

# The Kelman Report

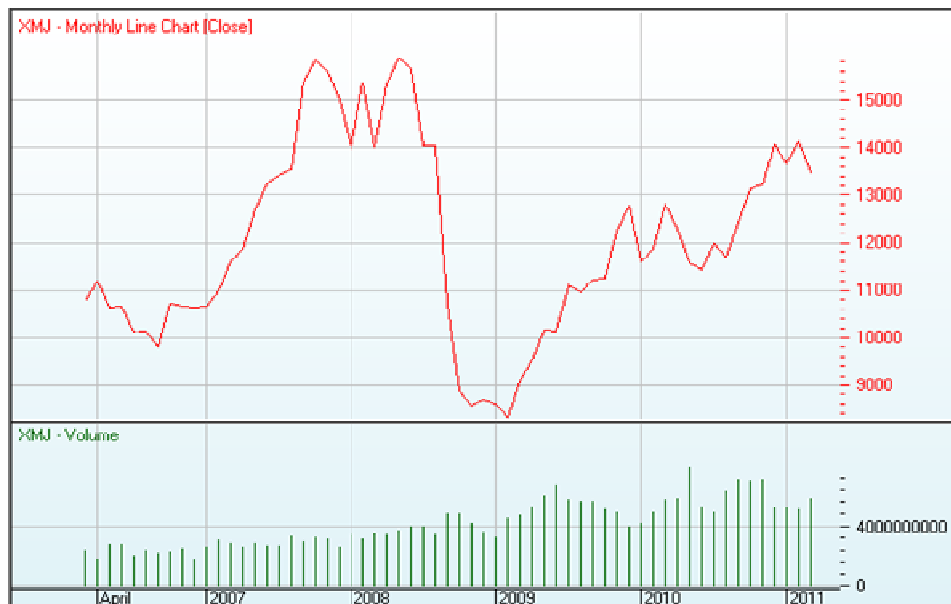
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This Kelman Report will be the last issue after 5 years of weekly publishing. From the beginning of next month the law regards me as a financial advisor. This requires registration, payment of fees and passing competency exams. I am fundamentally opposed to these new provisions in the Financial Advisers Act 2008 as they are totally unnecessary and are an over-reaction to some investment company failures. Of course governments love to regulate as they are seen to be doing something though it tends to destroy innovation, self reliance and individual responsibility. Certainly these new regulations are symptomatic of irresponsible Government behavior and exemplified by Ronald Reagan's cynical opinion of nanny state. "If it moves, tax it. If it keeps moving, regulate it. And if it stops, subsidize it".

Writing The Kelman Report has been an enjoyable challenge. It has been either accolades or condemnation depending on the outcome of a recommendation. Of course there are no guarantees as to future returns in any sphere of investment as markets are inherently volatile and no one can predict the future with any certainty. In essence successful investing revolves around playing with the "probabilities of risk and reward". Weighing up the odds is an imprecise discipline requiring knowledge and a feel for your own level of risk tolerance. Generally individuals are probably better doing their own assessment than delegating it to some fund manager. Trading shares on internet has revolutionized equity investing. Market information is now readily available to everyone and transaction costs are continually being lowered with completion. Executing a buy or sell order is just a mouse click away.

Below is a chart showing price movements in the S&P ASX 200 Materials Index.



Contrary to popular belief equity investing is not rocket science and comes down to some simple basics of making money by acquiring an undervalued asset that will reward you with dividends, interest and capital growth. The value of the asset can vary enormously depending on risk, future cashflow, intrinsic characteristics, fashion and the stage of the business cycle.

All assets have a price established by the market on the day though this can vary enormously from its intrinsic or fundamental value. In the financial world this is known as "value investing" and is widely

attributed to Benjamin Graham and his book "The Intelligent Investor" first published in 1949. Of course the philosophy of value investing is adhered to by the world's greatest share market investor, Warren Buffet. There are other investment theories and strategies though value investing probably achieves the best long term results.

