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GOLD NEWSLETTER
Beta's back

BLACKROCK®

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Gold equities were up by over 21% for the first two months of the year, compared to a gold price rise of 10%[1]. In this newsletter we consider what is behind this outperformance and whether or not it will prove to be sustainable.

The past

Between 2002 and 2012, the gold price rose from an average of US$310/oz to a peak of around US$1900/oz; with a compound annual growth rate for the average gold price of 16.5%[2]. During this period, the gold industry used ever higher gold price assumptions in its reserve modelling to bring what were previously uneconomic ounces into mine plans. Mine lives were extended as a result, which allowed for production expansions, which in turn increased the value of those mines for as long as the gold price continued to rise. The gold industry was thus able to grow production from 2008 to 2013 by 24%[3], but from lower grade ores at a higher cost per ounce than the companies had expected. In combination with other factors such as strengthening currencies, rising labour and equipment costs, as well as an increasing rate of taxation, the sensitivity of the gold sector's earnings and operating cash flows to a rising gold price plummeted.

At the same time, as the industry's existing production moved from barely breaking-even to strong cash flow generation, management teams of the world's major gold mining companies embarked on more and more ambitious (and complex) green-field projects, as well as dilutive acquisitions. This meant that by the end of 2012, despite the gold price averaging close to US$1670/oz, the industry made almost no free cash flow and levels of debt had increased significantly.

Throughout this period, long-term shareholders, such as our investment team at BlackRock, became increasingly vocal, calling for better capital and operating discipline and a greater proportion of operating cash flows to be returned to shareholders. These calls initially fell on deaf ears, but the severe underperformance of gold equities relative to the gold price during 2011 and 2012 began to force change.

Change came first in the form of increasing dividends, then through management turnover at the top of some of the largest gold producers and, subsequently, through greater transparency with the adoption by the World Gold Council of All-In-Cost reporting which takes into account items such as sustaining capital expenditure and royalties.

However, it was too little, too late and the sharp fall in the gold price during the second quarter of 2013 left the gold industry stranded. The tide had gone out and the larger gold producers were left facing the naked truth that a significant proportion of the ounces they had brought into reserves over the last five years were worthless, projects viable at a gold price of US$1600/oz were no longer economic and further spending on development projects would not only be value destructive but could also risk default if the gold price were to remain around US$1300/oz or less. Gold companies' share prices collapsed, write-downs ensued and management teams withdrew to lick their wounds and take stock.

1 Source: Thomson Reuters Datastream, as at end February, using the FTSE Gold Mines Index for gold equity returns.
2 Source: BlackRock, Thomson Reuters Datastream.
3 Source: GFMS.

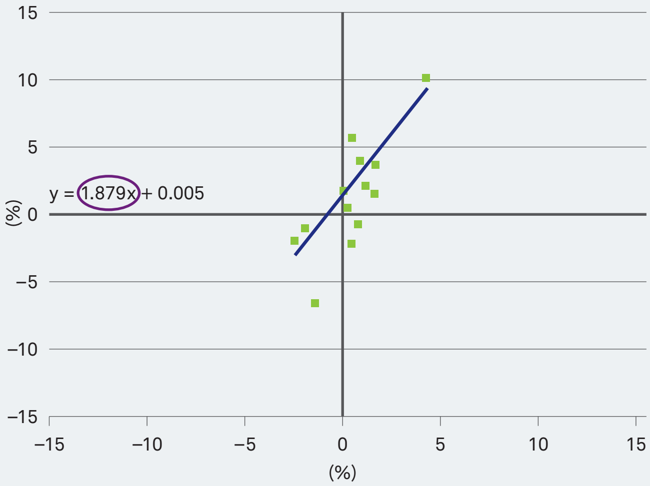
The present

The last six months have seen drastic changes, exemplified in the results released over recent weeks. The first and most striking change has been the improvement achieved in operating performance as well as the reduction in both operating and capital costs. Across the board, companies have met or exceeded production guidance and, where possible, companies have increased the average grade of ore mined. Corporate costs have been slashed. For example, AngloGold Ashanti announced in August 2013 that it intended to get rid of 2,000 (40%) non-mining managerial jobs. Exploration budgets have in most cases been limited to nothing but near-mine resource and reserve drilling, while sustaining capital expenditure has been pared down to just the bare essentials. As a result, we now estimate the average 'all-in-sustaining-cost' for the industry (as defined by the World Gold Council) has fallen from over US$1200/oz at the end of 2012, to below US$1100/oz in Q4 2013, reversing a decade-long inflation trend. Meanwhile, development projects have been cancelled or postponed, such as Barrick's Pascua Lama and Kinross' Tasiast projects, and balance sheets have been strengthened either by equity issuance or debt restructuring.

