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Precious Metals – Industry Thematic

Denver Gold Forum Highlights – Trends Reinforce Focus on "Walk Before Run" Strategies

THEMATIC RESEARCH

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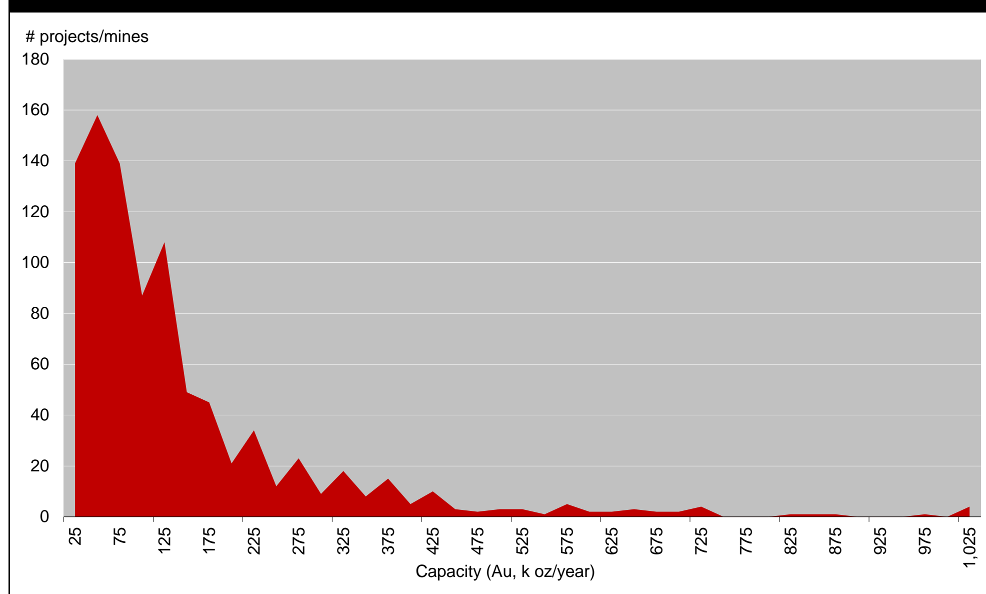
(NBF Economics & Strategy Group)

The focus of the 2016 Denver Gold Forum (DGF) centred on existing themes and variations thereof as senior producers remain generally focused on execution at operations, free cash flow and balance sheet strength with a stated preference to stick to the plan. Surely, this is also a consequence of investor preference for the seniors to deliver on the existing portfolio of mines before embarking on transformative projects or M&A. As such, the net result was a lot of "more of the same" strategies. Albeit, there are slight variations to existing themes which we believe are worthy of discussing herein. We review their intended purpose and relevance. We also note instances where strategies, while buoying FCF now, may ultimately serve to exacerbate the outlook for production declines later as seniors grapple with a paucity of exploration success, notably of deposits that offer the size to sustain production as well as the capex intensity and execution risk to satisfy hurdle rates.

Conference and industry themes dictated by production scale. The challenges and opportunities faced by senior gold producers are vastly different to those of intermediate and junior producers. Senior producers spend their existence operating in the tail of the distribution curve, while intermediate and junior producers benefit from broader availability of mines or projects of a size that can make a difference. For instance, in our dataset of 930 assets (mines and projects), 88% of them either produce or are designed to produce less than 275k oz/year (Figure 1), below the minimum threshold for most senior producers. This backdrop introduces conditions and consequently industry themes that are unique to the seniors, whether related to technical, tactical, geopolitical or financial strategies.

FIGURE 1: SENIORS' STRATEGY FOR LARGE CAMPS CHALLENGED BY STATISTICS – 88% OF MINES/PROJECTS IN OUR DATABASE (930 SAMPLE SIZE) PRODUCE LESS THAN 275K OZ PER YEAR



Source: SNL, NBF Estimates

2016 trends generally in keeping with conservative strategies – sufficient to maintain investor interest, yet charting a direct course for production declines and/or harder decisions later. A retrospective on the main conference themes going back to 2012 illustrates a "two steps forward, two steps back" process with recurring themes, occasions of misplaced optimism and just generally very slow progress. For 2016, though, with cost pressures benign, companies generally adhering to conservative "walk before run" strategies that focus on core

mines, modest Brownfield expansions, continued cost cutting and optimization efforts, the result (one of improving FCF) should be sufficient to maintain the renewed interest in gold equities. Ironically, for most senior producers and select large intermediates, it is these same strategies that will bring forward production declines or expose companies to industry congestion later once projects do get the greenlight.

2012 – capex escalation and heightened project execution risk drive project deferrals; growth for the sake of growth shelved as companies slowly re-establish a focus on IRR.