The key is to discover the intrinsic value of an asset and test to see whether the market price diverges from this assessment. Generally markets are efficient in valuing assets especially in a situation where there is high liquidity, information is easily understood and disseminated and trading costs are low. These factors are often

absent in distressed markets where information is distorted (e.g. Japanese nuclear reactor explosions) or in illiquid situations where sellers swamp buyers or in niche markets where there is limited understanding of particular businesses (e.g. mineral explorers). Share market values also become distorted by investor behavior. In bull markets, euphoria rages, greed reins and prices rocket to giddy heights creating bubbles such as the tech boom in early 2000 or the housing boom in the US. At other times investors succumb to an Armageddon scenario and sell at any price. Even in highly educated societies, investors including fund managers are susceptible to indiscriminate bouts of fear leading to irrational investment behavior.

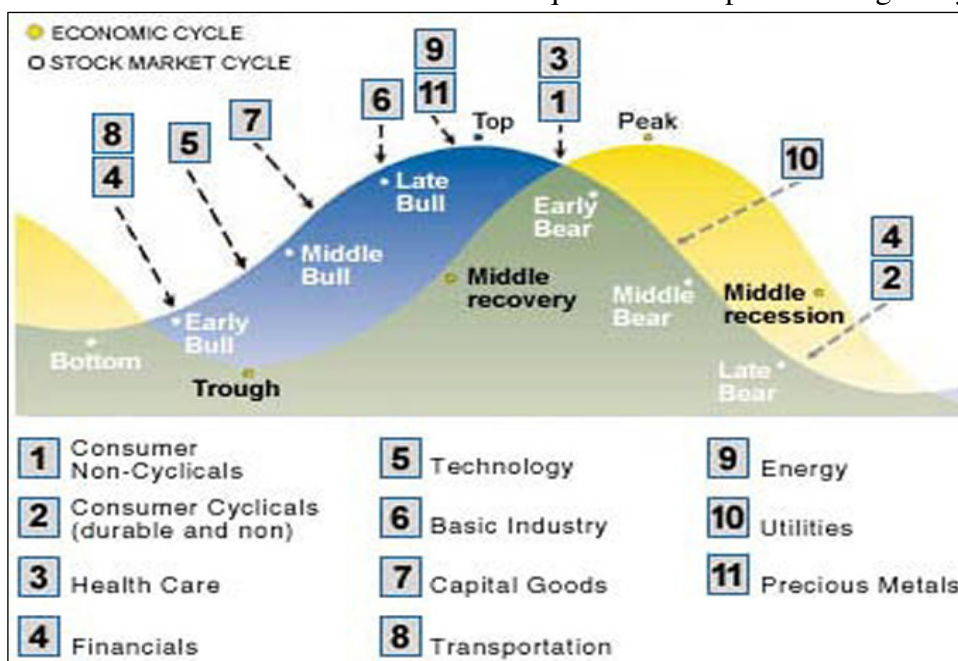
The moods of any market period are generally transitory and are often diverge from longer-term outcomes. Exploiting these periods of doom and euphoria are probably the most rewarding though not knowing where the bottom or peak is can be a bit nerve racking. At times markets become totally irrational especially when they are confronted with extreme uncertainty or “unknown unknowns”. This is sometimes referred to as Black Swan events. Examples of Black Swan events are the 9/11 terrorist attack in New York and the banking meltdown in October 2008. These rare events can have far reaching impact on markets and investor attitudes to equity investing. Consequently fundamental valuations of shares are sometimes meaningless. It certainly takes courage to buy in this market though returns can be extraordinary.

Even when markets appear to be stable there are always a few gold nuggets in areas that are out of fashion. Discarded sectors or regions are worth picking over when looking the discrepancies in price and intrinsic value. Often the most lucrative investment opportunities come from a sector that is the “least loved” by those who should know it best. A recent example is the US tech sector. Analysts were quick to dismiss technology companies mainly on the back of past losses despite clear evidence that profit margins are rapidly expanding. It’s a case of the old adage that “the immediate past is a poor guide to the future”.

