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Golden Opportunities in Mining

“Price is what you pay. Value is what you get.”

Warren Buffett

Key Takeaways

- 2020 saw a considerable improvement in the financial position of gold and silver miners.
- In 2020, producers had their most profitable year ever. The average spot gold price increased to USD 1,770/oz., but average industry AISC — representing the cost of mining — remained flat.
- While gold prices have enjoyed a substantial two-year rally, the valuation of gold miners does not yet reflect their greatly increased profitability.
- M&A was a major theme in 2019, which would have continued in 2020 were it not for strict travel restrictions. Nonetheless, M&A will be a key theme going forward.
- We expect gold and silver mining companies to generate record-high free cash flows in 2021 and beyond.

Introduction

> *"There's nothing you can do that can't be done*
> *Nothing you can sing that can't be sung*
> *Nothing you can say, but you can learn how to play the game.*
> *It's easy*
> *Nothing you can make that can't be made*
> *No one you can save that can't be saved*
> *Nothing you can do, but you can learn how to be you in time*
> *It's easy*
> *All you need is love."*
>
> The Beatles

"Mining Stocks: The Party Has Begun" was the title of last year's *In Gold We Trust* report chapter on mining stocks. Since then, senior mining stocks (HUI) have risen by 23% while the juniors (GDXJ) are up by 26%. We concluded:

> *"There are still few sectors that are more underweighted by the investment community than the mining sector. This is demonstrated by the almost dwarfish market capitalization of mining stocks. In this respect, we expect that the mining companies – and their shareholders – will reap a rich harvest in the next few years after a grueling dry spell.* ***But now it is up to the industry to deliver on the promises it has made in recent years, to build new investor confidence and attract generalist investors****."*[1]

The gold industry is now a real business.
Alex Black

One year on, we can fairly say that the industry has delivered. The value proposition of the miners has done nothing but improve.[2] Much of what was said in last year's issue regarding mining stocks remains the case today. The biggest change has to do with just how disconnected valuations of gold stocks have become relative to their cash flow. Remarkable undervaluations have gone largely unnoticed as investors focus on cryptocurrencies, SPACS, Reddit-induced squeezes like GameStop, and of course FAANG stocks. This lack of focus on gold is substantiated by the fact that Dogecoin – a satirical homage to bitcoin, designed to serve no real purpose other than generating a few laughs[3] – in May had a higher valuation than Newmont Mining and Barrick Gold. However, at some point, generalists and value investors will rediscover the value proposition of the mining sector. **To quote the Beatles, all you (they) need is love.**

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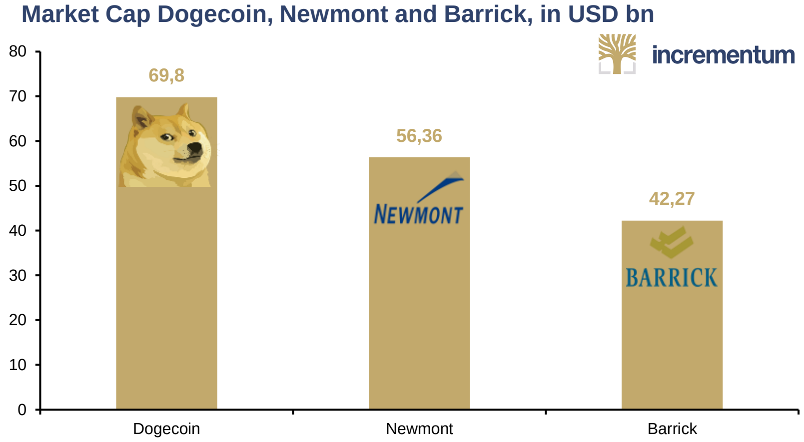
[1] "Mining Stocks: The Party Has Begun", *In Gold We Trust* report 2020, p. 300
[2] *See* chapter "Mining Stocks and Real Interest Rates: An Unsurprising Relationship" in this *In Gold We Trust* report.
[3] *See* Ostroff, Caitlin and McCabe, Caitlin: "What Is Dogecoin, How to Say It, and Why It's No Longer a Joke", *The Wall Street Journal*, May 10, 2021



Source: Reuters Eikon (as of May 14th, 2021), Incrementum AG

I feel like an oversexed man in a harem. This is the time to start investing.
Warren Buffett, October 1974

Over the last 12 months, the *In Gold We Trust* team has conducted more than 120 company meetings. Attending these (virtual) mining conferences, we sometimes felt like we were attending deep value forums. To us, it is clear: the gold and silver mining industry is in the best shape it has been in in a long time, at least since we started researching and investing in mining stocks 15 years ago.

2020 – The Year in Review and Status Quo

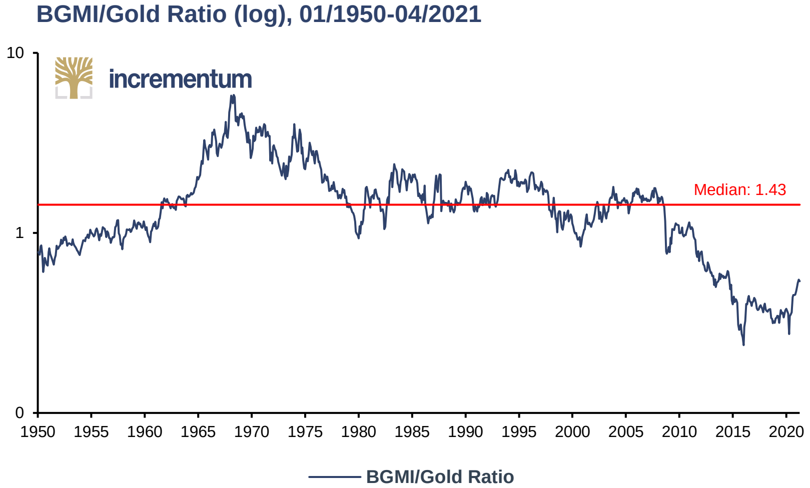
"Markets tend to return to the mean over time."
Bob Farrell

To us, redeployment of a portion of general U.S. equity exposure to gold shares at this juncture represents a non-consensus portfolio allocation with extremely high probabilities for success.
Trey Reik

Before looking further at mining stocks' performance in recent years, it is worth briefly looking at the industry from a longer-term perspective. The following chart depicts the performance of mining stocks (the XAU Index) relative to equity markets (S&P 500), illustrating clearly how low mining stocks prices are.

Source: Reuters Eikon, Incrementum AG

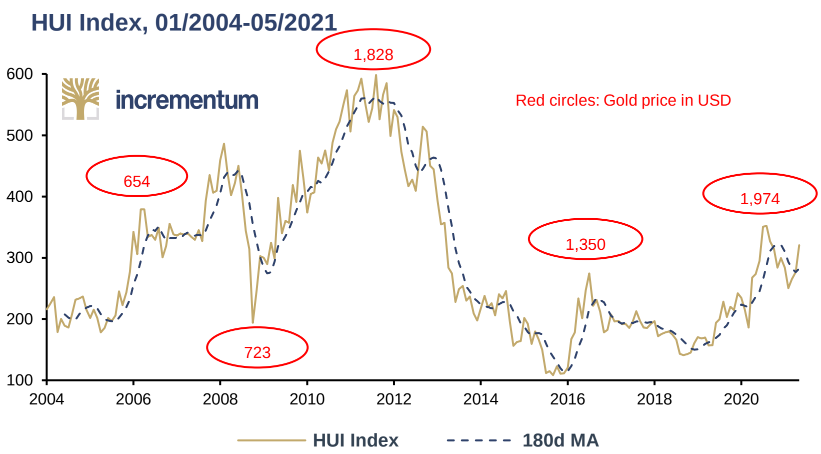
This underperformance of mining stocks is particularly apparent if we make an even longer-term comparison. The oldest available gold mining index, the Barron's Gold Mining Index (BGMI), is currently trading at 0.53, close to the lowest level in 70 years and far below the long-term median of 1.43x.



Source: Reuters Eikon, Nick Laird, goldchartsrus.com, Incrementum AG

All we need is just a little patience.
Guns N' Roses, *"Patience"*

Now, what happened in the last 12 months? The HUI peaked on August 5th at the 360 level and since then retraced down to a low of 250 in March 2021. It is worth noting that the HUI is currently trading at the same level as in 2016 when the price of gold stood on average at USD 1,350. The additional USD 500/oz. translated into significant margin and cash flow expansion.

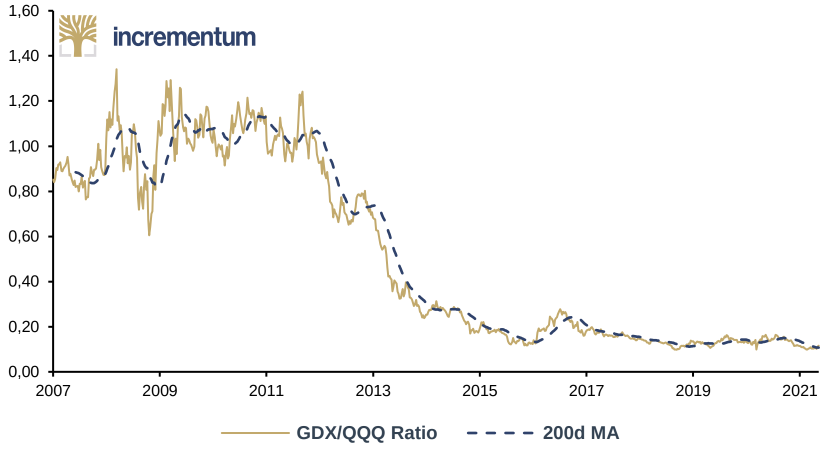


Source: Reuters Eikon, Incrementum AG

Every move you make
Every vow you break
Every smile you fake
Every claim you stake
I'll be watching you.
The Police, *"Every Breath You Take"*

Interest in the mining sector picked up noticeably last year, probably also due to Warren Buffett's investment in Barrick Gold, but since then has leveled off again. However, looking at relative strength, it seems that a sector rotation is currently proceeding, slowly but surely. If we have a look at the relative strength of mining stocks (GDX) versus the leading sector in the stock market — technology stocks (QQQ) — we see that miners have gradually increased relative strength. This illustrates that the value proposition of the mining sector is recognized, and that the relative strength of the sector has improved recently.