2013 – despite being two years too late, seniors still suggesting they have abandoned growth for the sake of growth; corporate cost cutting accelerates including cuts to exploration; focus on higher IRR projects drives more project deferrals; focus on free cash flow at existing operations spurs the concept of targeting higher margin ounces, which creates a buzz about the potential for companies to introduce/increase dividends while delivery lower operating costs.

2014 – companies show little progress in adapting mine plans to target higher margin ounces (mine plans not that flexible); dividend increases not only abandoned, but dividend cuts manifest; on-site cash costs little changed, but cuts to corporate overhead, including to exploration deliver lower AISC. Companies gearing up to make project go-ahead decisions, waiting on a higher gold price.

2015 – a higher gold price does not arrive, project deferrals continue; companies generally showing lower AISC, as all-in costs benefitting from cuts to overhead, sustaining capex, and exploration; continuous improvements the new catch word (isn't this something that should always be happening>?); lower diesel prices and FX rates drive lower on-site costs; yr/yr cuts to exploration spending and project deferrals beget concerns about declining production profiles; lower gold prices and declining production put balance sheets, specifically debt obligations in focus.

2016 – Despite the positive year for gold prices, companies' mindsets continue to be shaped by recollection of a low gold price environment with the pause in the 2016 rally serving as a reminder. With this, a focus on driving NAV growth at the mine level remains topical as companies seek new and creative ways of achieving operational efficiencies. Discussions on organizational structure gained prominence in 2015 and early 2016 as it is seen to provide opportunity for additional savings. Notably, adoption of a de-centralized structure is regaining prominence, with greater independence delegated to mine camps to promote performance, and a leaner corporate office with pared down service offerings to achieve cost savings. As has been the case since 2012, we still see a bias for Brownfield over Greenfield investments to leverage camp staff and infrastructure, thereby minimizing both capex and execution risk. Strategic hesitation on M&A is observed and reflects a preference to preserve balance sheets, a depletion of economic M&A targets and companies not willing to pay up for exploration optionality.

Drilling Down on 2016 Themes

Themes Relevant to Senior, Intermediate and Junior Producers

- **Exploration budgets getting a lift.** With balance sheets in better shape from non-core asset sales, higher metal prices, and, in cases, financings, senior and junior companies alike are ramping up exploration budgets and project evaluation programs.
- For the juniors and intermediates this could generate discoveries of a size that is material to production. Recent exploration and project examples include Newmarket Gold (Fosterville), OceanaGold (Macraes, Waihi, Haile), Richmont (Island Deep), Alamos (La Yaqui) and Alacer Gold (Gediktepe).
- For seniors, exploration spending remains disproportionately focused on near-mine and Brownfield targets (Figure 2) as they look to add and upgrade ounces proximal to existing mine infrastructure. This focus also seems appropriate in the context of recent trends that show a declining discovery rate despite higher-than-average exploration