Basically, the whole US market looks undervalued from an Australasia point of view especially with our currencies at historical highs. An example of the tech sector is market heavy weight, Intel which has a forward PE of 9.5 and a dividend yield of 3.7%.

Another unfashionable sector at present is the big pharmaceutical companies such as Merck and Co whose PE is 8.7 and dividend yield is 4.75%. Interestingly investors have been dismissive of the US given its fiscal and current account debt problems and this has tended to blight their perspective. However the US has the distinction of being dominant global economy and is likely to remain in that position for many years to come. In 2010 US GDP was US\$14.62 trillion compared to the next largest, China at US\$5.75 trillion.

Different asset classes or sectors have unique valuation phases though they all revolve around economic cycle.



Basically the economic cycle is closely correlated to monetary and fiscal conditions. In the expansionary phase inflation is minimal, interest rates are low and governments are spending freely. Conversely in the contracting stage interest rates increase and funding becomes tighter. Investors should grasp an understanding of the business cycle though each peak and trough can vary in time span and geographical region.

Picking trends before everyone jumps on board is a prerequisite to attaining above average returns. Importantly investors should shun the crowds and seek

out those opportunities that are overlooked by the masses. Following the mob insures that your returns mirror the market of mediocrity. Finishing in the middle of the pack is underperformance. Striving for supremacy requires being unique and seeking out opportunities that have been overlooking by the majority.

Over the years The Kelman Report has tended towards specializing in the Australian market and specifically the mining and energy sectors. Basically investors should seek diversity of markets and currency and Australia

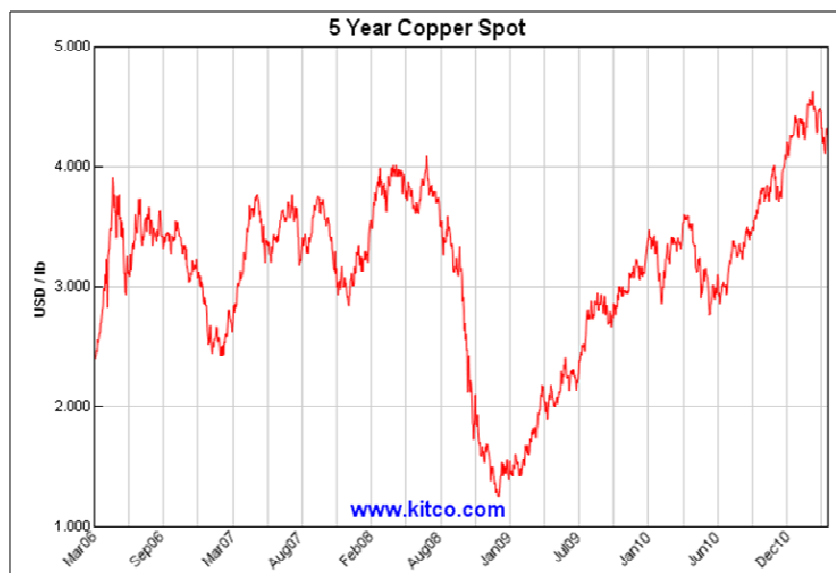
is the obvious first step for New Zealanders. Likewise Australians should consider the US as their diversification target. When looking at companies or sectors the keys are pricing power and natural barriers to entry. That is an important investment philosophy adhered to by Warren Buffet.

## Mining Industry

In many ways the mining sector enjoys unique pricing power and barriers to entry characteristics. These factors are reasserting themselves on the back of rising demand, inelastic supply curve and growing supply deficits. Currently the world is at the beginning of a multi-decade commodity boom based on projected demand from the developing world. One of the megatrends in the 21<sup>st</sup> century is the emergence of China and India as world's economic growth engines. In essence this revolves around the industrialization and modernization of China and India.

