Profiting from the Dismal State of Gold miners and Explorers

by Brent Cook
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In our November 11 Exploration Insights letter (see excerpt below) we discussed the dismal state of the junior mining sector. Today we will expand on this theme, looking at the state of the larger gold miners and the obstacles they face going forward. The objective is to lay out an investment thesis premised on mining and exploration trends that indicate we are entering a rather unique, and potentially very profitable period of time in the junior mining sector.

From EI Nov. 11:

> "Nevertheless, money for exploration will remain tight for anyone that cannot demonstrate a potentially significant success. A persistent theme from many of the companies at the various resource conferences I attend is: "When the markets pick up in January we will finance".
>
> I doubt it."

Conversations with a number of companies at the reasonably well-attended San Francisco Hard Assets show reaffirm our previous observations--there will be a very long line of micro-cap juniors desperately seeking money early next year. I don't think it will turn out well for most, and suspect that next year's junior company exploration and wine cellar expenditures are going to be severely curtailed. A further observation from the San Francisco and New Orleans shows was that those companies with just enough cash to survive next year will be doing little more than making property payments while their geologists sit on their hands, "looking for an opportunity".

Consider: it costs in the order of $100,000 just to cover the public company filing fees, pay for the financial audits, and share an office and phone line. If you have a secretary, president, and geologist on staff you're looking at around $400,000 a year minimum. Add to that, property payments, a few field trips, and samples and you're nearing $800,000.

Drilling and serious work using consultants or staff puts your junior company over the $1 million mark just to do a little work on a long shot exploration property. Based on data collected and published by John Kaiser, about 50% of the Venture-listed companies will fall into the category of being unable to cover basic costs, while another 20% can't afford to explore. As of September filings, there are over 600 junior explorers with less than $200,000 in the bank! Welcome to the land of the walking dead.

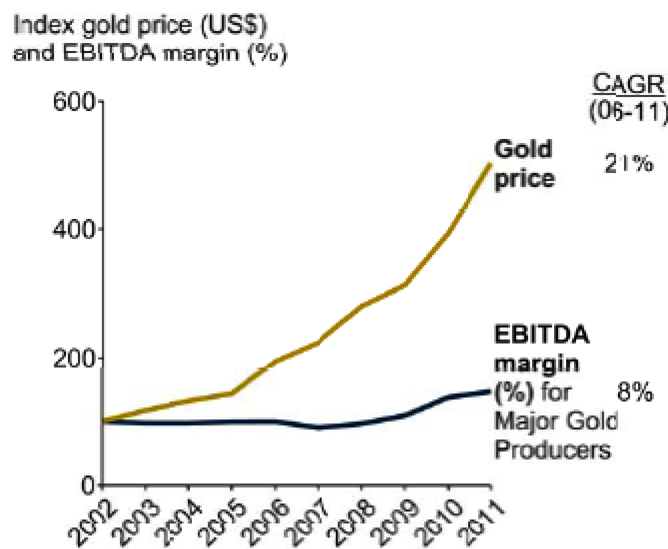
Accordingly, grassroots exploration by the juniors will be virtually dead next year (tough to raise money on concepts and soil anomalies) and aggressive drilling will be seriously curtailed (tough to raise money if you miss). Frontier regions like the Yukon and Colombia will be empty compared to the previous three years, with much of the ground coming free (expensive to explore and keep up property payments). Worse, the industry's only real hope for new large discoveries, deep and blind targets, are for the most part not going to be tested by the juniors because of the high cost and even

higher risk ("technically encouraging" results are tough to sell). Discovery takes time, patience, and money; all of which will be in short supply next year.

This all bodes ill for the major gold miners that desperately need new large and economic deposits and have been increasingly relying on the juniors to supply them.

Here's why

Since 2006, major gold equities have significantly underperformed gold bullion. The primary reason for the underperformance is that, despite the ~20% annualized increase in the gold price, major producers have only seen an 8% annualized margin growth since 2002 (Fig. 1 below). This equity underperformance has left many institutional investors who got the gold price investment thesis right sorely disappointed in the mining sector and recognizing it for what it is—a lousy business. They are unlikely to pile back into the miners; hence the high valuations for royalty companies whose exposure to cost pressure is less.



