Junior Gold Stocks 4

Junior gold stocks are a contingent of the greater junior resources circuit that has simply been obliterated in the recent stock panic. Even though gold has been strong over this stretch, the risk capital that usually finds its way into these gold explorers had all but left the scene.

Measured by the S&P/TSX Venture Composite Index (CDNX), the juniors saw the worst of the damage in all the equity markets. From its 2007 high, the CDNX *fell by 80%* before it finally hit bottom in December. And at sub-700, the CDNX's gains for the entire secular bull had been wiped clean, and then some. Check out my Juniors in Hell essay from November for more details on this junior genocide.

At Zeal we pay very close attention to the gold juniors considering their potential to yield legendary gains leveraging the yellow metal. And like most of the junior faithful were well aware, the junior sector was already unsettled even before the stock panic unfolded. In gold's powerful 2007/2008 upleg that briefly drove it to touch $1000 for the first time ever, the junior gold stocks were nowhere to be found.

The juniors not only didn't take part in that upleg, they fell on balance. And this was a most precarious season for these tiny but promising companies. Now juniors typically lag gold and even the larger gold stocks over the course of an upleg since institutional investors usually can't buy them. It isn't until the enthusiasm of individual traders takes hold, in the latter halves of uplegs, that junior rallies are ignited.

And of course we were excited about the prospects for the juniors as gold was picking up steam. We even published a junior-gold-stock-specific research report in March 2008 in anticipation of a junior rally. But no matter how fundamentally strong a company may be, it proved too difficult to fight against the overlying strategic trend that unfolded over the last year or so.

Leading into summer 2008 it was apparent that the juniors had missed the boat. Not only had gold given up its ghost and entered into its summer doldrums, but the general stock bear was starting to suck in everything around it with the force of a black hole. And the CDNX's sharp linear descent since July has caused wailing and gnashing of teeth among junior gold stock investors.

The carnage that ensued is a *big problem* for this sector. Decimated stock prices and fleeting investor interest is a bad combination that does not bode well for the futures of many of these small companies. Ultimately with juniors reliant on bullish sentiment to survive, many will now be strained to stay their course. When positive sentiment is destroyed, righteously or not, it takes time to return.

You see, since juniors have no source of revenue they are heavily dependent on equity financings to fund their exploration endeavors. And mineral exploration is not cheap as finding a gold deposit is very difficult and expensive. It takes significant capital to acquire land rights and mineral concessions, pay geologists, and perform the preliminary field work to identify high-potential targets.

And then if a junior actually finds attractive-enough targets, the more advanced exploration work is even more costly. Trenching, drilling, and metallurgical studies require hefty capital commitments. Junior explorers can't do what they do without capital. And without cash flows this capital must come from investors buying their shares.

And this stock panic that is source to capital leaving the junior sector with reckless abandon is deadly for the survival of this species. Selling begetting more selling has driven the stock prices of many juniors to alarmingly low levels. And this damage done over such a short period of time has radically changed the landscape for junior gold stocks. For some of these companies the damage may be irreparable.

Every year or so we survey the junior gold stock sector to find those stocks with the highest potential for success. And this latest round of research revealed just how rotten the environment is for these gold seekers. In my painstaking quest to filter through the masses to identify the best, I perform a high level fundamental scrub of the universe of junior gold stocks. And after accumulating the data on 300+ juniors what I found was frightening.

Most investors who speculate in the junior gold stock realm are well aware they are trading in the land of small-cap stocks. But after this massive sell-off, "small-cap" is a generous classification for these juniors. According to Investopedia.com, the definition of a small-cap stock is a company with a market capitalization between $300m and $2b. Provocatively, at the time I compiled this data *only 3%* of junior gold stocks had market caps above $300m.

This astonishing revelation shows just how small and unpopular junior gold stocks have become. The next classification *down* from small-cap is micro-cap. Micro-cap stocks have market capitalizations between $50m and $300m. And it appears as though micro-cap is even too generous of a classification for most junior gold stocks. *Only 15%* of these companies fall in this range.

