Margin trumps ounces as gold miners shine despite COVID-19

Precious metals equities: Q2 2020 results update

Baker Steel Capital Managers LLP

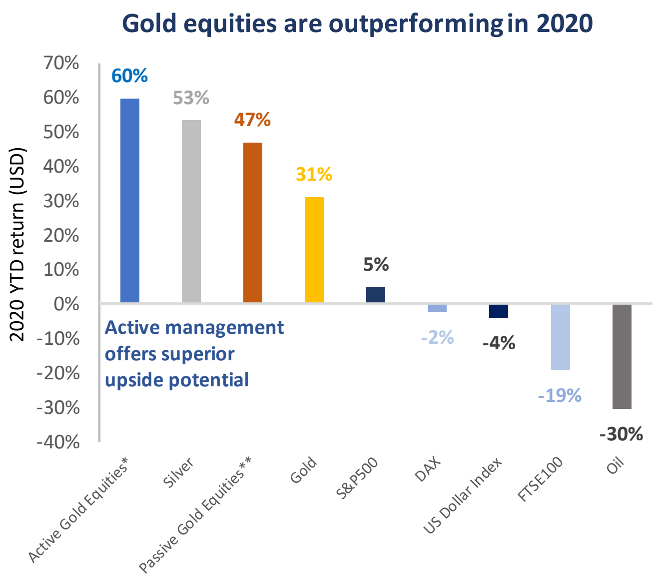
26 August 2020

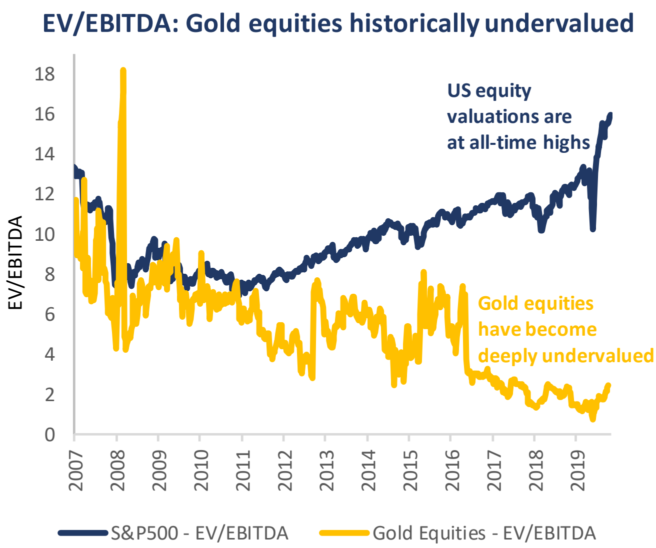
It has been over six months since the COVID-19 pandemic struck, upending business activity across virtually all sectors and pushing economies into recession. For the precious metals mining industry, COVID-19 has brought both challenges and rewards. Miners have faced operational difficulties due to the pandemic, while seeing a boost of profitability from rising metals prices, including new record highs for the gold price. Company results for Q2 2020 released over the past few weeks show that miners have now largely overcome the challenges of COVID-19 and many are well-positioned for the new precious metals bull market. Producers' margins are increasing, as rising gold and silver prices boost revenues, while cost inflation remains restrained. Among the most encouraging news has been announcements of increases of gold miners' dividends.

The rush of results from miners reporting on the second quarter of 2020 are of particular significance for investors, offering an insight into how the industry has fared since the pandemic took hold in March 2020. COVID-19 has presented a multitude of challenges for mining companies, from restricted site access and increased safety measures for personnel, to concerns over supply chain disruption and in some cases, government mandated shuttering of mines. While the resulting operational delays and impact on production during this unprecedented period have clouded quarterly results, as a whole the sector has handled this crisis well and we see certain positive trends appearing:

- Margins have increased quite significantly
- Several producers have increased their dividends
- More producers are reporting their dividends in a measurable way such as $/oz of gold produced

As investment specialists in the precious metals sector, we are encouraged to see these developments, particularly given the undervaluation of the sector relative to broader equity markets and compared to historic levels.





