

Opinion

FROM THE CAPITAL

'Dixon disparity' confounds gold miners

Gold juniors left scratching heads over metal's relationship with investors and equities

John Robertson

Blackham Resources chief executive Bryan Dixon has questioned the disparate trajectories of the Australian dollar gold price and ASX-listed gold equities in his recent presentations. "Something has to give," he said hopefully in the past week.

Blackham Resources is one of just a handful of Australian companies set to hit the 100,000oz/y production mark once it is up and running. It is scheduled to begin production in mid-2016 at its Matilda project near Wiluna in Western Australia.

Dixon's incredulity stems from the apparent reluctance of investors to re-price his company along with so many others despite the new-found profit potential of their businesses. Blackham, with a market value of A\$35 million (US\$25 million), is forecasting a margin of A\$500/oz.

At the end of September, the S&P/ASX All Ordinaries gold index was still where it had been trading in June 2013, and in the middle of a price range it had occupied since then. In other words, there had been no meaningful price change in over two years.

It is tempting to cast this as unfair or unsustainable, but the picture is more complicated. The Australian dollar exchange rate had fallen from over US96c to US70c. That 37% decline would have been equivalent to a margin gain of A\$535/oz, or A\$5.4 million for every 10,000oz, of gold production if the US dollar gold price itself had not fallen \$270/oz.

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As it was, the gain for the Australian producers was limited to A\$152/oz, or a little over 10%. This is not a trivial amount. Under some market circumstances and in some industries a similar gain for a company of Blackham's anticipated size could have a capitalised value of A\$45-50 million. There are several reasons, unfortunately, why this does not happen in the gold industry and why the apparent valuation gap should come as no surprise.



US\$-denominated gold prices have more impact on investment in Aussie gold miners than the price achieved locally

Firstly, gold-related equities are used as proxies for gold bullion. The same macroeconomic factors that drive the bullion market will generally affect equity prices. Valuation, to the extent it exists as a market driver in the sector, is more likely to play a role at the extremes in establishing maximum and minimum prices and not day-to-day.

Secondly, the motivation to invest in gold stocks comes from movements in US dollar gold prices, even among investors in Australia. They wake up each morning to news reports about what happened in New York or London before they think about trading.

Thirdly, near-term gold industry profitability plays a lesser role in setting the price of gold equities than financial results in other industries. Profits from gold, even when successfully reaped, are less likely to flow back to shareholders than in other industries. Most typically, exploration will be the first priority to sustain production beyond what is often a very short formally defined mine life. Then, all going well, capital will be used for a larger-scale development.

If exploration has been unsuccessful, the profits will have been used. Consequently, the first-stage profitability of a gold mine is largely irrelevant to a valuation. Anticipated outcomes in the second or third stages more appropriately dictate what prices should be paid.

Fourthly, the gold-mining industry displays a history of persistently rising costs. To validate a current market price against this backdrop, gold prices need to rise by enough to compensate for the anticipated inflation. In

the event the gold price is not rising, market prices should be falling.

The 'Dixon disparity' could persist indefinitely without an exogenous financial market shock to precipitate a flow of funds looking to take advantage of the leverage offered by gold equities. There has been a hint of that in the past few days.

Between the end of September and writing this column, the gold price has risen US\$42/oz. This rise of barely 3% is nowhere near enough to force the gold price from a lengthy downtrend. The equity market reaction to even this scrap of good news suggests investors were poised for the market to go higher. The NYSE gold BUGS index, for example, shot up 16%. The Australian market index rose 12%.

The most recent rise in the Australian gold-equity market comes atop building momentum evident since early August. Since then the index has added 35%. That makes Bryan Dixon right. Something did have to give and, even as he was speaking, an adjustment had been underway. The Australian market had been leading the US dollar denominated markets for nearly two months before US investors joined the party.

The most recent and strongest part of the Australian dollar equity price rise has coincided with a strengthening Australian dollar. In other words, the best gold-sector investment performance has come as the local industry's operating margins have been facing new downward pressures.

This apparent contradiction emphasises the dual role of the Australian dollar in the local investment market. It can make Australian assets cheaper when it falls and, in theory, encourage fresh buying. But, for most, investing in Australia is made more lucrative when the exchange rate is on the rise.

The dual role creates some ambivalence among those overseas investors who can so easily dominate pricing in the Australian market. They will often eschew an asset for which the price has fallen, and is obviously already cheap, in favour of one whose price is rising.

The best combination for Australia's gold producers in this decision making situation is probably a rising US dollar gold-bullion price accompanied by a rising Australian dollar. Second best would be a rising gold price and a falling Australian dollar.

The least preferable alternative would be a falling US dollar gold price and a falling Australian dollar, even when the currency shift more than compensates for losses in bullion value. ▼

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