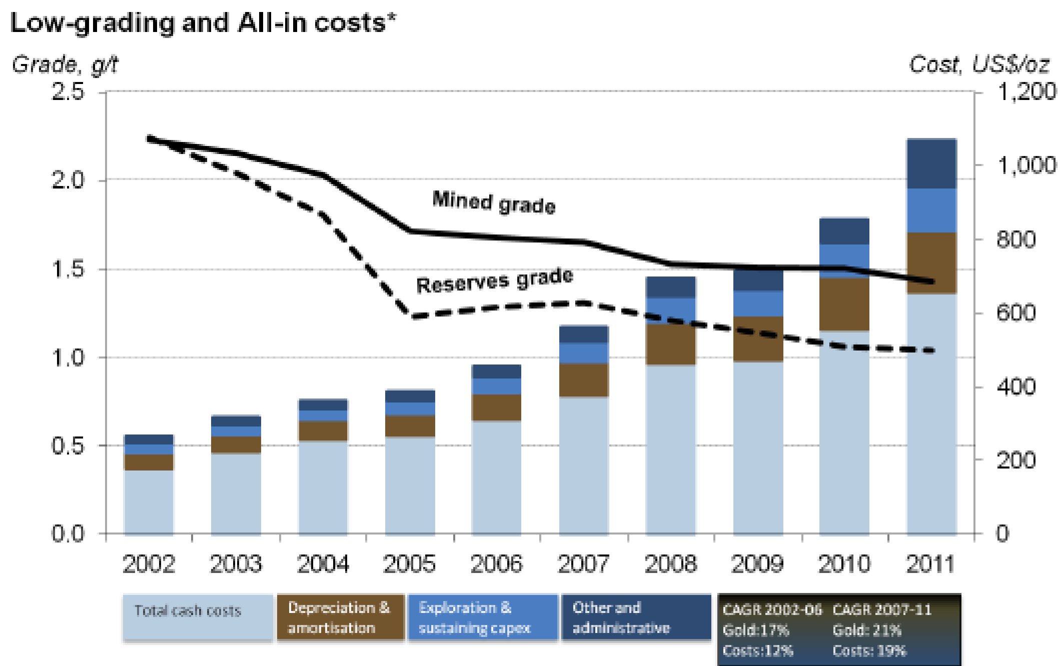
(Fig. 1: EBITA margins of six major producers compared to annualized gold price increase. From Nick Holland, CEO Gold Fields Ltd. Melbourne Mining Club; available here)

The reasons for the poor economic performances are many and, to some degree, company specific; overall, however, it comes down to mining costs (which have shown an annualized increase of 32%), and the declining quality of gold deposits.

Exploration, development, and sustaining capital costs have gone through the roof, resulting in a number of gold deposits being put back on the "maybe someday" shelf and out of the economic reserve category. Recent examples include Barrick Gold's decision to hold off on the development of 19 million ounces at Donlin Creek and 17 million ounces at Cerro Casale because they "do not meet investment criteria". Just this month, Gold Fields also pulled plans for open pit development of its 7.5 million ounce Chucapaca deposit due to high capital costs. Even smaller deposits like Richmont's ~2.5 million ounce (measured indicated and inferred) Wasamac gold deposit has been pulled because "it generated a less than adequate return" following the results of a number of optimization studies. I suspect there are many more large and small scale projects to be pulled; companies want to avoid the

dilemma Barrick faces at Pascua Llama--an initial $3.5 billon capex estimate is now over $8 billion, with no turning back.