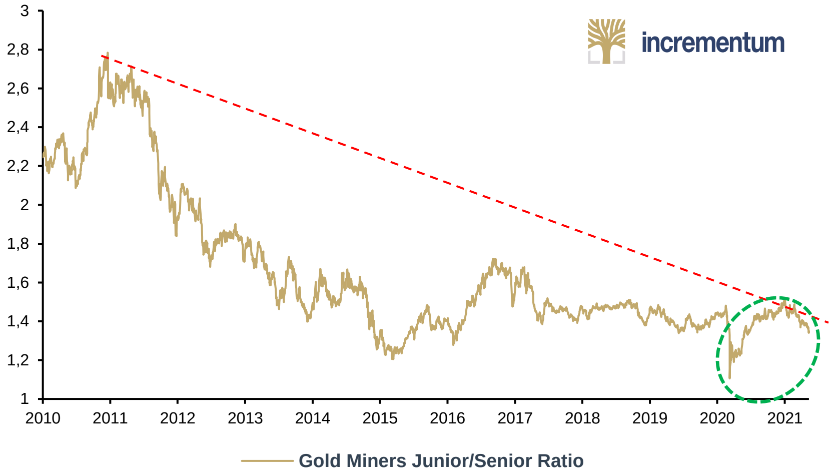
GDX/QQQ Ratio, 01/2007-05/2021



Source: Reuters Eikon, Incrementum AG

Moreover, if we examine relative strength within the mining sector, it seems that risk appetite is slowly coming back, with juniors (GDXJ) slightly outperforming seniors (GDX) since 2020.

Gold Miners Junior/Senior Ratio, 01/2010-05/2021



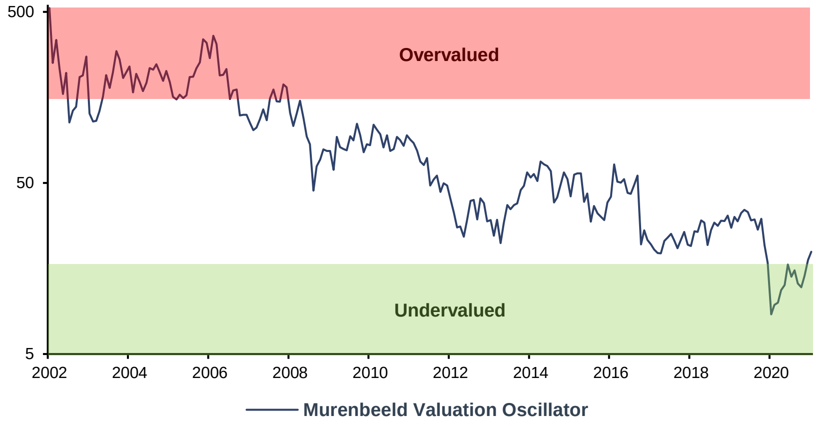
Source: Crescat Capital, Tavi Costa, Reuters Eikon, Incrementum AG

Valuations in the Mining Sector

> *"Whether we're talking about socks or stocks, I like buying quality merchandise when it is marked down."*
>
> Warren Buffett

The above-quoted "Sage of Omaha" made headlines last year, as Berkshire Hathaway made a surprising USD 500mn investment in Canadian gold miner Barrick Gold. This was somewhat surprising, as Buffett had never tired of "trash-talking" the yellow metal.[4] However, this love affair would not last long. Berkshire's 13F report showed that he liquidated his position in Barrick in the fourth quarter. Still, it is remarkable that the famed value investor seems to have found value on the balance sheet of a mining company. **From a valuation perspective, the gold mining industry has never been better regarding what you get versus what you pay.**[5]

S&P/TSX Global Gold Index - Capitalight Research Valuation Oscillator, 03/2002-03/2021

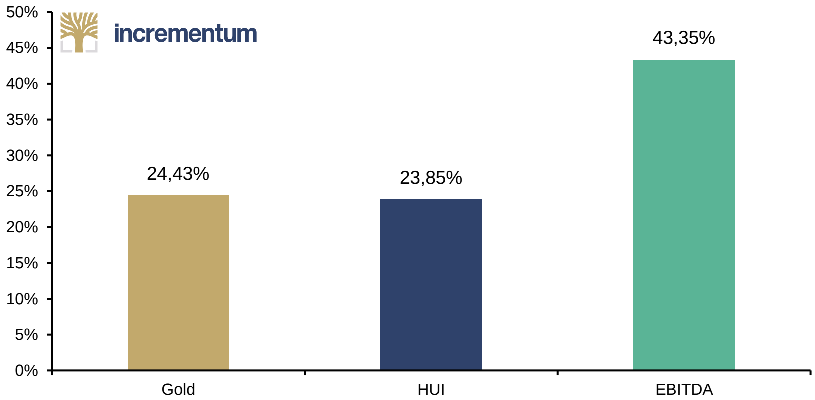


Source: Bloomberg, CapitalightResearch.com, Incrementum AG

Nobody can catch all the fluctuations. In a bull market, your game is to buy and hold until you believe that the bull market is near its end.
Jesse Livermore

In a typical bull market, **for every 1.0% increase in the gold price, the gold miners should appreciate 2-3% due to the leverage involved.** For example, if the gold price is USD 1,000/oz. and all-in costs are USD 950/oz., the net margin is USD 50/oz. If the gold price increases 10% to USD 1,100/oz., all-in costs are the same; the 10% increase in the gold price leads to a 20% increase in margins, from USD 50/oz. to USD 60/oz. While this is an extreme example, the same principle of margin expansion applies to smaller price increases as well. The opposite happened in 2020, with mining stocks underperforming the gold price.

Gold, HUI, and EBITDA, Return 2020



Source: Reuters Eikon, Incrementum AG

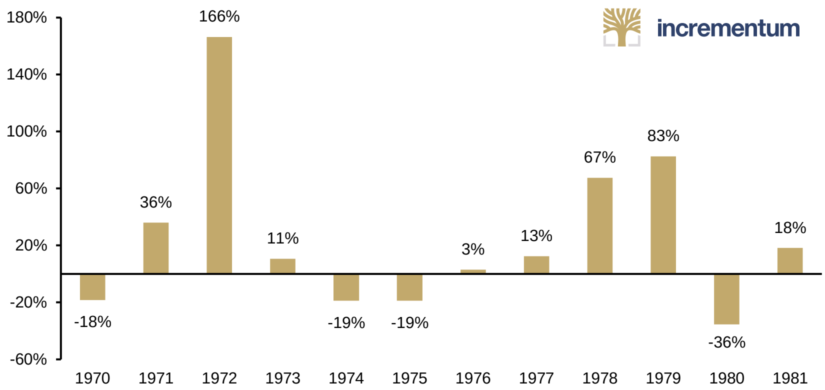
[4] Warren Buffett's aversion to gold may also be explained by a desire to rebel against his father, Howard Buffett. Buffett Sr. was a liberal senator (in the sense of a classical liberal) who spent every living day campaigning for a return to the gold standard. *See* "What explains Warren Buffets 'aurophobia'?", *In Gold We Trust* report 2012
[5] This great chart was provided by our friends at Capitalight Research Inc. Readers of the *In Gold We Trust* report can subscribe for an exclusive free trial under the following link: Incrementum | Capitalight Research

However, the substantial increase in profitability is not reflected in current market valuations. This disconnect is seen in every valuation metric, including price-to-net asset value (P/NAV) and enterprise or price-to-operating cash flow (EV/CF or P/CF). This is further supported by quality junior, mid-tier, and senior gold producers having FCF yields as high as 12-16%+.

I love it when people always say I´m always 'too early'. You can be late to a bull market – it's an escalator on the way up. You can't be late to a bear market – because it's an elevator going straight down.
Dave Rosenberg

Valuation in the gold sector would make sense if the increase in precious metal prices were transitory and unsustainable. However, we do not believe this is the case. The macroeconomic backdrop supporting precious metal prices has never been more robust, and it should only be a matter of time until new all-time highs are achieved and surpassed. The last major bull market for precious metals in the Western world was back during the 1970s, though it was confined primarily to the U.S. Metals and mining stocks alike soared, as measured by the Barron's Gold Mining Index (BGMI), making investors small fortunes.

BGMI Performance, in %, 1970-1981



Source: Nick Laird, goldchartsrus.com, Incrementum AG

I believe in yesterday.
The Beatles, *"Yesterday"*

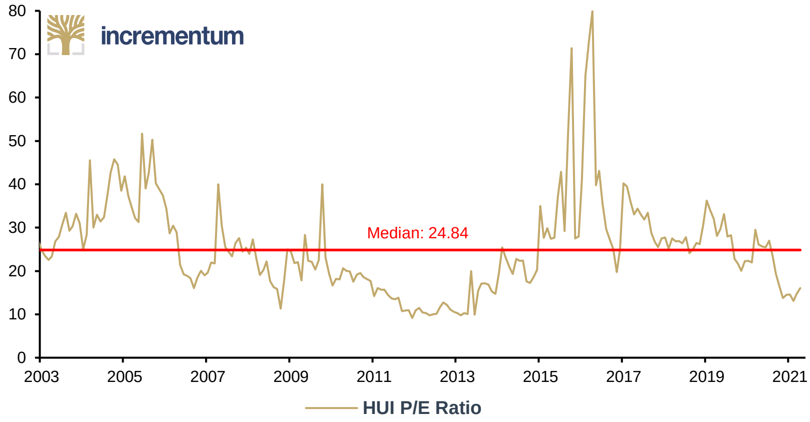
While it is challenging, if not impossible, to construct a diagram of companies trading at various P/NAV multiples or in the aggregate/indices, we will take a look at one index. It is worth mentioning some select premier companies and their NAV multiples, using a long-term gold price deck of USD 1,725/oz. and a 6.0% discount rate. We calculated the following average P/NAV multiples for each group:

- **Senior producers:** 1.04x NAV; group consisting of Agnico-Eagle Mines, Yamana Gold, Barrick Gold, Anglo-Gold Ashanti, Kirkland Lake Gold, Endeavour Mining, B2Gold, and Kinross Gold.
- **Mid-tier producers:** 0.66x NAV; group consisting of Equinox Gold, Eldorado Gold, Centerra Gold, Pretium, Torex Gold, and SSR Mining.
- **Junior producers:** 0.54x NAV; group consisting of Resolute Mining, Victoria Gold, Gran Colombia, Argonaut Gold, Calibre, and Roxgold.