Can there possibly be a formal classification underneath micro-cap? Yes, and Investopedia.com calls these little guys the nano-caps. Incredibly most junior gold stocks reside in this sub-$50m nano-cap range. And this is not just a slight majority, but a large majority. *82% of all junior gold stocks are nano-caps!*

And I can even take this thread a step further. Since there is not a formal classification smaller than nano-cap in the stock market world, I'll make up my own. The next unit of smallness according to the International System of Units has the prefix pico. So I'll call those with market caps under $10m pico-cap stocks. And most interestingly, the majority of junior gold stocks are pico-caps. Just over 50% of all junior gold stocks have market caps *under $10m!*

When it comes to investor awareness, sans a major discovery the smaller a company is the harder it is to attract interest. And with size now working against many of these juniors it is also important to consider share price in their ability to raise capital going forward. If a company has 100m shares on the shelf yet its share price is only $0.05, releasing the bulk of these shares would prove to be an exercise in futility.

A company can release only so many shares to the market without disrupting share capital provisions and diluting the heck out of existing shareholders. And when it comes down to it, if a junior tries to raise capital with an over-ambitious offering size relative to its market cap and existing shares outstanding, it simply won't find the subscribers.

Many juniors with super-low share prices will have a difficult time raising capital in today's environment. And if they are able to find subscribers to new shares, they aren't likely to raise significant-enough capital to fund costly exploration programs.

It will always be difficult for penny stocks to raise capital. And I say penny because most junior gold stocks are measured in pennies. According to my research 85% of all junior gold stocks are currently trading *under $1 per share*, 75% are trading under $0.50, 59% are trading at less than $0.25, and *nearly 40%* are trading under $0.10. Utilizing this market-cap and share-price data we can really gain an understating of the magnitude of reduction this stock panic has bestowed upon the junior gold stock sector.

To take it even further I can throw in some volume data to reveal another staggering fact. Using 3-month average volume and the average share price for all the nano-cap juniors, the average daily trading value per stock only amounts to $44k. And this same calculation for the pico-cap juniors returns an average daily trading value of only $18k.

The fact of the matter is it will be extremely difficult for many juniors to flex enough muscle to obtain the capital necessary to fund multi-million dollar exploration campaigns when they are so small.

Interestingly according to the Metals Economic Group, junior equity financings were down by $6b in 2008. And this led to a big decrease in the juniors' overall share of worldwide exploration, falling under 50%. MEG acknowledged that dismal equity markets among many factors have greatly diminished the ability of junior resource companies to access near-term capital.

And with the order and magnitude of equity financings likely to decrease even further in 2009, there is likely to be a contraction in gold exploration. And MEG believes an overall decline in mineral exploration budgets will be in large part from lack of spending on the junior front. Those juniors that don't have cash will not be able to tap the equity markets in the fashion in which they had in the past. And those that do have cash will reel in spending to conserve capital.

And this trend is apparent in the language of the juniors. In my research I scanned hundreds of MD&As (Management's Discussion and Analysis) in order to gain an understanding of each company's direction and strategy going forward considering the dire economic conditions. And the excerpts below directly from the MD&As of two unnamed companies seemed to be all too common across a large contingent of juniors:

"Investor interest in junior mining exploration companies has all but collapsed over the last several months. As a consequence, it has become increasingly difficult for companies such as XXXXX to attract sufficient investment capital to meet commitments and fund ongoing operations. Should the Company be unable to raise additional capital, there can be no assurance that it will be able to … fund general operations … maintain its interest in its material properties."

"As a result of the recent turmoil in worldwide financial markets and the reluctance of investors to participate in the exploration sector, the Company has determined it necessary to revisit its operating plan. In connection with this review, the Company announced that it had suspended additional drilling beyond the already completed XXXX zone to reduce its ongoing operating expenses. In light of current market conditions, the Company also commenced evaluating strategic options to address its short-term and long-term project development goals."

