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**To:** MJG Capital Limited Partners  
**From:** Matthew J. Geiger  
**Date:** January 29, 2014  
**Subject:** 2013 Second Half Review

Below is set forth The MJG Capital Fund, LP's performance since inception.

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**Performance Since Inception (9/1/11):**

The MJG Capital Fund, LP (net of all fees and expenses)	(67.27)%
S&P 500	51.64 %
S&P/TSX Venture Composite Index	(48.53)%



**Note:** All returns for MJG Capital partners are estimated and subject to the completion of an audit at a future date. In addition, the returns for each limited partner may vary depending upon the timing of their individual contributions and withdrawals.

## ***Introduction & Partnership Update***

This is The MJG Capital Fund, LP's fifth semi-annual letter. The Partnership was formed twenty-eight months ago and the results are detailed on the previous page. The S&P 500 is used as a gauge for the "alternative investment of choice", while the S&P/TSX Venture Composite Index is the closest proxy for the universe of junior resource companies.

No partners were added in the recent period. However, over the next six months, I am personally investing an amount greater than 5% of the Partnership's current Net Asset Value. **My conviction stems from the fact that after watching nearly every resource company (regardless of the company's quality or future prospects) fall in tandem for nearly 36 months, we have finally seen bifurcation between the best and the rest within the past 120 days. This is a thrilling time to be investing in resources - the leaders of the next cycle are pulling ahead, while the large majority of companies are praying for financing. Over the next six months, I will continue to refine the partnership's holdings to include only companies with sufficient working capital, a reasonable "Margin of Safety", and exciting economics. Additionally, the Partnership will be adding a new set of "Alternative Resource Investments" to the portfolio. This will reduce correlation between the Partnership's holdings, as these companies belong to resource industries (i.e. Forestry, Farmland, Water Desalinization, and Aquaculture) that do not follow the Mining Cycle.**

In absolute terms the Partnership's performance remains very disappointing. Over the past 2-3 years, there has been a historic bear market in mining equities. The causes for this vary: (a) a somewhat significant drop in commodity prices, (b) an unsustainable increase in both production costs & G&A expenses, and (c) the inevitable fall from grace that accompanies the speculative euphoria that engulfed the mining space from 2006-2011. From a return standpoint, there hasn't been such a severe and protracted bear market in over 12 years. And when you compare the share performance of senior mining equities to the price of the metals they are producing, the equities have not been this undervalued in over three decades. The markets reached panic levels in mid-2013 and have remained subdued since, aside from the recent bifurcation in the very best equities.

A long-term value perspective proves to be incredibly elusive in times of panic and declining share prices. However, it is important to remember that when investing for the long-term, the performance of the underlying companies is the only thing that matters. (The minor caveat is that this is always relative to market expectations, but I won't elaborate to keep it simple). While rising share prices are often indicative of improving performance of the underlying companies, this is not always the case. Similarly, falling share prices do not necessarily predicate business failure. Exceptions can be found and it is the value investor's job to (a) identify these exceptions and (b) show enough patience to be proven right.

The Partnership continues to buy companies that are undervalued for a whole host of reasons, including companies trading below cash, companies with minimum risk and a major discrepancy between expected value and current price, companies priced far below the value of their underlying assets, and companies with an underappreciated technological advantage, to name a few.

At the same time, we have to be willing to clear out holdings that have ceased to deliver results on a company-specific basis. The fund will continue to clear out holdings that have stalled in their progress due to a lack in working capital. A notable example is Soltoro Ltd, which was the Partnership's featured investment in Jan 2013. I misjudged the company's willingness/ability to raise capital when they had the chance at share prices 7x higher than where they are currently. Instead they missed the window for financing early in 2013 and accordingly exploration progress on the company's various projects has ground to a halt. While it is never easy to bite the bullet and admit a failed judgment, the Soltoro stake was sold in Q3 at ~\$0.20 and has been redeployed to better, more cash rich prospects.

In the *Market Outlook*, I will discuss the Partnership's market outlook – with a comment on the S&P 500 followed by thoughts on the direction of the resource market.

In the section titled *Margin of Safety*, I share my key learning from this painful bear market. Especially considering the volatile behavior seen in the junior resource market, *adherence to conservatism and the avoidance of "timing the market"* are the keys to multi-cycle success. Furthermore, companies with a high working capital percentage (preferably in cash) relative to their market cap should be coveted for two reasons: (a) this cushion affords the company with the luxury of timing when next to fundraise, minimizing dilution and (b) more importantly, this working capital cushion provides a major Margin of Safety that limits downside.

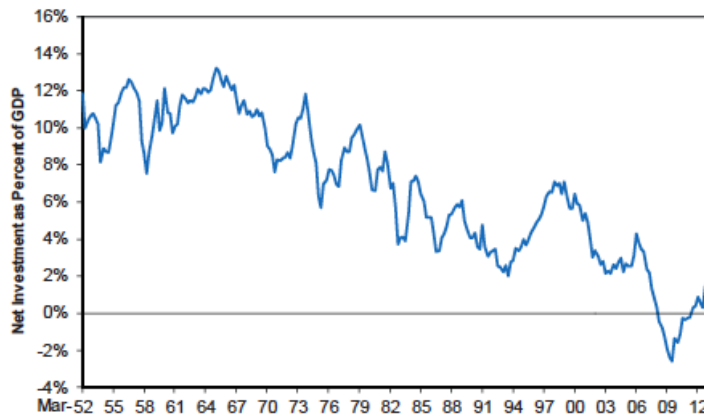
In the section titled *Portfolio Allocation Change*, I discuss a change in regard to the Partnership's portfolio management. As this adjustment is implemented over the next 12 months, it will make the Partnership less correlated to the whims of the junior mining market, while remaining consistent with fund's investment goals of finding undervalued businesses that stand to benefit from the continued Commodity Super Cycle. This different, more illiquid class of resource investments (think farmland, aquaculture, seawater desalinization, and forestry) will provide a dependable cushion in future downturns that is not correlated to mining cycles; as well as a vehicle for excess cash inflows when the Partnership's junior mining prospects inevitably swing from serious undervaluation to serious overvaluation. It will happen, and these holdings will provide a dependable and growing investment option in these times.