Source: Bloomberg, BMO Capital Markets, Baker Steel Capital Managers LLP. Data at 18 August 2020. *Active Gold Equities are represented by BAKERSTEEL Precious Metals Fund. **Passive Gold Equities are represented by the EMIX Global Mining Gold Index.

With gold miners now having largely weathered the pandemic, the economic environment for the sector is becoming increasingly supportive. Falling real interest rates, rising debt, and resurgent protectionist sentiments were drivers for gold prior to COVID-19, and have been amplified by policymakers' response to the economic crisis brought on by the pandemic. With investors facing a prolonged period of uncertainty, heightened risk and potential volatility, demand for gold as a safe-haven investment appears likely to continue. The implications for gold miners are substantial, particularly given the reforms undertaken by a selection of companies in recent years, improving cost control and capital discipline, which will allow these companies to outperform as the bull market develops. Furthermore, there are positive signs of growing generalist interest in gold equities, highlighted by Warren Buffett's Berkshire Hathaway making a substantial investment of c.USD 500 million in Barrick Gold, a prominent gold major, a notable and highly significant change of tack for a famously gold-averse investor.

As margins expand, gold producers are raising their dividends

As active investors, shareholder returns policies are a core focus for Baker Steel's team. Yield analysis is a key element of our value-driven investment process. Through bottom-up quantitative research using our proprietary GenVal system, coupled with analysis of revenue multiples, yield potential and other tools our team have delivered consistently superior risk-adjusted returns relative to our peers and passive investments in the precious metals sector.

A renewed focus on dividends is a significant trend for gold equities, particularly at a time when yields are falling in other sectors. The capacity for further dividends increases, as margins expand, is a key driver for the sector's re-rating potential in the months and years ahead.

A true stand-out company has been Kirkland Lake, which is the largest holding in BAKERSTEEL Precious Metals Fund ("the Fund") at the time of writing. The company returns money to shareholders via both a dividend and share buybacks and just reported the following:

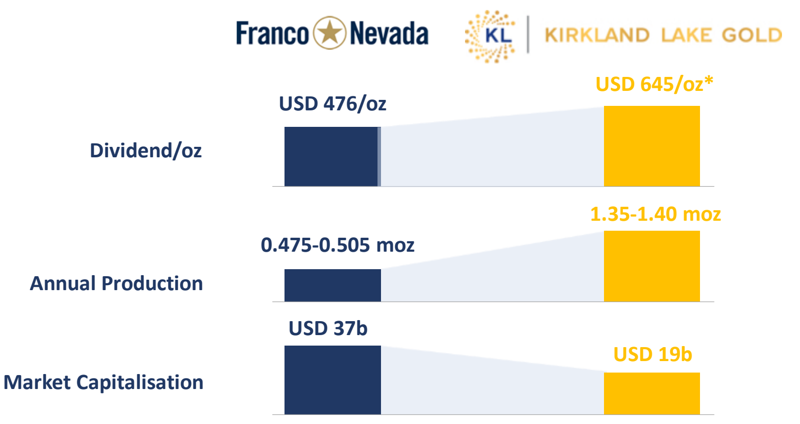
> *If we combine the amount of cash used for share repurchases and dividend payments in the first half of 2020, it represents approximately USD645 per ounce of gold produced during the period.*
>
> *Tony Makuch, CEO, Kirkland Lake Gold*

The significance of this statement, which may take a few moments to sink in, is to confirm that USD645/oz of production has been returned to shareholders in some form. In this simple and easy to understand metric Kirkland has succinctly communicated that the company's margins are substantial and sustainable, and that the company's balance sheet is strong enough to produce this type of return.

This example from Kirkland Lake shows that gold mining companies are capable of generating the superior, quality returns that were historically only reserved for royalty companies such as Franco Nevada. This bodes exceptionally well for the future of the sector.

