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Share Structure, People, and Projects: A Primer for the Lay Investor

A Monday Morning Musing from Mickey the Mercenary Geologist

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December 15, 2008

This is the second in a series of Musings in which my intent is to inform and educate the layman and help him become a better and more successful investor in the junior resource sector.

The first in the series was called Reserves versus Resources: A Primer for the Lay Investor. It defined the various categories for classification of reserves and resources in simple terms, detailed the important distinctions in the various categories defined by the Canadian Institute of Mining and Metallurgy, and emphasized that a *reserve* is a mineralized body that can be mined *at a profit* while a *resource* has not undergone an evaluation of its economic viability.

This Musing will detail my systematic methodology and process in evaluating the merits of a junior resource company for investment.

I am asked frequently how to evaluate companies. For those familiar with my audio interviews (http://www.miningcompanyreport.com/geologist-audio-video-interviews.htm) this will sound (pardon me while I employ a favorite quote from The Firesign Theatre circa 1971) as if it's coming from the *Department of Redundancy Department*.

But this statement always bears repeating:

There are three key ingredients to any junior resource company: **Share Structure, People, and Projects.**

Many of my stock finds occur at the numerous investment conferences in North America; I attend about a dozen every year. There are sometimes hundreds of companies exhibiting and thousands of people on the floor of the convention hall. Working efficiently in this environment can be a daunting task.

In a typical two day conference, I visit with 20-25 companies, attend a couple of talks on macroeconomics and/or commodities forecasts, give one or two audio or video interviews, take a half dozen private meetings with CEO's, and do the usual schmoozing and networking. These conferences are fun but absolutely the hardest work I do as an analyst. I must have a well thought-out plan and be efficient; there is never enough time to get everything done on my list because there are so many spur-of-the-moment add-ons to that pre-conference list.

As a result, I have developed a quick and dirty methodology that allows me to reject most companies in a maximum of 15-20 minutes. It is a standard list of rapid fire questions. The goal: Separate the contenders from the pretenders ASAP.

In my analysis, I value each of the key three criteria equally. But I do not consider them in the order presented above.

I start with **Projects**. At any given time, I have priority targets of specific commodities in specific deposit types in specific areas of specific countries. That eliminates most companies immediately.

As an experienced geologist who has seen almost every rock type that exists on the Earth, the **Flagship Project** is my first focus. Generally I am not interested in a company without a flagship property.

I want an advanced play in a particular commodity in a prospective geological environment in a geopolitically stable jurisdiction with permissive size and grade to develop as a possible mine or attract acquisition by a larger company.

That's a mouthful but the necessary characteristics of a Flagship Property are all summed up in that one run-on sentence.

So my first set of questions goes something like this:

- What is your flagship property?
- What is the commodity?
- Where is it located?
- How large is the land position?
- What is the geological setting?
- Are there producing or past-producing mines in the district or region?
- How many drill holes have penetrated the prospect?
- What are the results of these drill holes?
- Is there a historic or 43-101 qualified resource or reserve?
- Is there metallurgical testing?
- Are there environmental or geopolitical concerns?

I want to see good graphic presentations at the company booth, including location map, geology map, and plan map, long-section, and cross-sections showing the deposit and the drill holes. It also improves the company's chances if there is someone with a geology or engineering background on hand, and it is especially good if he is the CEO, COO, Chief Geologist, or VP of Exploration. I generally want to engage the IR-types only to request a meet with the technical guy in charge. It is not intended as disparaging but those who took Mining Geology 101 from the BC Institute of Technology in North Van do not have the in-depth knowledge I am seeking.

If the project has a pre-feasibility or feasibility study with reserves in the ground, I want to know projected operating and capital costs, what metals prices and recoveries were used, the projected Net Present Value (NPV) and Internal Rate of Return (IRR), how debt and/or equity financing will be procured, and projected time to positive cash flow.

As an aside, I will ultimately examine those documents in detail and reach a preliminary decision on the project merits and demerits. If it passes my vet (which many don't), then I get my consulting mining and metallurgical engineering colleagues to review the technical data and double check the operating and capital costs. We must ascertain if the NPV and IRR valuations are done per our conservative industry standards.