## Market Outlook

The S&P 500 has continued to outperform over the past six months, as it has from the Partnership's inception. Using cut and dry valuation measurements, the index is fairly overpriced on a historical basis. This does not mean that the market will not go higher. In fact, it likely will. Jeremy Grantham (probably the most accomplished economic forecaster of the past 20 years) wouldn't be surprised to see the S&P 500 increase by 20-30% more over the coming couple years. This is despite his long-term view that the S&P 500's return will be "1.3% per year for the next seven years after inflation."

So I do not dwell on forecasting the S&P 500's future direction (there is no lack of literature regarding the S&P 500's impressive run since the 2008 Recession and, regardless, forecasting the market is generally a fool's game), I will highlight one major point on why this powerful move in the S&P's share price is not likely supported by the performance of its underlying companies. While the profits of S&P companies have certainly impressed in recent years (especially relative to our deer-in-the-headlights mentality in 2008), there has been a stunning lack of investment by large American companies. The substantial lack of investment relative to GDP growth is displayed below.

**U.S. Net Investment**



Source: Bureau of Economic Analysis As of 6/30/13

In the 1938, Russian economist Nikolai Kondratieff was executed on Stalin's orders for predicting that collectivization of Russian agriculture would lead to sharply lower production. His theory states that every 50 years a technological wave crests. Furthermore, in the last twenty years of the cycle, the growth companies seem to be performing very well. Instead they aren't investing their earnings and are merely returning cash to shareholders as they grow weaker. Interestingly, the USSR indeed collapsed 53 years after Kondratieff's prognostication. While this does not make his word golden, it does illustrate that, on a large-scale, underinvestment results in deceptively strong gains followed by a sharp dropoff in production.

While it would be a stretch to equate the entire S&P 500 to a technological cycle, I suggest that the Fifty Year Kondratieff cycle can be used to illustrate anecdotally

why underinvestment by American companies is a major red flag on the macro level. In the past 50 years, US Net investment has dropped from between 10-12% per year to between 0-2% in the present day. Earnings have been strong pretty much across the board since the 2008 Recession, but this underinvestment belies the market's perception that these companies' future prospects are strong. While the S&P 500 may continue to produce exciting returns for the next 1-3 years, smart value investors with a longer-term time horizon are steering clear at these historically high valuations.

Some good news is that the junior resource market generally performs extremely well in periods when the S&P 500 reaches overvalued territory – major S&P 500 appreciation preceded both the 1993-1996 and 2002-2007 resource bull markets. Rick Rule (a successful participant of the junior resource market for the past thirty years) recently provided some wisdom on market cycles:

*"There is usually one time a decade where even the finest of resource holdings will fall 50%. Investors in the space should realize that even best of breed companies can see major price distortions over the period of a couple years. On the flipside, periods after these clean outs inevitably result in fantastic profits for those who stick with it. In the 2 most recent periods of 1991 and 2000, the gains in this inevitable bull market are somewhere between 500-1000%.....We play this game because, historically, the gains that occur are disproportionate between a bear market bottom and a bull market top. Of course, history does not always repeat itself. Nonetheless, I believe that we are entering the period of recovery now. I can tell you that having suffered an 80 percent decline, the sector is likely a lot closer to the bottom than to the top."*

In the past six months, the junior resource market has remained virtually flat. This is a relief compared to the 30% drop (complimented by steep capitulation in late June 2013) that we saw in the first half of this year. The chart below shows the trailing 1-year performance of the TSX Venture Exchange (the closest proxy to the limited Partnership's holdings).



One surprising fact over the course of both the past six months has been the relatively small amount of delistings that have occurred on the Venture Exchange (~50 in 2013). In the last letter, I shared John Kaiser's view that we would see up to 500 delistings by the summer of 2014. The pace of TSX Venture delistings in 2013 signal that this prediction will prove to be too aggressive, though it still remains to be seen how many companies will survive the Spring (the season in which filing fees, accounting expenses, legal expense, etc are typically paid).

In an exciting development for those who select individual resource companies (versus investors buying, say, the TSX Venture Index or a silver mining ETF), bifurcation is finally happening within the resource industry. To illustrate this point, I have included two charts below. The first shows the trailing 1-year performance of the Partnership's current holdings (equally weighted with the assumption that you invested \$10,000 on Jan 1, 2013). The second shows the trailing 1-year performance of companies that the Partnership owned at inception, but has since fully sold the positions due to negative company-related developments (equally weighted with the assumption that you invested \$10,000 on Jan 1, 2013).

### Current Holdings



### Past Holdings



Over the past year, the Partnership's "Past Holdings" have lost 45% of their value while the Partnership's "Current Holdings" have lost only 3%. Additionally, while it is hard to make out on the above graphs, over the final 30 days of 2013, there has been acceleration to the upside in the case of current holdings and steep declines for holdings the Partnership has liquidated (such as Soltoro). While this hindsight does not do too much good for the Partnership's returns, it does indicate that future performance will be starkly different from what we have seen thus far.

