Baker Steel Capital Managers LLP
Defining a New Identity and Restoring the Appeal of Gold Shares

Nov 2012

In 2011 the Chairman of Barrick Gold, Peter Munk, in his address to shareholders stated *"**our most serious challenge is our stock performance. It's simply not good enough.**"*

He continued...

"Clearly, there could be a variety of reasons for this unacceptable development, but I consider the introduction of the spectacularly successful gold exchange traded funds (ETFs) to be a key factor. As gold ETFs have become ever more popular, a growing number of institutional holders have trimmed their investments in gold mining companies, ploughing that money into ETFs. Total gold ETF assets have reached nearly US$140billion, a staggering figure that helps to explain why the gold industry's multiples have compressed significantly, even while our earnings per share have sharply increased, and the prevailing outlook for gold itself is very positive."

The growth of the ETF has been a factor in the de-rating of gold equities

"While the diagnosis of a problem is a necessary precondition for finding a solution, it is by far not the same. There are no doubt differing views on how to make gold equities more valuable and more reflective of their performance, particularly in light of the market's universally positive outlook for gold prices. The general consensus of a solution seems to be that gold producers, to see their shares trade once again near earlier multiples, need to offer the one thing that investors crave universally – and what ETFs can't offer – a meaningful, growing and regular dividend."

At Baker Steel Capital Managers this is a topic consuming a great deal of our time and effort. After all, the de-rating of gold shares directly impacts our funds' performance therefore we need to understand the reasons for this and then clearly communicate this to our clients and the boards and management of gold companies. This paper attempts to do just that; we don't profess to have all the answers but we do believe that a fresh approach to the topic may stimulate debate and be the first step towards helping to achieve a solution.

...but restoring the identity and appeal of gold equities is urgently required

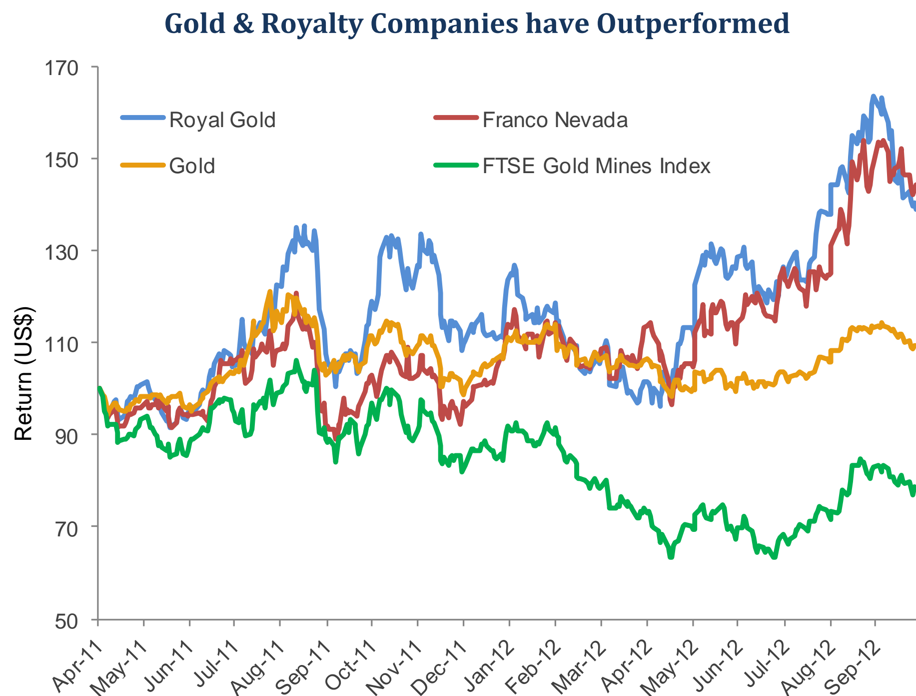
What does the market want?

The first step is to understand just what the market wants. There are 2 clear observations;

- From the success of the ETFs it appears investors first and foremost want gold.
- In the gold equity space the sector which is delivering is the royalty company, and from this we can conclude that the market wants a margin – after all royalty companies collect the 'cream' from their stable of royalties, and whilst their take might be modest, the market nevertheless rewards

them handsomely.

Gold equity investors first and foremost want gold – as demonstrated by royalty companies



Source: Bloomberg. Data at 26 October 2012.

What do gold companies offer to the market?