Things we take for granted in a modern society such as cars, electricity, running water, refrigerators, washing machines, modern houses, education and medical care etc are now being sort by your average Chinese, Indonesian or Indian citizen. In fact China has clocked up an average growth rate of 9% over the last 25 years and this is now being emulated by other countries such as India, Indonesia and Vietnam. China's growth will probably slow marginally but demand for base metals and energy will remain strong. With policy makers putting less emphasis on export production and more on domestic consumption demand for all sorts of commodities could escalate above forecast levels. Of course Chinese doomsayers have kept a lid on investor expectations. China's per-capita GDP is about US\$4,000, compared with Japan's US\$42,000 and the USA's US\$47,000. On this basis China has an enormous task of achieving a goal of US\$21,000/capita or 50% of Japans GDP/capita. With 1.33 billion people, China will require massive quantities of Australian iron ore and other metal resources.

On the mining production side, most metals suffer from severe supply constraints. For this reason metal commodities should enjoy increased pricing power over the next 5-10 years. Already we have seen copper go to a record high of US\$4.62/lb and is currently trading around US\$4.30/lb. At these lower levels copper mining companies such as Freeport McMoRan are making extraordinary profits. The basic law of economics states that when prices increase demand drops as substitution kicks in and/or supplies increase to meet higher



returns. However with most metals substitution alternatives are more expensive and nature of mining ensures that there is delayed commencement of new production. Unlike most other industries there is minimal spare capacity in mining due to a number of historical reasons including lack of exploration and shortage of skilled manpower.

The dearth of exploration in the last 15 years has meant that ore bodies are not being replaced by new discoveries. Furthermore the timeframe from discovery to production is forever increasing as ore bodies are generally lower grade, invariably deeper and harder to extract and are located in less

hospitable regions. Just gaining a mining license requires a vast array of environmental reports, public consultation and native title negotiations. Most projects come in over budget and are behind schedule. That is the situation in the mining industry and the financial rewards for those that achieve production status are outstanding.

Iron ore is a key resource commodity that is highly leveraged to economic growth taking place in the developing world. According to forecasters China is set to achieve 8% annual GDP expansion over the next 15 years. Apparently by 2025 there will be 221 Chinese cities with populations of more than 1 million people, which compares with 35 in Europe today. To cope with this massive urbanization program China will need to build 170 mass-transport systems, pave 5 billion square metres of new roads and construct 50,000 skyscrapers. This massive expansion will consume huge amounts of steel. Of course steel requires a number of essential

alloy metals such as manganese, molybdenum, nickel and zinc. There are three resource companies that have unique competitive advantages to benefit in this environment; Freeport McMoRan (NYSE listed FCX), Bass Metals (ASX listed BSM) and Atlas Iron (ASX listed AGO).

Freeport McMoRan FCX (28<sup>th</sup> January 2011 Kelman Report) is the world's second largest copper mining company and is also substantial gold and molybdenum producer. FCX has a diverse number of operations in the Americas and the Congo though its key asset is the immensely rich Grasberg mine in Indonesia. Basically they are a massive cash generating machine especially with copper over US\$4/lb.