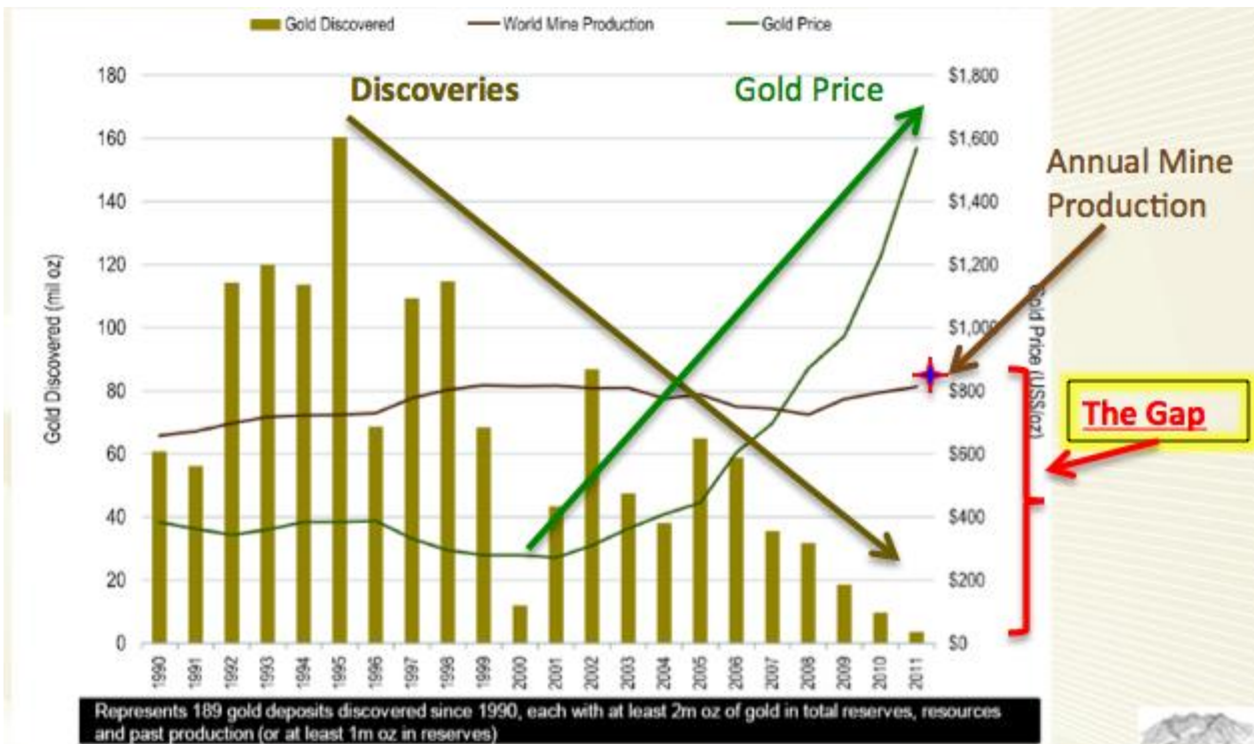
Total industry cash production costs have increased since 2002, from about $200 to nearly $700 per ounce (Fig. 2 below), while all-in costs are between $1,100 and $1,500 (depending on your source). Over the same period, the average mined grade of deposits has fallen by about half, while the mine reserve grade is projected to be only about 1 gram per tonne this year: a 60% drop in 10 years.



(Fig. 2: Gold mining costs and grade, 2002 to 2011. Video link to Denver Gold Group presentation here)

