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Yamana Gold gets predictability premium

Yamana Gold is being generously rewarded by investors for its consistent production outcomes and discovery potential.

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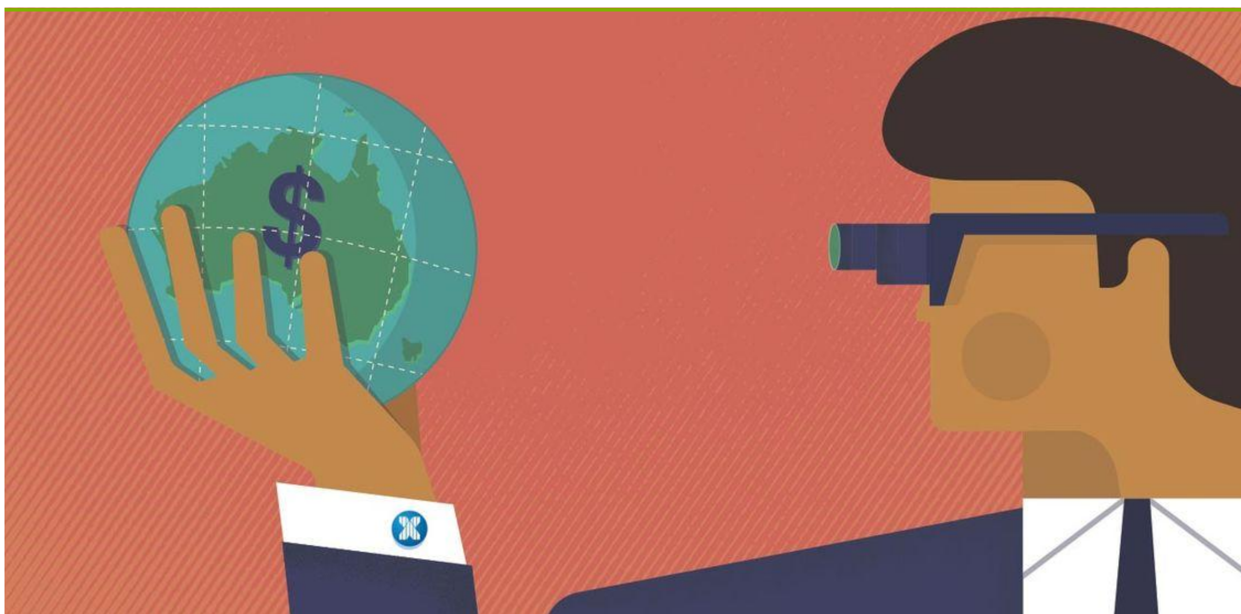

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New York and Toronto listed Yamana Gold has an interest in five mines operating in Canada, Brazil, Chile and Argentina. The fifth, coming on stream in 2018, pushed 2019 gold and silver output to 850,000 ounces and 10.5 million ounces, respectively.

Consistency in output is an important value contributor in an industry in which unanticipated output fluctuations are common value disruptors.

Production steadiness across the Yamana properties over the past five years is one of the attributes contributing to an investment narrative which highlights the underlying operational and financial strength of the company.

Yamana executive chairman Peter Marrone also drew attention to the long life nature of the properties held by the company, in a recent online briefing for investors.

Despite Marrone's references to multi-decade production profiles, the company's mineral reserve position implies an eight-year average mine life across the group, at the 2019 production rate.

Marrone highlighted how continual reserve replenishment has enabled the Canadian Malartic mine in Quebec, the company's largest production source, to retain a seven year reserve over many years.

The Canadian Malartic mine has the potential to support annual production of several hundred thousand ounces for decades, according to the company.

Raising the discovery rate to more than compensate for reserve depletion would be value enhancing. Without that, the company risks trading at a discount to others with similar production and cost profiles extending over longer operating lives.

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Marrone used two measures of value - price to net asset value and price to estimated current year cash flow - to show that comparable gold companies are viewed more favourably by the market.

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As I discussed in last week's From the Capital column, self-serving opportunism rather than analytic rigour drives selection of corporate value benchmarks. Whether there is any tendency for the two selected measures to converge across companies went unaddressed. Nor was there any explanation as to why the gap can only be closed by an appreciation in the Yamana share price (and not a decline in the prices of other companies).

In any case, one would expect valuation measures based on funds invested or current production to be lowest for companies with the shortest operating life. The value differential identified by Yamana is consistent with scepticism among investors about the company's mine life, notwithstanding the high confidence of directors that the reserve base can be expanded.

The relatively modest reported mineral reserve is obviously a point of sensitivity for Marrone who was at pains, in his briefing, to emphasise the capacity to find more ore. The company spent $135 million in 2019 on exploration and expansion capital at the five currently operating sites.

Yamana's 50% share of Canadian Malartic output in 2019 was 334,596 ounces. Marrone suggested that annual production could be pushed to 450-500,000 ounces.

Beyond value enhancing opportunities within existing properties, the company has a range of exploration targets in Canada and South America. Marrone expressed confidence that at least one of the exploration sites in Canada and Brazil will be a mine within 10 years. Any future mine will need to demonstrate annual production of 150,000 ounces over eight years while lowering the company's existing cost base.

An attractive element of the narrative surrounding the company's investment positioning is the framing of a dividend policy. The company's dividend has been increased three times in the past year. More important than the increase has been the guidance to investors about future dividend flows.

The conventional wisdom that investors do not buy gold miners for the income has let companies off the capital discipline hook. Earnings volatility has also offered an excuse for failing to outline medium term capital management policies.

Yamana directors have decided to link the level of dividends to the amount of gold being produced. They have foreshadowed dividends of between $50 and $100 per gold equivalent ounce.

The company's 2019 gold equivalent production of 972,000 ounces would mean an annual dividend payment sitting somewhere between $48.6 million and $97.2 million. The midpoint would imply a $0.077 per share dividend, an increase of 23% on the most recent annual rate, for a yield of 1.5%.

Average monthly share price variations over the past five years of 29% would swamp a still modest 1.5% yield. Nonetheless, investors value predictability. A rule based 1.5% will be worth more in market value than an irregular dividend averaging 1.5% and upon which investors are unable to plan.

To help secure the value impact from the revised dividend policy, Marrone's capital management package includes building up a financial reserve capable of securing the dividend for three years.

Marrone emphasised the importance of the company's cash producing capacity. Over the past four completed quarters, the company has generated cash of $193 million before dividends and debt

repayments.

The current $1,736/oz gold price sits $271/oz above the company's average realised price over the past four quarters. At the higher price, the 2019 cash haul would have doubled.

Even at the higher gold price, the 2019 outcome, if replicated over 20 years, the equity return would be equivalent to investing in a bond with a 4% yield. Interest payable on Yamana corporate debt averages 4.8%.

Even in a world of historically low interest rates, the equity return is too low for a value oriented investor in any industry let alone one with the peculiar risk characteristics of gold mining.

Of course, the higher gold price expected by Marrone would conveniently paper over a lot of valuation cracks. But any number of companies or financial instruments, many with potentially far greater sensitivity to changes in gold market conditions, are available if that is what motivates an investment.

In the absence of a higher gold price, the company needs meaningful growth, well beyond anything currently foreshadowed, to validate its current market value.

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