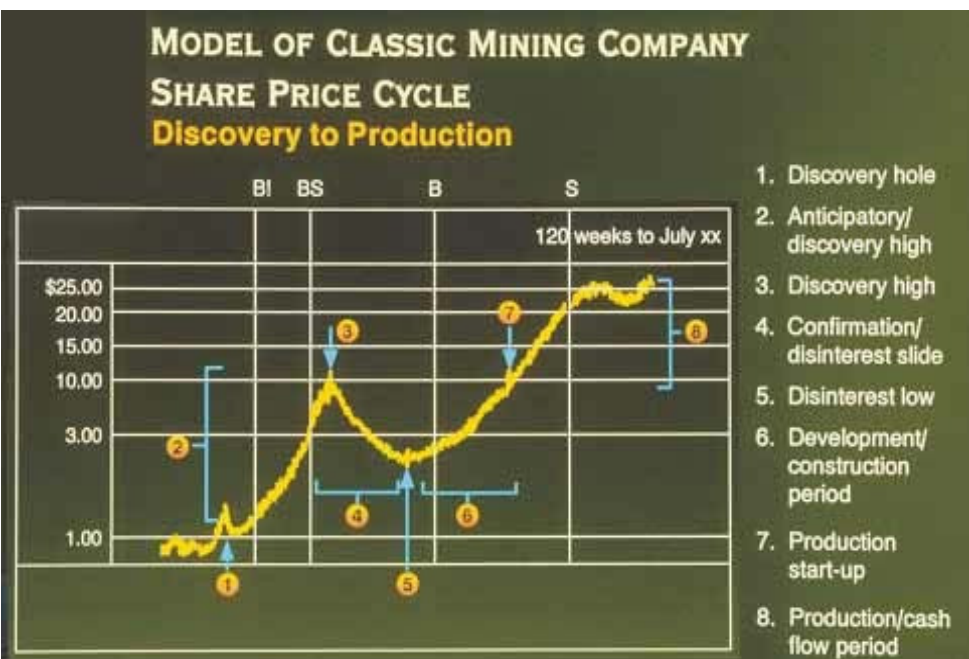
Bass Metals BSM (18<sup>th</sup> February 2011) is a small Tasmanian company whose key ingredients to success are its high grade ore bodies and accompanying processing plant. Their Fossey deposit is high grade (lead, zinc, copper, gold & silver) deposit, cash costs are in lower quartile of comparative mining operations and there is potential for further major discoveries. Last week the shares dropped to a 12 month low of 34 cents but have quickly recovered to 40 cents.

Atlas Iron AGO (11<sup>th</sup> February 2011) has accumulated a number of ideally located iron ore deposits that can be easily mined though ultimately its competitive advantage is their access to ship loading facilities at Port Hedland. Basically without shipping capability (barrier to entry) an iron ore body is largely worthless. In six years AGO has gone from a one man operation to currently exporting 6 million tonnes of iron ore per annum. However this is just the beginning as they are set to boost output to 12 mtpa by the end of 2012. This company was first recommended on 16<sup>th</sup> February 2007 when shares 58 cents. Their core theme back then was being at "the right place at the right time". In February 2007 AGO's major investment attributes were its funding and large iron ore tenement holdings at the best possible address; the Pilbara. Furthermore the company was is an aggressive explorer and was enthusiastic about making a rapid transition to becoming a producer. The rest is history; shares have been trading as high as \$4.09 but have weakened to \$3.30.

In the precious metal sector gold has had a great run trading at a new record high of US\$1,438/oz. The major attraction of gold is its unique investment characteristics as it is believed to be the ultimate store of wealth in times of crisis and rampant inflation. Essentially gold is the only real alternative to fiat currency though its long term appeal is dependent on price appreciation. In fact gold is only worth what others will believe it is worth in the future. In the last two years major buying power has come from investment funds (ETF's) and traditional hoarders of gold such as the Indians and Chinese who have experienced revolution and debasement of fiat currencies and other asset classes such as property. Interestingly gold has failed to break through the US\$1,450/oz barrier despite major catastrophes around the world including the Japanese earthquake and nuclear power accident and the Libyan war involving major western powers.

Gold flourishes when risk aversion events debase fiat currencies. Conversely now that global growth is returning and worries of an imminent financial collapse are receding, gold is fast losing its lustre as an investment. Chances are that gold will trend downwards and could break below US\$1,300/oz.

The Australian share market has a wide range of attractive gold explorers and miners. In the exploration sector



Gold Road Resources GOR (18<sup>th</sup> March 2011) and ABM Resources ABU (3<sup>rd</sup> December 2010) are probably the most attractive investments. Another explorer and near term producer is Doray Minerals DRM (4<sup>th</sup> March 2011). Low cost producers worth considering are Troy Resources TRY and Integra Mining IGR. Successful mining companies typically have a unique evolution path from explorer to producer. Along the way there is ample opportunity for patient investors to achieve above market returns. Attached is a chart showing the relationship of

the share price to the stage of development of a hypothetical mining company.

Often the best returns are achieved at the exploration/discovery stage and before the company publish its JORC resource estimate. Invariably investors' expectations are not satisfied by the grade and size of the resource and shares begin their weakening stage. In addition investors become impatient with the speed of development and the share price is often at its weakest just prior to development and production. Obviously some companies follow a slightly different path to this model depending on funding and commodity pricing.