## ***Margin of Safety***

The best description of a Margin of Safety that I have come across is from Seth Klarman's appropriately named book *Margin of Safety*. Klarman states that:

*"Because investing is as much an art as a science, investors need a margin of safety. A margin of safety is achieved when securities are purchased at prices sufficiently below underlying value to allow for human error, bad luck, or extreme volatility in a complex, unpredictable, and rapidly changing world. According to Graham, 'The margin of safety is always dependent on the price paid. For any security, it will be large at one price, small at some higher price, nonexistent at some still higher price.'*

*Buffett described the margin of safety concept in terms of tolerances: 'When you build a bridge, you insist it can carry 30,000 pounds, but you only drive 10,000-pound trucks across it. And that same principle works in investing.'*

*What is the requisite margin of safety for an investor? The answer can vary from one investor to the next. How much bad luck are you willing and able to tolerate? How much volatility in business values can you absorb? What is your tolerance for error? It comes down to how much you can afford to lose."*

The Partnership began with an overly aggressive stance with the belief of a near-term market turnaround. When this turnaround didn't materialize, it became clear that the Margin of Safety for around 1/3 of the Partnership's original holdings was insufficient. At inception, the Partnership's investments were too optimistic and did not account for a historic bear market. In hindsight, we should have been more conservative, placing a higher premium on companies with the larger quantitative Margins of Safety. These 1/3 of holdings would qualify more as "speculations" (versus the "investments" that we currently own) and do not belong in the Partnership's portfolio.

An example of a "speculation" is Soltoro Ltd. If silver today were at \$35+ per ounce (which it probably should be from both a historical and supply/demand perspective), then the Partnership's Soltoro investment would certainly be in the money. This rationale however is speculation and not value investing. Instead of focusing on the upside, the more important question involves the risk. In other

words, in a worst-case scenario, how far can this thing drop? In the case of Soltoro, the answer was a lot. In January 2013, the company had a ~\$40M market capitalization with only ~\$4M in working capital. While the company did have experienced management as well as a promising land package, a more conservative measure of risk would have been to only assign value to the purest tangible asset possible: working capital. If this were instead used to measure SOL's downside, it would have been obvious in Jan 2013 that Soltoro had 90% downside in the case of "failure". (The 90% downside number was found by dividing working capital by the company's market cap.) In the future, the Partnership will steer clear of these types of investments.

The Partnership continues to either (a) transition funds into positions with much larger Margin of Safety or (b) more preferably, fortify existing positions that meet this criteria. After all, in the words of Peter Lynch, "The best stock to buy is the one you already own." The Partnership has averaged roughly 15% annual turnover since inception. Particularly in the past six months, multiple companies with high upside, but also high risk have been jettisoned in favor of holdings with a larger Margin of Safety. Minimizing downside risk is a key priority for the fund, and starting in this letter, there will always be a section discussing downside risk for each Featured Investment.

### ***Portfolio Allocation Change***

By the end of 2014, the Partnership will hold at least 30% of its total portfolio in what I call "Alternative Resource Holdings" (aka Forestry, Farmland, Water Desalinization, and Aquaculture investments). These longer-term, more illiquid, and slower moving holdings are resource focused and fit the Partnership's focus on value investing. The key difference between this category of resource investments and our other holdings is that these resource industries are minimally correlated to the "Mining Cycle" that the Partnership has fully embraced thus far.

The advantage of this approach is that the Partnership's overall returns will be less influenced by the intensely cyclical mining industry. Additionally, these Alternative Resource Investments provide an outlet for excess cash inflows when the Partnership's junior mining prospects inevitably swing from serious undervaluation to serious overvaluation. This is illustrated both by the charts provided at the end of this section and the fact that, in stark contrast to the mining equities the Partnership has owned since inception, these industries have been UP since Sept 2011.

The Partnership's approach with these alternative holdings fits the mission of our partnership—to invest in the resource area and to make money through multiple cycles. Make no mistake, I believe the value of these Alternative Resource Holdings will grow and contribute meaningful profitability to the Partnership's overall portfolio. Nonetheless, in an effort to provide a view of the impact of these newer



holdings on the value of the broader partnership, let's conservatively assume that these holdings do no more than maintain their original stock values. This simplifies our math and treats the value of these less volatile stocks more like "cash in the bank". In this case, should Rick Rule's "500-1000% mining stock increase transpire, the 30% of the Partnership parked in these Alternative Resource Holdings will limit the Partnership's overall upside to roughly 300% to 700%. We consider this trade-off between upside and prudence to be more than justified for two main reasons:

- 1) Sometime in the next 10-15 years, there will likely be a similarly ferocious decline mining equities. In this highly cyclical business, this is not a matter of if, but when. If this happens, the Partnership will be in a much better position to weather the storm. If we continue to pretend that these Alternative Resource Holdings are equivalent to cash, this means that even if an identical period of losses occurs in the mining space to what we saw in the past two years, the fund losses would be contained to approximately 40%. This number, while not pretty in its own right, is preferable when compared to current performance both for the Partnership and across the resource space at large. (Ironically, both Eric Sprott and Rick Rule are now stating a 50% loss being acceptable in this bi-polar market...I remember quoting Rick in a previous semi saying that 30% losses are what you should shoot for in bear markets!) Needless to say, this downturn has been deeper than almost anybody thought. The good news is that deep, prolonged downturns usually translate into upside returns that are commensurately powerful and prolonged.
- 2) But before point #1 happens, we will see the exact opposite - a proverbial "feast". Just as junior mining equities can grow increasingly undervalued (and can do so very quickly as we've seen in this market), they can also reach fair value and then overvalued territory in a few years. When this occurs, the Alternative Resource Holdings will importantly provide an outlet for excess cash as the metals holdings reach extreme overvaluation. Ironically, it is at times like these when money will be flowing into the Partnership like water, at the exact time where metal equities are most undesirable from a valuation perspective. It will be harder to find strong value investment candidates during this future resource "feasting" time, and in this scenario I envision that the Partnership could "park" as much as 70% of our total capital into Alternative Resource Holdings. This capital would eventually be used as our "dry powder" for redeploying into undervalued mining equities during the next bear market (which inevitably follows periods of euphoria and overvaluation).

