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Gold's Growth Strategy: Green or Brown, Cash or Stock?

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Trade Deal or No Trade Deal?

There was not much news of significance to drive markets in November. As such, markets became fixated on whether or not a trade deal might happen between the U.S. and China. Gold fell to its low for the month of $1,445 per ounce on 12 November 2019 amid press reports of a "Phase 1" tariff deal that has yet to materialize. However, there was little movement in the dollar or interest rates, and the stock market turned giddy once again, with the S&P 500[1] zooming to new all-time highs. Perhaps the stock market is also responding to the resumption of quantitative-easing-style stimulus, disguised as support for the overnight lending market for which the U.S. Federal Reserve (the "Fed") has started purchasing $60 billion of U.S. Treasuries per month. During November, the gold price declined $48.99 (-3.2%) to $1,463.95. Gold stocks performed in-line with gold, as the NYSE Arca Gold Miners Index[2] fell -3.46% and the MVIS Global Junior Gold Miners Index[3] declined -2.79%.

Correction Continues but Warning Signs Are Flashing

The gold price remains elevated above $1,450 as it enters its fourth month of correction after reaching a six-year high of $1,557 on 4 September. In early November, global gold bullion exchange traded products (ETPs) experienced their first significant outflows since early September, though small inflows did resume later in the month. It is difficult to see much market movement in the near term as the Fed's rate outlook appears to be on hold, Brexit was postponed again, and there has not been much change on global trade. Geopolitical risks continue to escalate with persistent protests in Hong Kong and Latin America. Brazen terrorist attacks have gripped West Africa, while conflicts continue in the Middle East. Political unrest has yet to have a significant impact on global financial markets despite its increasing breadth and frequency. We believe late-cycle financial risks will increase, and with no end in sight to the spread of geopolitical turmoil, we believe gold might see significant gains in the coming year.

Growth Strategy: From Exploration to M&A

The Mining Journal reported S&P Global Markets estimates for 2019 exploration spending. Australia is now the top country in the world for exploration, followed by Canada and the U.S. Gold remains the leading metal with $4.29 billion allocated towards exploration—down 12% from last year despite the jump in the gold price. As well, this is actually the first year that mine-site, or "brownfields", budgets have accounted for the largest share of exploration spending, with past spending results typically dominated by new, or "greenfields", exploration. We believe that this reflects the current strategy of many producers to focus on getting more from their existing assets to create value organically, rather than building in new areas. While this strategy is working quite well, we believe that it has its limits and that, eventually, companies will need to increase their greenfields efforts or engage in mergers and acquisitions (M&A).

M&A activity has increased recently: On 2 December, Zijin Mining agreed to acquire Continental Gold in a $1.05 billion all-cash deal valued at a 29% premium over Continental's 20-day volume weighted average stock price. The company is building Colombia's first world-class underground gold operation, set to start production in 2020. Continental has done a phenomenal job of discovering and developing the Buritica Project. While Zijin is paying a hefty premium, our valuation indicates that if the company can navigate the recent political turmoil gripping Colombia and properly manage the start-up risks that all new mines face, they, too, will realize a generous return on their investment.

A Closer Look at the Kirkland-Detour Deal

On 25 November, a friendly acquisition was announced between mid-tier producers Kirkland Lake Gold and Detour Gold. The two combined have a market value of roughly $12 billion. Kirkland company presentations estimate 2019 production of 960,000 ounces, mainly from two high-grade underground mines in Canada and Australia at all-in sustaining cost (AISC) of $540 per ounce. Detour estimates 2019 production of 600,000 ounces from a large low-grade open pit in Canada at AISC of $1,140 per ounce. We hold both stocks in our Fund, and Kirkland is our top holding.

Both companies have been stars. Kirkland has been our top performing gold producer for the last two years. This year, the stock is up 60% and still one of our top performers. In our view, the company has extraordinary gold deposits and sound management. Detour is in the process of a turnaround under its new CEO, and its stock has embarked on a re-rating. It is our best performing producer in 2019 to date, with a gain of 119% (Source: Bloomberg).

The acquisition provides a third cornerstone asset for Kirkland. Kirkland also has the capital needed to advance exploration and hopefully increase Detour's production by up to 50%.

While the strategy behind this acquisition makes sense, we are extremely disappointed with the structure of the deal. This is an all-stock deal where Kirkland has offered a 24% premium for Detour. As we detailed in our October report, premium all-stock deals usually result in substantial declines in the acquirers' share price. In addition, large quantities of the stock winds up in the hands of M&A arbitrageurs and can churn in the market for months, keeping further pressure on the stock. Unfortunately, this deal has followed the same share price pattern we have seen in past all-stock deals. In the two days following the announcement, Kirkland declined 17.8%, nearly wiping out Detour's premium. The decline cost $2 billion of market value for Kirkland shareholders.

Shareholders will vote on this deal in January. It will be interesting to see if they accept the recent loss of value in exchange for the promise of a stronger future, or whether they reject a deal structure that has destroyed value for other companies in the past. In our opinion, gold companies that are not willing or able to pay cash must find more innovative ways of doing M&A deals that preserve and enhance value for their owners.

[1]S&P 500 Index measures the stock performance of 500 large companies listed on stock exchanges in the United States and covers approximately 80% of available market capitalization.

[2]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

[3]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.

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