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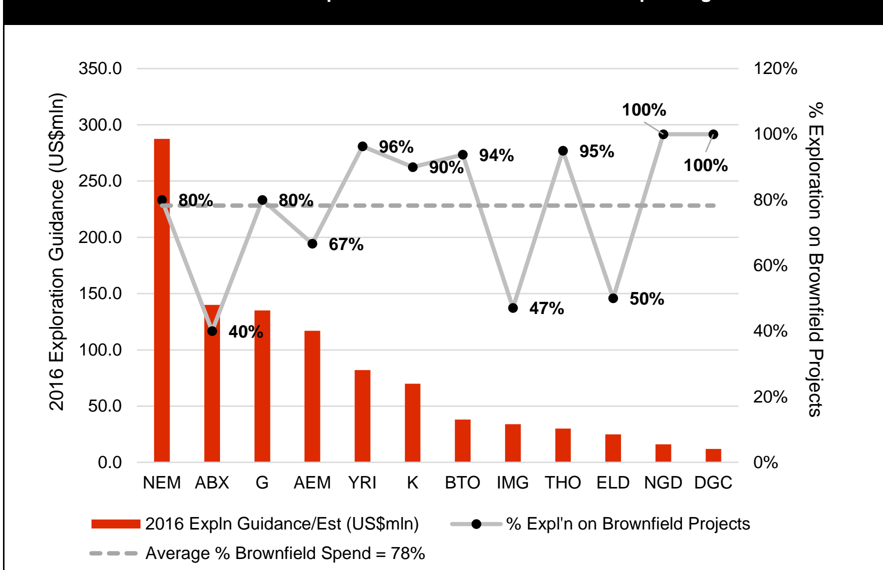
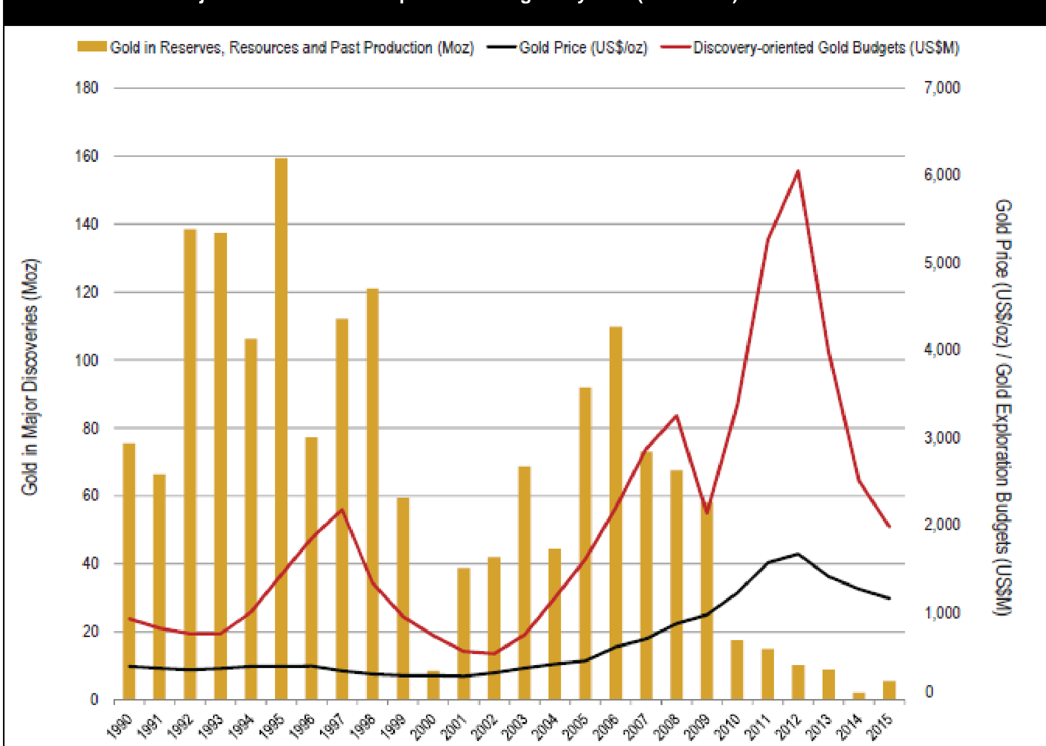
expenditures. For example, from 2006 to 2015 some US$54 bln was earmarked for discovery-oriented exploration budgets (69% of total spending from 1990 to 2015), yet gold in major discoveries dropped every year except in 2015. *Refer to Figure 3.* Thus, in our view, it is unlikely that the recent uptick in exploration spending will generate a different result, specifically new discoveries of a size that can thwart the outlook for production declines. Recognizing that the odds are stacked against them, we view as prudent senior company's focus on near-mine and Brownfields exploration.

FIGURE 2: Focus on Brownfields Exploration a Clear Trend With 2016 Spending



Source: NBF, Company Reports

FIGURE 3: Gold in Major Discoveries and Exploration Budgets By Year (1990-2015)



Source: SNL

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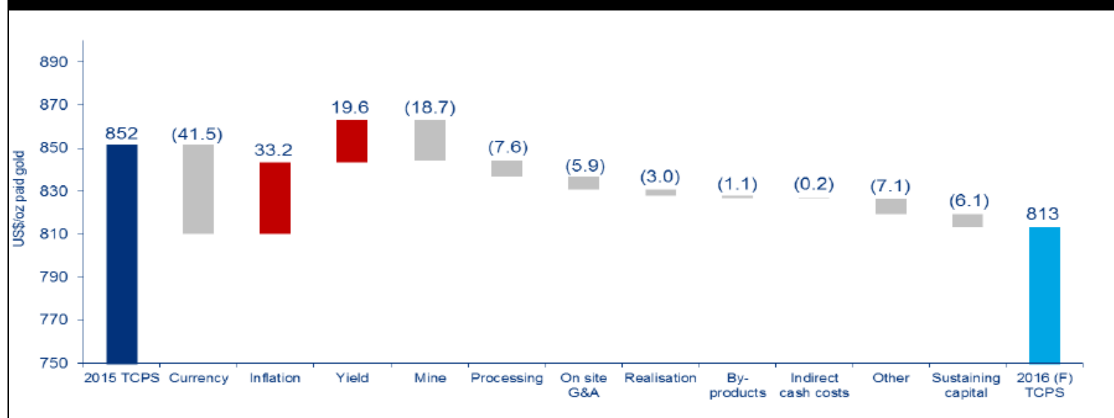
- **Benign cost pressures bode well for continuing balance sheet improvements and FCF – conditions that appear to buoy the interest of generalist investors.** With currency one of the principal drivers of cash cost trends and FX rates in key mining jurisdictions still generally weak vis-à-vis 2014 and 2015 levels, the backdrop remains constructive for lower costs year-on-year (Figure 4). With that, we expect operating margins to remain robust and be of a magnitude sufficient to maintain investor interest in gold equities. In fact, in speaking with several generalist investors, arguably, this was one of the main takeaway from the DGF.