Moreover, there are countless quality development-stage companies with NAV multiples ranging from 0.25x up through 0.50x.

Prevailing valuations would be more palatable if not for the increasingly outrageous valuations of mainstream equities. The average company in the S&P 500 is trading with a trailing 12-month price-to-earnings ratio (P/E) of over 30x. On the other hand, the following charts clearly show that companies included in the HUI Gold Bugs Index[6] are trading at the lowest P/CF and P/E multiples in more than 20 years.

HUI P/E Ratio, 01/2003-04/2021

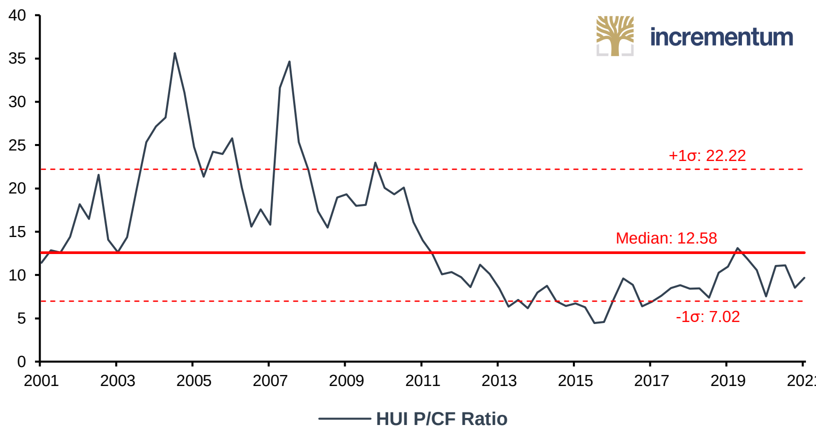


Source: Reuters Eikon, Incrementum AG

History teaches that when valuations are extreme, "mean reversion", a move towards historical norms, is likely. Once value stocks turn, the recovery can be fast and intense.
Rob Arnott

The next chart depicts the P/CF multiple of the HUI from Q4/2001 through the end of Q1/2021. The red line is the mean over this period, which is 12.58x. The dotted lines are one standard deviation above and below the mean. As of the end of Q1/2021, the index was toward the bottom end of the range, suggesting gross undervaluation. **In the first quarter of 2021, the spot gold price averaged USD 1,799, while various estimates suggest industry AISC nudged below USD 1,000. This means that despite a consolidating gold price, the industry-average cash margin per ounce in Q1/2021 was still increasing to over USD 800.**

HUI P/CF Ratio, Q1/2001-Q1/2021



Source:Reuters Eikon, Incrementum AG

[6] Companies in the HUI include Newmont, Barrick Gold, Wheaton Precious, Agnico Eagle Mines, Kirkland Lake Gold, AngloGold Ashanti, Kinross, Gold Fields, B2 Gold, Yamana Gold, SSR Mining, Alamos Gold, Novagold, Compania de Minas Buenaventura, Harmony Gold, Coeur Mining, Equinox Gold, Eldorado Gold, Pretium Resources, and IAMGOLD.

We have already looked at various valuation metrics. It is also worth looking at the gold price divided by the mining stocks price (HUI). During bull markets, gold stocks tend to trade with a premium, as was illustrated in the last bull market (2001–2011/12). The HUI/gold ratio indicates that gold stocks are trading one standard deviation below the mean, thus gold stocks are currently one standard deviation cheaper relative to the historical mean.

HUI/Gold Ratio, 01/1997-05/2021

Source: Reuters Eikon, Incrementum AG

Conclusion

A speculator is a man who observes the future, and acts before it occurs.
Bernard Baruch

No matter how one looks at it, using every valuation tool in the toolbox as well as some basic statistics, it is difficult, if not impossible, to argue that gold stocks are not inexpensive.

Our dear friend John Hathaway at Sprott recently mentioned another stunning example of the undervaluation of gold mining stocks, which currently trade at a 50% discount to the S&P 500 Total Return Composite Index. **Gold miners trade at an EV/EBITDA of 7.81, compared to the equal-weighted S&P 500 level of 16.76. This is the widest spread in 10 years.**[7]

While the valuation discrepancy has been ongoing for a while now and has been frustrating for most precious metal investors, the metals and mining stocks will have their day in the sun; it is a question of when, not if.

[7] *See* Hathaway, John: "One of the Greatest Bubbles in History", Sprott Gold Report, January 22, 2021

A Deep Dive into the (Under)valuation of the Mining Sector

> *"Patience is power. Patience is not an absence of action; rather it is timing; it waits on the right time to act, for the right principles and in the right way."*
>
> Fulton J. Sheen

As mentioned in the previous sector, on the back of higher gold prices, the value proposition of the mining sector has started to shine. Not only on an absolute level, but also relative to other sectors, as the following chart of total debt to assets shows.

Median Total Debt to Asset Ratio, Russell 3000 Index and Top 50 Precious Metals Miners by Market Cap, 2020

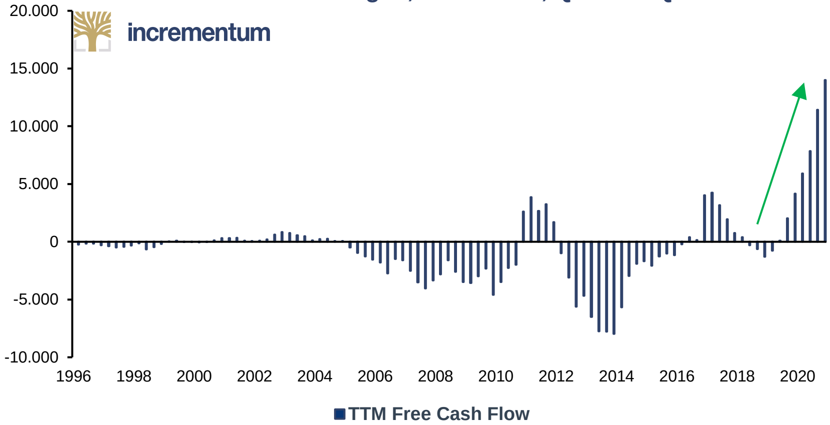
Source: Bloomberg, Crescat Capital, Tavi Costa, Incrementum AG

This achievement also includes higher profitability, vastly improved balance sheets, and excess cash generation. Leverage ratios have been greatly enhanced, with companies now returning material amounts of capital to shareholders through a combination of share buybacks and dividends. Currently, due to bargain valuations, stock buybacks are considerably more accretive than dividends. Once this is corrected, it is reasonable to expect that most companies will focus on raising dividends.

We cut back on expenses to yield a better balance sheet next year. We avoid ice cream today for a better body next year.
Chip Heath

The financial position of gold producers has improved dramatically, especially following the breakout from the USD 1,350/oz. resistance level in mid-2019, as cash flow and, more notably, free cash flow is now being generated. Before the breakout, only those producers located in the bottom quartile of the industry cost curve were generating free cash flow.

TTM Free Cash Flow of Top 50 Miners by Market Cap in the Canadian & US Stock Exchanges, in USD mn, Q1/1996-Q4/2020

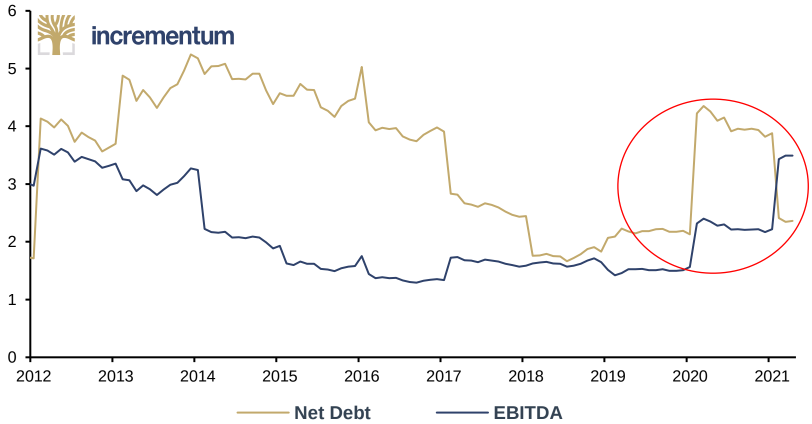


Source: Crescat Capital, Tavi Costa, Incrementum AG

Gold companies improved on leverage ratios in 2020. With an expected increase in performance, leverage ratios are expected to further decrease significantly, providing a much healthier balance sheet in the near future. Leverage ratios for the gold industry are expected to be significantly better than most other mining industries.
McKinsey

Net debt positions started to fall as the current bull market began in 2016, as illustrated by the net debt position of the HUI Index. The big spike corresponds to the outbreak of the Covid-19 pandemic. Many companies drew down cash from their revolvers due to uncertainty in the marketplace. Companies wanted to insure against liquidity issues, as numerous mining operations faced mandated government shutdowns. Net debt has since come down, and it is likely to continue to fall. However, companies are likely to remain conservative, paying down their revolvers in full, as there remains a degree of uncertainty around the Covid-19 pandemic, despite the advent of several vaccines. At the same time, debt financing is attractive in the current environment, as the cost of debt is far cheaper than the cost of equity, so net debt could fall more slowly than it would otherwise, at least until the cost of equity falls.

