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Special Subscriber Report

“THE ANATOMY OF AN AREA PLAY”

**Following and Trading one of the Most Rewarding
Situations in the Resource Sector**

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Anyone who has been an active trader in the past few years is more than familiar with the concept of Momentum stocks and Momentum plays. Indeed, it's fair to say that NASDAQ was simply a series of one momentum play after another during the late 1990's.

These situations are attractive to investors for several reasons. They have the safety of numbers and the liquidity that a lot of market and media attention brings. They make it easy for the investor to justify their purchases because "everyone's doing it". And, last but not least, they can generate good returns, even for otherwise mediocre companies, if the play is strong enough and the sector hot enough.

Well. As you know well, the Resource sector has been the hot one recently. The Resources sectors, be it precious metals, base metals, diamond or oil and gas also have a form of the momentum play, known in the industry as the Area Play.

Area Plays develop when a company hits on a major discovery, one that dramatically boosts its share price. Just as companies reinvented themselves to be part of the "flavor of the month" tech sector, junior resource companies will rush in and stake claims near the discovery hoping some of the attention will rub off on them. If the Discovery is exciting enough a large group of companies in the area can suddenly be "in play" and there will be a series of profitable trading opportunities as exploration on the Discovery project

and the surrounding properties advances.

Before we go any farther, we should point out that, curiously, the current cycle has not really generated many of these plays. Why is that? Partially, it's due to lack of large scale exploration success, at least with the kind of project that allows others to follow the lead company.

The one notable example we have seen is Virginia Gold's Eleonore discovery. There are a number of companies, including "New Virginia" itself that are now exploring the Eleonore area. Although Eleonore is the first real area play of the cycle we do not expect it to be the last. With the number of explorers fanning out around the globe and the investment being targeted at exploration there will be more big discoveries.

One thing that this cycle has generated is "commodity" plays rather than "area" plays, with specific metals going in and out of favor. Uranium has been a particularly strong one. Though we are dealing with area or geographic plays in this article one important aspect of them that applies to commodity plays as well deserves mention. That is the added value that comes from a group play. While it's a nice bonus, don't forget that the commodity premium, like the area play premium, soon fades if the company does not come up with the goods.

It takes more than just a big discovery, however. There are a number of added factors (detailed below) which will determine how strong the area play around a

particular discovery might be, or if an area play will happen at all. The rest of this article will follow an idealized Area Play (the sections in italics) with comments and general trading guidelines for each stage of the play.

Of course, any investor experienced with momentum plays knows that they are definitely double edged. It is almost inevitable that companies in a strong momentum play will become overvalued (absurdly overvalued in the case of many Tech sectors in the NASDAQ bull market). Momentum plays can be very rewarding to those who trade them well, but disastrous to those who do not.

It's critically important to understand that a strong momentum play will lift almost all participants, and that the "favored few" in any play will see some big price increases based on their similarity to the main drivers of the play, not their own merits – at least at first. Because of this it's important to "trade smart" which, first and foremost, means **TAKING PROFITS!**

If you are trading an area play you are playing at the speculative end of the spectrum. You are also counting on the market's enthusiasm for the play to do a lot of the heavy lifting, which, by definition, means you are expecting the stock to exceed reasonable levels of valuation (whether you admit this to yourself or not). There's nothing wrong with this but you need always keep the reality of the situation firmly in mind. If and when the market offers you a "free pass" in the form of a big gain before there is new exploration results or other data to back it up – TAKE IT.

Trade your share cost down to zero or close to it, then you can follow the play in comfort rather than lying awake worrying about how the next set of Discovery Company drill results will stack up against the market's expectations.

As a general guide to following a successful Area Play you can follow the graph below which gives a visual representation of the market value of the Discovery Company, the Area Play companies as a group and the number of companies involved in the Play as time progresses.

Note that this graph is based on a successful Play by which we mean a Play where the Discovery Company goes on to either put the Discovery into production or to get taken over by a competitor at a market value that makes all its shareholders money. It also assumes there are "satellite" discoveries (see below), which are why there is a second rise in Play Value and the number of companies, involved near the right side of the graphs.

Note that most of the way through the play the Discovery Company gets the lion's share of the market value, though that doesn't mean it gets the best returns all through all periods. The Discovery Company's market value climbs rapidly in absolute terms then starts to level off as it enters the resource definition and pre feasibility stage.

