Mining Journal

Gold miners need strategy revamp

Gold miners must cope with the competitive threat posed by bullion investments by reinventing how they engage with investors.

John Robertson*

1 August 2019

My column last week drew attention to the consequences for gold miners of gold bullion investments becoming easier and cheaper to access.

The gold miners' positioning as relatively cheap and easy gold bullion proxies is no longer needed. Nor can gold-related equities demonstrate consistent outperformance against the gold price to maintain a comparative advantage.

With gold prices being driven overwhelmingly by the effect of macro variables on relative asset prices and new output contributing only 1-2% annually to the stock of gold, miners are being shunted closer to the fringes of financial markets.

As gold companies lose what had once been a near monopoly doorway to the gold market for most investors, they must sharpen their investment appeal in other ways to compensate for the loss and keep their access to funding.

Within the overall mining investment universe, gold miners retain two outstanding attributes: they have a guaranteed market that is readily accessible to a producer of any size; and gold is logistically among the least complicated of mining products.

Market development efforts and sales teams coping with the ebbs and flows of industrial cycles are not problems confronting a gold miner. Gold is cheap to ship, easy to move and without any significant competitive threats to its market access.

The first step in rejuvenating their investment attractiveness is for miners to correct a myopic view of what capital markets will accept.

Among the clearest signs of blinkered vision are the low investment hurdles miners

set for themselves. It is commonplace for gold miners to measure their ability to add value with reference to a miserly 5% return on capital.

Use of this benchmark is usually justified by referring to its widespread use. Such a self-delusional rationale is an implicit admission that companies see themselves as competing for funds against other gold miners but not against non-gold mining investments.

Running a gold account for shareholders is one obvious way to claw back lost ground from competing bullion-oriented products

A 5% rate of return on a development property is significantly out of line with other risky investments. Yields on corporate bonds rated CCC or below currently sit just below 12%, for example, and have topped 20% within the past four years.

A 2013 valuation of the Moss Lake gold property in Ontario using a 5% discount rate came up with a net present value of C$196 million (US$150 million). Wesdome Gold, an existing Canadian gold producer and the current owner of Moss Lake, holds out the property as a source of future production growth "providing significant optionality on gold prices".

Put simply, the underpinning investment proposition involves upfront spending of $543 million to produce cash flows of C$983 million over 12 years of development and production time.

The implied 6.8% annual yield has been well below the cost of equity in public markets and the return available from comparably high-risk investments.

If a more realistic capital charge was applied to the Moss Lake development, say 14%, the present value would plunge below zero. Any intimation of value creation rests on the adoption of an inappropriately low hurdle.

Dutifully following industry practice to ignore this inconvenience allowed the authors of the economic appraisal to conclude that their work "demonstrates the potential viability of the Moss Lake project".

Leagold Mining, another Canadian producer, acquired the Santa Luz mine in Brazil last year. An October 2018 feasibility study into reopening operations, closed since 2014, put a value of US$149.2 million on the future cash flows of the company, also using a 5% discount rate.

The Santa Luz economic assessment suggests it could produce US$289 million from an investment of US$70 million over 12 years for a return on capital nearly four times higher than for Moss Lake.

Not only is the industry's chosen benchmark out of line with investment market asset pricing but it is prone to give misleading signals about relative asset attractiveness.

Leagold Mining, already producing profitably at a 394,000 ounce annual rate, has recently finalised a US$400 million loan refinancing and development capital package. The cost of the new borrowings, secured by existing operations, is LIBOR plus a margin of up to 4.45%.

The approximately 7% cost of debt secured with an established income stream illustrates the inadequacy of any 5% cost of equity assumption or even a similarly low, pre-tax marginal cost of debt.

Prior to the refinancing, the company's borrowings had a 10% price tag, making the feasibility study assumptions even more implausible, if not misleading.

Adding shareholder value, as it is for everyone outside the mining industry, means achieving returns in excess of a company's cost of capital. Meeting that test requires, firstly, a realistic view of the cost of capital against which corporate decisions are being benchmarked by the wider investment community.

With a clearer understanding of the true cost of capital to put investment decisions on a more solid footing, a gold miner can look to other opportunities to differentiate their investment attributes.

A May 30 column highlighted ways in which companies could utilise their cash flows to increase their investment appeal. There, I argued that delivering the cash proceeds from project development into the hands of investors needs to take priority over redeployment of hard-won equity funds into higher-risk

ventures.

After committing to push value into the hands of shareholders, companies could consider more innovative ways to catch the eye of investors. For a gold miner operating in the digital age, running a gold account for shareholders is one obvious way to claw back lost ground from competing bullion-oriented products.

One way or another, new ways must be found to rebuild investment appeal. Providing an unneeded gold price correlation in exchange for a sub-standard return on capital is no longer value for money.

**John Robertson is the chief investment strategist for PortfolioDirect, an Australia-based equity research and resource stock rating group. He has worked as a policy economist, business strategist and investment professional for nearly 30 years, after starting his career as a federal treasury economist in Canberra, Australia*