

# Industry Consolidation and the Gold Price

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*Gold industry consolidation is long overdue and market conditions are such that it may finally happen. Sir John Harvey-Jones identified defragmentation of the gold mining business as the number one priority of the sector during his 2001 presentation to the LBMA entitled*

## *Troubleshooting the Precious Metals Industry.*

At the time of Sir John's address, jewellery demand was easing and companies were facing rising costs. Today those issues are just as concerning, and large mining companies are challenged with replacing reserves and sustaining production while competing for a shrinking pool of new discoveries. Smaller companies and junior explorers are also facing limited access to credit and capital amidst escalating volatility in the equity and debt markets. It is no coincidence that the latest drivers pointing to consolidation are also indicative of higher sustained bullion prices to come.

### **State of the Industry**

**The gold sector is extremely fragmented with the top tier of producers only controlling a small percentage of global mine output.** This is in contrast to other segments of the mining industry in which a few large companies dominate the production of commodities such as platinum, uranium, nickel, copper etc (Figure 1). The inherent nature of the gold business is such that there are very low barriers to entry and little to be gained from vertical integration.

Junior exploration and development companies play a vital role in the discovery process, but their ability to bring new mines



to production is in jeopardy. The smaller and nimble companies are still very good at finding mines and advancing them towards production. In fact, the juniors have been responsible for some of the most noteworthy new deposits of this cycle. For example, Aurelian's Fruta del Norte in Ecuador, Virginia's Éléonore in the James Bay area of Quebec, Ivanhoe's Oyu Tolgoi in Mongolia and Bema's Kupol in Russia.

It is noteworthy that many of the aforementioned discoveries have taken place in areas where the more established mining companies have not been active themselves. This is a principal reason the juniors have been so successful. They are willing to deploy risk capital into new areas and cast a wider net for discoveries. In the process, the first movers can develop deep local knowledge and begin breaking trail for future companies doing business in the region. Examples include pushing for and helping to establish up to date mining legislation and land tenure precedents. The majors have found a few notable exceptions such as the still expanding Cortez Hills deposit in Nevada now owned by Barrick and first identified by Placer Dome and Barrick's Lagunas Norte deposit in Peru. By contrast with the juniors and not surprisingly, the discoveries made by Placer Dome and Barrick were not far from existing operations.

### **The Case for Consolidation – Ounces not Synergies**

**Gold companies consolidate primarily as a means of achieving growth and sustainability.** In the past, acquisitions have often not resulted in real per share growth of

earnings, cash flows, reserves or production. This is because consolidation is most commonly done on a share exchange basis and the transactions are nearly always dilutive to near-term financial metrics. Likewise reserves and resources as well as production often decline on a per share basis.

However, now, with junior explorers trading down to record low levels, resources can be acquired on a per ounce basis for what a company might expected

to spend discovering new deposits organically through exploration. Figure 2 indicates that a number of multi-million ounce ore bodies can be acquired for less than \$20/oz of measured and indicated resources. Even better, ounces like these discovered on the stock exchange through corporate transactions usually come with many added benefits.

For example, acquisitions add resources all at once not over many years. The uncertainties associated with exploration are mostly eliminated and in many cases there is advanced metallurgical data, initial engineering studies to determine mining options and permitting that can be well underway. Purchasers can also hope to gain in-depth, local knowledge from inherited personnel and a jump on base line studies for future environmental monitoring.

**Consolidation does not bring competitive advantage nor are there appreciable synergies.** Gold mining has relatively low barriers to entry, proprietary processing techniques tend to be the exception rather than the rule and downstream processing and marketing offer few benefits from vertical integration opportunities as seen in the base metal sector. In most cases, there are few cost savings to be realized beyond consolidation of exploration efforts and head offices. The far flung locations of many mines tend to eliminate greater synergies.