FIGURE 4: Global Average Total Cash Plus Sustaining Capex (TCPS) Cost is Forecast to Fall from an Estimated US$852/oz in 2015 to US$813/oz in 2016 (WoodMackenzie)



Source: WoodMackenzie

- **Narrow differentiation between jurisdictions, mine life and execution risk.** A recurring theme from our own marketing and that of company commentary at the DGF is that valuations do not appear to be adequately discounting differences in geopolitical risk, mine life (i.e., the strategic nature of a long mine life in a market where discovery rates are declining) and execution risk (i.e., expansions vs. Greenfields development). The trigger for increased differentiation usually comes with input cost inflation and heightened project risk. With cost pressures benign and companies steering clear of capital-intensive projects, in our view, the potential exists for limited differentiation to continue for longer.

Senior Producer Themes (Production Decline Playbook)

- **Ramp-up in exploration spending.** As detailed earlier, seniors are boosting exploration and evaluation budgets vis-à-vis 2015 levels, though focus remains on near-mine and Brownfields exploration to add and upgrade existing resources.

- **Talking up optionality within the portfolio.** In the context of a slowing rate of new discoveries juxtaposed with declining reserve lives, it should not come as a surprise that the DGF saw seniors talking up optionality within their portfolio, highlighting projects and exploration properties and making the case that analysts should be valuing this. In our view, the case for optionality is a function of the characteristics of Brownfield or Greenfield projects. For Brownfield projects, optionality is most supported when multiple criteria are satisfied: a demonstrated depth of near-mine ounces; a track record for replacing reserves; and telegraphed intent to advance development. The latter may occur by way of progressive technical reports and suitable project returns. Conversely, large tracts of unexplored Brownfield may offer blue sky potential, but are more speculative in nature and less likely to garner value for optionality value in our analyses. For Greenfield projects, optionality considers additional elements: jurisdictional attributes including geopolitical factors and permitting hurdles; project economics including IRR and capex; development and operational complexity;

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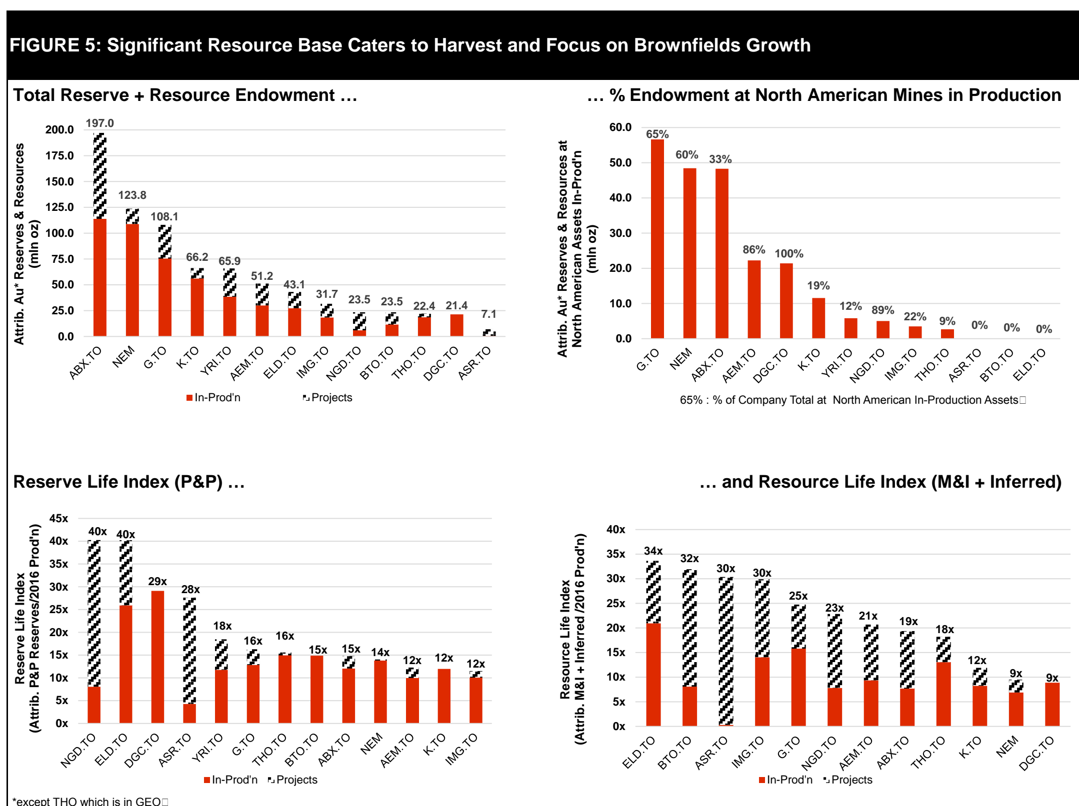
financing requirements and the development timeframe.

