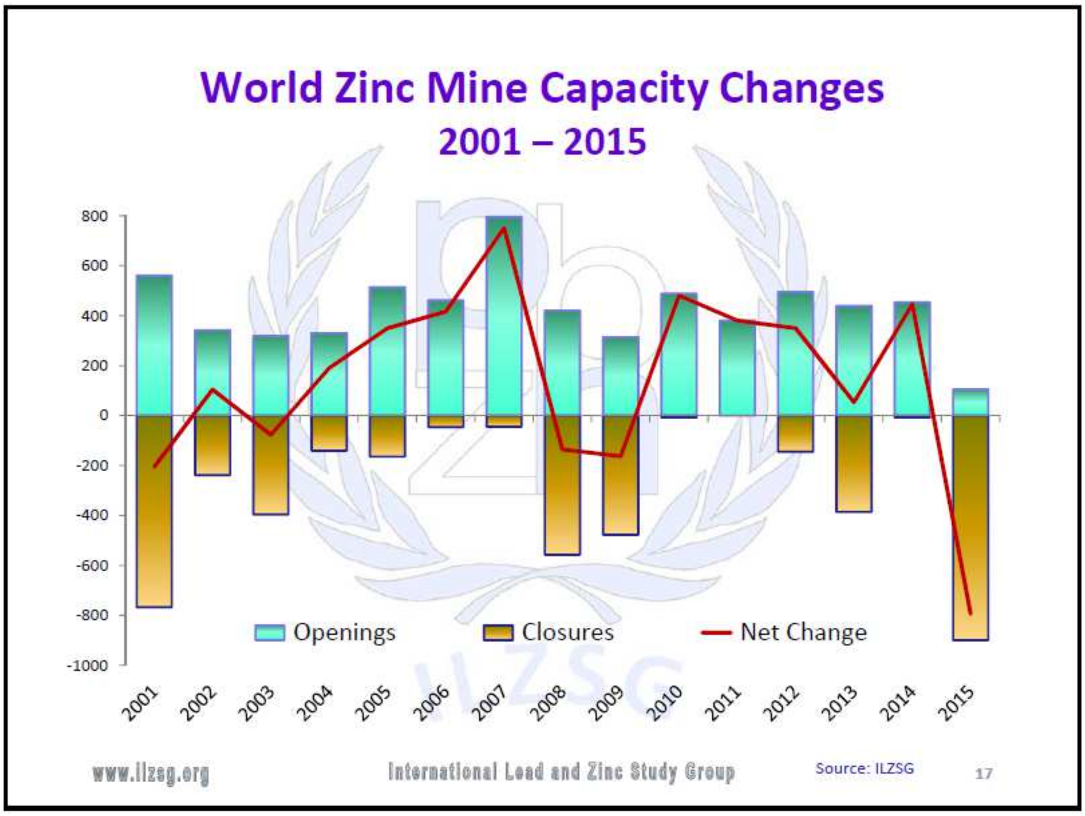
As the LME Zinc price chart shows, zinc has found resistance in previous years around the $1.10 per lb level and has then retreated. However the supply situation has never been as bad in the last ten years as it is now. Heavy underinvestment has taken its toll on the pipeline of new projects, to the effect that there aren't any to speak of. Therefore the International Lead and Zinc Study Group (the leading thinktank on this topic) have projected a shrinkage in supply for 2016, just as prices have started to surge. Here is their projection.



It may not be a large decline but it's the second negative year in a row and reflects declining production from existing mines rather than mothballing or production cuts as a response to weak prices. We are gearing up for the long awaited perfect storm in zinc, where a modicum of demand growth encounters a chasm in the production pipeline. Though maybe we should rephrase that as there is NO production pipeline to speak of. This is the major metal where least money has been spent since 2006 in new discoveries or development than any other metal.

Zinc is of course linked inextricably with the fortunes of Lead, where prices have lagged and production has also been impacted by closures of mines (and repurposing of refineries).

This trend is shown in the chart below:



The year to contrast with is 2008, a bad year for every metal where the opening/closing was not even vaguely as unbalanced as now with an even greater accentuation of the closures in 2015.

