CRATON CAPITAL

THE BOTTOM – Are we there yet?

Gold and US rate cycle – Gold with improved prospects
Miners continue to "clean up shop" – balance sheets get stronger
A reassessment – risk/return profile attractive

By Markus Bachmann & Douglas Orsmond | 4 February 2016

Summary

- Chekhov's gun: the shot has been fired. The US interest rate cycle has started. Contrary to market expectations, gold has strengthened since the lift-off and the Dollar index has drifted sideways.
- A turbulent start into 2016: oil's collapse pushes markets, commodities and currencies into turmoil.
- Gold appears to be in a bottoming-out process from its 4 ½ years correction. It is a possibility that the bottom has been reached in December last year.
- To critics of gold saying it pays no interest: government bonds with negative yields currently amount to around 5.5 trillion US dollar or an estimated 23% of global GDP area!
- Regardless of the possibility of a bottom in gold, miners continue to clean up shop. After four years of restructuring and cost cutting, miners deliver visible, tangible and impressive results.
- Gold indices hit a new low on 19 January but the miners are in a much healthier state than in 2011 when gold peaked, yet the sector trades at levels when the metal was priced around USD 260 per ounce! Continued cost cutting will facilitate strong balance sheet improvements and positive free cash flow generation. It is a possibility that the miners therefore reached the bottom of the five year correction as well. A continuation of the recovery would confirm this.
- In contrast to 2001, a new and cost inflating investment cycle appears highly unlikely. Consequently miners will enter a new gold price period no longer as "concept stocks". A lot of the producers are fit for purpose as free cash flow generating entities.
- Within our investment portfolio, 23 companies are now in production, representing 84% of the Fund's volume (including cash). The average All-In Sustaining Costs amount to USD 796 per ounce (vs. industry average of USD 900 per ounce). For 2016 we expect 18 companies to produce a positive Free Cash Flow at the current spot gold price.

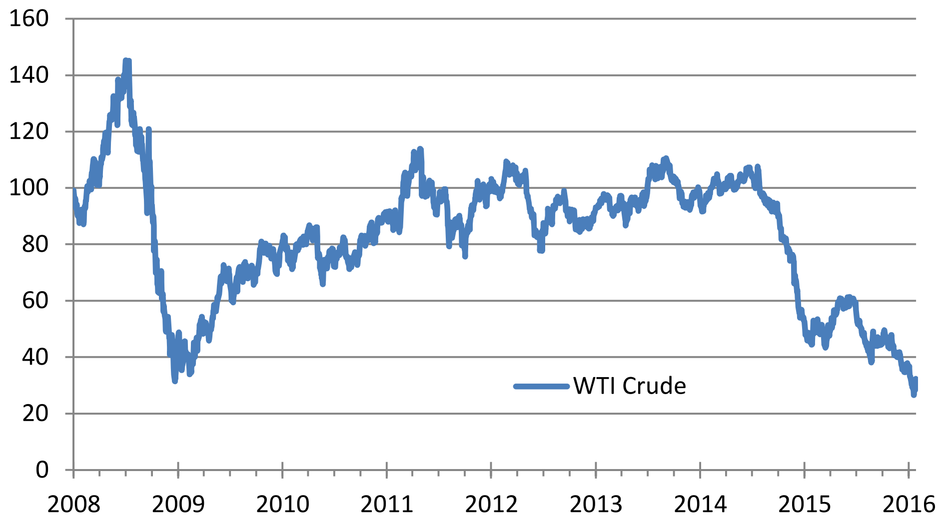
A re-assessment of gold and the miners

Since May of last year global equity markets lost around USD 15 trillion in value and the beginning of this year has been turbulent. Into January, Wall Street had the worst start on record. For an industry that is obsessed with numbers and rankings this might be noteworthy.

Gold has been firm in January. Has the investment appeal for gold returned? It may be premature for a conclusive statement but the gold price is higher than it was the day after the Fed announced the interest rate hike. The dollar is trading sideways and has not strengthened. ETF inflows and other measures of physical demand have been impressive since the beginning of the year although a similar trend has been witnessed at the beginning of last year too.