- **Resource Life Index help infers optionality potential**. Resource Life Index (defined as resources exclusive of reserves divided by forecast 2016 production), can be used to infer optionality whereby contribution from in-production ounces (i.e., resources at existing mines) is suggestive of Brownfield optionality, while allocation from project ounces may be indicative of Greenfield potential. Our preference is typically for Brownfields optionality since mine and process infrastructure is already in place. Producers ranked by Resource Life Index are presented in Figure 5 (lower right corner), with ELD, IMG, G and THO showing the largest contribution from in-production ounces (including in-construction for ELD).

- **Portfolio optimization.** In the absence of material production growth, senior producers need to dangle other shiny objects to gain traction with investors, particularly those generalist investors who are returning to the space. With that, Net Asset Value (NAV) and NAVPS growth were the focus of senior producer presentations. Typically, this is achieved by cost cutting, reserve accretion (size and quality) and/or throughput expansions. Decentralizing organization structures is expected to drive the bulk of cost and efficiency gains. With respect to reserve accretion and throughput expansions, we expect these benefits to materialize at a slower pace. Both require spending, whether added exploration and evaluation budgets or capex in the case of expansions, and thus offset cost cutting efforts.



Source: SNL

- **Decentralized organizational structures.** A prominent theme characterized by greater independence delegated to mine camps, and empowered mine leadership accountable for performance. The decentralized structure also sees a leaner corporate office with pared down service offerings delivering common platforms for reserve calculations, financial reporting, CSR programs and allocation of scarce corporate resources. We see Newmont Mining, Barrick Gold and Goldcorp among others adopting this structure. It's still too early to assess effectiveness or company

reorganizations; the next few years will be telling and we will look for evidence of success in cost cutting and impact on G&A in particular.

- A decentralized structure may be more effective for companies without transformative projects. With such projects, however, the corporate office has the additional burden and cost of overseeing consultants who may also be running at low staffing levels. With this, in reconciling a decentralized structure against declining production profiles, an absence of bandwidth at head office suggests to us that replacing reserves may be best achieved by buying operating mines rather than developing Greenfield projects.
- This analyst worked for a senior gold producer when decentralized organization structures were adopted in the late 1990s. My experience and that of others polled at this year's DGF was that the decentralized structure was effective for the time. That is, when there are no large development projects in the hopper. Moreover, we expect added manpower to be added at mine sites as additional bandwidth may be required for mine projects, specifically those designed to boost NAV.
- **Investments in exploration companies to gain exposure to new discoveries.** With senior producers earmarking much of their exploration budgets to near-mine and Brownfields targets, investments in explore companies will be key to gain exposure to new discoveries and new districts. Goldcorp has a stated objective to ramp up these efforts, joining Agnico Eagle and Kinross Gold. Frankly, competition on this front is expected to intensify, as intermediate producers, too, are expected to intensify efforts.
- **Succession planning.** Succession planning continues to be topical on the back of leadership changes and probable retirement of certain mainstay CEOs in the coming years. Industry statistics presented in Figure 6 do not suggest any potential talent bottlenecks on the horizon, as the average ages of CEOs, CFOs, COOs or company presidents are well below 65, let alone 60. Yet, it is the looming retirement of certain soon-to-be-65 CEOs, several of whom are company founders with no apparent successor, that will keep this theme topical in the coming years.