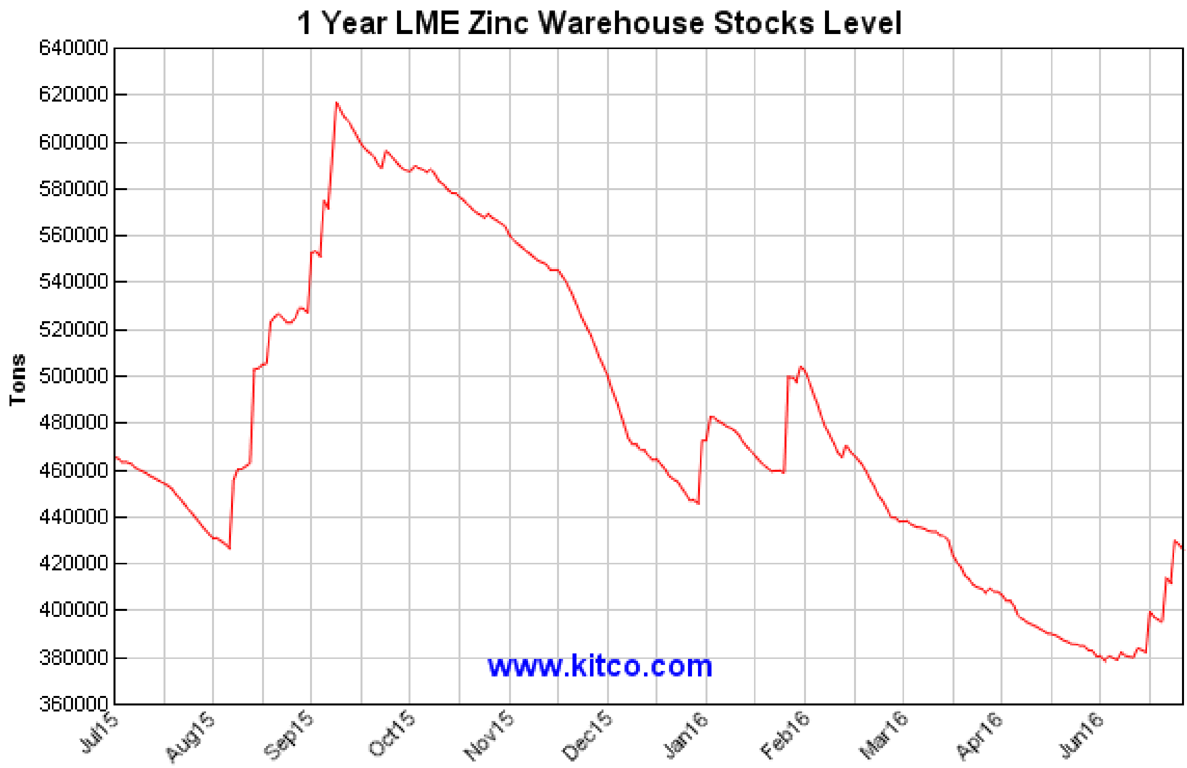
Zinc capacity closure in 2015

Mine	Closed Annual Capacity (Zinc contained - tonnes)
Century, Australia	-500000
Duck Pond, Canada	-34000
Myra Falls, Canada	-27000
Wolverine, Canada	-53000
Lisheen, Irelend	-175000
Campo Morado, Mexico	-10000
Naica, Mexico	-25000
Pallca, Peru	-15000
Gordonsville, USA	-60000

Then if things couldn't get worse in 2016 we are seeing:

- Glencore has reduced zinc mine output by 500kt/yr in Australia, Kazakhstan and Peru
- Reduced output at HZL's Rampura Agucha operation in India due to technical difficulties
- CBH Resources and Perilya to reduce production at Endeavour and Broken Hill mines in Australia
- Suspension of output at Al Masane in Saudi Arabia

This trend is feeding through to LME warehouse levels as the chart below shows. Statistics (always rubbery out of China) suggest that Shanghai stocks are not what they were either with a considerable shrinkage.



Added to this is the estimate for the trade study group of a 3.5% rise in demand in 2016, we can see a supply crunch that is motoring the price along nicely. With such a tailwind, and end users scrambling to write contracts to guarantee supply, I would expect the price to breach $1 per lb in the very near future and then head steadily towards the previously impenetrable $1.10 barrier. As they said on old maps "Beyond here there be monsters". What will happen is that no one in the mining industry shall stir from their behinds until prices breach $1.20 and even then they would rightly (on previous bad experience) want to see them hold there before getting over-excited about launching projects. This means an ever-worsening supply situation. For existing producers this will be a deeply profitable and long overdue development.

The mood will fire up the hunt for juniors that have respectable projects. Many have been on the backburner so long they have melted onto the pot…. With an investor universe largely clueless on zinc's dynamics this will very likely degenerate into a blind rush in the direction of the best promoted offerings. Ever was it thus, but still zinc above $1.20 will be exciting territory and well worth positioning for now.

