When the Drills Start to Spin Again

It is said that truth, in war, is the first victim. In mining the first victim of a financing crunch is IR, closely followed by drilling. When times get tough in mining IR gets chopped and yet the most that can be saved is maybe $15,000 per month by forgoing the glad-handing IR people, conferences, roadshows, and the like. The real savings though come from slashing exploration.

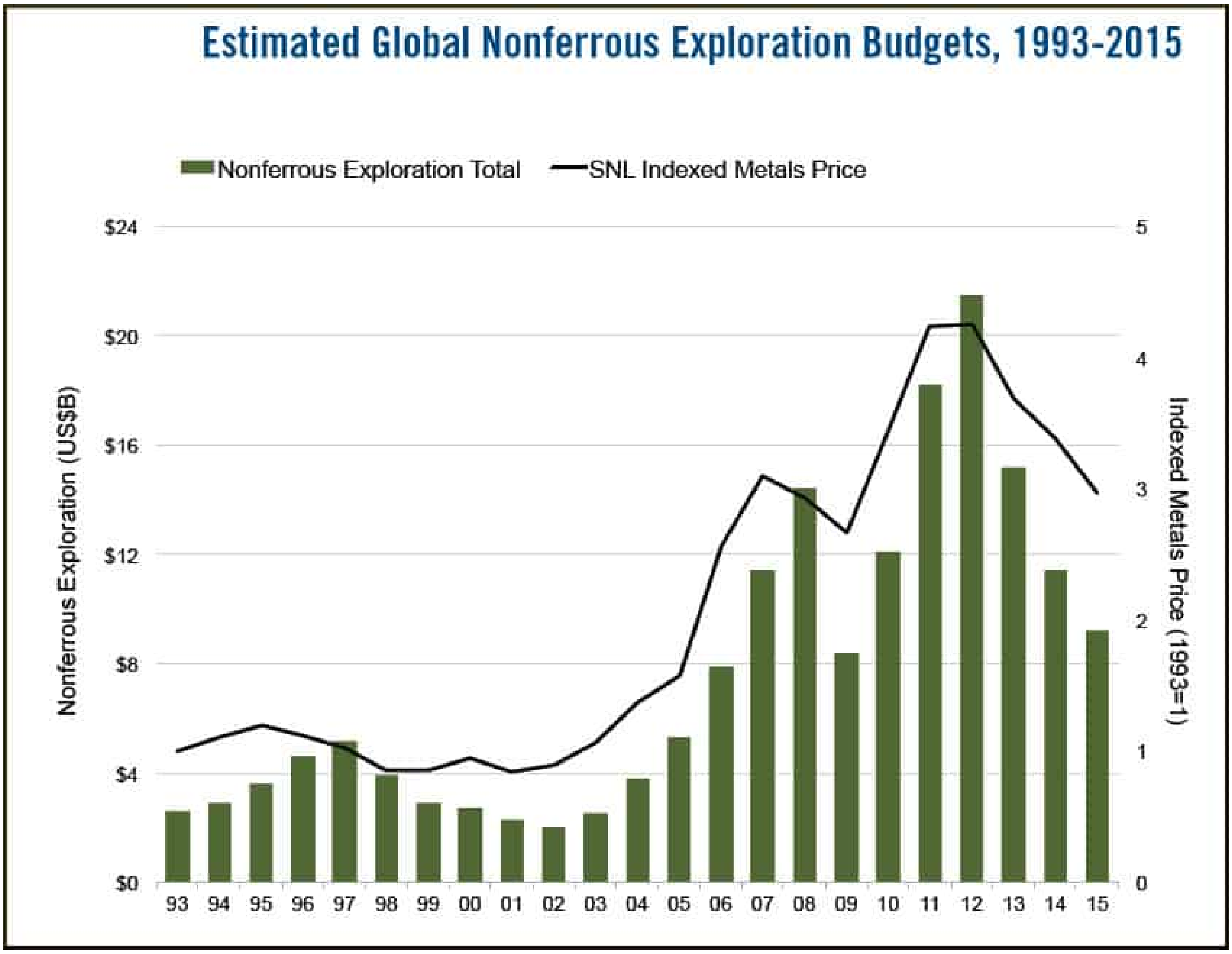
Of course hopes springs eternal in the breast of mining executives and a financing downturn as we experienced from late 2011 until late 2015 was widely thought to be of brief duration. However a futile rally in early 2012 had barely enough time to bring some rescue financings before it faded again and the mining space was subjected to a nightmarish nuclear winter. Despite their deep attachment to drilling and press releases or vice versa (or usually both), the majority of Canadian mining executives were forced to trim their coat to suit their cloth. And the cloth was more like an oily rag than a Saville Row suit during the downtimes. As the bottom of the financial barrel was reached, exploration programs felt the knife and drilling was about the most expensive exploration one might undertake, so the knife was wielded.

