EQUITY

Why Gold-Mining Stocks Could Regain Some Luster

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Here, Franklin Equity Group's Steve Land, vice president and portfolio manager, Franklin Gold and Precious Metals Fund, digs deeper into industry fundamentals that he thinks make for an attractive longer-term investment case for gold or gold stocks.

Physical gold prices moved up to new one-year highs in September, reaching similar levels to those seen in September 2016. Yet many gold equities are trading at prices significantly below where they were trading a year ago. This is especially true for the smaller-cap miners, which have barely participated in the recent gold rally.

It seems to us that gold's inability to hold a rally over the last 18 months has created fatigue with investors. As a result, many investors have felt they should sell into rallies. However, given the overall global macroeconomic backdrop, this view may be creating an interesting opportunity for longer-term investors.

Why the Current Gold Rally Could Continue

Several key factors can heavily influence the price of gold, including:

- US dollar movements;
- market uncertainty;
- global inflation;
- real interest rates; and
- supply and demand economics.

Considering the overall market, we think the current gold rally seems well supported.

We believe the recent weakening in the US dollar is good for gold, which tends to move in the opposite direction of the currency. The US dollar has been depreciating as investors prepare for higher baseline interest rates in other parts of the world, and further US Federal Reserve (Fed) rate hikes become less certain given the country's lack of inflation, low unemployment and the impacts of hurricanes Harvey and Irma.

Against this backdrop, we believe it will be difficult for the Fed to continue to raise rates ahead of inflation. That, in turn, could make gold more attractive on a relative basis, because when real rates rise, investors in physical gold do not receive any yield and the opportunity cost of holding bullion compared with yield-paying investments increases.

What's more, gold tends to have a very low correlation with other asset classes. It typically attracts investor interest during periods of global uncertainty because it is not tied to any one country or economic system. Rising global trade tensions and aggressive posturing out of North Korea are just two examples of current catalysts. Although we remain hopeful that tensions die down, North Korea remains a highly unpredictable wildcard in the global scene, especially as it seems to be distancing itself from China while more directly antagonizing South Korea, Japan and the United States.

Falling Gold Mine Supply Could Support Prices

On the demand front, China and India are the largest buyers of physical gold, and India's demand was very strong in the second quarter. We also see other supply-side dynamics at play.

Gold-mining profit margins peaked in 2010. Despite the fact that gold prices rose for an additional two years, mining companies had lost control of costs, which rose faster than the price of gold. By the time miners collectively regained their cost discipline, gold prices began to fall, with each year of lower prices forcing deeper and deeper cuts.

During this challenging environment, many mining companies slashed exploration budgets and reduced the number of new projects. Lower assumed gold prices also resulted in reserve cuts, as new mine plans left previously economic gold in the ground.

Although the industry has moved to reporting an all-in sustaining cost (ASIC), we think most companies are not actually investing enough to sustain their businesses. Many miners are not replacing the gold ounces that they produce via new discoveries, nor are they investing in future mines to replace their current operations once they fully deplete the existing ore bodies.

As a result, gold mine production is forecasted to peak in the next several years and, in our view, will likely take a long time to reverse trend. Using the '90s as a reference, gold prices bottomed in 1999 at around $250/oz. but gold production peaked in 1998 and declined through 2007 despite steadily rising prices. It can take 10-15 years from first discovery to get to a producing mine, and lately there are very few quality projects in the development pipeline. Constrained mine supply should remain supportive of the gold price for the foreseeable future.

Higher Gold Prices Are Great for Gold Miners

Part of the reason gold equities tend to be so volatile is that relatively small swings in the price of physical gold can result in large swings in cash flow available to shareholders. For example, suppose it costs $850 an ounce for a company to mine and process the ore into a gold bar, and costs it another $350 an ounce in capital to maintain the mill and exploration to replace the ounce and corporate overhead. So, the total cost per ounce would be $1,200, and when gold prices are $1,200, the company doesn't generate extra money.

When gold is below $1,200 an ounce, in our example the company will likely underspend on exploration and draw down on its reserve base, and likely underspend on capital such that its plant will eventually suffer from potential operational issues. However, it would probably be able to stay in business for a few years even if gold fell to $1,000 an ounce.

At $1,300 an ounce, the company would generate $100 an ounce, and at $1,400, it would make $200 an ounce. So a $100 move in the price of gold would result in cash-flow generation doubling. Although this is a hypothetical example based on our research and analysis, the real-world experience is not far from these numbers.

