Gold equities still under pressure

The gap between bullion and share prices is at risk of widening

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Gold bullion

Gold mining companies should be pressed by investors to explain why they are better investments than gold bullion because, in all likelihood, they are not. More industry cost data is showing the extent of the value loss.

Gold miners are almost uniquely positioned insofar as their investment attractiveness is tied directly to the investment appeal of the product they make. Moreover, gold bullion or products replicating gold bullion are now widely available inexpensively leaving a choice between bullion and the related equities for even the smallest investors.

The apparently symbiotic relationship between the value of gold miners and the investment attractiveness of their product makes a 40% difference in the return between gold bullion and gold equities since the beginning of 2012 seem, at face value, aberrant and reversible.

Many like Soros Fund Management, which pumped US$27 million into gold equities via an exchange traded fund (ETF) in the September quarter, have concluded there is something amiss in the pricing of gold equities, leaving scope for the bullion-equity gap to be closed or, at least, narrowed.

Between 1997 and late 2010, the gold price rose at an annualised rate of 10%. The equity index rose at a 9.3% rate. Subsequently, the gold price continued to rise from US$1,383/oz to US$1,896/oz in early September 2011, or just under 40%, during which time the equity index increased by only another 9%.

Near the top of the gold market, equities were discounting apparently extreme prices driven by momentum as they generally do in markets for other commodities in which price patterns suggest the nearing of a cyclical turning point.

In the next phase of the cycle, the gold price fell 30% and the price of gold equities fell by 65%. Using a simplified valuation model helps us to understand why the prices of gold equities are so highly leveraged to falling or even static gold prices.

Let us assume a gold miner has a 20-year mine life with all pre-production capital behind it and ongoing costs of US$850/oz. A standard cash flow valuation model would suggest that, at a gold price of US$1,400, an investor could reasonably pay around US$5,000/oz of annual sales for the company described in this model. But at the end of December 2012 Newmont Mining Corp was priced at US$4,200/oz of production in that year and Barrick Gold Corp was priced at US$4,700/oz.

The model valuation assumes static output and costs. Neither is likely.

Rising costs have the potential to create havoc with the valuation. With no cost inflation, the value of the model company will halve in 15 years. This is because, as time goes on, remaining mine life will fall. If cost inflation is set to 3%/y, the value halves in seven years. The value of the model company halves in three years if the rate of cost inflation is set at 5%/y.

In practice, over the nine years between 2003 and 2012, Newmont's cash unit production costs increased at an annual rate slightly under 14%. Barrick's costs rose at an 8.5% annual rate. Thomson Reuters GFMS has estimated that average total cash costs for the industry were 7% higher at US$782/oz in the first half of 2013 compared with the same period a year earlier.

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Even in the event gold prices rise, they may not go up enough to compensate for the fundamental value erosion occurring at the company level – primarily due to rising costs. After all, they failed to do so in the most recent cyclical upswing, which presented some of the most favourable conditions imaginable for the sector.

Explorers can generate value through previously unanticipated exploration success and there may be other instances in which it would make sense to buy a gold equity to take advantage of a short term trading opportunity.

Other than those specific and special situations, unfortunately, the burden of the maths is too great for a gold miner to escape, in most cases. ▼

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