Remember what happened with the Galore Creek capital expenditure fiasco a year ago? In my opinion that one enormous technical screw-up was the beginning of the current bear market in commodity stocks.

If it is a producing mine, I want to know the strip ratio if open pit, or tonnes of underground development and waste rock versus ore, mining method, and dilution if underground, metallurgical process and recovery, yearly production and reserves, operating cost, projected capital expenditures, royalties, short and long term debt, last quarter and year to date cash flow, exploration potential, and what the company has done and intends to do with their profits.

P.S. I really like producing mines issuing dividends to shareholders even though that might impact growth and expansion.

To the Board of Directors: Please reward your shareholders. They are your lifeblood, especially in difficult times. Foster their loyalty by returning capital and they will support you time and time again.

These questions can be asked and answered in ten minutes or less and they eliminate half or more of all junior resource companies. Note also that my acceptance or rejection of a company is highly dependent on the projected supply/demand curve and current and projected price of the commodity in question.

My next set of questions is designed to evaluate the **Share Structure**:

- How many shares are outstanding?
- How many shares fully diluted?
- What is the current share price?
- What is the 52 week high/low?
- What is the range in the past thirty days?
- How many shares trade in an average week?
- What percentages are insider held, "family and friends", and institutions?
- Who are those institutions?
- How large is the public float?
- How many warrants are outstanding?
- At what prices are they fixed and what are the expiry dates?
- What is the current working capital?
- How much is cash and how much is equities?
- How much are the long term and short term debts?
- Are there recent proposed, amended, closed, or cancelled private placements?

I want to see a company that is tightly held by insiders and family and friends (a minimum of 15-20%), and a low number of shares outstanding commensurate with the advanced status of the project. There should be a healthy working capital position that can carry the company for a year or more without dilutive financing, warrants that are in-the-money and will raise substantial working capital for future funding, or warrants out-of-the-money that will not cap a rising share price. Institutional funds that are financially viable and committed to their investments and a large enough public float to produce consistent moderate to high liquidity are also necessary ingredients.

This simple exercise can eliminate another quarter of all juniors.

Now we can get down to the final nitty-gritty: I want to learn about the **People**, i.e., the management and technical teams. Here's the interrogative:

- Who are the Chief Executive Officer, President, Chief Financial Officer, and Board of Directors?
- What are their educational and professional backgrounds?
- What experience do they have in the junior resource sector?
- Were they successful at previous ventures in this sector?
- How and to what levels are they compensated?

Note that I personally want to see people on the management team that have considerable *technical* expertise. By that I mean the CEO and most of the BOD are geologists or engineers. It takes years of experience as a practicing technical professional to understand what constitutes a good or a bad project.

I absolutely do not want to find that *all* the professionals in charge are lawyers, accountants, ex-brokers, fund managers, or investment mavens. If that is the case: *Adios Amigos*.

An Executive team and Board of Directors must have successful track records in the junior resource business; i.e., they have raised significant monies, acquired and developed viable mining projects, and *rewarded their shareholders with two or five or ten baggers*, not just took the money and ran. Too many executives and directors, in particular the old school Vancouver promoter types, have found an easy way to make comfortable livings on the dole of public companies thru salaries, options, and management fees.

Success in some other segment of venture capitaldom is not sufficient. They must be players with financial acumen in the hard assets business that have been there before and done that. It better not be your first rodeo or I'm out.

I am looking for names that I know or at least recognize. This is a small business; we all know each other or have mutual friends and business partners who know both parties. Be assured that I will talk with those mutual acquaintances and check the historic trading ban list. I also will vet them with my broker: You all know from my previous writings that Murray Mac has been in the biz since 1981 and *he is in the know*.

And finally, I want to ascertain that their first and foremost interest is the shareholders. As you know, I am on a bit of a mission to reject all those promoters who make a living running public companies into the ground (Mining the Stock Market). It is not hard to ferret out these charlatans: Look at their track records, how long they have doing it, and how many of their companies have succeeded versus how many have gone bankrupt or become shells.