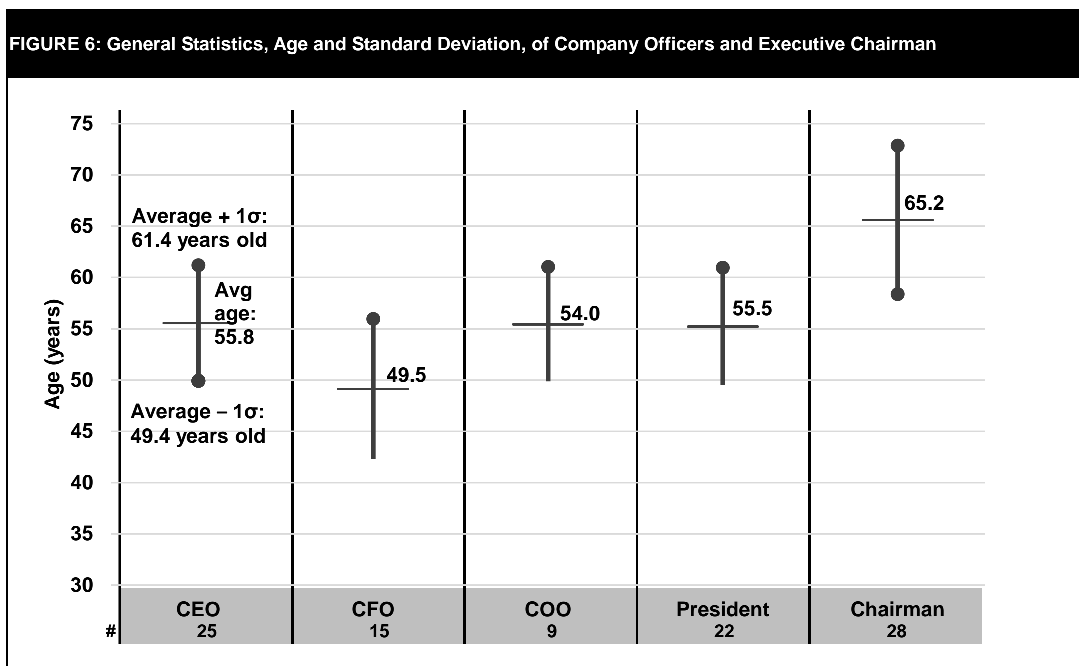


FIGURE 6: General Statistics, Age and Standard Deviation, of Company Officers and Executive Chairman

Source: SNL, NBF est.

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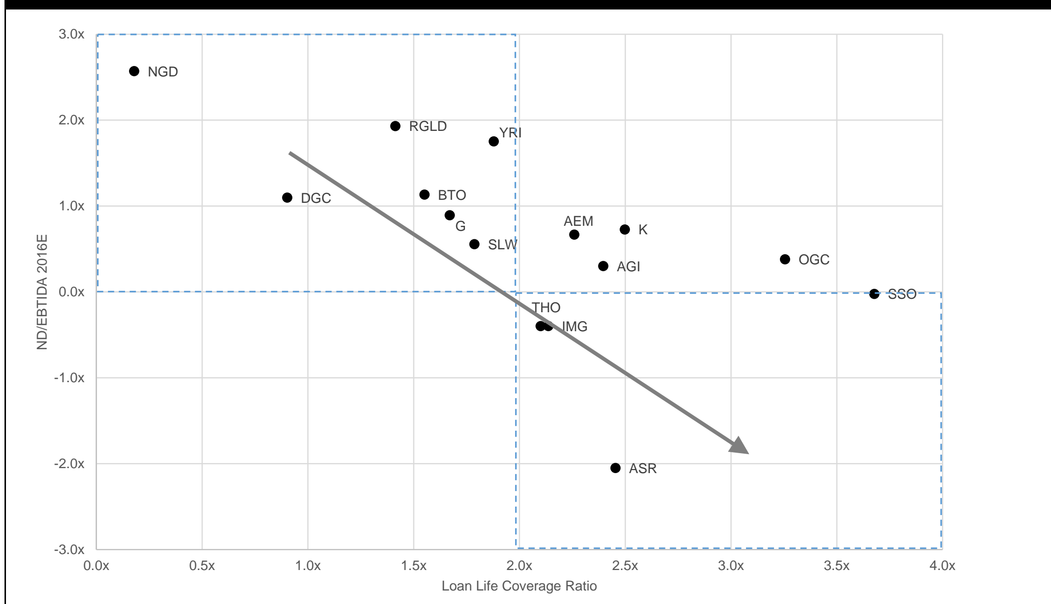
- **Balance sheet strength.** Balance sheets are indeed on the mend, yet we notice that companies continue to rely exclusively on ND/EBITDA as a measure of balance sheet strength. When convenient, some use year-end 2015 values, while others may use forecasts for year-end 2016. Either way, ND/EBITDA on its own does not capture important distinctions, such as differences in debt maturity profiles and marked differences between EBITDA and free cash flow. Such differences are significant across our producer universe with debt maturities disparate and capital intensity highly variable and of a magnitude that materially affects cash flow available to service debt. Moreover, ND/EBITDA is a snapshot and does not capture instances where production and EBITDA are declining – two notable trends that we see for many of our senior gold producers.
- Loan Life Coverage Ratio is a useful, if not an essential, complement to ND/EBITDA. LLCR is a measure of the number of times project (or company) cash flows over the scheduled life of the loan can be used to repay the loan balance (cash + DCF of cash flows available to service debt / loan balance). Consequently, LLCR captures situations where production profiles are declining over the loan period and/or where a project (and its capex) is being considered to address this. A LLCR below 1.0x implies that the company's cash and projected free cash flow are inadequate to repay existing loan commitments. Figure 7 presents both ND/EBITDA and LLCRs. Overall, LLCR analyses reveal balance sheets that are perhaps not as strong as ND/EBITDA ratios would suggest, but continue to improve, particularly as metal prices remain buoyant and as debt is termed out.