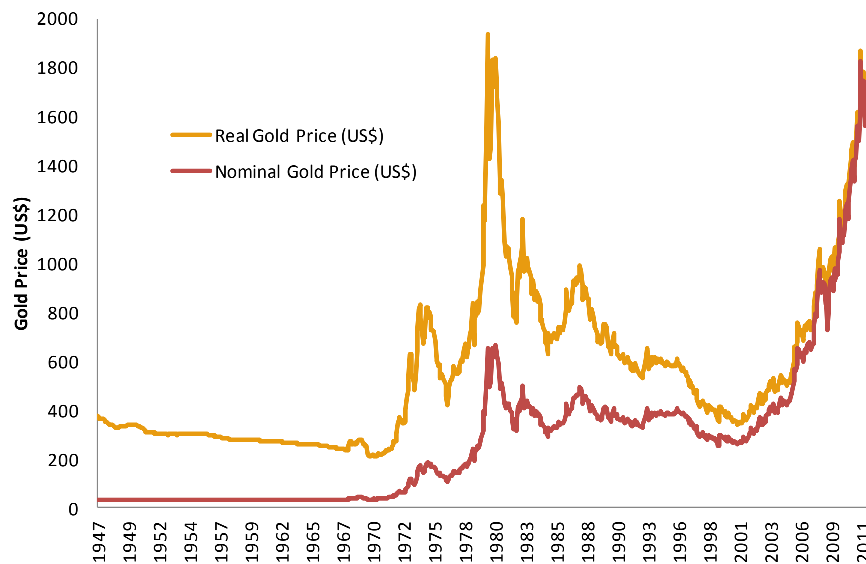
Gold companies go to considerable lengths to find their reserves, build their mines and then produce gold; it is both an expensive and time consuming business. CEOs are keen to tell investors how much gold they have in the ground and how many ounces they will mine, but when it comes to the numbers suddenly the language changes from one of gold to one of dollars. To make matters worse once the prized possession has been extracted, the gold is then exchanged for US dollars – the producers convert an appreciating asset for a depreciating asset. Mining companies send a totally confusing message to investors by combining gold and dollars. We believe that, by this low-value exchange, gold companies have confused investors and that gold companies should be accumulating gold on their balance sheets and reporting in gold - the currency they espouse as supreme. Could the historic gold price and the practice of forward selling gold explain why the miners have not resolved this confusion?

Mining companies risk confusing investors by mixing gold and dollars

The gold and dollar cycle

We are 10 years into a bull market where gold is appreciating and the dollar depreciating. The following chart shows the gold price in dollars of today and highlights the critical impact of inflation.

Shouldn't our gold companies be accumulating gold on their balance sheets and reporting in gold - the ultimate currency?



Source: Baker Steel internal, Bloomberg. Data at 28 September 2012.

In real terms, gold peaked back in 1980 followed by a brutal 20 year bear market which totally destroyed all credibility the market had in the yellow metal, replacing it with its utmost faith in the US dollar as the world's reserve currency. During this disinflationary period, costs of production held steady; the US dollar was appreciating as the gold price fell, so it made complete sense to not only sell your gold for dollars but to sell gold that you had yet to mine for dollars to avoid the dollar appreciating further by the time the gold was mined. This formed the advent of forward selling and in its time made absolute sense. It took ten years from gold's peak in 1980, before forward selling gained general acceptance by CEOs. The early adopters were hailed as heroes and so popular was this trade that at its peak, forward selling accounted for over 3000t of gold, more than the world's annual mined production. However, like all trends, by the time the majority of producers had followed suit, the trend was passé. After 2000 gold began to outperform the US dollar as we moved from a dis-inflationary environment of the 1990's to a period of inflation and the logic of forward selling crumbled. Rising costs of production left the forward seller struggling to mine gold below the cost it had been sold for.

Mining companies currently convert their precious commodity into depreciating dollars

Some 10 years following the end of the bear market, it is now widely understood that as the dollar depreciates and gold prices rise, forward selling makes no sense (*unless that is, you are forced to forward sell for finance/cash flow purposes*). Nonetheless, mining companies still feel compelled to sell the precious commodity immediately having been mined and to convert their margin into depreciating dollars, an 'industry standard' practice they have become accustomed to. The approach is clearly flawed otherwise gold equity shares would be outperforming the metal.

Gold companies confuse analysts as well as investors

To compound matters, combining dollars and gold confuses analysts too. Whilst analysts understand we are in an inflationary environment, they are still forecasting

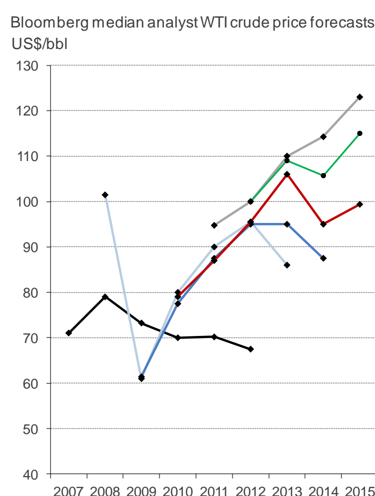
lower future gold prices contributing to the gold equity price lag. Analysts have witnessed annual rising dollar costs and forecast this will continue, and whilst the gold price has risen their recollection of that brutal bear market when gold prices fell for 20 years has led to a reluctance to apply higher gold prices much after next year, after all, we are told what goes up must come down and isn't gold in a bubble anyway?