I am refining our approach so that this Partnership is designed to withstand multiple cycles—as my ambition is to continue management for decades to come. Please note this is not a significant change to the investment funds goals and investment psychology. It is instead a prudent approach that should provide limited downside risk and more stable returns moving forward.

Below is the 2013 share performance of the 12 Forestry names that I track (the Partnership currently owns two):



Below is the 2013 share performance of the 7 Aquaculture names that I track (the Partnership currently owns one):



Below is the 2013 share performance of the 3 Seawater Desalinization names that I track (the Partnership currently owns 2):



Below is the 2013 share performance of the 3 Farming names that I track (the Partnership currently owns 1):



In contrast to the mining sector, these Alternative Resource Holding stocks have all provided meaningful return on investment over the past year. Clearly, their stock value is not tightly correlated with that of the mining sector. And, although our conservative modeling of these valuations placed the value of these stocks at their original cost basis (in the beginning of this section), these stocks have the potential to deliver significant return on our investments.

## ***Overview of Partnership Holdings***

The Partnership is exposed to different commodities, different jurisdictions, and different stages of the development cycle. The holdings have been extremely correlated since the Partnership's inception; however, this won't always be the case. Below is an approximate breakdown of the Partnership's holdings as of January 15, 2014.

<b>Holding Allocation By Primary Commodity</b>	
<b><i>Food</i></b>	
Phosphate	6%
Farmland w/ Water Rights*	4%
Sustainable Aquaculture*	4%
Seawater Desalinization*	3%
Potash	2%
<b><i>Wood Products</i></b>	
Sandalwood*	2%
Specialty Cellulose*	1%
Lumber*	1%
<b><i>Clean Energy Metals</i></b>	
Uranium	18%
Silver	16%
Rare Earth Elements	9%
Platinum Group Metals	3%
Graphite	3%
Lithium	3%
Scandium	2%
<b><i>Infrastructure</i></b>	
Copper	15%
Iron Ore	2%
Nickel	2%
<b><i>Cash</i></b>	4%

\* Signifies minimum correlation to the "Mining Cycle"

<b>Holding Allocation By Country (Flagship Project)</b>	
Canada	26%
United States	14%
Mexico	13%
Sweden	8%
Botswana	7%
Morocco	4%
Serbia	4%
Australia	4%
South Africa	4%
Norway	3%
Turkey	3%
Eritrea	2%
Singapore	1%
Brazil	1%
Ethiopia	1%
Gabon	1%
<b>Cash</b>	4%

<b>Holding Allocation By Operational Phase</b>	
Exploration	26%
Development	54%
Production	16%
<b>Cash</b>	4%

## **Featured Investment: Western Lithium USA Corporation (TSE: WLC)**

Western Lithium is a Nevada-based development company advancing its Kings Valley Project. Kings Valley is a unique deposit that contains both “Organoclay” (valued as a drilling additive in the oil/gas industry) as well as substantial reserves of “lithium carbonate” (valued as an irreplaceable component of lithium-ion batteries). If WLC is able to execute its business plan over the next 4-5 years, the company will be a producer of both of these products through one streamlined operation. Aside from the unique aspect that WLC will be the only company globally producing these seemingly contradictory products (hydrocarbons and electric cars rarely go hand in hand), Western Lithium is priced at fractions of the future cash flow that may be generated. This makes me believe that WLC has a very high expected value relative to its current price.

While high expected value is one necessary component of a good investment, there is another more important criteria – the Margin of Safety. Opportunities with substantial upside and minimal downside are the bread and butter of value investing. When the Partnership first purchased WLC, the company offered a good margin of safety for two main reasons: (a) a Working Capital position which was 50% of the company’s market cap with a potential to increase in 2014 and (b) a high likelihood of positive cash flow in the immediate term.

The Partnership has purchased WLC within the past six months with an average cost of \$0.23 per share. As of January 15, Western Lithium is trading at \$0.31 with a ~\$31M market capitalization (and approximately \$12M in working capital). As more cash becomes available to the Partnership, WLC is a strong buy at these levels.