FIGURE 7: ND/EBITDA vs. LLCR (LOAN LIFE COVERAGE RATIO = [CASH + NPV5% (FCF OVER THE LIFE OF THE LOAN]/TOTAL DEBT)



Source: SNL

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New News – Not So Much

Denver Gold Forum light on material company-specific news. This does not come as a surprise since many producers are in the midst of their budgeting process and thus are not in a position to comment on operating results or year-ahead guidance. Rather, at this time of year news tends to relate more to exploration and project updates and, in cases, how these opportunities fit within the company profile and larger vision. This explains why the bulk of our report focuses on trends with a lesser focus on company news. We do provide select company commentaries where we felt an emphasis was justified. For a review of company catalysts, we refer you to our Catalyst Calendar that was published on Sept. 14.

B2Gold (BTO: TSX, BTG: NYSE MKT, Sector Perform, Cdn$4.50 target)

- **Masbate – confident on outcome of Philippine audit**. Results of the Philippine environmental audit are expected the week of Sept. 25. B2Gold is not concerned given its favourable environmental track record and GDP significance to the Island of Masbate. Moreover, B2Gold received support from the local community at the time of the audit, which is expected to carry some weight.

- **Fekola – deal on second 10% government ownership expected by year end**. Project development remains on track with production expected to commence in late 2017 (350k oz/year for first seven years). Under Malian mining regulations, the government is entitled to a free carry on 10% of the project and can acquire an additional 10% at market value. It is our understanding that an eventual deal will see the government apply dividends received from the first 10% towards the second 10% (new). The value of the second 10% is still being negotiated with a deal expected before year-end 2016.
- **Anaconda saprolite deposit – drilling results on deck.** Not much new info on the Anaconda saprolite deposit. Drilling results are expected at the end of the rainy season. B2Gold suggesting the Anaconda deposit could exceed 1 million oz and now sees potential for a standalone project due in part to the low capex intensity of saprolite projects.

Goldcorp (G: TSX, GG: NYSE, Outperform, Cdn$25.50 target)

- **Targeting US$250 million in annual sustainable efficiencies by 2018**. As telegraphed, Goldcorp's plan is to drive toward US$250mln/year in efficiencies by 2018 (equates to ~US$100/oz; or 12% of controllable spend). The company anticipates it should be able to exceed this target and identified 50% of the US$250 million target thus far with the bulk of the near-term benefit coming from cost cutting. We model the US$50-$60 million per year cuts to corporate G&A, but have yet to apply the others. We would like to see production track guidance for H2/16 before moving to incorporate the other efficiencies in our model.
- **Bonus structure aligned with strategy.** The company adopted a bonus structure for on-site GMs and corporate management driven by NAV and NAVPS, respectively, rather than production. This is new and shows the company's reward-incentives are aligned with its strategy.
- **Different hurdle rates for different projects.** The stage-gate process for allocating capital has also been modified. No details were provided during the DGF, though we expect it is weighted more towards NAV and NAVPS using the appropriate hurdle rates. The company uses three different hurdle rates for projects 8%, 10% and 12%.
- **Red Lake, Cochenour and HG Young.** Last three to four months has seen progress at Cochenour with respect to test stoping. Expect to hear more on this at the January 2017 analyst day.
- **Porcupine – newly-discovered XMS vein adds intrigue.** Discussions with Tahoe in respect to driving synergies in the Timmins camp have taken a pause as Goldcorp makes a fuller assessment of its options, including a review of the newly discovered XMS vein at Hoyle. Sounds like Goldcorp is very encouraged by this discovery, which was noted in the Q2 MD&A, though with little detail.