The other companies in the play see their biggest gains, as a group, while the Discovery Company is still putting out lots of exciting new results and getting plenty of media attention. Note also how the number of

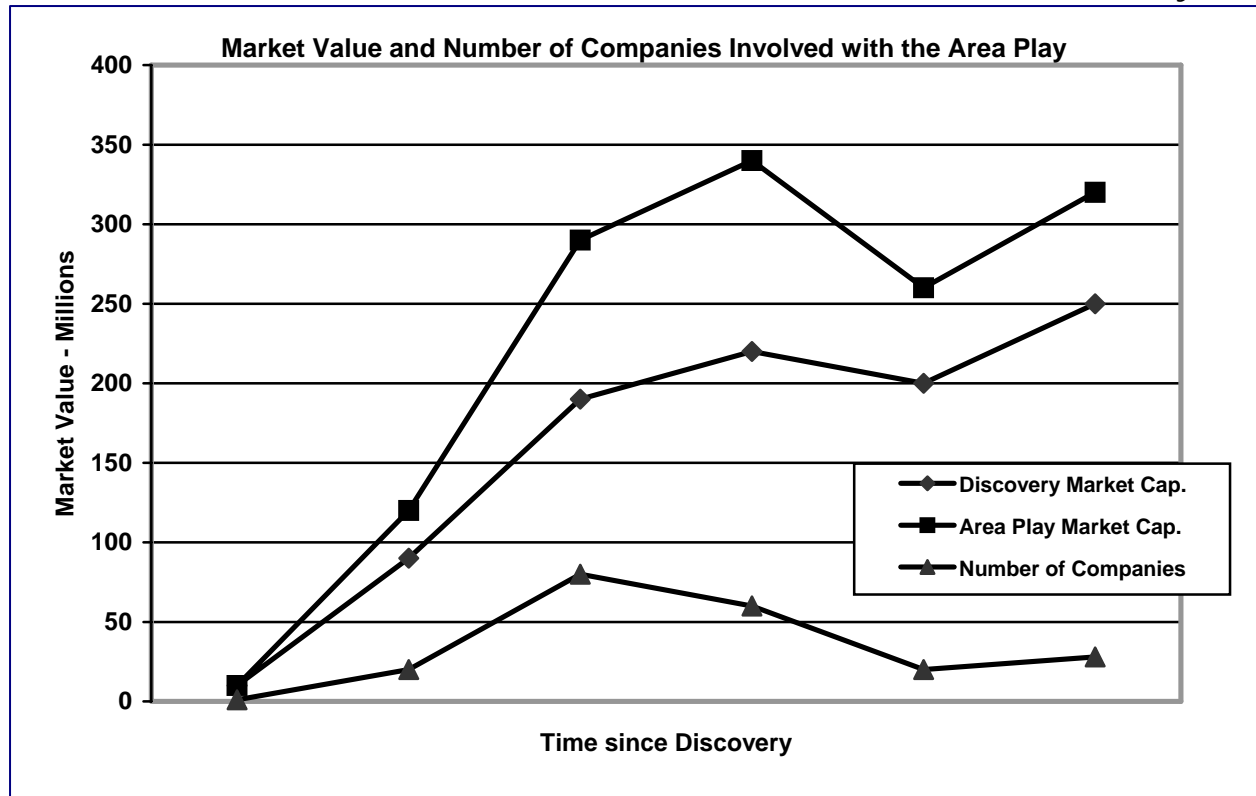
companies involved in the Play (the lowest line with the triangle markings) changes over time. As the Discovery Company's value is rising steadily the number of companies involved multiplies rapidly, only to start falling as the companies with less valuable holdings start getting ignored and drop out.

Those of you who are not familiar with a classic Area Play can look to the diamond play in the Northwest Territories. At its height, there were over 150 companies involved, tens of millions of acres staked and a cumulative market value in the billions. The NWT has had

have been a few periods of strong gains based on new discoveries and those who have traded it well have seen a number of profit making opportunities. It's an extreme example, because there are likely to be four or five mines come from it, but a trenchant one – Area Plays and the methods of trading them can be a very worthwhile addition to your arsenal of portfolio tools.