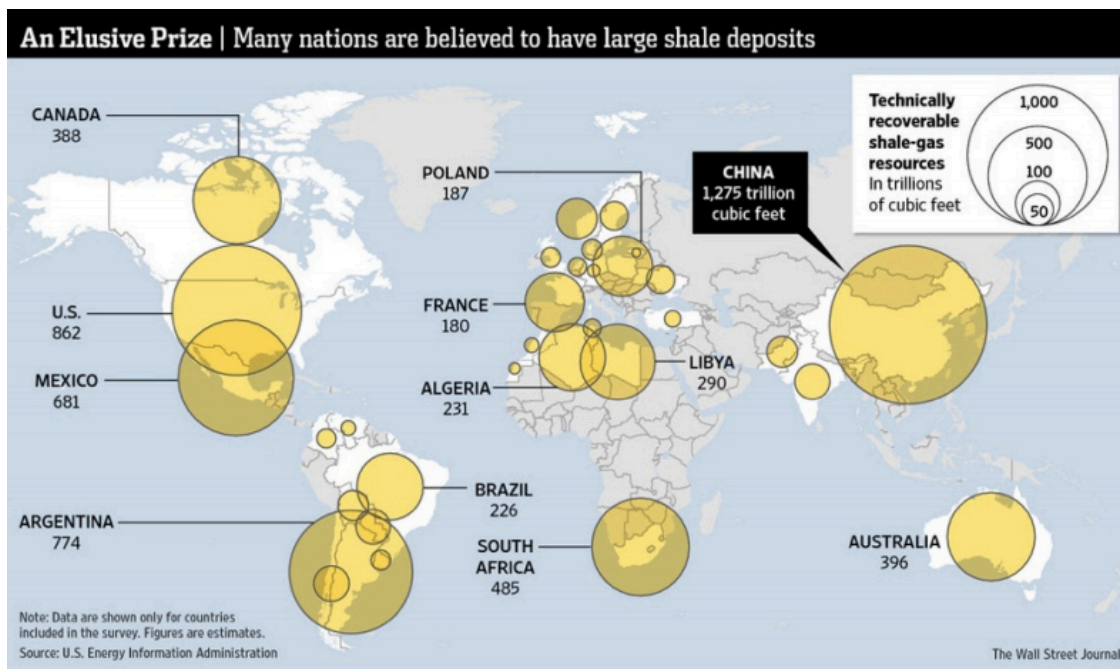
### ***Investment Thesis for Organoclay***

As conventional oil and gas reserves continue to deplete, energy companies have begun to implement deep drilling methods to increase production. These recovery methods, often referred to as “horizontal drilling,” now account for a large number of the new wells drilled within the United States. According to the US Energy Information Administration, horizontal drilling now accounts for approximately 23% of **ALL** US Natural Gas production. Due to the high-pressure nature of these wells, substantial amounts of drilling additives are pumped into the wells to yield higher levels of production. Arguably the most important of these substances is called “Organoclay”.

Initially, a deep horizontal well is drilled through a tight shale formation that provides little permeability. Though a practice called “hydraulic fracturing”, energy companies create fissures in this rock layer to open space for the hydrocarbons to enter the well. In the final phase of the process, a pumping truck injects fluids

(mixed with Organoclay) to increase hydrocarbon capture and lubricate the well. The Organoclay itself acts as a viscosifier for the drilling fluids.

On the demand side, these new drilling techniques that have recently been implemented for wells within the United States continue to emerge overseas. Exxon, Shell, ConocoPhillips, and other majors are just beginning to bring this technology to offshore rigs and assets in other regions of the world. The chart below demonstrates the vast potential of horizontal drilling beyond North America.



From a supply angle, there are currently no large-scale operations within the United States to extract Hectatone (the specific Organoclay compound used in horizontal drilling). This is surprising given Organoclay's key role in horizontal drilling, where there is more production from United States than the rest of the world combined. At the moment, all of these clays are imported (with the majority coming from China) at a premium and relatively inelastic price. This is unsustainable given both (a) the United States strong annual growth of horizontal wells and (b) the huge potential for Organoclay demand from within China itself!

Although somewhat rare, areas of the United States have proven to hold reserves of Organoclay substances. (One example is Western Lithium's Kings Valley Hectorite Clay Project.) The current Organoclay supply/demand situation is an excellent opportunity for mining companies who own sizable clay deposits to begin production specifically for horizontal drilling purposes.

### ***Investment Thesis for Lithium (in North America)***

The long-term future of lithium continues to look upwards. One factor behind the long-term success of this metal involves it serving as a crucial component to help bridge the gap between fossil fuels and greener energy sources. Lithium-ion batteries have proven to be important supplements to nearly every alternative energy source. With the application of these batteries, engineers have endless capabilities to continue improving the efficiency and capacity of almost any alternative energy source.

In addition to benefiting alternative energy sources, electric transportation is becoming more prevalent. Governments around the world are now pressuring car manufacturers to increase their respective amount of electric vehicles on the roads. For example, the Obama Administration set a goal to have 1 million electric vehicles on the road by 2015. If trends continue as planned, many estimates forecast that Lithium battery usage will be near a \$43 billion market by 2020.

On the demand side, it is surprising that electric vehicles currently account for just 6% of total lithium demand. This segment however is expected to triple in total demand in the next 6 years. The broader “automotive” category (lithium is used even in 100% gas cars for the navigation system, the car’s battery, etc) uses 36% of all lithium produced. In a testament to the healthy medium term future of the automobile industry, this segment of lithium demand is expected to grow at 37% annually over the next three years! Lithium usage in alternative energy production and consumer electronics (i.e. cell phones, MP3 players, laptops) is poised to continue growth as well.

Current global production of lithium is highly concentrated, both geographically and in corporate ownership. Approximately 80% of world production comes from Chile (SQM & Rockwood), Argentina (FMC Corp), and Australia (Talison Lithium). There are currently two sources of lithium production – salt brine and hard rock. Around half of global lithium production is produced from lithium brines in the Andes mountain region (Chile, Argentina, and Bolivia). Brine production is cheaper than hard rock, but does take longer (production cycles are roughly 18 months). While more expensive, hard rock lithium supply from both Australia and Canada account for a significant percentage of global supply. There is currently no lithium production from other possible sources, such as clay.

### ***Investment Thesis for Western Lithium***

Western Lithium is well positioned to become a multiple commodity producer over the next 4-5 years. Given the Kings Valley’s low Implied Project Value (or similarly the company’s low Enterprise Value), the market does not appreciate this possibility at current prices. If events play out positively over the upcoming years, WLC has the potential to increase in price in excess of 1000% - the proverbial “multi-bagger”.



More importantly, the company is positioned to also generate value in the short term. This both minimizes risk (which is discussed in detail in the following Margin of Safety section) and increases the likelihood of an overall success.