As margin expansion for certain companies is so significant in this market, gold miners' share prices might achieve similar or higher ratings compared to the royalty companies in the months and years ahead.

Kirkland Lake: Comparison against a leading royalty company



Source: Baker Steel Capital Managers LLP, Company Reports, Bloomberg. Data at 25 August 2020.
* Dividend/oz data based on combined share repurchases and dividend payments in H1 2020.

Q2 2020 highlights for selected precious metals equities

	B2Gold reports strong Q2 2020 results and doubling quarterly dividend to USD 0.04 per share; quarterly record for gold revenue and operating cash flows; cash operating costs and all-in sustaining costs ("AISC") less than budget.
	Barrick Gold declared a Q2 2020 dividend of USD 0.08 per share, a 14% increase QoQ. Quarterly dividend has more than doubled since the Barrick-Randgold Merger in 2018.
	Q2 2020 dividend of USD 0.25 per share. Returned >USD 2.0 billion to shareholders through dividends and share buybacks since January 2019.
	11.9 million shares repurchased for USD 388.4m so far in 2020 (representing c.USD 1.40 per share). Share repurchase and dividends combined total c.USD 645/oz of gold produced during H1 2020. Goal to repurchase 20m shares over a 12 to 14-month period.
	Paying based on cash flow targeting 50%. Returning AUD 365/oz produced in dividends. AUD 732m via 15 consecutive dividends.
	Dividend raised by 12%, the fourth dividend increase announced in the past year, for a cumulative increase of 250%.

Source: Baker Steel Capital Managers LLP, Company Reports.

But the good news keeps on coming for investors in the gold equities sector. For example during the past couple of weeks Evolution Mining reported that last year it paid out USD245/oz, at a gold price some USD285/oz lower than where we are today, indicating that we should expect to see an even higher dividend next year from this quality company.

A sustainable and growing margin is the key for stock selection

The metrics outlined above provide critical tools to help our team structure the Fund's portfolio, as we strive to invest in those producers which have the best sustainable and growing margin. The dividends per ounce data helps us to understand just how sustainable a company's board believes their margins are. While revenue is one side of the margin equation, the other is costs, and this is where it gets interesting. The state owns the gold, but the shareholders own the margin.

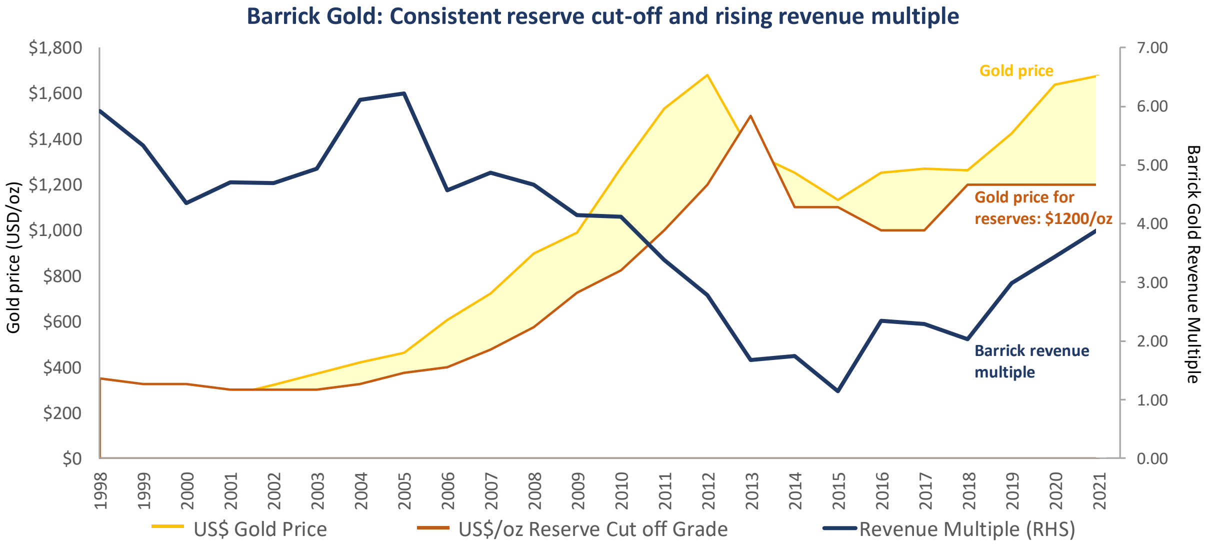
Notably, the deflationary impact of lower energy costs has helped to keep costs in line. Mining companies can also determine their costs per ounce by varying the grade at which they mine their orebodies. If they mine higher grade ore, all things being equal their costs per ounce should fall, likewise if they lower the cut-off grade that they mine at, their costs per ounce will rise and consequently at the same gold price their margins will contract.