The Discovery

The company had been quietly going about its business for some time. Considering the scale of the discovery it's amazing that little or no word leaked out in advance. By the



satellite discoveries, one of which just went into production and there will be a couple more before it's done, at least.

This play is now 15 years old, and though it's relatively quiet, there

time the market knew about the new Discovery, the company had covered all the ground they considered prospective. Market reaction was both dramatic and immediate when early results began to come out. Almost immediately the find was being

referred to as "world-class". Experts and analysts christen the find as "the best of its kind in decades" and predicted stratospheric price increases for the Discovery Company's stock.

The announcement of the Discovery has two immediate consequences. The Discovery Company's stock goes ballistic, and every promoter worth his or her salt tries to get a piece of the action. As every good promoter knows, involvement in a hot area play gets a company over the first and toughest hurdle most junior explorers have to face: convincing investors of a property's potential before significant exploration has been undertaken. A good area play is the junior miner's equivalent of a "brand name" product. It brings immediate name recognition, tons (or tonnes) of free press and a concrete example of nearby success. The promoter can entice with lines like "Their market cap is 500 times ours right now - even a sniff and our stock is sure to go up 1,000%!"

At this point the Area Play is still a one-company show. How quickly this will change depends on the area of the find (i.e. how accessible it is), the size of the Discovery Company and the amount of favorable geology that's "left over" for new entrants to acquire.

The size of the Discovery Company is critical. Large producers would not have to report even a major find for some time since it's not a "material" change in their affairs. Indeed, most Majors will put off reporting as long as possible and usually won't report on it at all until they are sure they have acquired any surrounding projects that might contain similar occurrences. For

this reason, big discoveries by major companies rarely trigger area plays.

The ideal candidate for the leadership position in an Area Play is a small to medium sized explorer that can quickly assemble more property and raise funds to step up exploration once a find is made. If the discovery is truly "world class" the financing side is rarely a problem. A company of this size is small enough to have to report new results on a regular and timely basis and (hopefully) smart enough to know there are advantages to having company in the area. The more companies that are touting an area the better the original Discovery Company is going to look.

The Early Adopters

*Analysts dissect the early results of the Discovery and pronounce them amazing. Even better (**here's the key, folks**) they point out that this type of occurrence tends to form in clusters over a large geographic area. The "cluster theory" is the linchpin of the great area play. It's not enough for the Discovery to be world class. A large number of companies have to be drawn into the play and be able to argue, convincingly, that they have a real shot at success.*

By this time competing companies that have access both money and technical expertise are in the field, staking furiously as close to the discovery as possible, covering what they guess to be the right geological trend and rock types. The "technical" group is closely followed by local stakers, who may stake blindly but have the advantage of local knowledge and very low access costs.

Private companies, often mining consulting or contracting groups, come in at the same time. They recognized the potential early and have the resources to blanket stake large areas. Most of these groups will farm-out their claims as soon as the general market accepts the potential of the area. In percentage terms at least, these groups often see the best return on investment, especially if the Area Play turns out to be one without much longevity.

During this early period, the Discovery Company presents the best profit opportunities, though it is likely to be putting out the kind of results that will lead to large moves on the release of results that call for properly timed trades. Buyers need to time their acquisitions for the quiet periods between news releases and try and avoid getting caught up in the speculative fever.

The kind of results that get Area Plays started often lead to the Discovery Company's stock gapping upwards and trading heavily on emotion. If you aren't lucky enough to own it before the results come out, be sure to let it settle if you want to buy it later.

It takes more than one hot drill hole to make an Area Play, and you will find that there are several "stillborn plays" every year. A company will put out a set of spectacular results and there will be a rush to stake adjoining ground until a set of disappointing numbers deflates both the Discovery Company's stock and any hopes of a play.

It's very tempting to jump on the first hot set of results, especially when a

stock has a huge jump, but you'll usually regret doing it. If it's a real play in the making there will be other trading opportunities either in the Discovery Company or newcomers. If its not, you're in for a rough ride.

As this phase of the play unfolds, the Early Adopters will get increasing attention and market values. If there are still no geological clues to narrow down the most prospective areas, investors will be gravitating to companies with the largest land positions and the most credible management, or both. This goes not only for retail investors but institutional investors and brokers as well.