Oil is causing trouble in global markets. The price saw an initial 30% collapse in January. The demise of the black gold captured the headlines and global financial markets plummeted into turmoil. But oil's decline is not a new phenomenon as the start of the correction dates back to 2008 at the dawn of the financial crisis. Some market observers consider that oil at USD 24-26 per barrel could mark the bottom range of this eight year correction. Even the cheapest of all producers, Saudi Arabia, needs at least USD 25 per barrel to finance its required social programs. Every other producer country is in dire need of much higher prices hence the current level is not sustainable and could prove fatal to many emerging market exporters. That said, only a significantly higher price would confirm that the long-term bottom has been reached.

Chart 1: Oil's correction since 2008



Source: Bloomberg

Oil's volatility wreaks havoc in what are perceived less correlated asset classes too. It appears that the markets will only calm when oil's decline abates and sanity could return. Markets may rebound *if and when* oil turns around but the volatility though could remain high for an extended period of time. It is a new phenomenon that nearly all market participants hope for higher oil prices.

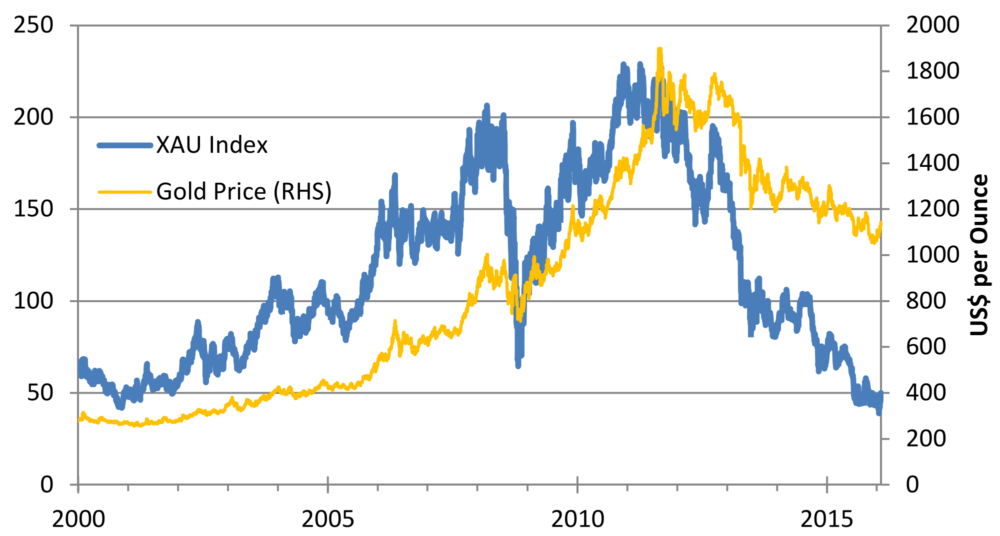
Gold's role during volatile financial market conditions is often wrongly perceived. Investors expect the price to go up but mostly it does not. In such instances, gold's role is transitioning to a source of liquidity for investors in distress. January was no exception hence bullion's strength is rather surprising. The lacklustre performance of gold equities year to date offers disappointment but the following aspects have to be considered:

- Gold equities are risk assets as well and right now investors are jittery of risk.
- Over the past years, investors have been disappointed by a strong performance of the gold miners in January, only to see the gains melting away thereafter – so why should it be different this time?
- This year's oil price collapse forced various large commodity hedge funds to liquidate positions to meet margin calls. Gold equities were sold too.
- Rebalancing: large commodity funds were buying energy companies since last August into the declining price environment, anticipating a rebound. To maintain the respective sector weight and to finance the trades, other metal producers had to be sold, gold equities amongst them.
- Gold's advance is treated with caution to this point. Some expect that once the market volatility abates, its appeal could fade.

To ignore these factors could lead to wrong conclusions. Therefore the 32-year low of the Philadelphia Gold Index (XAU) on 19 January doesn't surprise, 4 ½ years into the gold bear market. The level is a mirror picture of a bear market combined with what went wrong within the industry during the bull market. However there remains a strong element of schizophrenia compared to the current gold price. The index is now below the levels when gold was trading at USD 260 per ounce back in 2001!

Investors should note gold's good start into the year but we caution not to draw premature conclusions just yet. Current volatile market conditions are creating a smokescreen that distracts investors from the real issue: how will gold behave in this new US interest rate cycle.