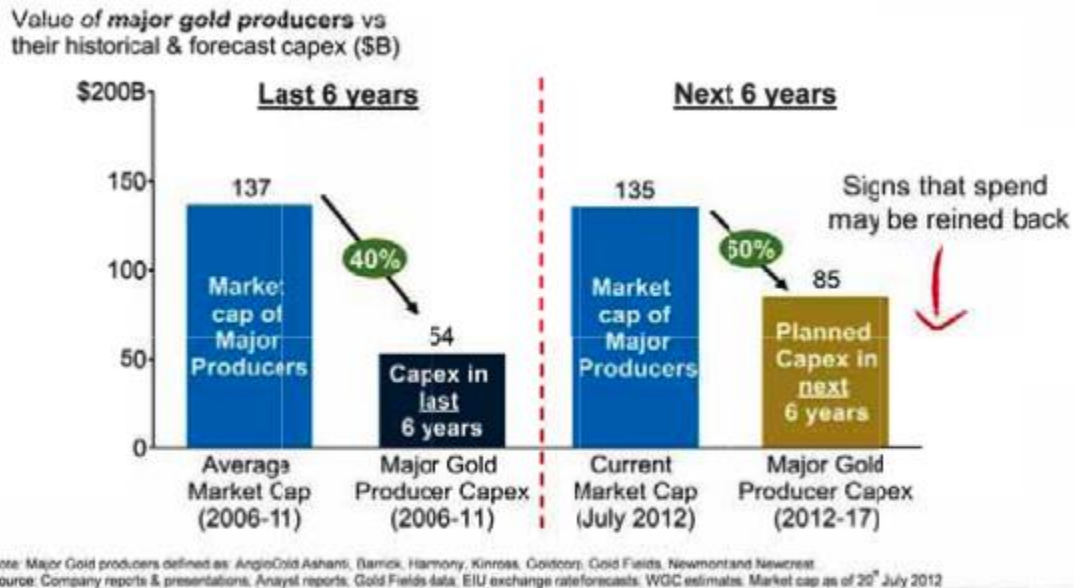
The declining mined and mineable gold grade is a direct result of the industry's inability to discover new high grade/high margin deposits. This lack of discovery has required companies to go after the lower grade/lower margin material around their current mines, using the increasing gold price to "find" the new ore. In fact, the Metals Economic Group estimates that the 99 significant discoveries (defined as greater than 2 mil oz) found between 1997 and 2011 could replace only 56% of the gold mined during that same period. Further, these discoveries only account for 18% of the reserves and resources in the current producing and development stage projects, again demonstrating the dearth of new deposits.

This can't go on forever, and how the *gap* between current mine production of ~83 million ounces and the rapidly declining discovered economic ounces plays out is going to be really interesting and profitable to those of us in the discovery game (Fig. 3).



(Fig. 3: Gold discoveries, production, and the gold price 1990 to 2011. The "gap" represents a serious discovery deficit. [Extracted from my recent San Francisco Hard Assets presentation] Source, Metals Economic Group)

Another interesting data point to ponder when considering the 83 million ounces of annual mine production, is how much it really costs the industry to maintain that production. Over the last six years, the major gold producers have spent 40% of their entire market capitalization building new mines (Fig. 4). In order to sustain that level of production going forward, published capex estimates project that the major miners will need to spend 60% of their market capitalization building the new mines, at a cost of $400 billion---and that figure doesn't even account for the nearly universal capex blow-out we have witnessed over the past six years. Ouch!



(Fig. 4: Six major producers’ market cap and capex-- past six years and projected six years)

The bottom line

The major gold producers desperately need new, quality gold deposits yet can’t afford to build many of the large deposits they already have on the books. These companies are facing margin squeeze in the form of increasing production and capital costs, taxes, royalties, regulations, etc., and are responding by cutting exploration, firing geologists, and cancelling projects. That is a tough and illogical way to find new deposits.

As for the junior exploration sector, it is in the midst of one of the worst financing environments I have seen and, unless things change drastically over the next six months, faces mass extinctions. Without a new infusion of cash into the sector we will see much less work (exploration) of substance and far too many companies just covering expenses and business lunches.

These situations exacerbate the economic discovery deficit problem the gold industry faces. Therefore, and this is a not a revelation to long time readers of Exploration Insights, the very few companies that have high quality gold deposits should be in more and more demand as this story plays out. Likewise, any exploration company with the property, competence, and cash to discover and define a quality deposit will be in even greater demand, due to the discovery leverage they offer. Conversely, a company with no cash and no property success means no more money and successively lower financings as they head off to the bone yard.

There are currently many junior mining stocks that are, or at least appear, “cheap” scattered across the decimated Venture landscape. They could get much cheaper. How one measures cheap, however, had better be relevant to the real issues at hand: underlying value and quality as opposed to last year’s share price or the price one paid. Specifically these are some of the questions that need to be addressed when considering “cheap”.

1. What is the realistic size and grade potential of the exploration target? Put another way: is the target worth the effort?
2. What are the probable mining, processing, and capital costs if a deposit begins to be defined?
3. What is the most likely metallurgy and recovery for the deposit type?
4. How are social, environmental, permitting, and political issues being addressed?
5. What project goals and hurdles need to be reached to confirm the investment thesis, and at what cost?
6. When and how does the company raise the money to advance the project and at what price?
7. And the most obvious question: how far will the money they have get them?