WLC has been busy over the past 4 months. In mid-September 2013, the company announced a \$20M financing agreement with Orion Mine Finance (a strategic investor that now owns 20% of WLC). This provides WLC with access to capital both for the near-term production of Organoclay and the development costs necessary to bring a project to construction. The company secured all necessary permits for Organoclay in December and has a significant amount of equipment already on site.

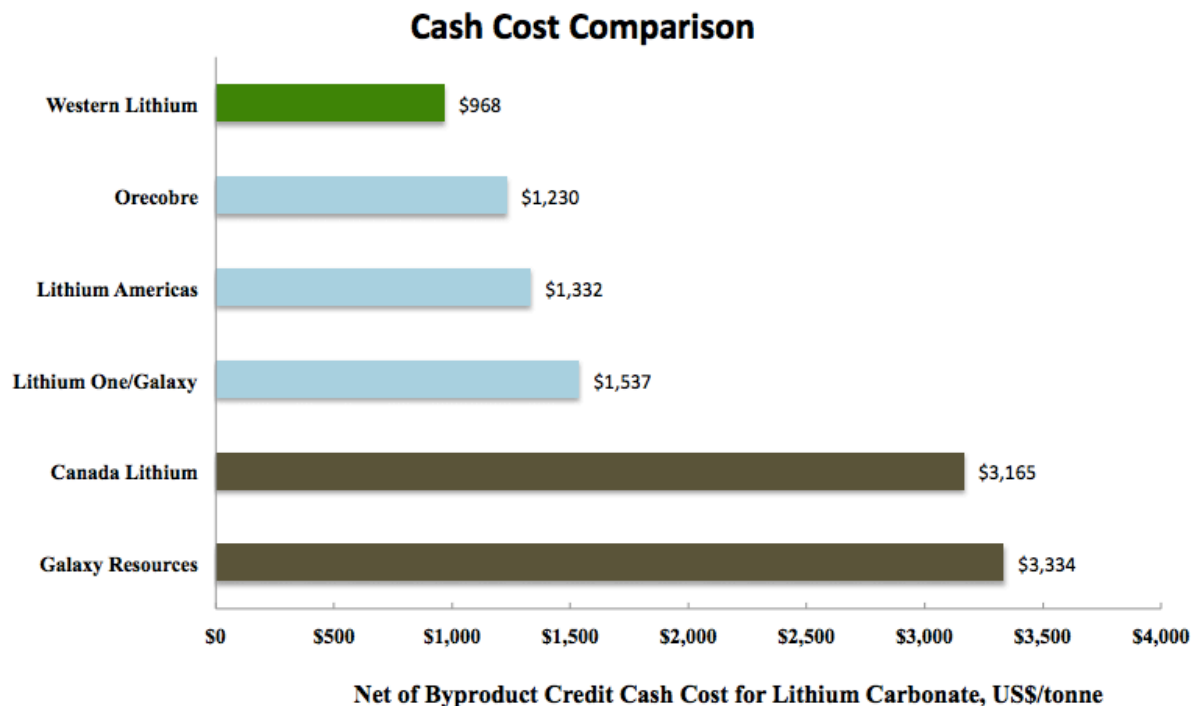
In the next six months, the company will commence production of Organoclay at the Fernley manufacturing plant (with the unrefined clay originating at WLC's 100% owned Kings Valley Project). The company expects to bring up to six different products to market in 2014, under the "Hectatone" brand. Annual production is projected at 10,000 tonnes per year. While production in the first half of 2014 is not a guarantee, the company is well on its way. According to CEO Jay Chmelauskas in mid-December, ""We are now focused on commencing construction of the Hectatone™ organoclay plant and finalizing our budget and schedule with the successful contractor... We are targeting the spring, or first half of the year, to get the commercial plant operating. In addition, we have been actively engaged with potential customers in the US Gulf Coast, the Rocky Mountains, and in Canada, and will seek to secure sales agreements in the new year."

This 10,00 tpa Organoclay operation, while relatively small in scale, has the potential of producing upwards of \$10M in free cash flow per year (more details on this estimate are provided in the following section). More importantly, if WLC is to be a home-run investment, near-term production and positive cash flow from the King Valley Project provides credibility to the company's aspirations to become the next US-based lithium producer.

In the latter half of 2014, a lithium demonstration plant is expected to begin production – using the exact same Hectorite Clay from which Organoclay is produced. While to my knowledge the demonstration plant's location has not been confirmed, either onsite at the Kings Valley Project or next to Organoclay facilities in Fernley, Nevada seem the likely candidates. Plant design was completed in late 2013 by US-based URS and German-based K-UTEK.

The purpose of lithium demonstration plant is three-fold: (1) demonstrate low cost lithium extraction from Hectorite Clay, (2) confirm design parameters and scale-up factor for commercial production, (3) produce bulk samples for off-take sales negotiations. Near term results from the lithium demonstration plant is especially helpful for the thoughtful investor. Within the next year, we will know whether lithium production from Kings Valley is either a pipedream or a distinct possibility.

Assuming that the lithium demonstration plant yields a positive result, WLC is well-positioned to become next lithium producer within the United States by 2018. In December 2011, the company released a Pre-Feasibility Study regarding lithium production at Kings Valley. The report was conservative in its assumptions regarding lithium carbonate prices and the project's contingency cost. Notable figures include: (a) first quartile production costs which are demonstrated by the below graph, (b) a low initial CapEx of roughly \$250M, (c) an impressive NPV of roughly \$550M, and (d) average annual cash flow of roughly \$125M.