One company that is currently in the disinterest stage, that is, its shares are falling due to investor apathy is Doray Minerals. This young explorer has discovered a high gold resource in Murchison region of Western Australia. Like Atlas Iron it has a clear strategy to advance rapidly to the production stage. The company is well funded and will no doubt emerge as a low cost and highly profitable gold producer.

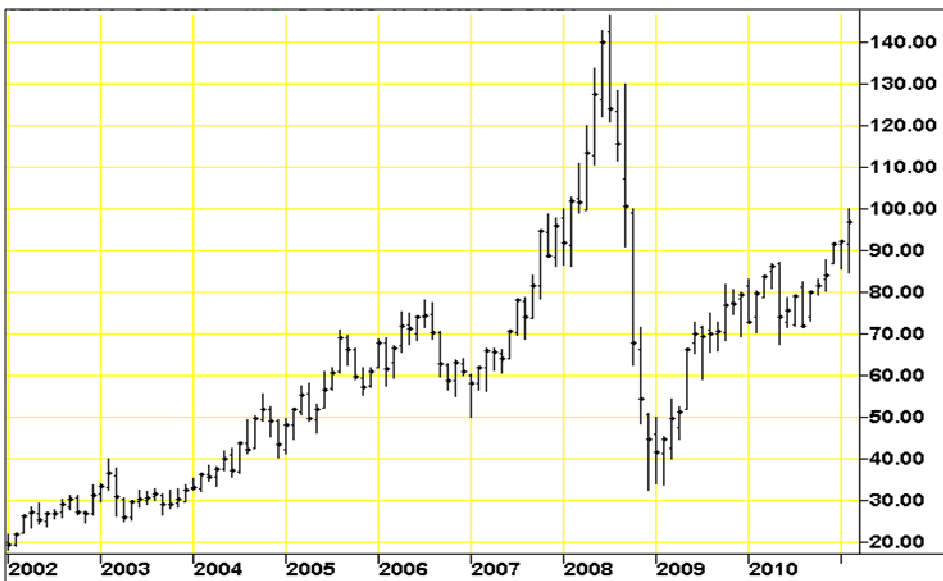
## Energy

Oil and energy is another sector that The Kelman Report has tended to emphasize. As living standards increase demand for energy rises exponentially. As households graduate from an open wood fire to an electric stove and central heating then demand for electricity and hydrocarbon based energy sources increases substantially. Meeting this future demand is a major challenge for today's energy companies.

According to the latest International Energy Agency (IEA) report, global oil demand in 2011 is expected to be around 89.4 million barrels per day (bpd); up 1.4 million bpd on 2010 or 1.6%. This growth rate looks conservative but with oil now comfortably above US\$100/barrel demand could weaken slightly. Demand growth is being driven by non-OCED countries like China, India, Latin America and the Middle-East. In fact China is now the world's largest energy consumer, exceeding the US by about 4%, according to the IEA.

Political unrest in the Middle East and North Africa, especially the escalating violence in Libya is causing crude oil prices to spike to un-forecasted highs. Earlier bullish projections of oil around US\$90/barrel for 2011 now seem conservative.

Below is a chart showing price movement for West Texas Intermediate crude over the last 9 years.



If you forecast out to 2030 using an annual growth rate of 1.5 million bpd then the world will require 120 million bpd. According to the oil drilling and services company, Schlumberger, over half the additional oil production reserves are still to be discovered and developed. "There is no question that oil and natural gas will still be the major source of the world's energy supply for decades to come," say Schlumberger. New sources of oil are likely to come from offshore Greenland, central Sub-Saharan Africa, Brazil, the North

Sea, North Africa, Southeast Asia, Eastern and Western Siberia and the Caspian region. Over half of this new oil will come from offshore sources and deep sea drilling will pay a major part. Certainly a huge exploration effort is required to build oil reserves that will meet this projected demand. In this scenario, neglected deep sea oil drillers such as Noble Corp (NYSE listed NE) should outperform. No doubt the marginal costs of producing oil from new inhospitable environments will underpin oil prices going forward.