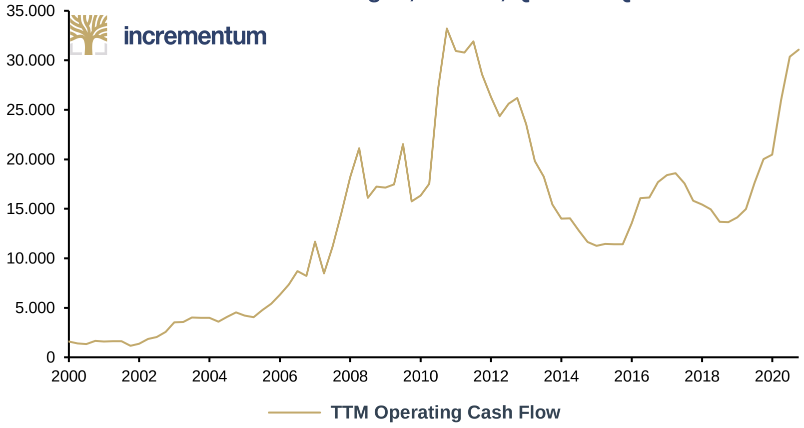
HUI Nebt Debt and EBITDA, in USD bn, 01/2012-04/2021



Source: Reuters Eikon, Incrementum AG

True profitability, especially for gold companies, is not reflected in net income; instead, it is just a starting point. If the company in question is a high-growth company such as Equinox, SSR Mining, or the like, a more accurate representation of earnings is operating cash flow. For more mature companies, such as Barrick, Newmont, Agnico Eagle, or other producers with output >1m oz. p.a. or those that are not ultra-high-growth, profitability is measured by free cash flow. Free cash flow is the excess cash generated beyond reinvestment and expansionary capital investment needs.

TTM Operating Cash Flow of Top 50 Miners by Market Cap in the Canadian & US Stock Exchanges, in USD, Q1/2000-Q4/2020



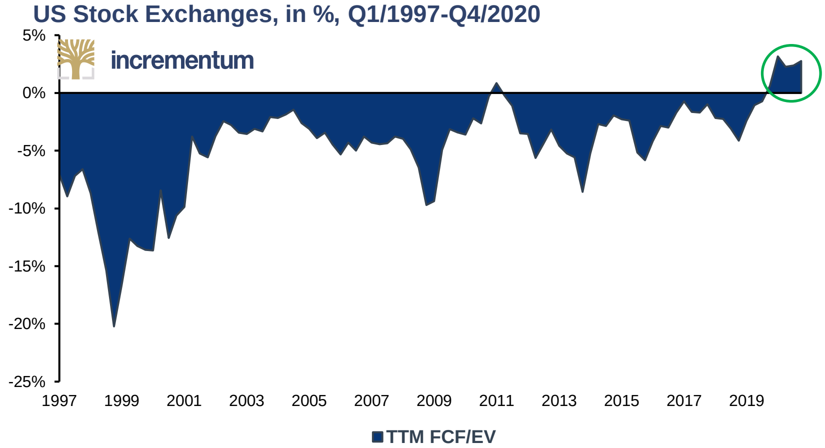
Source: Crescat Capital, Tavi Costa, Incrementum AG

The mining industry was not generating free cash flow from 2013–2015. Even after that, free cash flow was relatively marginal and confined to low-cost companies, with a reprieve for some companies beginning in 2016. Most of the industry – all but those in the highest-cost quartile – was free-cash-flow positive as a whole beginning in mid-2019. Once gold broke out of the key USD 1,350/oz. resistance level and reached USD 1,600/oz. and higher, the industry quickly became free-cash-flow positive, and low-cost producers became cash flow monsters. **Positive free cash flow generation also explains how companies have been able to deleverage.**

I guess what I'm trying to say is that if I can change, and you can change, everybody can change!
Rocky Balboa, *Rocky IV*

Furthermore, with regard to valuation, free cash flow yields are one metric we look at. They give us a rough idea of how cheap or expensive a company is, at least on the surface. We also examine some more involved valuation metrics. Free cash flow yield is defined as free cash flow/enterprise value (FCF/EV), with enterprise value defined as the current market price × the shares outstanding + net debt. Higher metal prices also lead to higher return on capital and equity.

TTM FCF/EV of Top 50 Miners by Market Cap at the Canadian and US Stock Exchanges, in %, Q1/1997-Q4/2020

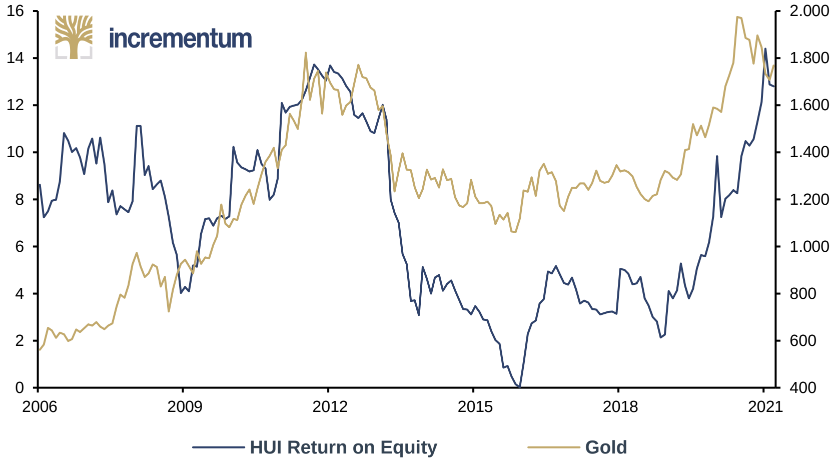


Source: Crescat Capital, Tavi Costa, Incrementum AG

Despite rising sustaining capital expenditure, most miners remain focused on cost discipline and cautious on capital expenditure. The emphasis of most companies remains on maximising value from their assets and increasing returns to shareholders.
Metals Focus

The return on equity (RoE) chart looks precisely how we would expect it to look. RoE peaked from 2011-1H 2012 but then fell and continued to fall as we entered a bear market from 2013-2015, with gold prices bottoming in 2H 2015. Bear turned to bull, but these are often lengthy processes; and while profitability improved, it fluctuated in a relatively tight range until mid-2019. After that, the gold price broke out, and profitability trended higher. Record RoE makes sense given the record AISC margins achieved in 2020.

HUI Return on Equity (lhs), in %, and Gold (rhs), in USD, 01/2006-03/2021

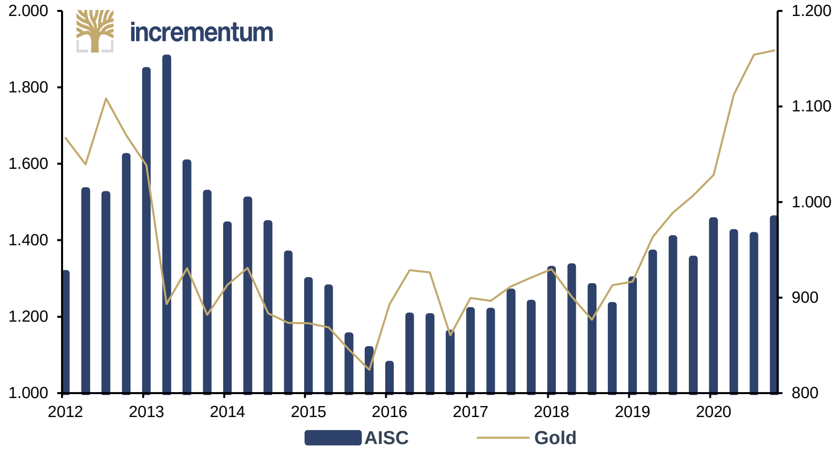


Source: Reuters Eikon, Incrementum AG

According to our friends at Metals Focus, average all-in sustaining cost (AISC) margins, defined as the gold price minus AISC, reached a record high of USD 828/oz in 2020, comfortably higher than the previous record set in 2011 of USD 666.[8] Silver miners achieved similar margin growth last year, although they did not reach record highs. AISC margins for the silver mining industry more than doubled year-on-year from USD 4.51/oz to USD 9.58/oz. Gold miners' costs rose in 2020. The average AISC in the gold mining sector increased by 1.8% yoy. This was a relatively modest increase given the disruption caused by the pandemic, which, according to Metals Focus, led to a 4.4% yoy decline in global mined gold output.

[8] *See* Christensen, Neils: "Gold miners generated historic profits in 2020, expect more of the same in 2021 - Metals Focus", Kitco, March 24, 2021

Gold (lhs), in USD, and AISC (rhs), Q1/2012-Q4/2020



Source: Metals Focus, Reuters Eikon, Incrementum AG

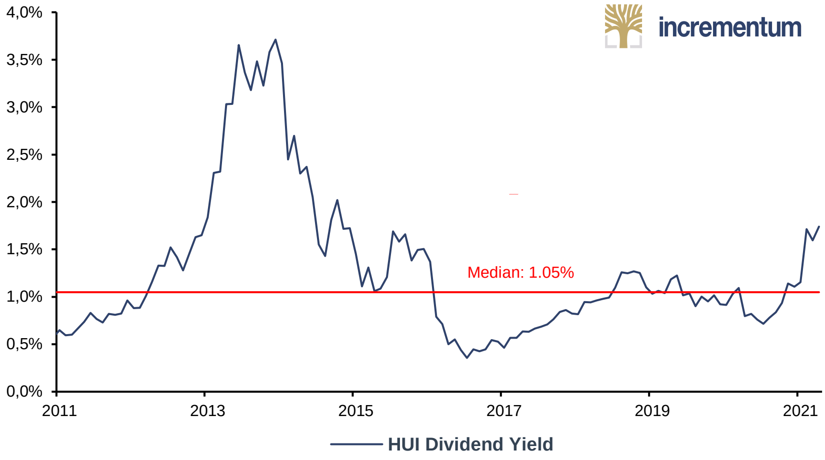
It has certainly been good to see companies that eliminated dividends six or seven years ago reinstating them now and certainly good to see, from an industry perspective, companies growing dividends.
Sean Boyd
CEO Agnico Eagle Mines

During the last bull market, high-quality companies generated solid free cash flow and, in turn, positive free cash flow yields. However, in the later years of the previous bull market, notably in 2010-2012, the average mining company (which is not high-quality) had exceedingly bloated G&A expenses, often paying management and everyone involved with the company far more than they deserved. Mining companies still generated free cash flow, but it was much lower on average than one would think, given the gold price. During the lean years (2013-2015), mining companies cut costs to the bone, which they should have been doing all along. In short, during much of the last bull market, the industry as a whole was free-cash-flow neutral. Luckily, at least to this point in the cycle, companies have been able to contain themselves.