Chart 2: XAU Gold equities index back to levels when gold was USD260/oz



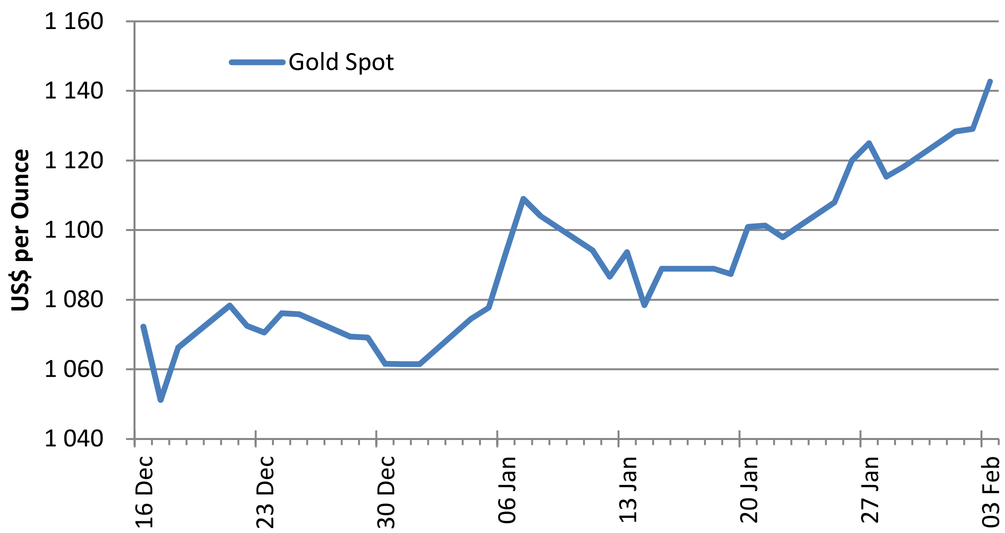
Source: Bloomberg

Is gold bottoming out or has the low of the correction already been reached?

Bullion reached a cyclical low of its 4 ½ correction on 3rd December 2015. It dropped to a similar intraday level the day after the Fed rate increase announcement.

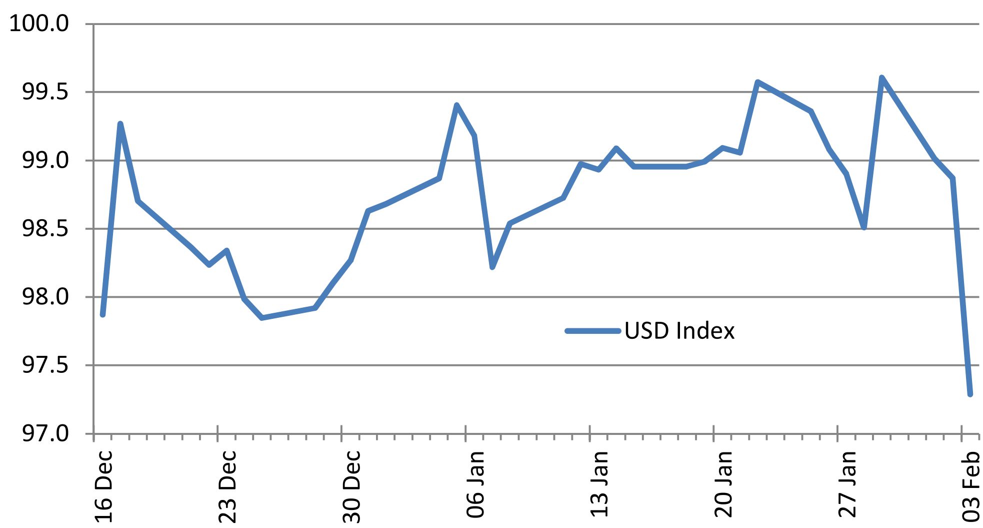
Prior to this first hike in ten years, wide expectations were that higher rates will result in a further sell-off in gold and in a stronger US dollar. So far, this has not materialized and it can be questioned if it will at all. The extended wait for the first increase may well have done all the work, pushing gold down and strengthening the dollar in advance. Also history has shown that the actual interest rate cycle is not necessarily negative for gold. Analysis of previous cycles (1994, 1999 and 2004) invalidates this widespread negative consensus view.