One of the major innovations in oil and gas exploration sector is the new technology that facilitates the extraction of hydrocarbons from shale deposits. This technology includes horizontal drilling and multi stage hydraulic fracture stimulation (fracking). Some say that getting oil and gas out of shale rock is the single largest and most important advancement in the energy industry since the age of oil began 150 years ago. Furthermore it's still in its infancy with major advances occurring each year. To date the most productive shale fields as far as oil goes is the Bakken located in the Williston Basin in North Dakota, eastern regions of Montana and southern Saskatchewan.

One company that is riding this wave being an early entrant to the Bakken shale play is Brigham Exploration (NASDAQ listed BEXP). The company has been featured in various Kelman Reports (4<sup>th</sup> February 2011) and is set to reward investors with increasing oil production selling at premium prices.

Interestingly most oil companies have enjoyed higher share prices on the back of oil above US\$100/barrel. Maybe investors are finally conceding that oil will remain at current levels and that premium oil assets should be priced at higher valuations. Unfortunately natural gas prices have remained very weak on the back of oversupply from shale gas developments. This situation has taken the gloss off the Australian coal seam gas developments with share prices of aspiring producers trading at two year lows. There is certainly an opportunity to buy those with excellent prospects such as Bow Energy BOW (10<sup>th</sup> December 2010) and Molopo MPO (4<sup>th</sup> February 2011)

Beach Petroleum BPT (11<sup>th</sup> March 2011) is leading the shale gas revolution in Australia with 2 wells being drilled into the Nappamerri trough area of the Cooper Basin. Results from the first well, Encounter-1, look very promising with flow tests due to commence in June. Beach has been largely unloved by investors for most of late 2010 and was selling around 65 cents. Being unloved by those who should know better is usually a great buying opportunity. In fact the market had a change of heart in December on the back of some positive drill results in the Cooper Basin. Shares have been rising strongly and are now trading over 90 cents.

Tap Oil TAP has also enjoyed a change of fortune with a major gas discovery at Zola-1 in the Carnarvon Basin. Both companies look set to reward patient investors in the future as they are nicely hedged to high value oil and gas deposits.

Carnarvon Petroleum CVN was first recommended in September 2006 when shares were trading at 6.6 cents. Back then oil production from its central Thailand oil field was 75 barrels of oil per day (bopd). Since then the CVN and its partner have discovered new fields and developed its Wichian Basin oil fields to around 10,000 bopd. Unfortunately the company had a double exploration failure at its other Thailand prospect L20/50 in the Phitsanulok Basin. Shares are very weak at present though with oil trading at current levels and new production coming on stream at its Wichian field's results should improve later in the year.

## **Finding hidden value**

Usually equity investments that outperform the market have a number of important traits that indicate hidden value. In essence this is basis of fundamental analysis. The major characteristics that sort to wheat from the chaff are;

1. Predictable growth in free cash flow.
2. Rich in assets with little or no debt.
3. Low multiple of price to free cash flow.
4. Generous returns on equity.
5. High proportion of insider ownership and shareholder friendly management.
6. Insider buying especially by executive staff.
7. Leadership in their business sector.

Obviously not all companies score 100% but rating the companies on these qualities is an important step to discovering an undervalued company.

For resource companies other worthy characteristics are;

1. Efficiency of operations preferably being a low cost producer.
2. Large resource that can be converted into a minable reserve.
3. Exploration potential so as to sustain future production.

Having found an undervalued share don't wait for the market to prove you right; if your analysis tells you that a stock is likely to go higher from today, then buy it today. Don't wait a week until the stock has gone higher before entering. To be successful, you have to be one step ahead of the mob. Chasing stocks higher with the sheep will lead you to the slaughterhouse.

As this is the last Kelman Report I would thank all subscribers for supporting me over the last five years. I have thoroughly enjoyed the challenge each week of writing about various economic issues and companies.