It is during this period that the first major financings for secondary companies start getting done, and the largest ones tend to be completed by companies with strong, trusted technical management. Neither a large land position nor strong management guarantee success, but they will often allow for good short-term gains. Money is the lifeblood of the exploration business; a company that can complete a large financing is at least in a position to pursue opportunities, within the Area Play or elsewhere.

The Also Ran's

Once the find starts getting talked about in the general financial press the early entrant's shares are rising rapidly. The Discovery Company already has the market capitalization of a mid sized producer. Envious promoters start looking for properties to option. It is during this period that the number of companies involved in the play increases very rapidly. Joint venture agreements are signed almost

daily as early entrants farm-out property to decrease their holding costs, and weaker entrants option or stake properties which are farther and farther from the discovery company's core holdings. The area covered by claim maps sent out by promoters gets larger and larger until the new claims reach tens of millions of acres, all of it declared "prospective" by its owners.

So far, everyone's happy. The discovery company has more millionaire shareholders than you can shake a Porsche at. The early entrants are fielding calls from brokers who have investors lined up to do private placements. Even the most dismal also-rans have seen their market cap increase by 20-50% just by hinting at option negotiations.

Soon, however, cracks begin to appear. Investors are starting to get concerned by the lack of news, or just plain bored. They start skipping from stock to stock, briefly resting wherever the latest news release can be found. Some early entrants, thinly disguised "bucket shops" with more outgoing lines than a 900 number phone-sex empire, are usually the most severely bruised. For weeks they have called every one on their lists. They promised huge short-term gains. The gains were delivered as long as everyone followed the script, held their stock and believed in the "greater fool" theory. Inevitably, early buyers start telling themselves to take the money and run. More recent investors begin to wonder what the promoter put in their coffee when he talked them into buying the stock at \$8.00. All this and we haven't even started exploration yet!

During this period the number of companies involved in a true Area Play will be increasing rapidly. By now, virtually all the available ground that looks like it has even a remote chance of protecting an occurrence similar to the Discovery has been staked. Locals looking for a quick sale and consulting groups who will use the projects to generate new clients carried out most of the staking.

During this phase late entrants who feel they have to be involved in the play will pick up the new properties. They might not have the financial resources to do anything but option a distal project and try and raise money with it. The Discovery Company's stock has probably started to level out by this point and the early entrant's shares have found new higher price levels. The Also Ran companies will get a lift too, though it will be a smaller one.

It often gets to the point with a very large Area Play that there is a real law of diminishing returns for new entrants. There are simply too many companies involved for even the analysts to keep track of so the focus tends to stay with the more established players and companies in close proximity to the Discovery. Companies are cashed up and its time to start actually getting crews on the ground to explore. It is at this point that the play starts to really fragment as the market passes judgment on exploration results (or the lack thereof) as they come out.

The Weeding Out

All the action so far has been restricted to the secondary markets. Old warrants and options have been exercised and promoters with good

land positions and/or phone lists have been announcing ever-larger private placements and financings. Most of the stronger companies have filled their treasuries and are sending out exploration crews.

The first exploration phase almost always involves airborne surveys. Most of the early entrants have very large land packages. An airborne survey is the quickest way to locate favorable areas and narrow the areas picked for surface work to a manageable level. It is during this period that many shares have a second price spike. Some companies announce airborne geophysical anomalies that appear to match those from the discovery property. New investors pile in and current shareholders humbly admit that they predicted this success all along.

When the groundwork begins, many shares will see a second price trough; for some of them it will be the last. Investors are getting increasingly impatient and expectations are very high by this point. The market quickly discounts any results considered sub-standard.

Companies unfortunate enough to miss on the first few drill holes will see its market cap rapidly plummet. These judgments will sometimes be unfair. Many investors expect too much of geophysical surveys. They are designed to highlight rocks with certain physical properties; mines are built on rocks with the right chemical properties. Investors who have come to expect the extraordinary view results that would normally ignite a company's stock price dismissively. Many companies with above average

results will already be, in the minds of investors, "out of the play".

In most great area plays, the Discovery is truly a new one and even the original company will be feeling its way through the exploration process, building a model for the deposit as it goes. As time passes and more results arrive there will be a string of re-interpretations. You need to keep track of these interpretations or follow them through newsletters or analysts you trust.