What does this all mean? When analyzing development projects that have already filed an NI 43-101 report, I have found success using Rick Rule's "3 Point Development Checklist". Good investments in development stage projects usually fit three quantitative criteria: (1) a low initial CapEx relative to the current value of the asset ( $\text{NPV of Project} > \text{EV} + \text{Initial CapEx}$ ), (2) a high IRR in comparison to other possible investments (an  $\text{IRR} > 25\%$  is desired), and (3) a quick payback of invested money (3 years or less). Applying this checklist to Western Lithium, the economics of lithium carbonate production at Kings Valley look compelling, even at conservative prices. Below are the results for the three tests:

- 1) a pre-tax NPV of \$550M compared to a \$270M initial CapEx + Enterprise Value sum
- 2) an IRR of 24%
- 3) a before tax payback of 3.5 years

While the payback timeframe and IRR estimates fall just short of Rule's strict criteria, the figures in WLC's Pre-Feasibility Study are well within the ballpark of an economic development project that would be bought by a major mining company. The company also has additional advantages compared to a standard greenfield development project. The first is that clay extraction at Kings Valley will already be ongoing, due to Western Lithium's Organoclay production. It is always easier to produce a second product if "the earth is already moving". Second, Western Lithium is to my knowledge the only advanced stage lithium project in the United States. Considering the novelty and strategic value of domestic production, there is no reason why permitting would not be fast-tracked. Finally, the biggest wildcard regards Tesla's plan to build the largest lithium-ion battery plant in the world right in North America. If Elon Musk follows through, this undeniably would provide a substantive boost to WLC's aspirations.

### ***Western Lithium's Margin of Safety***

Western Lithium has a high Margin of Safety (especially relative to its peers) for three reasons: (a) in a worst case scenario, WLC has substantial liquidation value relative to its market capitalization, (b) near term cash flow expected from operations, and (c) strong shareholder support, including future commitments. In reverence to Benjamin Graham and the fact that his principles are at least as relevant now as they were 80 years ago, I believe that only quantitative measurements can determine a true Margin of Safety.

The most conservative Margin of Safety involves liquidation value. Regarding liquidation value relative to market capitalization, WLC is well within the top quartile of similar companies. In a drop-dead scenario, where both OrganoClay and Lithium Carbonate prices fell from \$6000 and \$3000 respectively to zero and no speculative value was placed on the Kings Valley Project, a WLC share would decline no more than 60% before reaching liquidation value. (This is based off of the \$12M in working capital that WLC reported in their last set of financials.)

A second form of a Margin of Safety involves a major near term catalyst. This is less concrete than liquidation value because it is quite easy to trick yourself in to thinking that a certain "catalyst" really provides downside protection. However, in this case, Western Lithium expectation to generate its first cash flow as a company in H1 2014 is a big deal. Near term cash flow is both a qualitative and quantitative factor. From a qualitative perspective, very few companies have been able to advance a project from development to production over the past 3-year bear market. Any type of cash inflow without dilution is a huge win for a development company and will be an eye opener for investors. Currently, the stock is not priced as if cash flow in 2014 is a possibility. However, the company's progress says otherwise.

From a quantitative factor, WLC can realistically generate \$8M of free cash flow annually – which at current prices would pay back the company's entire market

capitalization within 4 years. The assumptions used in this estimate are conservative: (a) clay production of 10,000 tonnes per year, (b) an average price of \$3,250 per short ton of OrganoClay, (c) taxes at 40% and (d) a profit margin of 40%, including the 8% royalty owed to Orion. This is a substantial amount of free cash flow, which provides a further Margin of Safety beyond the liquidation scenario discussed above.

Finally, WLC has strong institution shareholder support. Again, this is unique given the fact that 80% of WLC's existence as a company has taken place during this severe bear market. Orion not only has provided the substantial capital to enable the OrganoClay production; but has also pledged their willingness to take the extra step to include lithium production within the next 3-4 years. In fact, there is \$9M in cash that WLC has not yet received from Orion. The September 2013 deal stipulates that the additional cash "will be funded upon completion of the engineering and design of the lithium demonstration plant and once certain regulatory assurances have been received from the Bureau of Land Management with respect to the sale of by-products associated with lithium production, provided that it occurs within the three years following the date of the agreement". This is not an empty promise considering the three-year buffer that Orion provides WLC. If things go to plan, I expect the \$9M to hit WLC coffers within 24 months. This is a strong Margin of Safety - \$9M is a lot of cash both relative to the company's working capital position and current market capitalization.

## **Past Featured Investments**

### **Phoscan Chemical Corp (TSE:FOS)**

Featured In: **July 2013**

Partnership Average Cost per Share: **\$0.29**

Current Market Price (Jan 15, 2014): **\$0.29**

Unfortunately, Phoscan's CEO Stephen Case recently confirmed that hopes of a niobium byproduct supplementing potential phosphate production are dead in the water. This means that at current phosphate spot prices, Phoscan's Martison project is uneconomic and will unlikely proceed in the short/medium term. For the upcoming 3-4 years, Morocco will be the dominant supplier of additional phosphate demand for North American fertilizer producers. As described in the previous letter, Morocco has disproportionately huge endowment of phosphate reserves relative to the rest of the world – a disparity that Jeremy Grantham has compared to the Saudis and their oil. Morocco's production costs are markedly lower than phosphate development projects in North America, such as Phoscan. It will be interesting to see whether Arianne Resources (North America's most prominent phosphate development project) reaches production in this pricing environment. Stephen Case certainly doesn't think so.

