

Philequity Corner (August 29, 2011)
By Valentino Sy

The Contrarian

When the stock market is flourishing, Felipe Yap and his stocks are hibernating. On the other hand, when everybody else is losing money, he is making all the money. We have kidded Felipe Yap about how this has happened so many times in the past.

When stock markets around the world crashed in the past 3 weeks, causing even the Philippine Stock Exchange index (PSEi) to pull back from its peak, Lepanto Consolidated Mining (LC) was continually making all-time highs. In previous years, and we can count at least 5 instances, LC moved in the opposite direction of the general market. It was truly a contrarian stock play in every sense of the word. So what is the reason for the contrarian move of this stock? Is it Felipe Yap's superior intellect? Or is he a very knowledgeable investor? Or could it be his persistence and his stubbornness? Or is he just really lucky? Perhaps, it is all of the above. Indeed, LC is a contrarian stock and Felipe Yap is a contrarian investor.

Traders' delight

Last Friday, August 26, LC had a value turnover of more than one billion pesos. The day before that, more than TWO BILLION PESOS worth of LC changed hands. Such trading volume in a single stock happens ever so rarely. For the month of August alone, LC ranked #1 in terms of volume in 14 out of the 20 trading days so far, practically amounting to nearly half an average day's trading volume. In the previous months, while it has been #1 only a handful of times, it is usually still within the top 5 most active stocks. See below a table showing how LC's value turnover has increased more than sevenfold from last year.

LC + LCB	2007	2008	2009	2010	YTD 2011
Average daily traded value (PhP)	27.3M	9.9M	15.7M	32.5M	245.1M
Year-end market cap (PhP)*	15.3B	2.0B	8.6B	15.3B	79.4B
Year-end stock price (LC)**	0.49	0.06	0.25	0.46	1.58
Year-end PSEi value	3621.6	1872.9	3052.7	4201.1	4305.6

Source: Wealth research

**Multiple rights offers have increased LC's shares outstanding, hence the percentage increase in market capitalization may be greater than the percentage change in share price during the period*

*** Adjusted for rights*

The volatility of the stock is also quite high, as demonstrated by intraday price swings of 5-10%. This combination of high volatility and high liquidity is what every trader looks for. As such, LC is now every trader's delight. Not only that, but most local stockbrokers are making huge commissions on this stock. In fact, the share of domestic brokers in trading volume has increased dramatically because of LC's activity.

The only game in town

We are not talking about soccer and the Azkals or the UAAP basketball league and the unbeatable Ateneo Blue Eagles. While the PSEi YTD gain of 2.5% is high relative to other stock markets around the world, it pales in comparison to LC's gain of 243% for the year. This made LC easily the best-performing

liquid stock. This gave short term traders and long term investors alike more reasons to rush into it, which pushed the stock's price further up. With the backdrop of plunging world markets and foreign selling which depressed large cap stocks, LC became the only escape. Soon, every Tom, Dick and Harry was trading LC. It had become the only game in town.

Catalysts of a seven-bagger

Since the beginning of the talks with Gold Fields, LC is already a seven-bagger. More strikingly, if adjusted for rights, LC is up 30 times from the low of 2008 and despite the large drop in the past 2 trading days, LC is still up more than 3 times YTD. The stock was propelled by a number of catalysts, namely:

1. After so many fall starts, from Ivanhoe to Phelps Dodge to CRA, and even Anglo American and Zijin, investors all but lost hope in LC's future prospects. As such, the market viewed the Gold Fields transaction with much skepticism. Eventually, the market realized that Gold Fields is very serious about its investment in LC's Far Southeast (FSE) deposit. This expectation that Gold Fields of South Africa, one of the world's biggest gold miners, will exercise its option to acquire LC's share in FSE was the primary catalyst for the stock's meteoric rise. While full payment will only be made in March, if the partial payment due in September is made, then Gold Fields will most likely exercise the option.
2. Manny Pangilinan's purchase of 5% of LC and speculation that he will buy more also contributed to the rise of LC. Whenever MVP starts buying into a company, he usually buys enough shares to gain control. As was the case with Meralco, Philex and most recently, Digitel (see *Follow the Money (Manny) Trail*, 23 May 2011), the runs as a result of MVP's purchases increase each company's share price by multiples.
3. High gold prices for most of the year have benefited LC because its current mine, Victoria, as well as the Far Southeast deposit, are gold and copper mines. Gold is currently trading at \$ 1,828/oz. Up 29% YTD and up 107% since the beginning of 2009.

Because of all this, LC's stock price appreciation gained a life of its own. Then, last Thursday, there came the plunge.

Post-mortem of a Blowoff

In spite of all the fundamental reasons behind the rise of LC, it just took two events to cause a 10% 1-day drop that may well have the makings of a blowoff top. First was the sharp correction in gold prices. After peaking briefly at \$,1910/oz., it pulled back by about 7%. Second was LC's surprising removal from the PSEi in spite of its high value turnover (see table above). This caught many traders by surprise because it is one of the most active stocks this year and practically the most heavily traded this month.

Undeserved Exclusion

Last April 26, the PSE released a memo regarding the new criteria for inclusion into the PSEi. The index composition will be changed every March and September. For next month's recomposition, a cut-off period for the calculation of each criteria was set to begin July 2010 until June 2011. This was the rub. One of the criteria for inclusion is the volume-weighted average price (VWAP) market capitalization of

the company during the period. Because LC had a low price during the second half of 2010, it did not make it to the top 30 companies ranked by VWAP market capitalization, thus meriting its exclusion from the index. Many traders, and even Felipe Yap himself, have expressed concern over the PSE's blind and mechanical application of its index recomposition model without regard to LC's current activity. In addition, the model used backward-looking data when it would have been more relevant to use more recent data to determine if a company is deserving to be included in the benchmark index or not. Finally, changing rules midstream in volatile market conditions such as now are counterproductive and may even spook investors. What the PSE did is similar to a coach benching his star basketball player with a hot shooting hand in the midst of the game. It is also much like a stage director removing his star performer and replacing her with a wallflower during the performance. While it is likely that LC will be included in the index once again in March 2012, the damage, both to the company's stock price and to investor confidence, has been done.

Game Over?

After the precipitous drop of more than 10% last Thursday, is the game in LC finally over? This will now depend on several factors. First is the feasibility study being undertaken by Gold Fields to ascertain the proven and probable reserves of the FSE ore body. So far, the reports from Gold Fields CEO Nick Holland show that they are very excited about the prospects of the FSE deposit. Another factor would be whether MVP would buy at these levels or not. As was the case with Philex and Meralco, MVP would usually acquire majority, or at least a 20% stake, in a company where he has a substantial investment. Finally, LC's performance would depend on the price of gold. Even though it corrected recently, the price of gold is still quite high. Now, should one still buy LC at these levels? Or should one wait for it to fall some more? Is there still significant upside to the stock? While you can call your broker, it is best to do your own research. For more information on LC, Goldfields and the FSE deposit, one can visit LC's website (<http://www.lepantomining.com/>) or Gold Fields' website (<http://www.goldfields.co.za/>) to read the transcripts of the conference calls and the message of the CEO of Gold Fields. Gold Fields is listed in the New York Stock Exchange under the symbol GFI.

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