Chart 3: Gold performance after the US interest rate lift-off



Source: Bloomberg

Chart 4: US Dollar Index DXY since Fed lift-off



Source: Bloomberg

To re-assess gold as an investment the following points should be considered:

- To what extent has gold already discounted higher US interest rates? We view the lift-off as a positive catalyst as it removes the multi-year negative sentiment overhang prior to the rate decision.
- Gold in Australian dollars, Canadian dollars, Euros and many other currencies already bottomed in 2013. At the time of writing, they trade at considerably higher levels.[1]
- Is the US dollar topping out? The dollar strength since 2014 was remarkable prior to the interest rate increase (and within the context of a stabilizing US economy). That increase has stalled since mid-December. Investors should apply an open mind to a scenario of an extended consolidation period against other currencies.

We note that gold has seen a couple of false break-outs in recent years, just to correct shortly thereafter. But with the start of the current US interest cycle a new chapter has opened and many negative bullion bets are challenged. It is a fundamentally changed market environment that could enable gold to end its 4 ½ yearlong correction and resume its long-term upward trend.

Concerning the miners, the sector is entering its 4th year of austerity and restructuring. In an essential need to survive the bear market, the results have been both remarkable and tangible. Gold and silver producers are ahead in the restructuring relative to other miners. They will exit the bear market in strong shape and form. The reassessment of the precious metal producers in combination with gold (and silver) is strongly linked. An advance of gold could enable a kick start in the shares of gold miners. The depth and success of their restructuring will define the sustainability and tenacity of any future rally.

The gold sector continues to "clean up shop"

In the period leading up to the 2011 peak in the gold price, investors in the sector became increasingly dissatisfied with gold mining companies. They suffered from very high inflation in operating costs and capex though most of this was due to booming activity across the broader mining sector. However, investor discontent extended to more than the loss of margins due to rising costs. The sector in general became notorious for production disappointments, even against companies' own targets.

The list of investor concerns thus centred on:

- not delivering on prior guidance
- operating costs increasing rapidly
- ballooning capex expenses and overspending on capex budgets

[1] AUD: 1'294.50 (27/6/2013) – current 1'593; CAD 1'258.30 (27/6/2013) – current 1'573; Euro 867 (30/12/2013) – current 1'031

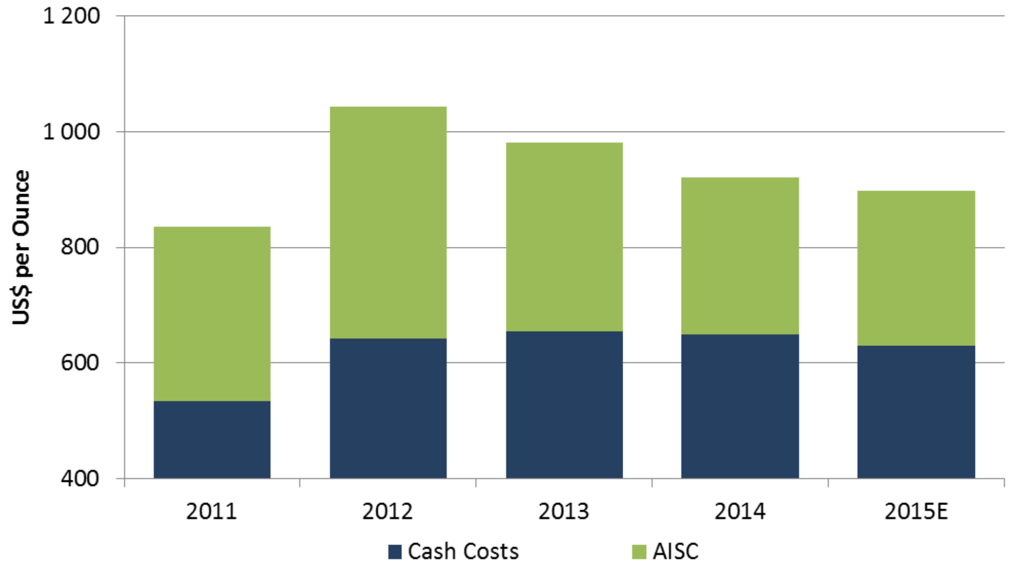
The loss of investor confidence compressed valuation multiples long before the gold price lost its upward momentum. However, we believe the sector has turned around significantly on these aspects. Gold miners have had support from several areas, such as the drastic slashing of capex and improved skills availability across the broader mining industry, weaker currencies of producing countries and of course, lower fuel prices. But management can take some credit for a renewed focus on operations, margins and delivering against expectations. In general, the gold sector has greatly improved its operational and financial performance since losing investor faith in 2011, as discussed below.