In terms of the Phoscan investment, the good news is that the company has around \$55M in cash, or \$0.35 per share in cash. This means that FOS shares are trading at a discount to cash value and remain a very low risk investment. FOS management is currently evaluating North American development properties of a variety of commodities looking for a worthy investment from the company's outsized cash position. I'd like to see FOS make a decision in the upcoming six months, allowing me to make a decision on whether Phoscan's choice fits with the Partnership's current holdings. The worst-case scenario is that a decision is not made in the near term and the Phoscan holding is the equivalent of holding cash – not a bad strategy in this steep bear market.

### **Soltoro Ltd (CVE:SOL) – NO LONGER A PARTNERSHIP HOLDING**

Featured In: **January 2013**

Partnership Average Cost per Share: **\$0.47**

Exit Price: **\$0.20**

In the case of Soltoro, I should have heeded my own warning in the July semi-annual letter – in which I wrote that "Soltoro is in the market's doghouse due to a low cash position of ~\$1.5M. They will need to raise money in the next six months from the market/strategic investor or stop making progress on their properties. The

company will likely be caught in the grey area between not raising enough money and risking excessive dilution.”

The company has stubbornly refused to come to market in 2013, bringing their working capital position to less than \$1M. For a company that prides itself in exploration success, there needs to be money to explore and their share price has suffered as a result. Moving forward the Partnership will focus on companies with at least \$5M in working capital to avoid similar results. The Partnership sold Soltoro at roughly \$0.20 a share.

### **South Boulder Mines (ASX:STB)**

Featured In: **July 2012**

Partnership Average Cost per Share: **\$0.58**

Current Market Price (January 15, 2014): **\$0.22**

South Boulder Mines continues to be a long-term Partnership holding, despite the recent upheaval in the potash market (with spot prices down roughly 30% over the past six months). Given the long-term demand outlook for inorganic fertilizer, this swoon is likely to reverse well before the Colluli Mine reaches production. But even with conservative potash pricing estimates going forward, Colluli still looks attractive given its lowest quartile OpEx compared to producing potash operations and its CapEx compared to potash development projects. The company’s current cash position of ~\$12M will be more than enough to take the company through their upcoming Definitive Feasibility Study (which is the final step before financing and then construction). At this point, the company’s major risks are Eritrea’s mining policies and the availability of 3<sup>rd</sup> party financing.

Over the past six months, there has been only one major milestone, albeit a highly positive one. In mid-November, South Boulder signed a definitive ownership agreement with the Eritrean government (after signing in May a binding Letter Of Intent with the same terms). Finalizing the project ownership structure was a huge step for STB in their search for an equity partner to fund construction. Without the agreement finalized, there was risk of a bigger party coming in, negotiating directly with the Eritrean government, and cutting STB out. Now that the ownership has been finalized, it seems that whoever takes this project to production will do so through taking a controlling stake in STB. This scenario would of course have positive implications for South Boulder’s share price.

Going forward I expect STB to release a Definitive Feasibility Study by the end of March 2014. This will incorporate the results of a processing review that the company is currently conducting. In the original mine plan, only 35% of the Colluli resource was included (more specifically, the most recent scoping study only included Sylvinite and Carnalite). The DFS will also include Kainite – the potassium bearing salt that makes up the remaining 65% of the resource. This will have a

material impact on the project's economics and could be a major catalyst for the company. Project funding and the start of construction should occur sometime shortly after the Feasibility Study's release. If construction doesn't commence in 2014, the Partnership will likely exit this position.

### **Northern Graphite Company (CVE:NGC)**

Featured In: **January 2012**

Partnership Average Cost per Share: **\$1.10**

Current Market Price (January 15, 2014): **\$0.69**

Northern Graphite Company (with its Bissett Creek property in Ontario, Canada) continues to be a Partnership holding. Northern Graphite remains an advanced development company with no production - the next step for the company is to receive mine financing and begin construction. Over the past six months, the company has released a string of good news including: "Major Permit and Mining Lease Approval" from the Ontario government in August (this is a relief to shareholders as the permitting process took 10 months instead of the standard 45 days), an updated Feasibility Study in September (which tightens up the project's economics and mining plan), and an Expansion Case PEA in October (which shows that a future \$45.2M million dollar expansion would raise annual production by 30% and reduce OpEx by 12%). While I remain disappointed that the company has not been able to commence construction, the company has done an impressive job of continuing to de-risk the project over the past six months.

As I've stated in previous letters, I like to look at three different measurements to evaluate the attractiveness of juniors in advanced development. The first views the project's NPV in relation to the project's initial capital investment and current enterprise value (one would like  $NPV > EV + \text{Startup Capital}$ ). According to the updated FS in September, NGC has an NPV of \$130M, EV of \$30M, and requires an initial investment of \$102M. The second looks at payback of initial CapEx once the project reaches production (a payback of 3 years or less is ideal; NGC's payback is expected to be three years). The third looks at the project's Internal Rate of Return (an IRR of  $>25\%$  is ideal; NGC's Bissett Creek IRR is 25.7%). The project seems to have a high likelihood of reaching production based on a holistic reading of the three measurements. Just as importantly, NGC's cash-position of \$4M will be more than enough to sustain the company as financing discussions continue. The only remaining dilution foreseeable for NGC will occur if/when an equity partner is announced.

Finally, there is a major wildcard in the form of Tesla's consideration of building the largest lithium-ion battery factory in the world in North America. According to CEO Elon Musk in November, "This will be a giant facility. We are talking about something that is comparable to all the lithium-ion battery production in the world - in one factory. It is big." Graphite is a very regional market, particularly in the

case of the large/jumbo flakes being used in advanced technologies. Since NGC is the most advanced junior graphite project period, major North American demand for lithium-ion quality graphite would be a huge boon to the company. It is worth giving the company 6-9 more months to get further clarity on both construction financing and Tesla's future plans regarding lithium-ion production in NA.