Thanks Tracy once again for your timeless quote: "I don't consider someone who has gone bankrupt three times an entrepreneur."

The next big test is the technical team and the questions are the same:

- Who are your Chief Operating Officer, Vice-President of Exploration, and Chief Geologist?

- What are their experience levels and track records?
- Are they consultants or company employees?
- How are they compensated?

The COO is an especially critical technical position; an experienced mining engineer in this job makes me smile. Many of the best geos are consultants who multi-task like Mercenary Me. I'm at my best with many items on the agenda as it leads to focus, concentration, timeliness, and aggressiveness. I look for a Vice-President of Exploration with 20-30 years of experience, a Chief Geologist equally as qualified, a crew of senior geos with field experience, and junior geos eager to learn.

I personally know half or more of the experienced, English-speaking, practicing economic geologists on the face of the Earth. We are not a big crew; at best we probably constitute 10,000 souls or so. At worst, I am one person removed from a good friend and colleague. Assessing the technical team competency is a relatively easy call for me.

If the property is advanced to resource stage, there should be a mining engineer and metallurgist on board as part of the team, perhaps as technical advisors.

All these aforementioned senior guys will ideally have Master's degrees; a B.A. from your local Canadian university or East Coast liberal arts college does not count for as much in my book. But if they are all a bunch of Ph.D.'s, then their practicality can be called into question.

I find that many companies are lacking the requisite management and technical teams and therefore fail at this stage of the inquisition. There goes another 15% of the prospective pool.

The last three critical questions are asked only of the CEO's of a few companies in which I have genuine interest. They are real zingers and indicate to me if he has a firm and well-reasoned corporate philosophy, goal, and plan:

- What most likely scenario would cause the company's share price to double in the next 12 months?
- What would cause the flagship project(s) to fail?
- What makes the company an investment of merit compared to the 1750 Canadian junior resource companies with which it is competing for exploration and development capital?

Most companies that get this far pass these final test questions but occasionally one will fail.

The above questions and answers constitute the interview process. If the company passes, then a perusal of the company's website is an additional necessary task. This post-interview examination of only the qualified lends particularly good insight into the company's inner workings.

- Is the website professionally done and ascetically pleasing?
- Is it up-to-date?
- Are all links functional?
- Is all requisite data provided?
- Are news releases with technical data accompanied by detailed plan maps, long-section, and cross-sections?
- How does it compare with its peers?

Junior issuers please note: Another 5% of companies are sent to my recycle bin because of an incomplete or badly constructed website. It indicates carelessness, sloppiness, and lack of attention to detail and that reflects management's style or lack thereof.

Now let's review where we stand:

100% of junior resource companies - 50% on Flagship Property - 25% on Share Structure - 15% on Management and Technical Teams - 5% on Website Presentation = *5% of All-Listed Junior Resource Companies, or 1 in 20 pique my initial interest.*

There are approximately 1750 Canadian juniors on the Toronto Venture and Toronto Stock Exchanges. Let's do the arithmetic:

A measly 5% or 85-90 junior resource companies will pass the initial *15-20 minute test* and website perusal and have the requisite **Share Structure, People, and Projects** to qualify for further *evaluation* by the Mercenary Geologist.

Yep, that's it Folks.

But whoa Nelly…wait a minute, there is the final *major* hurdle: The company must be currently undervalued with respect to its *peers.*

What was undervalued six months ago may not be undervalued today and, if I do my job right as an investor, it will not be undervalued in the next one or six or twelve months. As explained in My Investing Philosophy, I am looking only for companies where the share price will likely double in twelve months or less. These undervalued companies are always a moving target. So let's cut that 85-90 companies down by another three quarters which means I am considering about 20 companies for investment at any one time. That group is known as my *radar list* and it's kept in a separate basket on my TSX website account.