It's not uncommon during an Area Play to see a whole set of companies revalued by the market (upwards and downwards) Today's "on-trend" market darling will be tomorrow's also-ran. All this aside however, the real action is now on the properties themselves. If the Discovery is truly one related to geological events over a wide area (like a diamond-bearing craton or a nickel "province") many companies should receive encouraging results. This is especially true in areas that had seen little recent exploration. The vast amounts of funds being poured into the area will result in the discovery of many good showings.

At this stage the play will start to fragment geographically, as many "satellite" discoveries begin to attract their own followings. Many investors will be distressed to find that the shares of companies with tie-on ground to the original discovery are often the hardest hit during this phase, unless they continue to display extraordinary potential. Companies with the promising finds outside the core area will rapidly appreciate as investors start comparing them to the Discovery Company. When the drills

start turning, life gets lonely for a promoter. Until now, a rising tide of investor sentiment has lifted all boats. From here on in results speak for themselves and companies without them start thinking about share rollbacks.

If the original discovery is being developed quickly enough (as at Voisey's Bay) the success of the deposit will, perversely, start to hurt the shares of the surrounding companies. No matter how good or how big a deposit is you eventually run out of economies of scale and the Net Present Value curve for the deposit starts flattening out. The Discovery Company will often find its shares peaking, albeit at a very high price.

Reserve expansion is exciting. Mine development, for an outsider at least, is pretty boring stuff. Contrary to popular belief, it is not unusual for a development company's shares to slide a bit in price until production begins and it starts getting valued on its income, rather than its prospects. Some investors don't expect this and sell shares in the surrounding companies because they think something is fundamentally wrong. These phenomena will not affect companies pulling good drill holes. They will have their own following by this point. The inactive companies and those with small land holdings are usually hardest hit by this development.

Depending on the land area involved, the number of satellite discoveries and the speed of exploration, the play may go through several cycles of relative quiet, broken up by frenzied activity surrounding

new finds in the area. As time passes however the number of active companies continues to decrease, as does the total market cap. of all companies involved in the play. By the time the Discovery company is in production there will be a few surrounding companies with advanced deposits, usually smaller ones, and a long list of companies with area properties still on their books that have gone back to "pre-play" price levels.

Here are some guidelines for choosing shares to buy in an area play.

- 1) Choose a portfolio of stocks. It's still too early to tell who will be successful. A selection of stocks is much safer bet at this point. As exploration progresses, be prepared to shift these holding around and, probably narrow them down.
- 2) If possible, choose companies that are active on properties outside of the play as well. This gives the stock a fallback position. This is especially important if you are jumping in early. There are several "stillborn" plays each year. If you pick companies that have several "irons in the fire" you are much less likely to get hurt by a string of substandard results from the Discovery Company.
- 3) Look for experienced management. Many companies that jump on the bandwagon at this point have no mining experience and are just rolling the dice. This is the type of company

that usually crashes hardest if things don't work out.

4) Look for some confirmation of the company's share price in the form of private placements. There will be a lot of companies trading at \$2.50 who did their last financing at \$0.25. Treat this as a danger signal if the company doesn't have concrete results to back up the current price. Whenever a company's share price is seeing these kinds of moves you want to see distribution at higher levels, otherwise there is a huge overhang of cheap stock.

5) All things being equal, the bigger the properties controlled the better, especially if they are spread throughout the play. Companies with lots of ground won't run out of story as soon. A large land holding is usually the sign of a strong financing group

6) Many companies will see their best price increases in the property acquisition and reconnaissance phases. Take profits if you are faced with a 3-500% profit and the drill hasn't even started turning yet.

7) Each area play has a few companies that investors and brokers really focus on and they can provide some excellent gains. If this type of company has some moderate success during early surface work and the play is still hot the market will almost always overvalue them. NO company is worth \$200-300 million when

it has nothing but a few surface results in. If you own this type of stock and the market is offering this type of return before the results are even in - take the money.

8) Unless you are bound and determined to just follow area plays, don't blind yourself to everything else in the market. Remember: almost all great area plays are started by companies working "off the beaten track". If you focus too much on this play you may miss the start of the next one!