Costs continue to fall

Chart 5 shows how All-In Sustaining Costs (AISC) have fallen since their peak in 2012, at an average of USD 1050 per ounce to a forecast of USD 900 per ounce for 2015.

We have commented for several years on this encouraging trend, which has seen producers claw back some of the margin lost to the falling gold price. Sceptics may argue that the fall is only due to the postponement of sustaining capex, which will have to be incurred eventually. However, we note that for three years now, sustaining capex spending has not rebounded as expected, indicating that more enduring savings have been gained from operational adjustments and from lower costs across the mining industry. AISC has also benefited from reduced administrative costs and exploration spending. While cuts to exploration spend may have negative implications for the sector in the long term, it benefits the medium-term economics of the sector and will ultimately benefit those juniors with good quality deposits.

Chart 5: Gold Sector All-In Sustaining Costs (AISC) trending lower



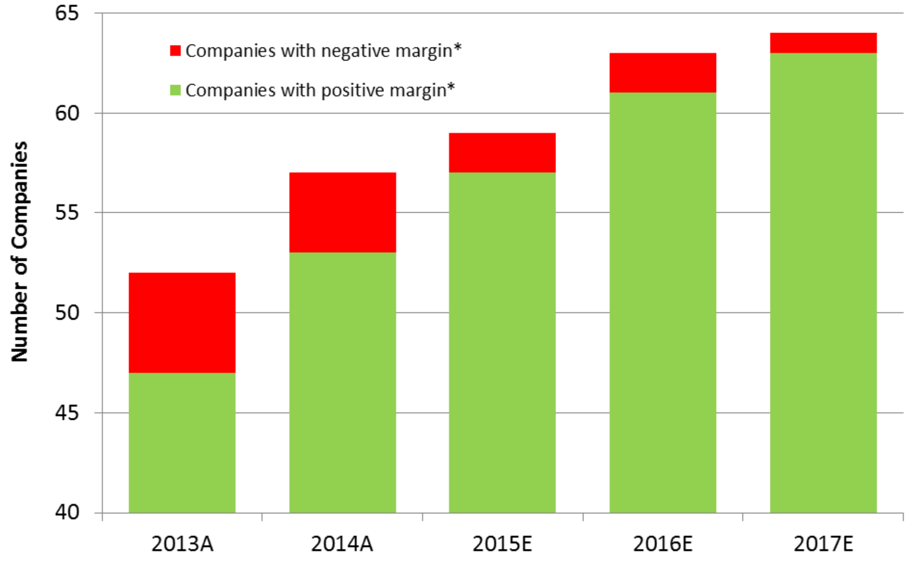
Source: RBC Capital Markets
Note: All-In Sustaining Costs (AISC) = Cash Costs + Sustaining Capital + General Administration + Exploration costs.

More companies have achieved positive operating margins

The improving state of the gold sector can also be seen in an increasing number of companies with positive ongoing margins[2]. Tracking some 50 to 65 producing gold and silver companies since 2013, we note how the ratio of companies with a positive margin has improved despite the gold price trending substantially lower since then. We expect the sector median All-In Sustaining margin in 2016 to be around USD 230 per ounce (assuming a gold price of USD 1’100 per ounce).