Many gold companies continue to show discipline and continue to use a gold price of USD1200/oz, about 40% below where the metal is trading today for planning. During the last gold bull market, which peaked in the fall of 2011, miners lowered their cut-off to increase their reserves, started expensive new projects and went on acquisition sprees, much of which turned sour as the gold price fell during the following four years. The changes are clearly illustrated in the chart below which plots the revenue multiple for Barrick compared to a simplified margin (gold price less the gold price used for the reserve cut-off), shown by the yellow shaded area. In the late 1990's, as Barrick locked-in higher gold prices with its forward sales (+USD100/oz premium to spot), its healthy rating reflected the anticipated growth in production. As this growth came through in the early 2000's, the market rightly sensed that the company had started trading margin for ounces. The revenue multiple fell as the growth in the margin failed to keep up with the growth in the gold price. Since the market low in 2015 we can clearly see evidence that the company is now focusing on margin over ounces, which is being reflected in the re-rating of Barrick's shares as measured by the expansion of its revenue multiple. **Margin, in our view, always trumps ounces.**

While most companies are still trying to keep this discipline, we have seen a few which have chosen to lower their cut-off grade and mine lower-grade ore, partly to increase or maintain their reserve base as they mine out their deposits. As the cut-off grade is lowered, a company may mine more ounces but at a lower margin. What these companies fail to realise is that when the industry as a whole did this last time around, it became de-rated. Fortunately, it seems to be a different story this time around but the emergence of some companies breaking ranks show the importance of active and selective management.

"Everyone kept changing their cut-off grade and following the gold price"
Mark Bristow, CEO, Barrick Gold

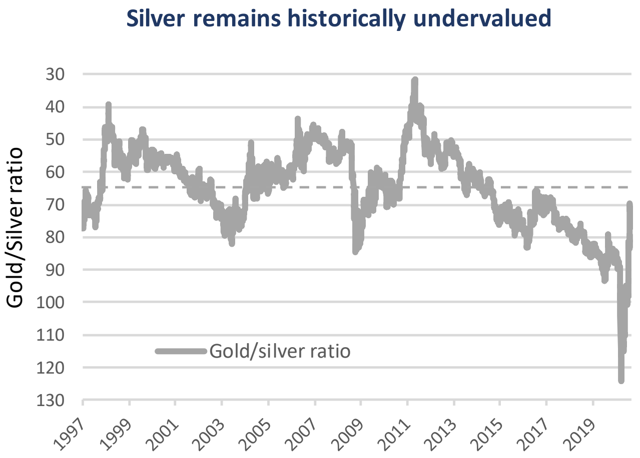
"This time, the key will be to show that the industry has not lost its discipline."
Sean Boyd, CEO, Agnico Eagle