Thus, at this juncture it is critical to review your stock holdings in the light of what could prove to be a very difficult period in the resource sector, yet one that offers exceptional opportunity when value is eventually realized sometime down the road. Significant economic deposits have been defined or will be discovered, and mining companies desperate to replace reserves and decrease overall costs will acquire them. There is no second option.

My experience has been that during bear markets like today's, one can often recognize and purchase deposits at a steep discount while the market wallows in self-pity. This is when ten-baggers are bought; but you had better know the value behind the deposits because there isn't much dumb money left to buy mistakes.

That's the way I see it.

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Mining Meets the New Normal

Exploration Insights
by Brent Cook
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This rant thrashes out my thoughts on mining, exploration, and the market as distilled from two solid weeks in the Vancouver area at various conferences, meetings, and bars. The text was then passed on to Quinton Hennigh (QH) for his thoughts before going to press and, in his usual direct style, he added some colorful insights to an otherwise drab dissertation. These are italicized within the paragraph and/or as sidebars directly after the paragraph of interest.

The Rant

The "New Normal" Goes Mining

The next 12 to 18 months could prove to be a defining time for how investors, speculators, and mining companies perceive and value both the junior and major mining sectors. The metals bull market has been ongoing for about 12 volatile years and, from the looks of the price charts (Fig. 1 below), seems to have stabilized at significantly higher prices than where they started. Considerable sums of money were made in the run-up by those who sold equities early in the cycle; however, over the past few years the realities of production cost increases, capex blow-outs, jurisdictional risk, and the poor odds of discovery have set in. This is the "new normal" of the mining sector and one I think we have to adjust to in order to profit.

(Fig. 1: 12-year prices copper and gold, ~ 7-year for zinc)

I'm afraid the TSX-Venture index does not seem to show the same stability as the metals; at least to some chart technicians it demonstrates signs of a classic head and shoulders pattern with the next leg down imminent, or maybe a triangle pattern with the next move straight up (I have no idea-just reporting what I hear). Regardless, there was plenty of outward optimism at the well attended Cambridge House Resource Investment Conference in Vancouver in January. There had to be; this is an industry that thrives on selling the dream of a massive mineral discovery that will take a nothing stock up 1,000%--and occasionally delivers. Put another way, it is a business that changes your money and their dream into their money and your dream. On the whole, it is an industry that is populated by geologists using nebulous scientific theories and patchy data to explore for hidden treasures under moose pasture held by a company that, more often than not, is being pushed on the public by well-dressed, persuasive promoters with a gift for simplifying the complex to simple greed.

Just beneath the optimism, however, are some fundamental cracks.

The majority of potential investors roaming the conference floor are underwater on most of their junior stocks and therefore less inclined to buy another dream until the previous one actually turns positive (goes up in price).

Our investor base is also quite old and looking to cash out, not jump in! These people are looking for fixed income, not a high risk gamble. Demographics play a huge role in what is happening.--QH

Likewise, my discussions with companies suggest they are either moving into hunker-down mode to preserve capital or touting exploration programs that appear to be larger than their treasury. To me, there was an underlying sense of desperation behind the "Everything's going just fine" front. This

won’t end well for most if the market’s sentiment doesn’t change soon. But first, a short parable about the good old days on the Venture exchange:

There is a Chinese fellow who owns an old building in downtown Vancouver filled with small offices that serve as headquarters to many of the micro-cap juniors listed on the Venture Exchange. When times are tough, he takes stock in lieu of cash with the understanding that, if a paying customer shows up, the financially stressed company moves out. Over the years and through several cycles, the owner has done quite well with his accumulated portfolio of penny stocks. You see, there is always the chance that out of the randomness that is the exploration game, one of these broken companies will actually hit something with the drill bit.

There is also a very wily Irish gent trolling the city who keeps track of which companies are headquartered in the abovementioned building. He calls a company’s office and if someone answers the phone he buys the stock, figuring the company has enough cash to at least pay the bills, as the phone company doesn’t accept script for payment. According to the Railway Club Bar he made money in the past with this strategy.

But. . .