Declining Gold Inventories Could Spark M&A

Given the extended multi-year downturn in gold prices through 2016, management teams remain squarely focused on cost control. They have generally been improving their balance sheets in 2017 and some have been attempting to rebuild investor credibility with modest dividend increases. Exploration in the current pricing environment has been deemphasized as too risky. Exploration budgets have largely focused only on areas within trucking distance of existing operations in order to ensure compelling economics from any success.

As a result, the industry has generally not been replacing production with new discoveries. Randgold Resources CEO Mark Bristow recently said that the industry has discovered about 10 million ounces of gold annually in the five years between 2011 and 2015, while producing 90 million ounces per year over the same period.[1]

In our view, many gold-mining companies have underinvested to the point that even with a large increase in spending, it's hard for us to envision gold production being higher in five years' time than it is today.

Looking forward, we see increased consolidation in the gold industry, as gold-mining companies look to rebuild asset bases. Eldorado Gold's acquisition of Integra Resources in July and the recently announced plans for Alamos Gold to acquire Richmont Mines are two examples of deals companies took to leverage tax and overhead synergies, while expanding and diversifying their asset bases.[2]

In addition, we see more partnerships forming as a way for companies to better manage and access the risks involved with new projects. In the past six months, Newmont Mining invested a little over $100 million to purchase a 19.9% stake in Continental Gold to gain access to its projects in Colombia, a country where Newmont had no prior operating experience.[3] Another example is Goldcorp's joint venture with Barrick Gold on the Cerro Casale project in Chile.[4] This is a very large project that requires high capital expenditures; by working together, the companies can better assess and manage the risk of the projects.

Outlook for Gold-Mining Stocks

In this environment, we see attractive opportunities in gold and precious metals stocks, with many companies trading at valuations below what it would cost to build their existing mines today. Valuation multiples, such as price to cash flow or Enterprise Value to earnings before interest, taxes, depreciation and amortization (EBITDA), also appear attractive on both an absolute basis and relative to historical levels.

When selecting gold-mining equity investments, we look for companies that have an attractive, low-cost resource base and strong management teams with established track records. We also seek companies with the ability to grow their production profile through new mine development or expansion. An active exploration program that may drive future reserve growth is also a way to potentially add value in the gold mining space.

Gold stocks are volatile, but we believe select mining companies appear well positioned to survive another downturn in prices while still offering significant upside potential if prices move higher.

We believe it's an opportune time for investors to take a fresh look at the gold-mining space.

What Are the Risks?

Franklin Gold and Precious Metals Fund

All investments involve risks, including possible loss of principal. Also, the fund concentrates in the precious metals sector which involves fluctuations in the price of gold and other precious metals and increased susceptibility to adverse economic and regulatory developments affecting the sector. In addition, the fund is subject to the risks of currency fluctuation and political uncertainty associated with foreign investing. Investments in developing markets involve heightened risks related to the same factors, in addition to those associated with their relatively small size and lesser liquidity. The fund may also invest in smaller companies, which can be particularly sensitive to changing economic conditions, and their prospects for growth are less certain than those of larger, more established companies. Investing in a non-diversified fund involves the risk of greater price fluctuation than a more diversified portfolio. These and other risks are described more fully in the fund's prospectus.

Investors should carefully consider a fund's investment goals, risks, sales charges and expenses before investing. Download a prospectus, which contains this and other information. Please carefully read a prospectus before you invest or send money.

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1. Source: Thomson Reuters. As of June 30, 2017, Randgold Resources Ltd common stock represented 1.15% of total net assets of Franklin Gold and Precious Metals Fund. Holdings are subject to change.

2. As of June 30, 2017, Eldorado Gold Corp and Integra Gold Corp common stock represented 2.45% and 0.76% respectively of total net assets of Franklin Gold and Precious Metals Fund. Alamos Gold represented 4.03% of total net assets of Franklin Gold and Precious Metals Fund. The Fund did not have any exposure to shares of Richmont Mines. Holdings subject to change.

3. As of June 30, 2017, Newmont Mining Corp and Continental Gold Inc common stock represented 2.02% and 1.72% respectively of total net assets of Franklin Gold and Precious Metals Fund. Holdings subject to change.

4. As of June 30, 2017, Goldcorp and Barrick Gold common stock represented 1.17% and 4.45% respectively of total net assets of Franklin Gold and Precious Metals Fund. Holdings subject to change.