The dividend streams from precious metals equities should attract a huge wall of yield-seeking money from the fixed-income market.
Thomas Kaplan

With gold mining companies generating significant cash flow, dividend payouts have increased. In the current environment, with depressed prices for gold stocks relative to cash flow generation, more companies will look to buy back their shares while the opportunity presents itself and hike dividends, though to a lesser degree than would otherwise be the case. This is something worth considering. For example, senior gold producer Kirkland Lake Gold returned USD 848.3m to shareholders during 2020. While this did include two dividend hikes, just USD 116m of that amount was returned via dividends, with the remaining USD 732m used for buying back 18.926m shares. While it was not the case for the industry as a whole, a fair number of companies chose to buy back shares while they were cheap, as doing so presented a better value proposition. **In other words, when gold stocks obtain reasonable and premium valuations in the market, buybacks are likely to fall considerably and be reallocated into higher dividend payments.**

HUI Dividend Yield, in %, 01/2011-04/2021



Source: Reuters Eikon, Incrementum AG

A New CAPEX Cycle Ahead?

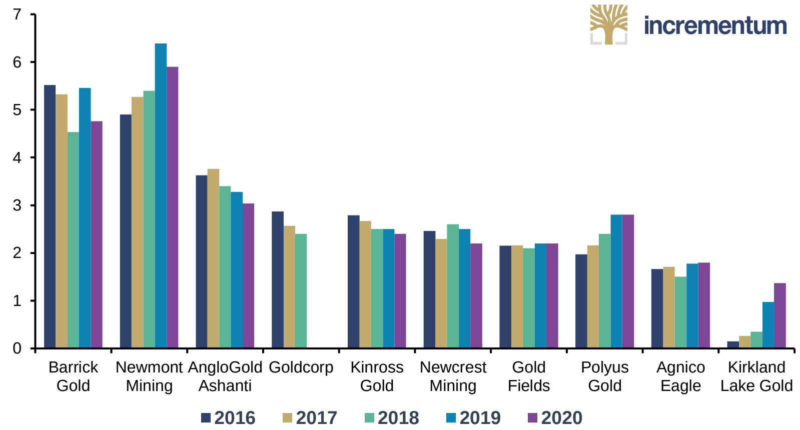
"It's time to get back out in the field and start drilling!"

Richard Schodde

278 major gold deposits were discovered between 1990-2019. However, only 25 of these discoveries were made in the last decade and none between 2017 and 2019.
Adam Webb

In 2020, gold production hit a five-year low. Of course, the disruption due to the Covid-19 pandemic played a role; however, the drop represents a secular trend of declining gold production. **In the coming years, a price will have to be paid for neglecting exploration spending.** The steady deterioration in production profiles is likely to continue. It is estimated that seven of the ten largest producers have reported year-on-year declines in production in 2020. Moreover, compared to 2016, four out of ten majors have shown falling production.

Gold Production of Top 10 Miners, in Moz, 2016-2020

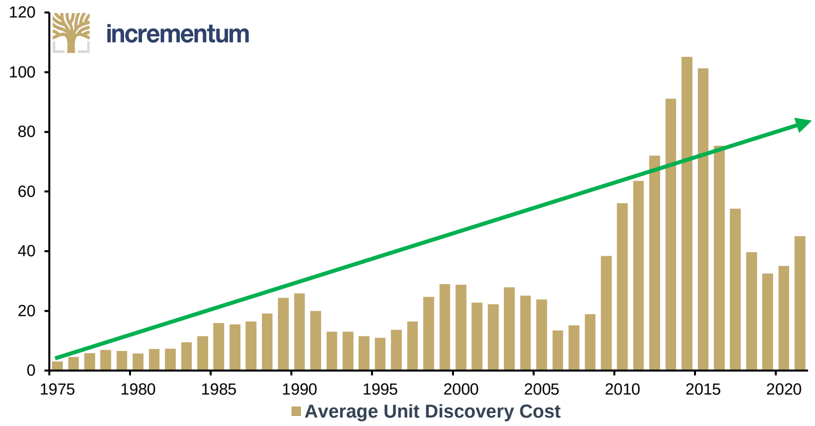


Source: Company Reports, IntelligenceMine, Seeking Alpha, Reuters Eikon, Incrementum AG

Does that mean that falling gold production is here to stay? What would that mean for gold prices? In our *In Gold We Trust* report 2018, we wrote extensively about "peak gold" and concluded that the fear-mongering is somewhat exaggerated.[9] **We primarily see the following trends:**

- An intermittent peak in gold production currently appears to be likely.
- Analogous to what happened in the oil sector, strong progress in innovation in the gold sector is urgently needed, particularly in making exploration more efficient. This technological paradigm shift is currently happening in mining.
- Spending on greenfield exploration should be increased substantially. Realistically this will only happen once a higher gold price is obtained.
- The cost of discoveries is set to rise in the long term. Richard Schodde of MinEx Consulting estimates an increase in discovery costs of USD 10/oz. per decade.

Average Unit Discovery Cost (3-year MA), in USD, 1975-2020



Source: Richard Schodde, Incrementum AG

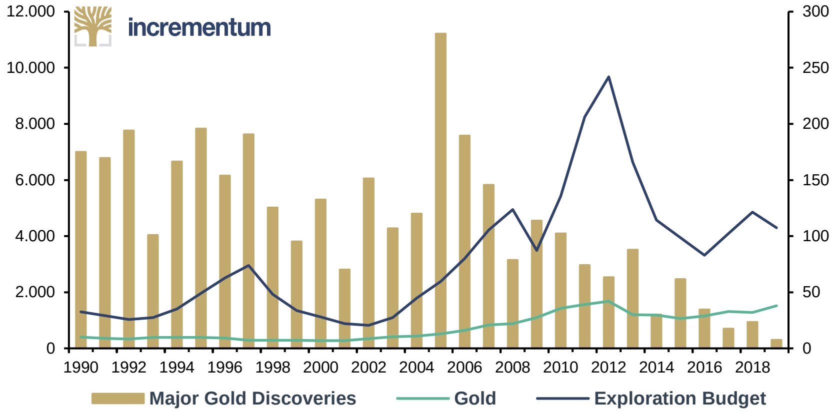
However, we do not regard "peak gold" as a viable argument for higher gold prices, as the extremely high stock-to-flows ratio of gold ensures that production declines are compensated for by the large existing stock of gold. **Nevertheless, "peak gold" will affect the gold mining industry, because it should be expected that the pressure to pursue mergers and acquisitions will increase.**

The prospect of a serious reserve crisis is looming.
Mark Bristow
CEO, Barrick Gold

As the next chart shows, there has been a dearth of new large-scale assets that have come online over the last decade. Given the severity of the previous bull market, large-scale assets were not advanced to the degree they had been previously, as free cash flow margins were thin to nil prior to June 2019. More to the point is that the lack of exploration expenditures after the last bull market ended (2011/12) necessarily reduces future capital investment needs, and fewer projects have been built. **There is a lagging effect as the lack of exploration and drop in capital investment will likely cause future gold supply to fall.**

—
[9] *See* "Precious Metals Shares – More Than a Silver Lining?", *In Gold We Trust* report 2018

Exploration Budget and Gold (lhs), in USD, and Major Gold Discoveries (rhs), in Moz, 1990-2019

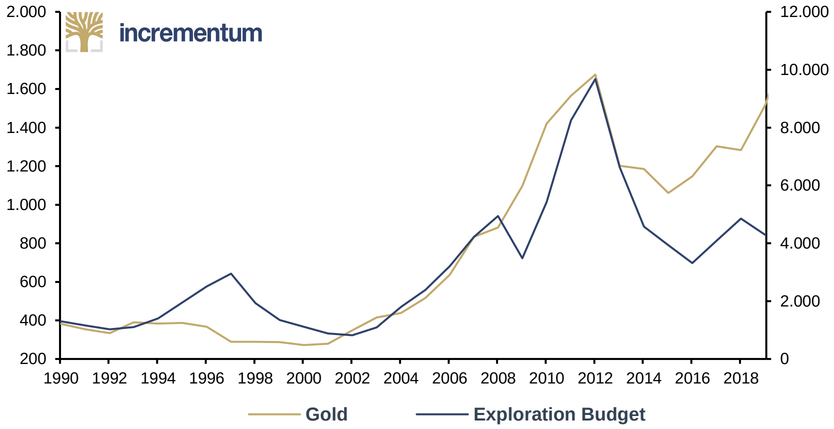


Source: Richard Schodde, Incrementum AG

You Mustn't Be Afraid to Dream a Little Bigger, Darling.
Eames, Inception

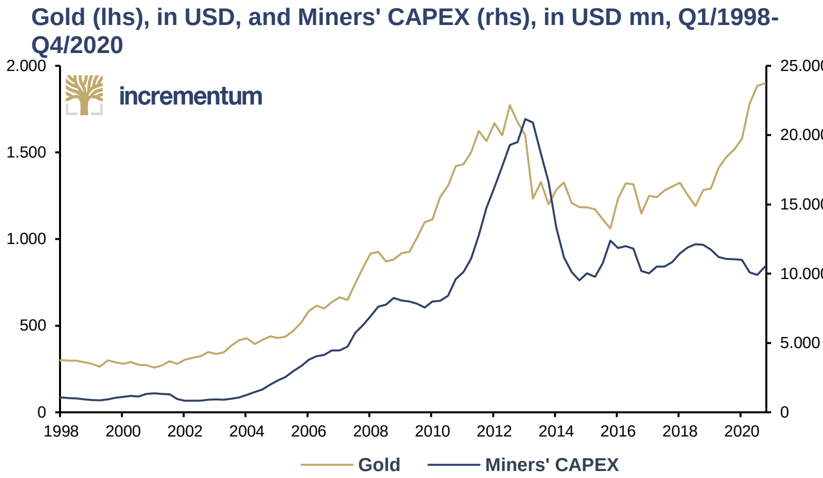
The significant decrease in exploration spending could be accounted for by senior producers doing less of their own drilling, outsourcing it to exploration vehicles, or waiting until a discovery is made and advanced through various studies (e.g., feasibility studies). Several new exploration companies have formed since 2019, and in 2020 one would be hard-pressed to find junior mining companies that did not raise adequate capital. Before and just after the gold price peaked in 2020, the cost of equity for junior exploration companies dropped markedly, allowing companies to raise more capital with less dilution.

