Has a Misstep by Management Created an Opportunity for Value Investors?

Description

It was only eight months ago when the management of **Sprott Resource Corp.** (TSX: SCP) announced that it would institute a lucrative dividend. At the time, current Sprott Resource investors, while maybe a little confused, were for the most part willing accomplices. After all, the initial rate would give them a handsome yield and pushed the price of the stock up over 10% on the day of the announcement. The stock continued to soar as income oriented investors piled in, laying there claim to a juicy yield of over 10%. A few weeks after the announcement, the stock was up over 24%.

Fast forward to the present. The stock price is now down roughly 20% from where it closed the day prior to the dividend announcement and down over 40% from its 2013 peak. Why the crash? Management decided to pull the plug on the dividend and in the process, pulled the rug out from under its investors. Even with the hefty yield, investors that bought after the dividend announcement still find themselves, for lack of a better term, holding the bag. The only good news…the bag is loaded with potentially valuable assets.

Understanding Sprott Resource

To understand the situation, one must first better understand the company. Sprott Resource is part of the **Sprott Inc.** (TSX: SII) family of companies and has a management contract with Sprott Consulting LP of which Sprott Inc. serves as a limited partner. Sprott Inc. refers to itself as an alternative investment manager and operates through four businesses – asset management, physical bullion, private equity/debt and wealth management.

Sprott Resource can be compared to a private equity firm that is accessible through the public markets. The firm is focused on investments in real assets in the natural resources sector. Its two largest holdings are physical gold bullion and **Long Run Exploration Ltd.** (TSX: LRE). Long Run is a Canadian oil and gas exploration company with a focus on the Western Canadian Sedimentary Basin where it currently produces approximately 24,000 barrels of oil equivalent per day and also holds a large acreage position.

In addition to gold and Long Run, which made up approximately 65% of net assets on June 30, the company also has investments in agriculture, agricultural nutrients and energy. These investments include publicly traded companies such as **Stonegate Agricom Ltd.** (TSX: ST), **Potash Ridge Corporation** (TSX: PRK) and **Virginia Energy Resources Inc.** (TSX: VUI). The company also holds positions in several privately held companies including One Earth Farms (agriculture in Canada), Independence Contract Drilling Inc. (oil and gas driller in the U.S.), Union Agriculture Group (agriculture in Uruguay) and One Earth Oil and Gas Inc. (oil and gas exploration in Canada).

Dividend justification and headwinds

Sprott Resource CEO, Kevin Bambrough, justified the dividend as a way of "providing shareholders with an attractive total return and increased liquidity." He went on to state, "We feel that our business has matured such that monetizations of our portfolio companies will be more predictable and the returns on such monetizations will support the dividend policy and grow SRC's book value per common share."

So from that statement it is safe to assume management may have expected to monetize one or more of its holdings during the first half of 2013. Long Run would have certainly provided the company with ample liquidity to support the dividend for many months to come, however the stock has been relatively weak during a period of rising oil prices in part due to a weak pricing environment for natural gas.

It's important to remember that Sprott Resource is primarily an investment company and generally speaking, does not provide predictable cash flows from operations typically seen in organizations rewarding shareholders with such a strong yield. By the time the annual report was released in March, the company had added that it would explore investments with cash flows from operations or near term prospects of cash flows to support the monthly dividend. Such an acquisition never transpired.

To be fair, management has faced other headwinds including a multi-year low for gold prices near the end of June as well as weakness in the agricultural sectors. Much of this would have been difficult for management to predict, however, they are paid handsomely for these kinds of insights. When you imply that you are the smartest guys in the room through your fees, then you really need to be the smartest guys in the room.

Valuation

If you haven't completely lost confidence in management, it may be worth taking a look at the current net asset value. The valuations of its two largest holdings, gold and Long Run, have performed well since net asset value was last reported as at June 30, 2013.

When the company reported its second quarter results, gold had fallen to $1253.75 per ounce and shares of Long Run were trading at $3.76 per share. Today, these numbers are very different. Gold has risen to approximately $1482.00/oz and Long Run recently traded at $4.52. Below is a comparison of the June 30 values announced earlier this month and an estimate of what net asset value might look like today.

In thousands except per share amounts	As at June 30, 2013[1]	As at Aug. 27, 2013

Net asset value	$346,818	$378,308
Net asset value per share	$3.47	$3.78

1. June 30, 2013 values per publically released information by Sprott Resource Corp.

Sprott Resource closed out June with a stock price of $3.51, essentially in line with its NAV. Now, even though the NAV has presumably increased due to the move in gold and the Long Run holding, the stock sits at just $2.75 – a near 30% discount its NAV.

Final thoughts

Management made some crucial mistakes by instituting such a large dividend. First of all, the dividend decision was made without any significant cash flows from operations in order to support it. Second, it is apparent without supporting cash flows, management assumed assets would be monetized or cash flows would be acquired. Finally, it has financed what appears to be a long-term investment in Independence Drilling with short-term debt. The margin account used for this investment is secured by most of the company's gold holdings which added substantial risk to the dividend when gold prices headed lower.

The selling has most likely been caused by both income oriented investors exiting their position and disgruntled investors. In the coming weeks, this selling should subside and if gold and oil continue to rise, the outlook for the stock will certainly brighten. Sprott Resource holds some attractive assets, but an investment here will require patience as a positive catalyst may be required to get the stock to trade appreciably higher.

More expert advice

In the market for a small cap with a yield that means something? The Motley Fool Canada has recently released its top small cap pick for 2013…and beyond. To download this profile, at no charge, simply **click here now**.

The Motley Fool's purpose is to help the world invest, better. ***Click here now*** *for your free subscription to* ***Take Stock****, The Motley Fool Canada's free investing newsletter. Packed with stock ideas and investing advice, it is essential reading for anyone looking to build and grow their wealth in the years ahead.*

Follow us on Twitter and Facebook for the latest in Foolish investing.

Fool contributor Alex Gray owns shares of Sprott Resource Corp. The Motley Fool doesn't own shares in any of the companies mentioned.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:SII (Sprott Inc.)

Category

1. Investing

Date
2025/07/02
Date Created
2013/08/29
Author
agray