Fig1 Global Mine Supply of Select Commodities

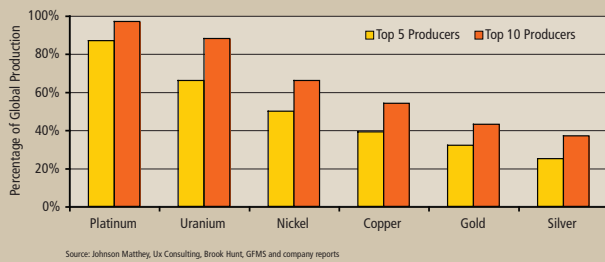
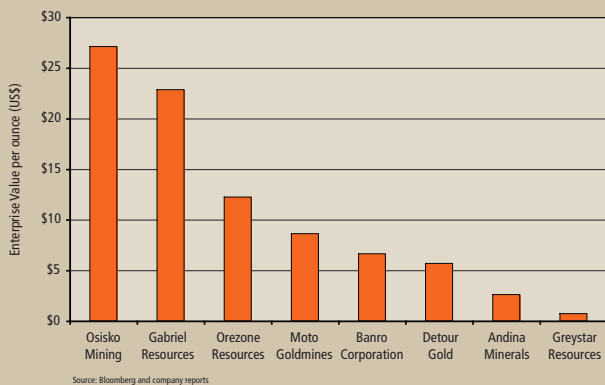


Fig2 Enterprise Value per Resource Ounce



## Consolidation in Today's Market Conditions

**The risk capital markets have reached the saturation point and access to funding has largely dried up.** As a result, exploration companies and smaller producers seeking to develop new projects without the benefit of significant cash flow are being gapped out of the credit and equity markets. This is starkly illustrated by numerous examples of exploration companies with capital requirements well in excess of their market capitalization. For example, many junior companies are now trading at less than \$20 per resource ounce yet their proposed mine development scenarios have capital requirements in the \$100 - \$150 per ounce range. The result being market capitalizations that are a fraction of the companies' funding needs. For companies in this situation, acquisition is the best they can hope for in the near-term.

While development capital may be impossible to secure, many juniors do have the means to continue funding exploration and feasibility study efforts on their properties. These companies can work to increase their resource bases and to add value through refined engineering designs and optimised mine plans.

Luckily, for Canadian explorers, flow-through share financing remains available. This is a government legislated arrangement to encourage exploration that allows investors to receive an immediate tax deduction. The exploration companies essentially pass

exploration expenditure deductions on to investors and in so doing receive a premium to their share price on the issue. In Quebec, companies benefit further from matching funds programmes that enhance exploration budgets.

## What Are We Waiting For?

The obvious question is when will the next wave of consolidation take place and will it spark a trend as the potential scarcity of bargains is perceived to be diminishing. The potential acquirers recognize the opportunities that exist under the current conditions,

but the perception now is that cash and credit should be used sparingly. It is also a buyers' market and there is little reason to rush into purchases. Un-financeable juniors are destined to remain so for some time.

Before the market conditions changed so dramatically, acquisitions in the gold sector used to follow the spot price of gold closely. The transactions from the past five years indicate that asset buyers were willing to pay close to 100% of the spot price of gold on a total acquisition cost basis.

The total acquisition cost of a company or asset is determined by three components; the total cash costs of production per ounce, the initial and life of mine capital costs per ounce and the purchase price per ounce.

Interestingly, over the past five years the price of gold has increased dramatically, yet the rule of thumb has generally held true. However, as the sector enters a buyers' market, premiums are expected to decline and acquisitions are unlikely to reflect nearly as much of the spot price of gold.

There are reasons to act sooner rather than later as acquisitions are often proposed when there is a valuation differential. Currently, the junior companies are trading at some of the largest discounts to valuation that we have ever witnessed. Also in many cases base metal prices can have an enormous impact on cash flow and net free cash flow for gold companies and the consensus view is beginning to anticipate less robust pricing for by-product income such as this.

## In Any Case Constructive for Gold Price

The price of gold should benefit from the fact that large mining companies are likely to struggle to replace reserves at the current rates of depletion. Likewise, if impaired access to project financing continues, many deposits in the hands of smaller companies are unlikely to come to fruition without help from established producers.

The net result should be beneficial to the gold price as world wide production levels are maintained in a best case scenario, but less likely to grow through the emergence of new junior companies. Hedging is also likely to decline as more projects are financed by senior producers with strong balance sheets and good access to credit without a requirement for revenue protection programmes. n



**Trevor Turnbull** is responsible for gold and silver sector coverage of emerging and growing producers. For 2005, he was recognized as StarMine's Best in Metals and Mining for 12-month

forecasts. Trevor is a geologist by training and spent ten years in industry throughout North America and abroad. His experience includes several years with Newmont in Nevada and Peru conducting production and exploration programmes and at Barrick's Bulyanhulu underground mine in Tanzania. He has an MSc in Mineral Exploration and an MBA from Queen's University in Canada in addition to a BSc in Geology from the University of New Mexico.