[2] Calculated as gold price less All-In Sustaining Costs

Chart 6: More Companies achieve positive margins

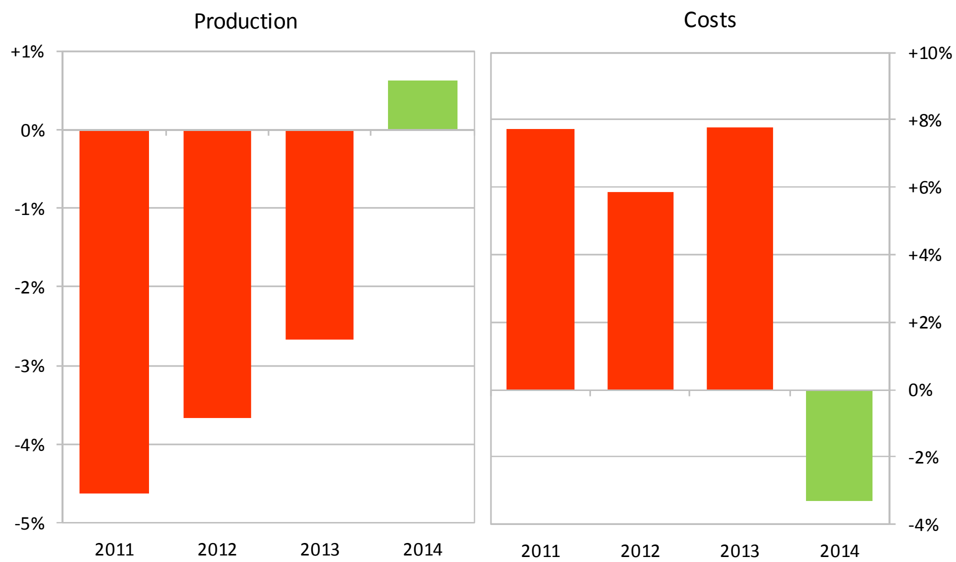


Source: BMO Capital Markets, RBC Capital Markets;
*Margin = Gold Price less All-In Sustaining Cost; the chart excludes royalty companies.

Delivery against prior guidance has improved

Most companies guide for production and costs for the next financial year. In 2011, the gold sector on average posted very disappointing operational results compared with management guidance at the start of the year. By 2012, many management teams were highlighting their renewed focus on delivering production and costs in line with their guidance. We believe this focus has improved the companies' operational performance and the sector on average is much better at meeting its guidance targets. We compared the track record of prior year guidance against actual achieved production and costs across 24 mid-sized companies since 2011. We note how the sector had improved significantly from 2011 to 2014. In 2011, these companies missed production guidance by an average of 5%. Each year saw some improvement and by 2014, the average production was better than guidance. Similarly, costs, on average, were much worse than guided levels in 2011 to 2013, but this swung around significantly in 2014. These improvements are shown in chart 7.
Full year details for 2015 are just coming in now but based on Q1 – Q3 2015 numbers, we expect the sector will once again show pleasing results compared to prior guidance.

Chart 7: Actuals vs Prior Guidance



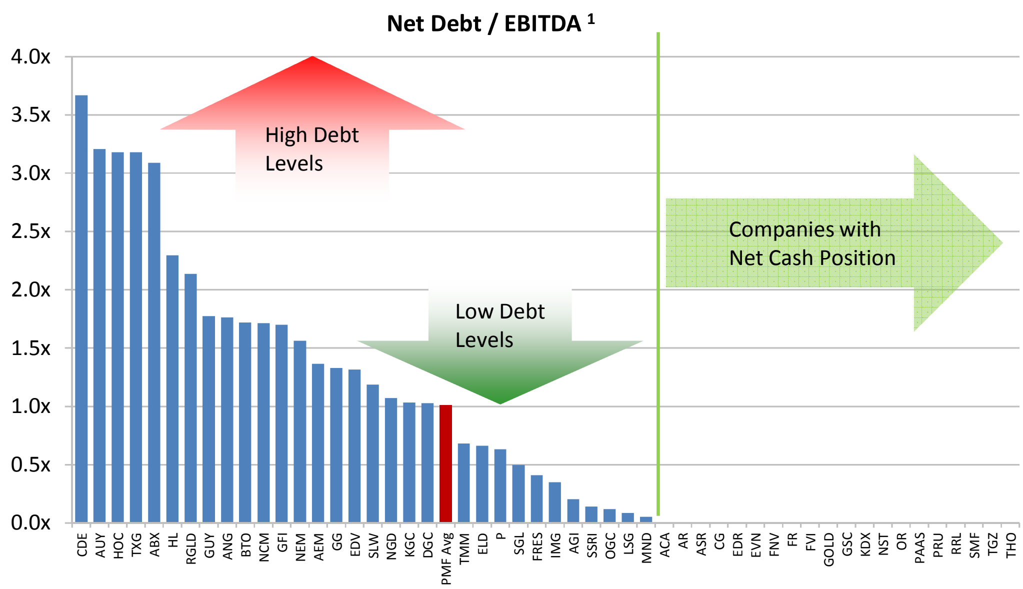
Source: Company reports, Scotiabank. Values are the average of 24 mid-sized gold producers covered by Scotia. Where Guidance was given as a range, the mid-point was used.