Gold (lhs), in USD, and Exploration Budget (rhs), in USD, 1990-2019



Source: Crescat Capital, Tavi Costa, Incrementum AG

The chart below depicts how capital investment has been trending lower. If gold prices hover around current prices or move higher, we will see growth in capital expenditures. Generally speaking, when a mining company decides to build a new mine, the project must have a minimum internal rate of return (IRR) of 18%-20%, using a relatively conservative gold price. Today that would mean a project that generates a minimum 18%-20% return at USD 1,500/oz. The developers of these mines are likely waiting until gold prices break higher to have a higher margin of safety. Some are likely waiting until they further deleverage their balance sheets or until the cost of equity comes down.



Source: Crescat Capital, Tavi Costa, Reuters Eikon, Incrementum AG

Given the size of the resource that is available to be developed, talk of peak gold supply may seem a little surprising. Crucially, however, it is not the lack of gold that is the constraint. Gold miners and investors are carefully searching for the deposit that is "just right" in order to allocate capital.
Rory Townsend
Wood Mackenzie

The always insightful "World Exploration Trends", published by S&P Global Market Intelligence, highlighted the following developments regarding mining exploration activities:

- **The global exploration budget for nonferrous metals decreased only 11%,** to an estimated USD 8.7bn in 2020, from USD 9.8bn in 2019, when a larger decline was initially expected.
- **Junior and intermediate companies were quite successful in raising funds in 2020**, with USD 11.2bn raised in the year: the highest total since 2012. While the bulk of the year's funding was raised on the Toronto Stock Exchange (TSX), which accounted for USD 5.5bn, the Australian Stock Exchange (ASX) had a record-setting year at USD 4.3bn.
- **Only gold and silver posted year-over-year increases in exploration budgets in 2020**, while industrial metals declined, led by copper, zinc, lithium, and cobalt.
- **The shift away from grassroots exploration has been reflected in fewer initial resource announcements during recent years.** There were 52 initial resources recorded in 2020 – a five-year low and a far cry from the 10-year high of 175 new deposits in 2012, when grassroots exploration comprised around one-third of exploration budgets.
- **Policymakers have raised red flags over negative impacts to future production from the lack of grassroots exploration,** spurring governments to boost domestic exploration through incentive programs. Although these trends have not yet appeared to affect current production levels, explorers and producers could be forced to refocus on discoveries via grassroots projects over the coming years, as metals prices are forecast to rise while the project pipeline narrows.
- **Drilling activity seems to have recovered swiftly.** Exploration results dipped in the June quarter but recovered strongly for full-year totals of 41,026 drillholes at 1,098 projects, up 5.3%.
- **Gold continued to be the top exploration target in 2020**, with its share of holes drilled globally increasing to 78% from 69% in 2019. The number of projects drilling for gold increased 17% year over year to 757 from 645 in 2019. The number of holes drilled for gold also increased, by 19%, or 5,246 holes.

- **The gold drilling increase was mainly at late-stage and minesite projects.** The more developed a project, the more focused the drilling required to define a deposit, while early-stage projects require fewer holes, spread over larger areas, to identify targets. The drilling increase therefore reflects companies' ability to conduct focused drilling on late-stage and minesite targets during the pandemic instead of large-scale, early-stage regional programs. It also reflects miners' focus on advanced projects to take advantage of gold's rising price. The number of projects drilling for gold increased year over year to 340 from 299 for grassroots, to 279 from 227 for late-stage and feasibility, and to 138 from 119 for minesite work.[10]

I never cared what something costs; I care what it's worth.
Ari Emanuel

Miners are primarily looking to buy gold through M&A to secure their future production. So far this has failed to significantly increase production, as a study by Wood Mackenzie confirms. The authors estimate the industry will need to commission roughly 9mn oz (262t) of projects by 2025 to maintain 2019 production levels. This equates to roughly 44 projects. **Based on the average project capital intensity, Wood Mackenzie estimates the industry must invest approximately USD 37bn on greenfield projects and restarts over the next 5 years.**[11]

Conclusion

***"Real value is created through the drill bit"* is an old saying in mining.** Brownfield exploration and the expansion of existing deposits accounted for the majority of investments in recent years. **In the coming years, the neglect of greenfield exploration will take its toll.** The gradual deterioration in the production profiles of many major producers is likely to continue.

M&A and Financing Trends in the World of Mining

> *"With high balance-sheet flexibility, M&A, capital structure, and payouts are likely to remain key discussion topics. Moreover, low exploration budgets over recent years, declining reserves of large gold companies, and high industry fragmentation may also cause a growing wave of M&A activity to make business sense."*
>
> McKinsey

In last year's *In Gold We Trust* report, we noted that one of the key themes in coming years would be M&A. Everything we discussed then regarding M&A in the chapter "Mining Stocks: The Party Has Begun" is worth rereading.[12]

Unlike a large number of deals completed from 2010-2013, in which massive premiums were offered, recent M&A activity continues to be

[10] *See* "Report: World Exploration Trends 2021", S&P Global, March 2021
[11] *See* "$37 billion gold project spend needed by 2025", Mining.com, June 17, 2020
[12] *See* "Mining Stocks: The Party Has Begun", *In Gold We Trust* report 2020

far more reasonable, and this looks to be the trend going forward. Deals are likely to see much smaller premiums, with the possible exception of acquisitions of single-asset companies, which have an asset of scale with a low-cost structure or are located in Tier-I mining jurisdictions and exploration companies that are sitting on a sizeable deposit with strong economics. Unlike in 2010-2013, most recent deals make sense in terms of synergies and value creation.

You will not be relevant if you are less than something like $20 billion in market capitalization. You're not going to appeal to funds. You're not going to feature in the indices.
Neal Froneman,
CEO, Sibanye Stillwater

According to a study conducted by S&P Global, the deal value of mining industry M&A in 2020 declined by almost one-third year over year. This was mostly due to disruption caused by the pandemic.[13] It included a 17-year low in the number of base metal deals. Another important factor was the lack of very large deals at the top of the industry, with resulting asset divestitures, as there were in the previous two years with the Barrick-Randgold and Newmont-Goldcorp mergers.

However, M&A activity bounced back in the second half of 2020, due in part to record gold prices. Strong gold prices should sustain M&A again in 2021, while the ongoing global economic recovery will likely support deal activity among industrial metals such as copper, nickel, and zinc.

Too many companies are looking for a Brad Pitt when in the right circumstances, they might be able to settle for a Bart Simpson.
Liam Twigger

We continue to believe that sector consolidation will continue, especially due to the high industry fragmentation in the gold sector. The top five gold producers contribute less than 20% of the world's gold production per year. In contrast, for most other metals, the top five producers make up between one-third and two-thirds of global production. Traditionally, the gold sector has remained fragmented because there are lower barriers to entry for the industry.[14]

Gold Acquisitions, 2011-2020

Year	No. of gold deals	Total price paid (USDmn)
2011	74	15,265
2012	92	12,606
2013	61	8,776
2014	44	8,482
2015	47	12,591
2016	44	5,011
2017	59	6,440
2018	46	11,723
2019	39	20,300
2020	50	12,924
Totals	**556**	**114,117**
2019-20 change (in %)	**28**	**-36%**
10-year averages	**56**	**11,412**

Data as of Jan. 18, 2021.
* USD 10mn minimum transaction value.
Includes completed and pending deals as of data compilation date in each following year.
Source: S&P Global Market Intelligence, Incrementum AG

The most important M&A activities were, among others, the acquisition of Saracen by Northern Star (USD 5bn), Teranga's acquisition by Endeavour Mining

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13 *See* Wright, Nick: "Mining M&A in 2020 — Deal activity bounces back in H2 after disrupted H1", S&P Global, February 17, 2020
14 *See* Callaway, Greg, Periwal, Siddharth and Ramsbottom, Oliver: "Gold industry M&A: Riding the new wave buoyed by lessons from the past", McKinsey & Company, February 26, 2021

(USD 1.9bn), the acquisition of Alacer Gold by SSR Mining (USD 1.8bn) and the purchase of Premier Gold by Equinox, as well as the merger between Equinox and Leagold. While there was some M&A activity toward the end of 2020 and some thus far in Q1/2021, e.g. Newmont buying GT Gold for USD 311mn and Fortuna Silver taking out Roxgold (USD 884mn), we expect M&A to remain somewhat depressed for the time being, due to Covid-19 protocols and travel restrictions, which make site visits still very challenging.