The financial year-end for over half the venture listed juniors’ is December 31, and audited financials are due about 40 days thereafter. Extensions to that date can be filed; the TSX is generally pretty lenient on letting companies slip by, as they want to keep collecting the filing and other fees. A struggling company may post a delinquent filing notice, but is allowed to keep its venture listing.

Unfortunately for the junior there is another, heftier, fee, which must be paid to a group that absolutely, won’t go for an extension or accept stock as payment--*accountants*. A basic audit with no complications for a company with one exploration property costs at least $30,000. If a company has projects scattered across the globe with active drilling, contractors, etc., the costs can rapidly reach $100,000 or more. Without the audit, a company will eventually lose its venture listing. Consequently, come about May we should begin to see which companies couldn’t afford a phone and audit pushed off the exchange and out of the building (delisted). They generally land on the NEX, where companies go to die (that would be an “avoid” in analyst-speak).

Back to the real plot. . .

More revealing to me than the sentiment of Cambridge conference attendees is the current state, and attitude, of the majority of large mining companies: they are facing a serious investor backlash and need to react. Investors, *big investors*, have begun to take note of the free cash flow (or lack thereof), share price performance, and persistent failure of miners to meet expectations. In the gold space, as discussed previously (link here), equities have significantly underperformed the metal (Fig. 2 below). This, to some degree, is the result of massive share dilution as companies struggle to replace and grow reserves and, to a larger degree, due to across the board cost increases.

(Fig. 2: Percentage return for major gold equities vs. gold price)

You see no one actually told institutional investors in New York, Atlanta, and London what a lousy business mining was, or that the sector would write off over $50 billion in 2012. From what I heard at the CIBC Institutional Conference, they are not happy campers and are demanding increased profitability, more accurate financial and technical reporting, and some restraint. In response, we have seen Kinross Gold, Anglo American, Rio Tinto, Barrick Gold, Newmont Gold, Vale, and BHP sack management. There is even a trend among gold miners to actually report all in total costs of production that include byproduct, G&A, exploration, and sustaining capital in the per ounce production costs. That number, by the way, comes in at an average of around $1,500 for the major producers.

Mining is a tough game-- always has been and always will be. This industry forgot that while prices rose over the past ten years. They thought they could operate gold-plated corporate offices, etc., but mining can no longer support such extravagance. BHP has a towering office building in Perth filled with 3,000 people…most of whom have !#!-all to do with digging rock out of the ground. Mining does not equal oil, tech or, banking. We are the tough bastards who work for pennies to squeeze a profit. Until we return to that, none of these companies can continue to be profitable.--QH*

For the most part, the sackings were the result of poor and/or overpriced acquisitions undertaken as the ousted CEOs struggled to replace and increase metal production in the face of growing demand and declining reserves. Sacking the culprits may temporarily appease shareholders, but it will not change or solve the fundamental problems companies face: increasing metal demand, rising production/capital costs, declining reserves, fewer discoveries, longer timelines, and unrelenting jurisdictional risks.

Nonetheless, the message to management is clear.

At most of the larger mining companies, management's *new* game plan seems to be one of extreme risk aversion when it comes to acquisitions and loudly declaiming to the markets that they intend to focus on cost cutting, while growing reserves "organically". They are also conspiring to under-promise and over-deliver in the misguided belief that this will matter. These changes may temporarily appease the MBA's running funds, but "optimizing" is much easier said than done, as incremental cost gains will come via tweaking mine operations that have been tweaked for years already, and cutting exploration.

Furthermore, although growing reserves organically via near-mine exploration (brownfields) offers the advantages of infrastructure and easier permitting, the added reserves almost always come in at lower grade, higher strip ratio, or deeper in the Earth; all of which represent higher unit costs—a questionable long-term growth story at best. Might as well buy a REIT.

And paying out dividends to thankless pension funds. . .this is robbing these companies of the capital for future mines! Note that most share prices have fallen steeply in spite of enhanced dividends. These did zippo to attract investors.--QH

Both Newmont and Barrick are severely stressed and reportedly not only laying off exploration staff, but have also begun to can folks from Human Resources, and even the occasional lawyer—this is serious.