Analysts are forecasting lower future gold prices, higher production costs and compressing margins

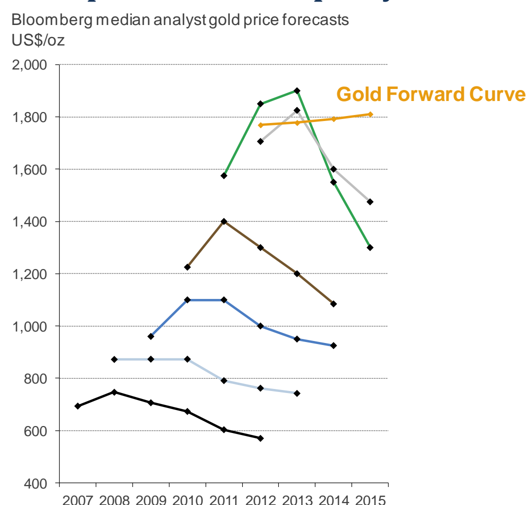
The following chart shows the consensus forward projections for gold prices over the past few years and demonstrates analyst forecasts of lower future prices, as they have predicted every year past. Our trusted analyst is, at the same time, forecasting higher input costs – we use oil forecasts as a reliable proxy to show rising price projections.

In the current inflationary environment, combining gold and dollars not only confuses investors, but provides analysts with every opportunity to de-rate gold companies.

Oil price: Costs proxy



Gold price: Revenue proxy



Source: Bloomberg, World Gold Council

Slowly but surely investors have lost faith in the option value of gold companies to higher gold prices and profitable growth from new discoveries

The generalist investor follows analyst sentiment and with margins forecast to shrink, is it any wonder that they struggle to pay for this, let alone pay a premium! This is the first contributing factor of the de-rating of gold shares. The second de-rating stems from our gold company discovering a new mine. As the trusted analyst models this new mine, by the time they forecast the mine to have reached production, the rising costs and falling gold price will likely eliminate any profit. Slowly but surely the gold shares have been de-rated by the market.

Is it any wonder gold shares have been de-rated

The market perceives that the gold companies are neither delivering shareholders the gold nor generating a sustainable margin. The success of the Gold ETF demonstrates that investors covet physical gold, however mining companies report and pay dividends in depreciating dollars not gold. With the gold price going up and the dollar going down investors clearly want ounces not dollars. Gold companies

Gold mining Investors want gold not dollar exposure…

should therefore report in ounces how much shareholder wealth they have added to their vault, not how much in dollars they have banked.

Gold producers should start their own gold standard

Gold producers should forget the views of pontificating economists and lead the way and **report in gold** in accordance with their own **gold standard**. Whilst there are legal and regulatory obligations to report in currency, the industry should adopt a gold accounting overlay which conforms to a new standardised approach, similar to the Gold Institute's standards for cash costs, not least, to promote understanding of ultimate shareholder value.

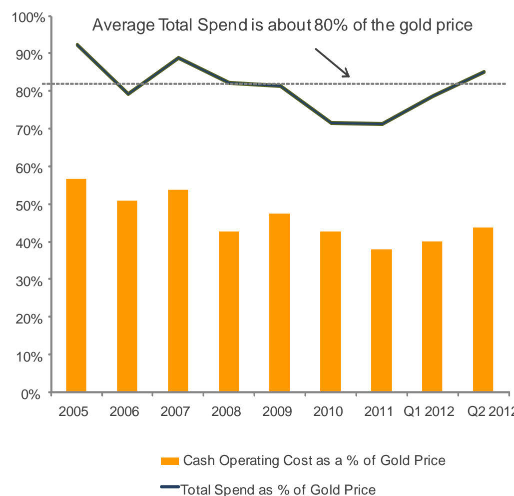
…so gold miners should introduce their own 'gold standard'…

Remarkably, when we convert dollar costs to ounces of gold, cost inflation is all but removed.

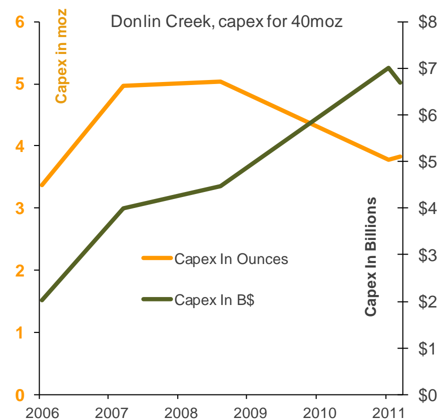
It is widely accepted that dollar capital and operating costs for gold miners have been rising over the past 10 years; however, when we measure these costs in gold ounces there has been **little cost inflation**.