The industry is sorely lacking high-quality exploration projects or development projects. The consequence of that is, when somebody makes a good discovery, they can be taken at absolutely eye-popping multiples.
Rick Rule

Despite all the excitement about an acceleration in M&A, we believe that this strategy should not be pursued at all costs. As we know, the industry has a somewhat "mixed" history with M&A, as the gold industry recorded impairments of roughly USD 100bn over the past decade.[15] Therefore, management must not fail to remember the mistakes that were made during the last gold boom. In the last gold price upcycle, both capital expenditures and M&A spending increased significantly. Reserves were added at a notably higher price. However, as gold prices fell post-2012, companies had to scale back capital spending substantially. The industry struggled for years to improve return on invested capital (ROIC) and was able to do so only through a combination of operating-expenditure control, capital-expenditure rationalization, and improved gold prices post-2015.

Given the context of increasing M&A in a climate in which there are potential concerns about such activity, **McKinsey has identified five key lessons for gold companies to consider incorporating into their M&A strategies:**

- Exercise rigorous validation of premiums paid (if they are paid at all).
- Focus on robust ROIC while chasing aggressive growth.
- Adopt a clear M&A theme with defined synergies and optionalities.
- Structure beyond pure M&A.
- Communicate (and deliver) to capital markets.

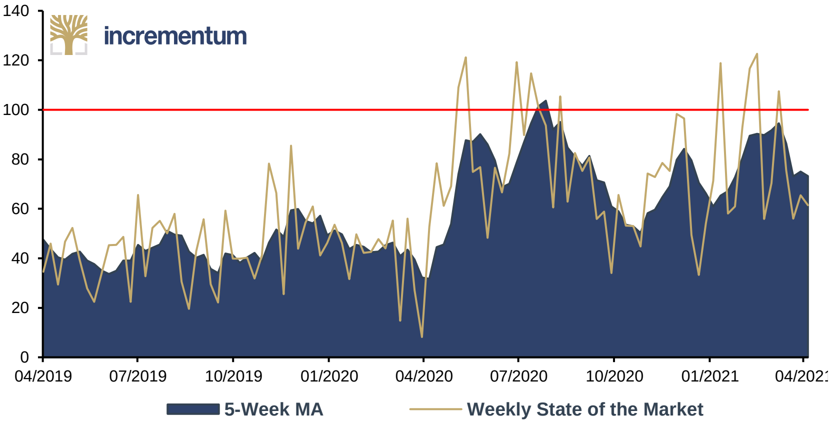
Now let us have a close look into the financing activities in the junior mining space. Our friend Kai Hoffman has provided us with an introduction and interpretation of his proprietary Oreninc Index, which measures the financial health of the junior mining sector on a weekly basis.[16] The index tracks and logs up to 41 data points of every financing.

The Oreninc Index is composed of three factors:
1) Total dollars of financings opened per week
2) Percentage of broker participation, including bought deals
3) Total number of deals opened

These factors are individually weighted, with broker participation contributing 50% to the weekly score. Oreninc believes that if brokers are getting involved, fees can be earned. It also means that confidence in placing the shares with clients is high. Increased broker participation, including the underwriting of bought deals, generally symbolizes higher overall interest in the sector.

[15] *See* Callaway, Greg, Periwal, Siddharth and Ramsbottom, Oliver: "Gold industry M&A: Riding the new wave buoyed by lessons from the past", McKinsey & Company, February 26, 2021
[16] You can sign up for the weekly newsletter at http://www.oreninc.com/

Oreninc Canadian Resource Financing Index, 04/2019-04/2021



Source: Oreninc, Incrementum AG

Let us examine financing trends in 2021. The top 100 financings of 2021, as of April 9th, totaled CAD 1.85bn. The bulk of the funds were directed toward companies exploring or developing gold projects. While 52% of the companies were primarily gold-focused, they attracted over 58% of the total funding, or CAD 1.1bn. Base metal companies, focused primarily on copper and nickel, raked in a total of CAD 284.7mn. Battery metals, dominated by financings of lithium companies, managed to raise CAD 207mn. Silver companies came in only fourth, with a total of CAD 141.2mn.

The first four months in 2020 looked drastically different. The Oreninc Index fell to one of its lowest scores in history in mid-April. The top 100 financings for the first four months of 2020 raised a collective CAD 733mn. Unsurprisingly, the largest financings during that period were dominated by gold, with the precious metal accounting for CAD 482.6mn or 65% of the money raised during that period. The Oreninc Index, then, tells you the story for the rest of the year. Investments in the mining sector have skyrocketed, pushing the overall funds raised by junior mining companies to over CAD 5.5bn, the second-highest level since 2011.

You never give me your money / You only give me your funny paper.
And in the middle of negotiations You break down.
The Beatles, "You Never Give Me Your Money"

In total US dollar terms, 2021 has already beaten 2013 and is soon going to surpass 2015, 2019, and also 2018. As laid out in the figures for 2021, the financing market is driven not just by gold or precious metals but also by base and battery metals. While the gold price has lost up to USD 250/oz. in the past six months, the copper price has shot up from USD 3.00 to USD 4.20 per pound during the same time frame. Another benefactor of the global transition to green energy is uranium. The price per pound of U308 has increased by 25% to USD 30.45 at present in the past 12 months.[17] The increased interest in the energy metal was directly followed up by investment demand, with uranium explorers and developers raking in CAD 119.6mn.

Taking a closer look at the list of gold financings in Q1/2021, it is obvious that money has been flowing to companies with later-stage projects that are higher up on the exploration value chain. The top spots are almost exclusively taken by

[17] *See* Uranium Resources Fund, Incrementum AG

producers such as Premier Gold Mines Limited (CAD 80.4mn) or developers such as Orezone Gold Corporation (CAD 73.8mn) or Osisko Mining (CAD 70.0mn).

Oreninc's observation that miners and developers are the driving force of gold financings is underpinned by the highest average offer size per financing on record. An average deal size of CAD 6.5mn per gold financing indicates that we are seeing fewer financings with the pure intention of keeping the lights on. Higher average deal size also means that the money raised is creating shareholder value. The average deal size per gold financing also beats the overall average deal size of CAD 5.6mn across the entire coverage universe.

Conclusion and Outlook

When investment flows into gold equities, it is like Niagara Falls running through a garden hose.
Peter Marrone
Executive Chairman,
Yamana Gold

The data tell us that the overall situation in the junior mining sector is not as grim as the market makes it out to be. Encouraged by higher commodity prices, investors opened their wallets and started financing projects across the board. Funds are still primarily flowing into gold exploration and development, but in recent months companies in the copper, lithium, and uranium spaces were able to attract investment dollars and to make up for weaker interest in precious metals. Financial stimulus and promises of infrastructure spending in the US have spurred interest in those commodities. Year-end total dollar numbers can reach or get close to 2011 levels of over CAD 8bn. **Looking ahead for the junior gold sector, it seems that mid-tier and major gold producers will be getting more active. For now, the focus will remain on projects in Tier 1 jurisdictions.**

Conclusion

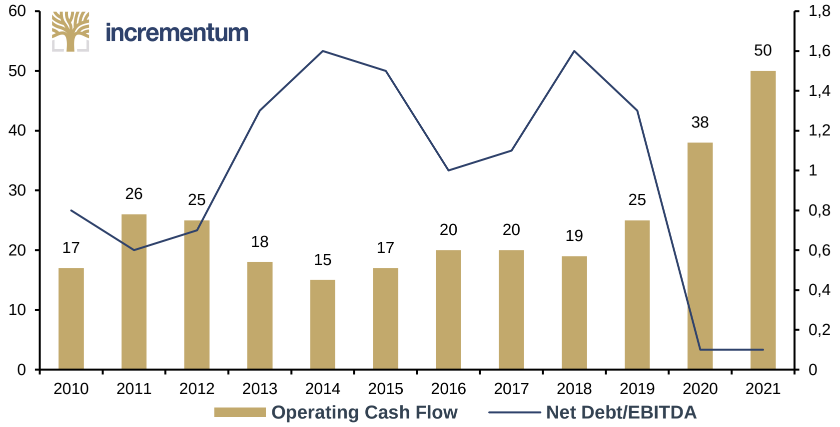
> *"Reality leaves a lot to the imagination."*
> John Lennon

Always buy your straw hats in the winter.
Benjamin Graham

We expect gold companies to harvest record-high cash flows in 2021 and beyond. As can been seen from the following chart, the gold industry is in better shape than ever. The authors of a highly recommended study analyzed a sample of 85 gold companies that sell-side analysts were expecting to generate nearly USD 38bn in 2020 and USD 50bn in 2021.[18] This is significantly higher than the USD 25bn generated in 2019 and the USD 15bn to USD 20bn generated from 2013 to 2018. Even though companies are expected to improve organic investments, both greenfield and brownfield, free cash flows will leave significant cash balances at their disposal. Additionally, the industry's debt capacity has climbed considerably, as leverage ratios have decreased with improving financials. This will provide additional room to invest, if required. Some part of this cash will be distributed back to shareholders. However, given the high attractiveness of the gold industry, McKinsey expects companies to redeploy a significant part of their capital to secure growth.

18 *See* Callaway, Greg, Periwal, Siddharth and Ramsbottom, Oliver: "Gold industry M&A: Riding the new wave buoyed by lessons from the past", McKinsey & Company, February 26, 2021

Operating Cash Flow (lhs), in USD bn, and Net Debt/EBITDA (rhs), 2010-2021E



Source: McKinsey, Incrementum AG

For your convenience, we have summarized the main reasons why we expect a bright future for the industry:

- FCF has been prioritized for (a) reinvestment in the business through exploration of capital spending and (b) returning cash to shareholders, mainly via dividends.
- Balance sheets are pristine, as those who are not already in a net-cash position should get there by early 2021.
- Most companies continue to use conservative pricing in the 1200 to 1300 USD range to calculate reserves and project economics, but we expect gold prices to rise considerably higher.
- The companies also expressed a convincing commitment to increasing ESG initiatives.[19]
- The sector is weathering the Covid-19 crisis well. Gold mine production was down only 4% in 2020.
- The gold mining industry is at its healthiest shape in decades, but valuations do not reflect it. Yet!

