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Making Sense of the Mega Merger Mania

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Gold Rides Momentum to New High

The gold price had advanced in January with the U.S. Federal Reserve's dovish response to the December stock market volatility. This provided the momentum for gold to move to a new yearly high of $1,346 per ounce on February 20. Gold then pulled back to finish the month with a gain of $7.90 (0.6%) at $1,313.31. In early March gold has fallen to the $1,290 level. Following gold's strong 2019 performance, it is too early to tell if this pullback is a consolidation within an uptrend or a return to the sideways range-bound trading that has characterized the price pattern since 2013.

The strong central bank buying that characterized 2018 seems to be continuing. China purchased gold for the second consecutive month, buying about 12 tonnes in January. Azerbaijan has decided to nearly double its gold holdings to 100 tonnes. Meanwhile, Romania has announced plans to move its 103 tonnes of gold reserves from London to in-country vaults.

For the month, gold stocks slightly underperformed gold. The NYSE Arca Gold Miners Index[1] declined 1.6%, while the MVIS Global Junior Gold Miners Index[2] fell 1.2%.

Stock Market Highs Pose Headwinds

The stock market has become a headwind for gold as the S&P® 500 is once again poised to make a run at new all-time highs. Complacency is creeping back, which weighs on safe haven[3] investments. Each Fed Chairman since Alan Greenspan has been accused of protecting the stock market with monetary policies. Chairman Jerome Powell was thought to be more hawkish and immune to the whims of the market as he took office. However, the Fed's policy pause in response to stock market volatility in December has shown Powell to be as sensitive to the markets as his predecessors. David Rosenberg of Gluskin Sheff[4] believes the proliferation of exchange traded funds (ETFs), quantitative models, algorithmic trading, and momentum investing are all perpetuated by central bank suppression of risk premia, creating artificial market conditions where pricing is divorced from fundamentals. Ten years after the financial crisis, and economies are so fragile that central banks are still being called to the rescue.

Weakness in housing, automobiles, retail, and manufacturing combined with the lagged effects of the Fed's tightening in 2018 could again weigh on the stock market in 2019. Another selloff might may be the catalyst gold needs to break through its price range.

Newmont/Barrick: From Supermajors to Super-Duper Major… Or Not?

Merger and acquisition activity has now reached the ultimate level in the gold industry. It started with the September announcement of the friendly Randgold Resources/Barrick Gold (6.2% of net assets) merger, which was essentially a reverse takeover that left Randgold's management in charge of the new Barrick. Then, in January, Newmont (5.8% of net assets) announced a friendly takeover of Goldcorp (1.8% of net assets), which goes to a shareholder vote in early April. In each case, the managements of Randgold and Newmont believe they can do a better job of creating value than the previous managements of their respective takeover targets.

Barrick and Newmont have spent the last five years downsizing by disposing of non-core properties, streamlining management, and strengthening their balance sheets. Now, in a stark reversal of strategy, they want to grow through mega-mergers. Newmont's management style is akin to a modern corporate structure, while Barrick under Randgold is more decentralized and entrepreneurial. Each believes their respective management and assets are superior. We will look for evidence of their success, or lack thereof, in unlocking value with their quarterly reporting. In the fullness of time we will find out if their focus on shareholder returns, operating discipline, and innovation are enough to insure success, and whether one is more effective than the other. We hope competition in the free market brings out the best in both.

In addition to the considerable skills needed to manage so many mines, it may be geologically impossible to sustain a gold company that is as large as these companies are becoming. Absent mergers, the size of a gold company is fundamentally limited by geology. The tier-one properties (with low-cost reserves of over five million ounces) that make up the core of the supermajors portfolios are freaks of nature and extremely rare. Gold deposits are generally limited in size and often discontinuous, with chemistry and rock conditions that can be challenging to manage. Companies have been searching for tier-one gold deposits for nearly 200 years and the surface of the planet has been thoroughly explored. They must search deeper with less success as discoveries become fewer every year.

Now, coinciding with the BMO Global Metals and Mining Conference on February 25, Barrick announced a hostile no-premium bid for Newmont that is contingent on cancelling the Goldcorp deal. Barrick believes it can unlock value in Newmont that would not surface if the Goldcorp transaction is allowed to proceed. This would create a super-duper major the likes of which have never been seen before in this business. Shareholders will soon decide whether Newmont is better off with Goldcorp or Barrick.

Barrick figures that roughly two-thirds of the added value of a merger will come from unitizing their Nevada operations. Newmont and Barrick combined produce about four million ounces per year from the state of Nevada, one of the most prolific gold regions in the world. This comes from operations scattered within a 100 x 100 mile area centered on the Interstate 80 corridor between Winnemucca and Carlin, Nevada. Within Nevada, Barrick has higher production and lower costs, while Newmont has more processing infrastructure. Without Nevada, most of the rationale for the merger disappears.

While we do not know whether Barrick's bid for Newmont will be successful, it does focus attention on the potential gains that unitizing Nevada would generate for both companies. My experience as a geologist in Nevada, and knowledge of the two companies, suggests there is significant value to be gained from merging their Nevada operations. However, shareholders do not have the data, resources, or technical expertise to comprehensively evaluate such a colossal project. We must trust managements within the companies we own to do this work. On March 4, Newmont released a Nevada joint venture term sheet in response to Barrick's hostile offer. Barrick has not yet responded. If these two adversaries cannot come to terms on Nevada, we call on them to prioritize their shareholder's interests by publishing a joint definitive feasibility study that quantifies this value and articulates plans to unlock it for all to see. Once this is done, the best path forward should become obvious.

Commitment to Juniors

Finally, lost amid all this mega-merger mania are the junior companies at the other end of the spectrum. In this range-bound gold price environment, there is little investor interest in the juniors. However, we continue to maintain a portfolio of junior developers with good projects. In this market, we expect our patience to pay off once investors return to the junior sector.

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*All company, sector, and sub-industry weightings as of February 28, 2019 unless otherwise noted.

[1]NYSE Arca Gold Miners Index (GDMNTR) is a modified market capitalization-weighted index comprised of publicly traded companies involved primarily in the mining for gold.

[2]MVIS Global Junior Gold Miners Index (MVGDXJTR) is a rules-based, modified market capitalization-weighted, float-adjusted index comprised of a global universe of publicly traded small- and medium-capitalization companies that generate at least 50% of their revenues from gold and/or silver mining, hold real property that has the potential to produce at least 50% of the company's revenue from gold or silver mining when developed, or primarily invest in gold or silver.

[3]Safe haven is an investment that is expected to retain its value or even increase its value in times of market turbulence.

[4]Gluskin Sheff + Associates Inc., a Canadian independent wealth management firm, manages investment portfolios for high net worth investors, including entrepreneurs, professionals, family trusts, private charitable foundations, and estates.

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