Balance Sheet Strength

High debt levels are frequently cited as a concern for the gold sector. But net debt ratios across 52 gold and silver producers show this concern to be unfounded (or at least, valid for only a few companies). The average Net Debt / Equity is only 0.20x and average Net Debt / Market Capitalisation is 0.13x. A more critical measure is Net Debt / EBITDA, which is often used in debt covenants. Using a forecast 2016 EBITDA based on USD 1090 per ounce gold, the equal weighted average Net Debt / EBITDA for the sector stands at only 0.85x (the median is only 0.3x while the average weighted by EBITDA is 1.4x, skewed upwards by Barrick).

Only 5 of the 52 producers post Net Debt / EBITDA above 3x (none of those are above 4x) hence only a few precious metals producers have high debt levels. Most of the sector has very little debt or is even net cash.

Chart 8: High debt is only concerning for few companies



Source: BMO Capital Markets, RBC Capital Markets, Macquarie Securities
Note: EBITDA forecasts for 2016 are based on gold price assumption of cUSD 1090 per ounce.

The Craton Capital Precious Metals Fund - Strategy

The collapse of the oil price since August, a declining gold price ahead of the Fed rate hike and “tax related selling” were factors that created headwinds to the Fund’s recent performance. We are not satisfied with the overall result but after careful consideration we don’t see these mainly external (and temporary) factors to enforce a change of the Funds’ strategy. The core investment criteria remain firmly in place:

1. Ideal size of 1 to 5 assets (more are difficult to manage efficiently)
2. Management with proven track record (development, operation, finances)
3. All-In Cost profile in the first or second quartile
4. Attractive production growth profile
5. Realistic chance for additional exploration success and therefore extending the longevity of the operation
6. Positive Free Cash Flow generation
7. Sound balance sheet

Within our investment portfolio, 23 companies are now in production, representing 84% of the Fund’s volume (including cash). The average production size equals 610’000 ounces per year of gold equivalent or 336’000 ounces if the four largest producers are excluded. The average All-In Sustaining Costs is USD 796 per ounce (vs. industry average of USD 900 per ounce). Eleven of the holdings had net cash on their balance sheets at the end of September 2015. For 2016 we expect 18 companies to produce a positive Free Cash Flow at the current spot gold price. These numbers should provide insight to our investors that:

a. there is consistency between the selected companies and the Funds' strategy and
b. it provides hard evidence that this is an industry that was able to survive the bear market and any improvements in the underlying metals price will be highly beneficial to economics and share prices.

It is also noteworthy that the portfolio does not hold any royalty companies and only few larger cap producers, both due to well-founded reasons that favour the investments chosen in the Fund. A consequence of the Fund's strategy is that there are barely any overlaps in the top 15 positions relative to peers and benchmarks.
Periods of "risk off"-behaviour by the market and collateral damage caused by other assets (e.g. oil price) have created headwinds. However, any improvement of the main drivers (e.g. improved metals prices or investor sentiment) will benefit the quality of the companies selected and should provide superior "torque" and returns. But most importantly, it will prove to investors that these miners are not "concept" stocks ("go up with higher gold price") – those are investments based on merits, also driven by company specific catalysts that not only survive the current challenging conditions but will also achieve incredible economics in an improved environment.

Conclusion

With the start of the current US interest rate cycle, gold is entering a new era. A widespread view that higher rates will lead to a sell-off in bullion and a much stronger US currency has not materialised. The possibility that gold has seen the bottom in this multi-year correction can and should be considered. It is possible that the miners reached the low this January. Short sellers will attempt to throw a few punches at gold, even if only to follow the popular script book. But they won't be strong enough to knock bullion off its feet anymore. The long period ahead of the rate lift-off may have done the work already.

More than four years of a vicious bear market forced the miners to fundamentally restructure their businesses and it appears that they perform the great escape. They are substantially stronger and healthier than five years ago and can still be bought at multi-decade low valuation prices.

The old argument that gold yields no interest is correct, but on the other side of the equation are an increasing numbers of currencies that demand a negative yield (after central banks of Switzerland, Europe, Sweden, Denmark and now Japan have introduced negative interest rates). JP Morgan recently calculated that government bonds with negative yields amount to around US dollar 5.5 trillion in value being the equivalent of circa 23% of global GDP!

Fundamental factors keep supporting gold in this new era. If bullion resumes its bull market then the miners will do very well, compensating investors for four years of sweat and pain. They will outperform most other asset classes.