Now amidst this calamity I'm not trying to convey that investors should run away from juniors and not look back. I'm simply outlining the dire straits that many juniors are faced with today. And there will be both bad and good that we can extract from these conditions.

The bad is that many juniors will not be able to survive these current economic conditions. Those companies that have seen their stocks crater to death-defying lows and are light in the cash department are in big trouble.

But there is good news on multiple fronts. First is a slowdown in exploration is smashingly bullish for gold's long-term fundamentals. The gold mining industry has already been struggling to keep up with growing demand. Less exploration means less discovery. And less discovery pinches the ability for mining companies to renew their reserves and build new mines.

Second is the extremely low market caps of the juniors will open the door for acquisitions. Both larger mining companies and junior peers that have cash will be able to take advantage of those juniors that are on life support. And with some juniors closing their doors and others gobbled up via M&A, we are likely to see a noticeable consolidation in the junior gold stock sector. This will allow investors to see the cream rise to the top.

Only those elite juniors that have superior management, high-potential projects, and sound financials among many important fundamentals will be the ones to survive and yes, thrive. Select juniors will be able to overcome this malaise and eventually provide investors with the spectacular gains that they should expect in this high-gold-price environment.

While the juniors are going through a season of reckoning, their role in the gold lifecycle has not and will not diminish. Junior explorers play an invaluable part in bringing gold to market. Most of the big mining companies simply cannot generate enough organic discoveries to sustain longevity.

For the gold mining industry to grow, the junior exploration companies gallivanting around the world serve their purpose to either feed their projects to the big fish or transform into miners themselves. Some of the best geologists in the world work for or run junior gold explorers. And in a modern world where the low-hanging fruit is gone, these rock jocks need to explore for gold where geopolitics and geology may not always be favorable.

So while the junior trade may seem dead, I submit that now may be the best time to consider speculation in these high-flying explorationists. Bargain hunters have already been on the prowl as the CDNX is up 42% from its December low, but it is still down 71% from its 2007 high and there is plenty of room left to run.

As for picking the junior gold stocks in which to speculate, quality is more important now than ever before. In past seasons it was much easier to buy a junior and watch it ride. In the days of yore speculative capital was pouring into this sector so fast that it was like throwing a stick of dynamite into a lake. The explosion sent anything in the area rising to the surface. Likewise, any junior with its hands in the gold pot was bid higher.

But with this stock panic the juniors have been revalued. And while an explosion of a different kind has sent many of these companies into a terminal spiral, there are still many good ones out there. In our latest survey we sifted through the junior gold stocks to find those that are of the highest quality and capable of thriving in this downtrodden environment.

Like separating the wheat from the chaff, those juniors that are brittle fell to the wayside. But those that are strong are at the top of the heap and in excellent position to emerge from these doldrums as sector champions. Our deep research narrowed the field down to our favorite 12, and their comprehensive fundamental profiles are now compiled in a report that is available for purchase today.

The bottom line is flecti, non frangi. Junior gold stocks are bent, but not broken. While the stock panic has done a number on this speculative sector, it will survive. Those elite juniors, whether pico-cap or micro-cap, able to maintain fundamental integrity will recover from their highly-sold-off levels.

There has indeed been a winnowing process that will rebalance the junior gold stock sector. Many juniors will not be able to survive this radically different economic environment. But with gold strong it is only a matter of time before investors return. And those investors that snatch up the elite stocks at these insanely-low levels will likely score legendary gains.

Scott Wright

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So how can you profit from this information? We publish an acclaimed monthly newsletter, Zeal Intelligence, that details exactly what we are doing in terms of actual stock and options trading based on all the lessons we have learned in our market research as well as provides in-depth market analysis and commentary. Please consider joining us each month at … www.zealllc.com/subscribe.htm

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