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IAMGOLD (IMG: TSX, IAG: NYSE, Sector Perform, Cdn$7.60 target)

- **Tangible opportunities to address "knocks on story."** While still in the early innings, IMG's commentary at the Denver Gold Forum may serve to address the knocks on the story with demonstrable results expected at an upcoming Rosebel site tour (Oct. 16-17) and analyst workshop (Nov. 23).
- **IMG's enthusiasm appears to be grounded in three main areas.** (1) Trend towards lower cash costs at both Rosebel and Essakane; (2) Mine life extensions; and (3) Cote Lake optionality.
    1. The trend towards lower costs at Rosebel and Essakane is not just a function of lower oil prices. Better understanding and blending of soft/hard rock interface is also contributing to production efficiencies. Furthermore, in Q4/16 commissioning of a secondary crusher circuit at Rosebel should facilitate treatment of harder ores. Should IMG's site tour of Rosebel be sufficiently convincing, we would suggest there is scope for analysts to apply lower costs for longer.
    2. Indications of mine life extensions at both Essakane (through 2025, was 2023) and Rosebel (through 2023/24, was 2022). At Essakane, Falagountou West and East are contributing to resource potential while the Saddle Zone and Saramacca (new acquisition) offer upside for Rosebel.
    3. Optionality. Cote Lake (global resource of ~9 mln oz) continues to be a topic of discussion. On the Q2/16 conference call, IMG noted it was reviewing a start-small plan for Cote Lake. At the Denver Gold Forum, IMG indicated its intent to release preliminary results before the end of the year. We currently value Cote Lake at nil.
- **Impact.** Combined effort of mine life additions, and a notional value of US$250 mln for Cote Lake drive the P/NAV to 1.15x from 1.45x (peers at 1.3x). Extending the current favourable cost structure into 2017 sees 2017 CFPS increase to US$0.88 from US$0.80 and P/CF drop to 4.9x from 5.4x (peers at 7.0x).
- **Upside needs to be demonstrable.** Site tour and analyst workshop clear opportunities for IMG to make the case for longer reserves and extension of lower costs.

Kinross Gold (K: TSX, KGC: NYSE, Sector Perform, Cdn$8.25 target)

- **Back-end loaded production year on deck.** Kinross is gearing up for a back-end loaded production year, notably at Bald Mountain, Tasiast, Chirano and Round Mountain offsetting Maricunga. We like this in the context of Kinross' recent share price underperformance and a valuation (P/NAV = 1.3x vs peers 1.3x) that is no longer at a premium to the peers while P/CF 2017 remains discounted (P/CF of 4.5x, peers 12.7x).
- (new) **Fort Knox – mine life extension may be in the cards.** While without detail, Kinross commented that the company's Alaska ops (i.e., Fort Knox) could see mine life extensions. This could suggest they have had some success with the drill bit at Fort Knox.
- **Tasiast – may not have seen the end of labour stoppages.** Negotiations are ongoing with the union as Kinross keeps the pressure on with respect to pushing towards lower labour rates, which are currently well above the national average. Sounds like this will be an iterative process. With this, it wouldn't surprise us to see more labour stoppages.

Tahoe Resources (THO: TSX, TAHO: NYSE, Outperform, Cdn$25.00 target)

- **Guatemala royalty risk on pause.** Instead of moving ahead with higher royalties the government has worked to balance its books by clawing back unpaid taxes from other industries. THO doesn't expect the new mining tax/royalty proposal to get airtime until mid to late 2017.
- **Escobal still on track for 20 mln oz in 2016.** As expected, THO calling for lower grades in H2 vs. H1, but higher mining and milling rates are expected to provide a partial offset.

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- **Exploration results to be a big part of the story in H2/16.** In terms of the exploration prospects in Timmins and drill allocation, the company budgeted 225k metres in 2016. 144 Gap (100k metres) and Whitney (70k metres). 144 South trend also looking prospective and to see drilling. It is our understanding that Tahoe is looking to release an exploration update before year-end 2016.

Yamana (YRI: TSX, AUY: NYSE, Outperform, Cdn$9.00 target)

- (new) **Brio garners focus during presentation**. Yamana is now clearly leaning towards creating a stand-alone company for Brio, not just ring-fenced, as the best way to realize value. Last year, Yamana's going-public strategy was geared towards generating cash to manage the balance sheet. Now, with Yamana's balance sheet in better shape, Brio delivering on operating targets and the valuation for Brio's junior producer peers supportive (thanks to higher gold prices), Yamana can consider spinning out all or most of Brio to shareholders. A decision or event is expected before the end of the year. Investors have expressed fatigue with the on-and-off again approach, so clarity here and actual progress could serve as a catalyst.
- **Internal project development favoured over M&A.** Yamana was not represented at the Beaver Creek Precious Metal's Summit. To us, this is supportive of YRI's focus on looking internally for projects and not looking towards M&A.
- (new) **El Penon messaging offers read-through for catalyst potential.** Yamana remains focused on mine life additions at El Penon. This is a notable comment given El Penon's status as a cornerstone mine yet grades have fallen short of expectations on the transition to narrower veins. Stay tuned for this as success at El Penon has the potential to be Yamana's most meaningful catalyst.

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