…under which cost inflation is more appropriately expressed.

Operating Costs



Capital Costs



Source: CIBC

And we can see that over the life of a project, gold companies generate a consistent 20% margin for shareholders that is also inflation protected

We have analysed numerous past and future gold projects and the results tend to converge around the following:

- The capital cost of a new gold mine is around 10% of its gold reserves;
- Mining the gold costs around half that gold;
- The ongoing capital requirement to keep the mine running costs around 5% of the gold; and
- Governments end up taking around 15% of the gold in taxes.

The balance of 20% is generally left for shareholders.

Whilst some mines may 'high-grade' in the first year or two to speed up the payback, the overall results are fairly consistent suggesting that a gold mine should be valued at around 20% of its reserves/resources. Reporting/accounting in gold links the ounces in the ground to the gold price, furthermore, analysts would have a

far simpler job analysing margins in ounces rather than in dollars and gold companies could begin to **trade in line with gold**.

There are several good reasons for producers to hold gold on their balance sheets

Producers need to hold their retained profits in gold

Producers should go one step further and stop selling their 20% profit margin for dollars and hold this in gold ounces. Some producers have in fact started doing just this, IAMGold and Resolute now hold gold on their balance sheet. Why is this considered a good idea?

- It makes no sense to sell an appreciating asset for a depreciating one.
- **A mining company with gold in their vaults and lucky enough to discover a new gold project; will no longer face a problem of capital cost inflation. As explained, capital costs are fairly stable in ounces and account for around 10% of the reserves**.
- Tax is deferred until the gold is sold
- More gold is kept off the market and as gold reserves builds up on balance sheets, gold producers emulate ETFs.

Consistent margins and inflation protected returns allow transparent valuation of reserves and resources, thus restoring the appeal of equities

Encouraging the market to pay for the leverage in gold shares

What we would really like to see is a market re-rating of our gold shares. We would suggest that if companies report in gold, one can quickly analyse what an increase in reserves is worth and not get 'short changed' by the analyst pricing out the new discovery. A company that reports and holds gold it has mined creates a direct link between gold in the ground and shareholder value. The mission statement of the gold producer should become ***'to build and grow shareholder value expressed in ounces of gold'***. Further, by holding gold on the balance sheet the market will have increased confidence that newly discovered reserves will not be priced out of the market by dollar cost inflation BUT will have a higher chance of being developed, encouraging the market to pay something for the optionality of a new discovery. If a company discovers a million ounces then one is quickly able to add at least 20% of this to the market value of the company. However the market has stopped paying for this 'blue sky' as it confuses dollars and gold. **The current depressed share prices of gold producers creates in our view an outstanding opportunity**.

Dividends

In an effort to distinguish themselves from ETFs, gold miners have started to focus strongly on dividends, many are paying them for the first time and others are lifting their payout ratios. Producers rightly point out that the ETF pays no dividend. Yet gold equities have continued to underperform. Gold miners should be linking their dividends to the gold ounces they produce, aiming to pay out at least 5% of their production in ounces and not in dollars. Newmont Mining has gone half way in its new gold price–linked dividend policy, whereby it pays out a dividend indexed to the gold price. In our view it should have **linked its dividend to both its production and the gold price** – and the industry should aspire to pay dividends based on a percentage of the gold mined, not dollars generated. Perhaps pay this dividend in the form of gold ETF shares if this is appealing to equity investors. By effectively paying a royalty to ALL shareholders, a gold producer can capture some of the ratings royalty companies enjoy.

By effectively paying a royalty to ALL shareholders, a gold producer should enjoy a rating more similar to royalty companies

Gold mining companies are at a watershed moment; expressing and growing shareholder value measured in gold ounces can only help restore their appeal

Summary

The gold producer is at a watershed moment, similar to the position at the advent of forward selling where the early adopters were the beneficiaries. We believe that the producers that will outperform will be those that understand and practice that 'gold is the ultimate currency', and instead of forward selling they should be forward buying gold. By forward buying we advocate that gold producers should be selling dollars to buy gold both today and in the future i.e. gold that is in the ground. They should refrain from selling their production for a depreciating currency and hold gold not dollars on their balance sheet. We believe the best way to look at a gold producer today is not in dollars but in gold. After all it is producers that are telling us that gold is the ultimate currency. Once gold companies understand this linkage and provide investors with what they want, they will have the ability to highlight just how cheap their shares are relative to gold and then there is every chance that they can at least go some way to restoring their lost premiums. You never know, we might even see selling of the ETF to buy gold shares – let us at least give investors a good reason to do so!

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