The industry has been brought back from the brink: from haemorrhaging cash to being just about free cash flow positive at gold prices greater than US$1300/oz. At the same time, reserves have been restated using gold price assumptions of US$1300/oz or below. Total reserves have been reduced, which had already been anticipated in the share price declines over the previous year, but most importantly the grade of these reserves has improved. In addition, a number of companies are now including economic hurdles within these reserve calculations to ensure that each ounce generates value and doesn't just break even at the gold price that is assumed for their calculation. This has improved the quality of each reserve ounce versus previously-stated reserves and suggests in future these mined ounces will generate an improved return and should therefore be valued more highly by the market.

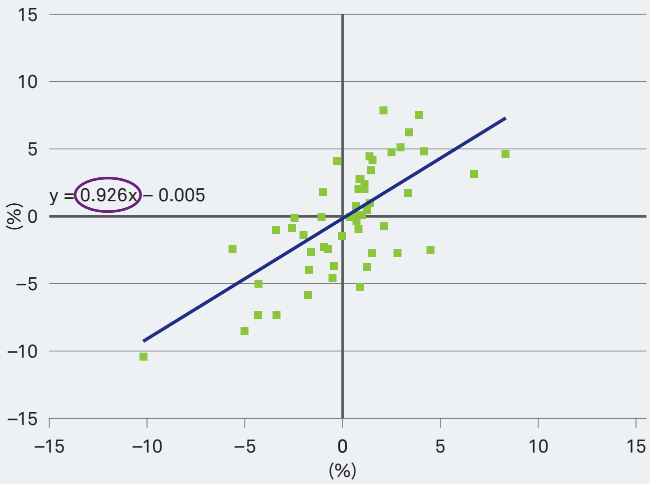
The result of the improvement in the gold sector's operating performance and the higher sensitivity of earnings and cash flows to the gold price has been an increase in the beta of the gold company share prices to a rising gold price. As the title of this newsletter indicates: the beta is back. This can be seen in the charts opposite with the beta of gold equities to the gold price rising from 0.9 in 2011, to nearly two in the last three months (to end February 2014).

THREE-MONTH BETA OF GOLD EQUITIES TO GOLD PRICE



Source: Thomson Reuters Datastream. Data points indicate weekly returns of the FTSE Gold Mines Index and gold bullion. The circled figure relates to the gradient of the trend line and measures the sensitivity of gold equity returns to gold bullion returns over the period. The steeper the gradient, the greater the sensitivity. Data 30.11.2013 to 28.02.2014.

2011 BETA OF GOLD EQUITIES TO GOLD PRICE



Source: Thomson Reuters Datastream. Data points indicate weekly returns of the FTSE Gold Mines Index and gold bullion. The circled figure relates to the gradient of the trend line and measures the sensitivity of gold equity returns to gold bullion returns over the period. The steeper the gradient, the greater the sensitivity. Data 31.12.2010 to 31.12.2011.

The future

The outlook for gold equities for the rest of the year is dependent on two things: the gold price and whether or not gold company management teams are able to continue to improve their operational and financial performance as well as not reverting to their old ways.

This year began with the onset of 'tapering', a sense of the inevitability of interest rate rises in the US, little expectation of inflation in the near term and a consensus anticipation of a stronger US economy. As such, one could argue, the headwinds for bullion were fully priced in at a gold price of US$1200/oz. Since then, the scale of outflows from the more financially driven futures and physically backed exchange traded fund (ETF) markets has slowed markedly and February saw the first month of inflows into ETFs since January 2013. Chinese physical demand proved robust prior to the Chinese New Year and reassuringly returned with similar strength post the holiday. As a result, gold has posted strong gains for the first two months of the year, which has caught many market participants by surprise. Signs of further potential positive drivers for the gold price have also appeared. Uncertainty in emerging markets has once again raised concerns over the stability of the financial system and the potential for further currency devaluation, while the still unresolved problem of the eurozone's debt situation and the fragility of the US economic recovery have pushed back expectations of imminent interest rate rises. In addition, with upcoming elections in India and the potential for a change in government, there is hope that some of the onerous restrictions on importing gold may be lifted or at the very least relaxed, which could provide gold with another fillip.

For gold companies themselves, weakness in producer currencies such as the South African rand and the Australian dollar should see costs in US dollar terms continue to fall year on year. Coupled with the potential for more cost-cutting momentum as further productivity improvements are implemented, there is the real possibility that we could see the industry's profit margins benefiting not only from a rising revenue line but also a falling cost base. In that scenario, beta might not only be back, it could be back with a vengeance.

WHY BLACKROCK

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Source: BlackRock, data as at 31 December 2013.

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