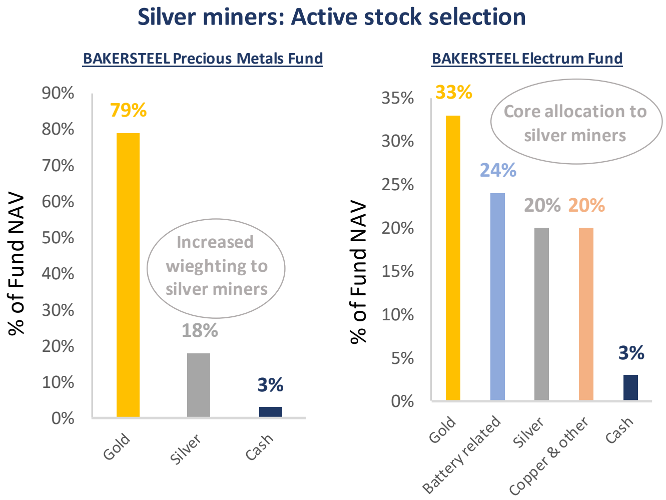


Source: Baker Steel Capital Managers LLP, Company Reports, Bloomberg.

The opportunity in silver equities

As investors in BAKERSTEEL Precious Metals Fund may know, the Fund has increased its weighting to silver mining equities recently, having increased our allocation prior to the recent run up in silver prices. This follows a turbulent period for silver miners during the second quarter of 2020, as COVID-19 risk in some jurisdictions impacted silver producers, prompting temporarily reduced ownership by the Fund while our team ascertained that companies' management teams were managing the crisis well. In past cycles we witnessed gold leading the rally, before silver quickly played catch up. As selected gold equities became overbought, we saw an opportunity to switch into preferred silver equities and, in this case, our decision seems well-timed.





Source: Bloomberg, Baker Steel Capital Managers LLP. Data at 31 July 2020.

Fundamentally silver mining equities can often appear expensive, but what is fascinating for investors is the leverage of silver producers, particularly those that also mine gold, with the longer-term driver of potentially increased industrial demand in areas such as green energy.

Building a position in gold equities, amid a positive outlook for miners

With the gold price having retreated somewhat in recent weeks, after reaching new highs during July, any further weakness in the weeks ahead will likely be a good opportunity for investors looking to build a position in gold equities. We believe that new record highs lie ahead for gold amid favourable market conditions and an increasingly supportive macroeconomic environment in the aftermath of the COVID-19 crisis. Baker Steel's gold equities strategy remains focused on quality and value, an approach which we believe will offer superior risk-adjusted returns relative to passive investments in gold and gold equities in the bull market ahead.

Overall, the Q2 2020 results show that a selection of gold and silver producers are positioned to generate strong returns in the months ahead under current market conditions, following a period of strong performance, and that many producers offer expanding margins and rising dividends at higher gold prices. With momentum building in the gold sector, active management will be critically important for the next phase of the bull market, to identify and access the fundamental value in the sector, focus on those companies with strong shareholder returns policies, and importantly to avoid those producers with weak and unsustainable margins.

The industry has never looked so healthy!

About Baker Steel Capital Managers LLP

*Baker Steel Capital Managers LLP manages the **Baker Steel Gold Fund**, **BAKERSTEEL Precious Metals Fund, BAKERSTEEL Electrum Fund**, **Baker Steel Resources Trust** and **ES Gold & Precious Metals Fund**.*

*Baker Steel has a strong track record of outperformance relative to its peers and relative to a passive holding in gold or gold equities. Fund Managers Mark Burridge and David Baker have been awarded **two Sauren Gold Medals for 2019** and were awarded **Fund Manager of the Year** at the **2019 Mines & Money Awards**.*

*BAKERSTEEL Precious Metals Fund is the **2020 winner** for the fourth year running of the **Lipper Fund Award** for Best Fund over 3 years and 5 years, Equity Sector Gold and Precious Metals while Baker Steel Resources Trust has been named **Investment Company of the Year 2019**, Natural Resources, by Investment Week.*

Sources: Bloomberg, BMO Capital Markets, Company Reports, Baker Steel Capital Managers LLP.