Catch 22

The problem the industry faces is that mine reserve grade has been decreasing steadily over the past 12 years; which is another way of saying that it is only the increases in metal prices that has allowed companies to stay in business. The quality of deposits, meaning grade and margin, has declined in tandem with the difficulty of finding new deposits. Presentations at the Cordilleran Roundup made it clear that, for the most part, new deposits are deeper and/or increasingly located in problematic jurisdictions (i.e. places you would, or wouldn't, go on holiday). Discovery is also requiring more esoteric scientific tools and interpretations, much more money (due to lack of surface data--which makes drilling a prospecting tool rather than discovery tool), and time, as companies battle social, political, and environmental hurdles associated with working in new areas and bending over backwards for any loser with a bullhorn.

Finally, analysts, bankers, brokers, and letter writers have glossed over what mining and exploration is really about. The discovery process and mine building take time-- no matter how easy or hard a project may be-- and the finance/money guys and gals have done the industry a disservice by ignoring this fact. That is because they are paid to eat what they kill and therefore devour any new money entering the sector before it even has a chance to enjoy the view down Bay Street.

This part of the rant is too short. Perhaps it is a topic in itself. I know what you mean, but I think some readers would benefit from a clearer picture of how these buggers operate. Basically, they feed out BS and ultimately believe their own BS once it comes back around. Also bear in mind that "smart" money often participated in these huge raises (ITH, Canaco, etc). A testament to believing one's own BS.--QH

Some clear examples (out of a long list) that pretty much insure the new money that went into these stocks will probably never venture into the murky waters of Bay Street again include:

- International Tower Hill: Analyst targets of $8 up to $20 as the company raised $30 million at $6.00 in early 2010, and $105 million at $6.25 later that year, based on "positive feelings" around a PEA and incomplete metallurgy.

(Fig. 3: 4-year share chart, ITH. $2.50 to $10 and back again)

- Canaco Resources: Analyst targets of between $4.50 and $8.00 as the company raised $163 million at $5.40 in the spring of 2011, based on high grade drill intercepts that didn't hang together too well.

(Fig. 4: 3-year share chart CAN. $0.50 to $6.25 and back again)

- Keegan Resources: Analyst targets of up to $15 as the company raised $213 million at $7.50 in early 2011, based on an expanding low grade resource and positive PEA, that overlooked the details of gold mineralization and rising capital costs.

(Fig. 5: 4-year share price KGN. $2.00 to $9 and down to $3)

There's even more to the story. . .

It is not only the bankers, analysts, and various gurus that are to blame for the optimistic expectations here, engineering firms and Qualified Persons (QPs) are often at the core of the missed technical and financial projections.

I was fortunate enough to be part of a pre-conference CIBC event ("Thoughts on the Reliability of Mining Studies, from PEA to Feasibility") that included some well respected mining CEOs, analysts, and investors. One of the main points of the discussion was the observation that there is an apparent lack of understanding by many of the independent resource estimators of what actually goes into a resource estimate! The reliability of the data is usually fine, the reliability of the estimates and conclusions are not. Likewise, maybe 50% of the Preliminary Economic Assessments (PEAs) reviewed by companies seeking an acquisition were considered unreliable, or only accurate to within 50%, with regards to cost estimates.

The reasons for the poor reliability are many but, most importantly, experienced people are in very short supply at most of the engineering firms. Their workloads have increased dramatically as has the complexity of the deposits being modeled. They have, therefore, had to bring on young and fresh modelers who have not had time to experience the real world problems associated with blowing up rock and coaxing the metal from it, yet are tasked with doing so on paper. Hence, far too many of the 43-101 compliant studies are based on computer modeling that overlooks (and cannot take into account) the variability and uncertainty of Mother Nature and her hidden levied taxes. Additionally, many of the cost blowouts are related to social, political, and currency factors that are outside the scope of their mandate.