But you may say: In this market, peer valuations are ridiculously cheap. *Correctamundo*. Let's use a gold example because base metals are so flushed down the toilet that I'm steering clear until the savants decide how long, deep, and wide this worldwide *Depression with a capital D* really is.

The average exploration company with an in-the-ground measured and indicated gold resource is currently trading at C$7 per oz gold. This has dropped precipitously from valuations of C$60/oz I was using as recently as March and April, and the loonie was on par with the greenback back then. Now that exchange requires a 15-20% discount.

Despite these ridiculously cheap valuations, I looked at a list of gold companies in a recent analysis and found very little of real value.

Why you ask is that? The answer is simple: Most of these deposits are *not* profitable gold mines or takeover targets in-the-making because they do not or will not produce in the lowest quartile of operating costs. They are recycled, marginal deposits that were subeconomic in the past, are subeconomic today, and baring some quantum leap in exploration success or metallurgical processing, they will be subeconomic tomorrow.

They should be avoided like the Plague. As we say about the pinon-juniper foothills of northern *Nuevo Mexico* in the summer: Land of the Flea, Home of the Plague. Avoid that terrain during the monsoon season. The analogy is intuitively easy and more broad based: Avoid high cost projects not only in times of low metals prices but altogether.

I am looking only for the cream that floats to the top. I am interested in deposits that can and will produce at operating costs in the *lowest quartile* of all mines in that particular commodity. Marginal, i.e., high cost producers, will not survive the natural boom and bust commodity price cycles. They fail the financial analysis mentioned previously.

Skeptical? Look at all the mines that are currently shutting down, cutting production, and laying off workers and all the new construction and expansion projects that have or will be shelved in the coming months. I'll guarantee none were or ever will be in the lowest quartile of operating costs.

You may ask: What in the hell do you like now, Meester Mickey?

The answer is *not a whole freaking lot.*

I really like companies that damn well do what they tell you they will do when they tell you they will do it and at the number of dollars they told you they would do it for.

For free email subscribers only, you may contact me at Contact@MercenaryGeologist.com and I'll send you an evaluation template that I use as due diligence prior to writing technical reports on junior resource companies. Be sure and include a previous notification you received from my webmaster indicating that you are a subscriber. The form will require some hard work on your part to conduct real honest-to-goodness stock evaluations but doing rigorous research will make you a more astute investor and should increase your return on investment.

Remember*: It's not my duty to do due dili for you, dude!* (Paraphrasing Otto.)

I must thank my friend, colleague, and fellow newsletter writer Jay Taylor for providing the original idea and basis for this evaluation template when he retained me to review nearly half of his portfolio recommendations in the spring and early summer of 2007.

Jay also was the first to predict that I would have my own newsletter in the future. It came to pass exactly one year later.

Now you have all that I have. This is how I do the deal, Folks.

I sincerely hope this missive will help you become better investors and make more moolah for you and yours.

It really just comes down to this: Learn for the sake of learning. *A day without learning is a day wasted.*

So I'm off tomorrow to the deserts of northern Mexico to chase gold nuggets, a.k.a., *las chispas*. That's the real money. Gold is money.

Buena Suerte, Inversionistas.

Ciao for now,

Mickey Fulp
Mercenary Geologist

The **Mercenary Geologist Michael S. "Mickey" Fulp** is a Certified Professional Geologist with a B.Sc. Earth Sciences with honor from the University of Tulsa, and M.Sc. Geology from the University of New Mexico. Mickey has 30 years experience as an exploration geologist searching for economic deposits of base and precious metals, industrial minerals, uranium, coal, oil and gas, and water in North and South America, Europe, and Asia.

Mickey has worked for junior explorers, major mining companies, private companies, and investors as a consulting economic geologist for the past 22 years, specializing in geological mapping, property evaluation, and business development. In addition to Mickey's professional credentials and experience, he is high-altitude proficient, and is bilingual in English and Spanish. From 2003 to 2006, he made four outcrop ore discoveries in Peru, Nevada, Chile, and British Columbia.

Mickey is well-known throughout the mining and exploration community due to his ongoing work as an analyst, newsletter writer, and speaker.

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