However, as is oft quoted in the mining industry (and particularly by me), the people who made money out of the California gold rush of the 1850s were those selling the shovels rather than those down the mines. This should not be any different today. Intermediaries such as drillers should be first-line beneficiaries of the reactivation of the mining space.

However for drillers the picture has been grim indeed until recent months. Companies used to drill to please the market but then in recent years, soil-sampling and trenching have been the “poor man’s drilling”. No drilling meant nothing much in the way of work for consultants converting non-existent drilling into resource estimates or scoping studies. While we have little to no sympathy for the consultants, the drillers had large capital invested in their rig fleets and have struggled to adjust to the tough times. Now the light is at the end of the tunnel we thought it would be useful to hunt down some of the sub-spaces of mining that have not yet turned and here we shall look at drillers and their potential to be a next mover.

What goes up…

….must come down, but then may go up again.. except, of course, if it’s a soufflé. The chart below shows that budgets were on a tear from 2003 onwards with a steep pullback in 2008 that was then followed by an even brusquer surge. This trend has been symmetrical around the 2012 high-water mark. From discussions with drillers in recent weeks, they have told me that numbers in the first half of 2016 were showing an even worse trend that 2015, but that a turn has come which saves the second half. However, 2016’s average drill utilization will still be lower than 2015’s, before the uptick becomes evident in 2017 numbers.

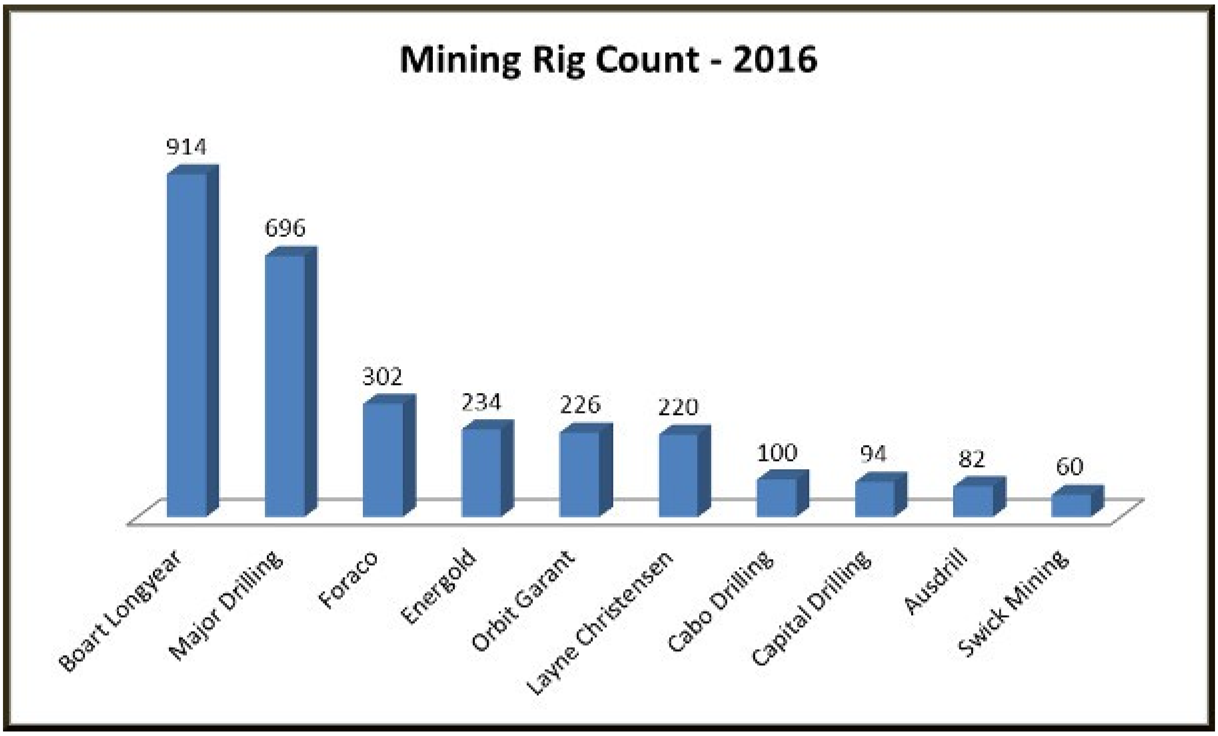


Source: SNL

The impression we have got from many miners is that drilling costs per metre have not been moving up all that much in recent times. One gold explorer in Quebec that we met this week said that they were paying an all-in $85 per metre for work there whereas we recall numbers closer to $200 per metre in the glory days. In a recent presentation Major Drilling claimed pricing was at a 15-year low.This has created a scenario where miners now want to get work done (if they have cash) while rates stay low.