Mining Model Portfolio as at: 1-Jul-16

	Security	Initiated	Currency	Price Avg.	Price Current	Portfolio Weighting	Increase in Value	12-mth Target
			Long Equities					
Various Large/Mid	Thompson Creek Metals (TCM.to)	1/15/2010	USD	9.85	0.54	0.90%	-94.5%	$1.00
	Capstone Mining (CS.to)	5/29/2009	CAD	2.32	0.85	1.20%	-63.4%	$2.00
	Eldorado Gold (EGO)	6/21/2012	USD	9.12	5.81	7.00%	-36.3%	$5.00
	NevSun (NSU)	3/23/2012	CAD	3.45	3.79	5.90%	9.9%	$5.00
	Sherritt International (S.to)	7/11/2013	CAD	1.78	0.8	3.70%	-55.1%	$2.50
	Palladium ETF (PALL)	10/16/2014	USD	72.08	57.61	4.60%	-20.1%	$74.00
	Metals X (MLX.ax)	29/5/2014	AUD	1.04	1.44	5.40%	38.5%	$1.80
Uranium	Uranium Participation Corp (U.to)	10/20/2010	CAD	7.01	4.03	3.10%	-42.5%	$6.00
	GoviEx (GXU.cx)	6/29/2015	CAD	0.08	0.1	3.70%	21.7%	$0.50
Zinc/Lead Plays	Zinc ETF (Zinc.L)	1/15/2010	USD	7.04	6.24	2.50%	-11.4%	£6.50
	Canadian Zinc (CZN.to)	12/9/2011	CAD	0.82	0.27	1.00%	-67.1%	$0.14
	Nyrstar (NYR:BR)	9/28/2009	Euros	65.1	8.47	1.50%	-87.0%	€ 15.00
Gold Producers	NewGold (NGD.to)	5/31/2013	CAD	7.05	5.65	5.30%	-19.9%	$4.20
	Patagonia Gold (PGD.L)	10/2/2013	GBP	3.6	1.76	1.90%	-51.1%	£4.00
	Teranga Gold (TGZ.to)	6/21/2012	CAD	1.57	1.15	4.30%	-26.8%	$1.00
Pre-Producer	Coro Mining (COP.to)	2/23/2015	CAD	0.03	0.1	3.10%	233.3%	$0.14
Trader	Glencore (GLEN.L)	1/5/2016	GBP	0.88	1.55	8.30%	75.9%	£2.20
Processor	IBC Advanced Alloys (IB.v)	4/29/2016	CAD	0.3	0.73	2.30%	143.3%	$1.40
Gold Explorers	Everton Resources (EVR.v)	4/17/2012	CAD	0.08	0.07	2.20%	-6.7%	$0.10
Other Juniors	Almonty Industries (AII.v)	7/31/2015	CAD	0.44	0.31	2.90%	-29.3%	$1.00
	Asiamet Resources (ARS.v)	4/28/2016	CAD	0.05	0.04	1.90%	-20.0%	$0.24
	Sama Resources (SME.V)	23/2/2015	CAD	0.16	0.1	2.50%	-37.5%	$0.30
	Neometals (NMT.ax)	7/31/2014	AUD	0.04	0.46	6.90%	1143.2%	$0.28
	General Mining (GMM.ax)	6/28/2016	AUD	0.77	0.79	11.80%	2.6%	$1.25
	Elcora Resources (ERA.v)	29/5/2014	CAD	0.2	0.37	5.80%	85.0%	$0.64
	Northern Minerals (NTU.ax)	6/9/2011	AUD	0.73	0.07	0.30%	-90.4%	$0.28
	NET CASH					**1,400,529**		
			Short Equities					
						Weighting		
Shorts	Bacanora (BCN.v)	12/4/2015	CAD	1.53	1.61	44.30%	-5.20%	$0.80
	Orocobre (ORE.ax)	6/28/2016	AUD	4.61	4.74	41.90%	-2.80%	$3.20
	Galane Gold (GG.v)	4/28/2016	CAD	0.06	0.05	13.80%	16.70%	$0.03

Current Cash Position	**1,400,529**
Current Liability on Shorts Not Covered	**168,886**
Net Cash	**1,569,415**
Current Value of Bonds	**0**
Current Value of Long Equities	**2,493,155**
TOTAL VALUE OF PORTFOLIO	**4,062,570**

Short Equities	**-7%**
Long Equities	**107%**

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