Last year, some major gold miners have broken out on high volume. Generalist investors in the gold space are slowly entering the sector again, while the silver sector still must be discovered by generalist investors.[20]

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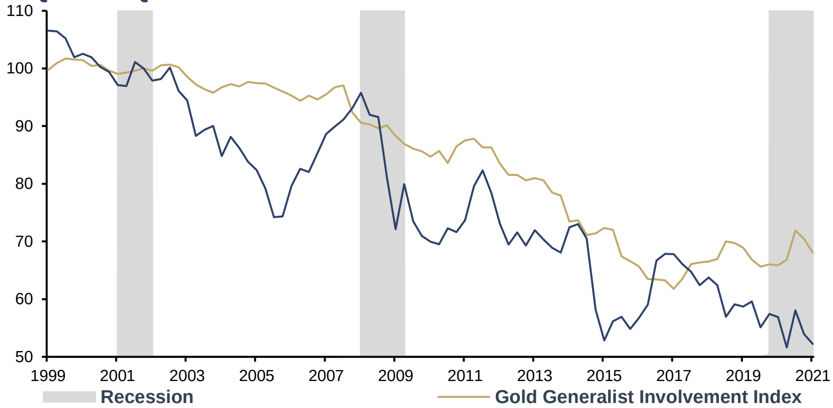
[19] *See* chapter "ESG and Your Portfolio – Building a More Sustainable Future" in this *In Gold We Trust* report.
[20] This great chart was provided by our friends at Capitalight Research Inc. Readers of the *In Gold We Trust* report can subscribe for an exclusive free trial under the following link: Incrementum | Capitalight Research

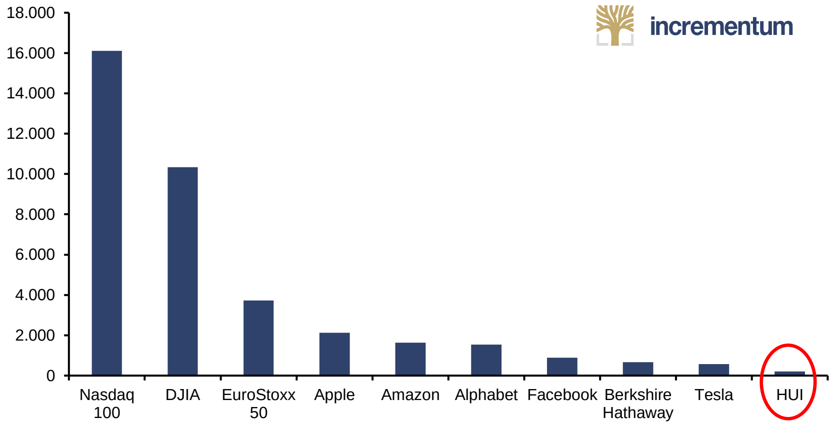
Capitalight Research Generalist Involvement Index, 12/2002 = 100, Q1/1999-Q1/2021



Source: Capitalight Research, Incrementum AG

A glance at the market capitalization of gold mining shares reveals a substantial discrepancy in valuations relative to other asset classes, which was not remotely evident in 2008. Currently the total market capitalization of the constituents of the HUI Index – which includes the 20 largest unhedged precious metals producers – amounts to a mere USD 209bn. This is equivalent to 0.56% of the total market capitalization of the constituents of the S&P 500 Index. **The valuation of Apple alone currently amounts to more than 10 times the total market cap of all HUI constituents.**

Market Capitalization of Major Indices, Global Players and Gold Shares, in USD bn, 05/2021

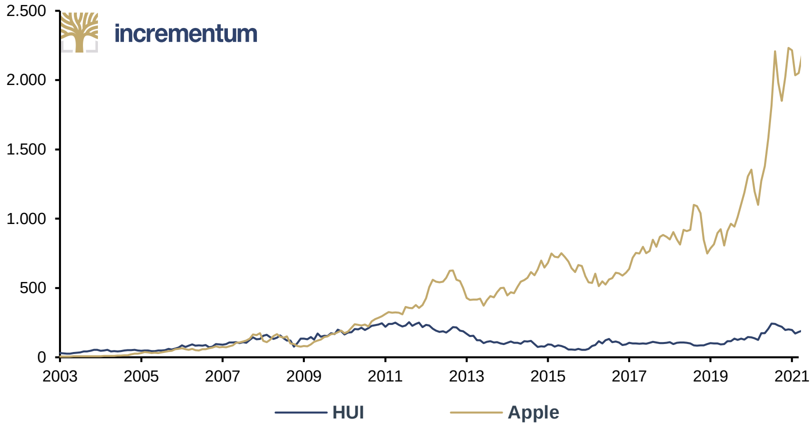


Source: Reuters Eikon (as of May 14 2021), Incrementum AG

Bull markets are more fun than bear markets.
Bob Farrell

Another interesting tidbit regarding gold mining stocks: With its current cash reserve of USD 195bn, Apple could in theory either buy almost the entire HUI or, alternatively, buy roughly 3,330 tons of gold. Continuing with this thought experiment, if the latter were to happen, Apple would become the world's second-largest gold holder after the US Treasury.

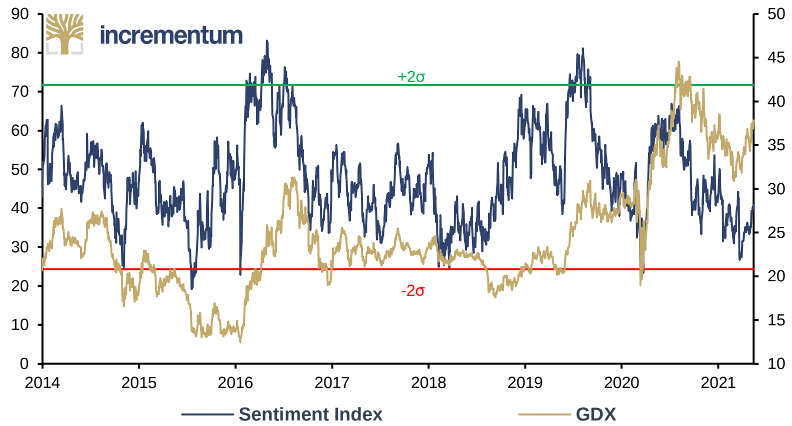
Market Capitalization of HUI and Apple, in USD bn, 01/2003-05/2021



Source: Reuters Eikon, Incrementum AG

A look at the Sprott Equity Sentiment Indicator confirms our bullish stance.[21] Sentiment reached a low in March, and the indicator plunged to two standard deviations below its mean. Since then, the Sprott index and the GDX index have recovered but are still far from the euphoric levels of August last year. **In this respect, the current foundation for further price increases seems superb.**

Sprott Gold Equity Sentiment Index (lhs), and GDX (rhs), 01/2014-05/2021



Source: Sprott Asset Management, Incrementum AG

Blackbird singing in the dead of night. Take these broken wings and learn to fly. All your life / You were only waiting for this moment to arise.
The Beatles, *"Blackbird"*

The potential rates of return over the next several years could surprise even the most ardent gold bugs. However, in advocating mining stocks, we are still reminded of "The Dancing Sasquatch Guy".[22] Right now, it seems that we are at minute 1 but as can be seen in the video, once a certain degree of awareness is reached, it can turn into a mass movement quickly.

[21] The data was kindly provided to us by our premium partner Sprott Asset Management.
[22] Great interpretations of this video can be found here: "The Dancing Guy at Sasquatch!", Eight Leaves, or *also* "Ideas Into Execution: Giving Away An Idea To Make It Happen", Tech Dirt

About Us

Ronald-Peter Stoeferle, CMT

Ronnie is managing partner of Incrementum AG and responsible for Research and Portfolio Management.

He studied business administration and finance in the USA and at the Vienna University of Economics and Business Administration, and also gained work experience at the trading desk of a bank during his studies. Upon graduation he joined the research department of *Erste Group*, where in 2007 he published his first *In Gold We Trust* report. Over the years, the *In Gold We Trust* report has become one of the benchmark publications on gold, money, and inflation.

Since 2013 he has held the position as reader at *scholarium* in Vienna, and he also speaks at *Wiener Börse Akademie* (the Vienna Stock Exchange Academy). In 2014, he co-authored the international bestseller *Austrian School for Investors*, and in 2019 *The Zero Interest Trap*. He is a member of the board of directors at *Tudor Gold Corp*. (TUD), a significant explorer in British Columbia's Golden Triangle as well as a member of the advisory board of *Affinity Metals* (AFF). Moreover, he is an advisor to *Matterhorn Asset Management*, a global leader in wealth preservation in the form of physical gold stored outside the banking system.

Mark J. Valek, CAIA

Mark is a partner of Incrementum AG and responsible for Portfolio Management and Research.

While working full-time, Mark studied business administration at the Vienna University of Business Administration and has continuously worked in financial markets and asset management since 1999. Prior to the establishment of Incrementum AG, he was with Raiffeisen Capital Management for ten years, most recently as fund manager in the area of inflation protection and alternative investments. He gained entrepreneurial experience as co-founder of *philoro Edelmetalle GmbH*.

Since 2013 he has held the position as reader at *scholarium* in Vienna, and he also speaks at *Wiener Börse Akademie* (the Vienna Stock Exchange Academy). In 2014, he co-authored the book *Austrian School for Investors*.

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Incrementum AG is a boutique investment and asset management company based in Liechtenstein. Independence and self-reliance are the cornerstones of our philosophy, which is why the five partners own 100% of the company.

Our goal is to offer solid and innovative investment solutions that do justice to the opportunities and risks of today's prevalent complex and fragile environment.

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We would like to thank the following people for their outstanding support in creating the *In Gold We Trust* report 2021:

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