The Business Model

From our interactions with the drilling industry there are two key factors in driller selection. Firstly there is traditional usage and secondly is geographical location, with an overlay of the over-riding consideration of availability of drill teams. Firstly explorers tend to use the drillers they have used before with the only factors shaking them loose being a breakdown in relations (i.e. a poor job done or the miner being a poor payer) or an unjustified escalation in drilling costs. The second factor is more self-explanatory with a company obviously using a driller than is on the scene in a mining region rather than requesting that a previously favoured supplier ship in a team and equipment. The factor of time availability was a crucial one in the boom years where sometimes mining companies could not secure a driller for love nor money in some locations due to intense demand in some locations. This has not been a problem in the last four years. As demand recuperates in some parts of the world we would expect greater mobility in rigs than hitherto as companies attempt to redeploy from dead locations to hot spots.



Source: Foraco/Hallgarten

State of the Players

Boart Longyear is currently a prisoner of its creditors. Major Drilling, much to our surprise, has a rather stunning market cap of over $500mn at the current time, which makes it very heavily overvalued compared to the rest of the universe. We would venture that it has nowhere to run. Energold and Cabo are the companies we know best and they seem to be light and nimble.

Residual debt burdens are the big problem. Layne Christensen has total liabilities of US$355mn, while Boart Longyear has a stunning US$670mn in debt and that was after various rescues/restructurings during the grim times. Foraco has CAD$153mn in debt, while Major Drilling has only $77mn at the current time. Ausdrill on the other hand, for quite a small fleet has AUD$543mn in total liabilities. Cabo Drilling in contrast has CAD$11.67mn in debt and Energold has CAD$44mn in debt. Frankly we would prefer to run with the players with the smallest debt burdens.

Conclusion

The old adage about it being more profitable to sell miners their shovels than actually doing the mining oneself sounds rather attractive and indeed fortunes were made on that basis in the past. Then again if one's total inventory is a wagon full of spades it is no great loss if the gold suddenly runs out. It is not such an auspicious moment though if the vendor concerned has a widespread inventory of expensive drillrigs, a mountain of debt and an army of employees to man them. Even worse is if the terms of trade are not little pouches of gold dust but rather extended credit and the clients cease to pay. Despite all these negatives, the drilling space has all the same players as 2012, which is quite spooky as it implies no rationalization. Also rig numbers have not gone by any noticeable amount.

Quite clearly though there has been a massive culling of junior explorers, which used to make up most of the customer base of the drillers. The surviving miners/explorers have managed to still be around for the recovery by basically cutting exploration to the bone. With the recovery now six months old, the flow of financings is healthier but we noticed that many of those raising funds were stashing the money and focusing on “cheap and cheerful” exploration like rock sampling and geochem. The most prosperous sub-sector, Lithium, has seen very little drilling at all and is a microcosm of this Scrooge-like attitude. However, new investors (or reawakened investors) are not going to tolerate companies raising funds and giving nothing back in terms of work. The longer the recovery lasts the more likely the need for the rubber to hit the road or the drill-bit to hit the ground spinning.

Another thing to consider is that the mix of metals hunted for, and the hunting grounds, have changed. Gold has led the recovery in drilling activity and that activity has been more noticeable in Australia than Canada. The results of Ausdrill bear this out. The future focus, however, will need to be more on base metals, specialty metals and uranium. Secondly, regions that have been in favour in the last ten years will not necessarily be the flavor in coming times. A good example of “new” territory is the Balkans and the Iberian Peninsula where there is now quite a lot of activity, ex-CIS is out of favour and Africa will have to await its turn. Other areas that will remain out of favour might be those with low-grade gold, massive iron-ore projects, high operating cost zones and those countries with difficult or capricious legislative regimes (such as South Africa and Turkey).

They say it is cheapest to buy straw hats in winter, but in the case of drillers, you can buy them in this mining spring still at prices that reigned during the mining sector’s long winter of discontent. The pitfalls to avoid are the over-indebted (Boart, Layne and Ausdrill) and the overpriced (Major).