A lot of this is simply not appreciating what the real cost increases have been over the past decade. Some guys are still using $1.00-1.50 for mining costs! Try $3.00!!! Osisko built the Malartic mine for $1B in 2008. Today, I am sure it would be $2B!!! How can a PEA today really capture costs for something to be built 3, 4, 5 years out? Until costs stabilize, we are screwed. As Lassonde says, what is the discounted NPV on a project that is 10-20 years out…bupkis!--QH

Ultimately, and all too often, the mining-finance game goes something like this:

Companies that are desperate for money and need a technical report to (hopefully) survive the mayhem hire QP's, resource estimators, and engineering firms that are overworked and understaffed. Many studies (but certainly not all) are carried out by a firm's B team who produce a positive result that pleases the current, and hopefully future, client. Analysts and letter writers accept an engineering firm's study (be it resource, pre-feasibility, or PEA) without question; they tweak it to add some "independent" caution then hit the funding and commission road where dreams are sold.

Here's the catch. . .

Bear in mind, the analyst's and banker's job is to supply product to demanding clients in a bull market-- investors and speculators like us who want to be "talked" into a purchase and are therefore inclined to overlook some of the finer details. Fantasy and dreams in the mining sector are a lot more

fun than reality, and what this entire process boils down to is them fulfilling our short term investment demands while keeping up *their* lifestyle.

I think, at least for the time being, the finance scenario presented above is mostly dead. Non-industry investors and speculators have been (and allowed themselves to be) shafted too many times by now and are less inclined to believe *anything*—fact or fiction. Although there is purportedly a lot of money sitting on the sidelines, it will take a serious paradigm shift to bring it back en masse to the riskiest investment sector—mining and exploration.

Mining companies are also exercising more caution and are unlikely to pay large premiums for mineral deposits. They not only need to have confidence in a resource but must be comfortable that social and political issues have been addressed. The poor junior exploration sector can’t thrive in this reality-based climate and is on the ropes. Almost any company short of cash, a stellar property, good share structure, and competent management could very well go down for the count this summer.

This puts the entire burden on the junior company to continue to advance the project and de-risk it. It is simply too costly right now. Nobody wants to invest in a company whose game plane is to spend a gazillion dollars in permitting, social relations, economic studies. This is pretty unsexy stuff compared to pulling out drill holes with lots of gold!--QH

On a more positive note. . .

Still, the recent financial pain inflicted by the mining sector cannot last forever. As we have discussed too many times in the past, metal demand is increasing, mines are running out of ore, and economic discoveries are declining rapidly. Mining companies need to find or buy new deposits to stay in business. Scraping the low grade sides of a tired old deposit doesn’t cut it. That is a fact. Although many of the larger mining companies are caught like deer in the headlights, many others are not, and will use the current poor market to expand.

The list of companies potentially seeking an acquisition includes Yamana Gold, Centerra Gold, AngloGold [*They’re screwed in S Africa, Tropicana has eaten them alive; costs are out of control--QH]* Newcrest Gold *[Also screwed, profits down 50%. They have terminated all serious new business activity--QH*], Randgold, Alamos Gold, Iamgold [*Cote was a bigass mistake, they are realizing this and pulling in their horns. What a waste of $600mil--QH*], Osisko Mining, Endeavour Mining, Fortuna Silver, Dundee Precious Metals, McEwen Mining, Capstone, and Hudbay Minerals. These are the companies to keep on our radar screen and consider as possible acquirers of companies we own or may buy—our customers, if you will.

Concluding the story. . .

Within the EI portfolio it is time to recognize and concede that we are neither the owners of an old office building in Vancouver nor going to buy any company trading at pennies because someone answers the phone. The reality for the sort of companies we play in is that money will be hard to come by: cheap for a very few with a stellar discovery, expensive for the somewhat better than average, and highly dilutive, if not impossible, for the average and sub-par.

I intend to trim the portfolio down to higher quality projects and companies with sufficient cash to survive and take advantage of market conditions, at least as I see it. There are many solid, honest, hard working geologists, brokers, bankers, analysts and promoters in this industry that will survive the current malaise; we will continue to seek them out. Early stage exploration will remain my focus, but success there comes very infrequently and mistakes in this market can be brutal. You, however, may have concluded that the bottom is in and is being marked by today's EI, deciding it is time to accumulate some of the distressed juniors. Markets and sentiment can change rapidly and usually do so without warning; so please, go with *your* assessment of the mining markets.

Did I miss anything?

That's the way I see it.

Brent Cook

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