Gold Report

April 22, 2019

Whitney George
Chief Investment Officer,
Sprott Asset Management

Maria Smirnova
Senior Portfolio Manager,
Sprott Asset Management

Miners Ride a New Wave of Consolidation

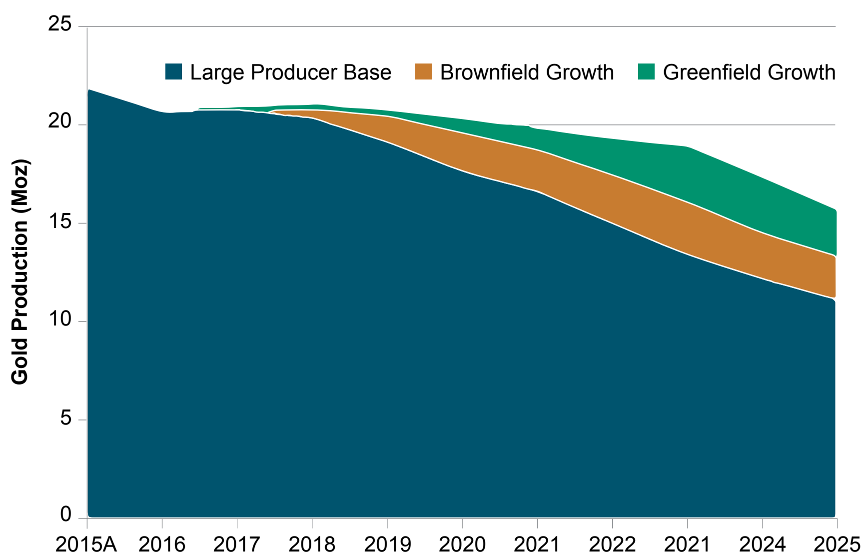
Maria Smirnova, Senior Portfolio Manager interviews Whitney George, Chief Investment Officer, Sprott Asset Management, about the latest wave of gold mining consolidation.

Investment Thesis: *We believe a new gold mining mergers and acquisitions (M&A) cycle has been ignited, and we expect this merger boom to accelerate over the next several years. The tepid gold price environment since 2011 has forced many gold producers to decrease their focus on exploration and this has caused a significant drop in new discoveries, at a time when global gold reserves are being depleted (see Figure 1).*

The challenging environment is forcing the largest miners to strategically combine to reduce expenses and improve their operations. We expect these mergers will create a cascading effect in the industry as the combined entities shed non-core assets and prompt other companies to rethink their strategic priorities. Within the sector, we also see meaningful gradations of valuation between larger- and small-cap companies which could further fuel the cycle.

Our new investment strategy, Sprott Hathaway Special Situations Strategy, pays attention to many likely takeover targets and we believe it has the potential to produce positive returns even in the absence of rising gold prices.

Figure 1: Gold Production is Declining (2015-2025e)



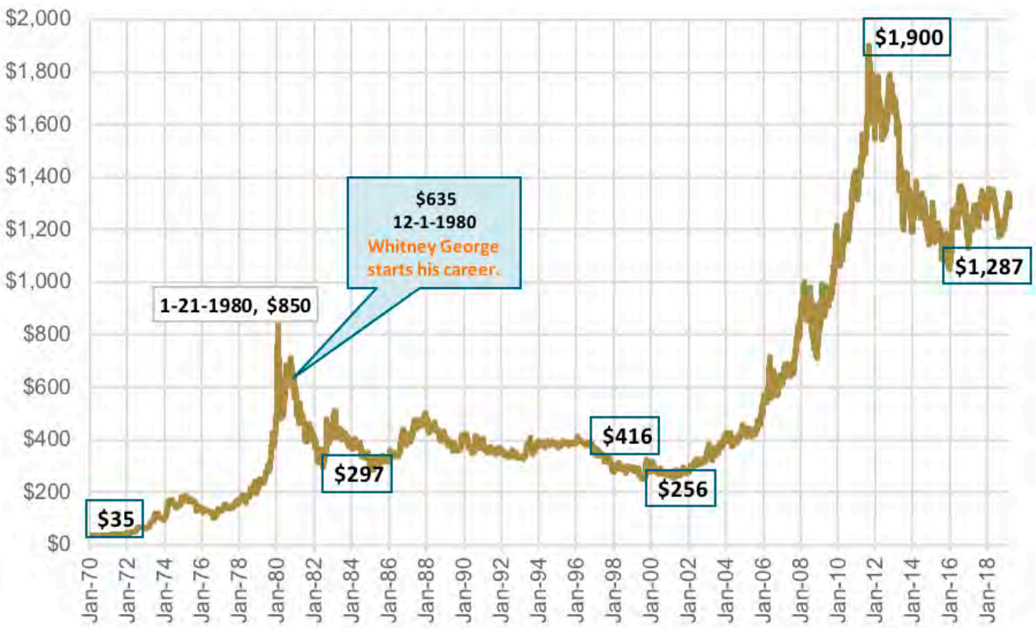
Source: BMO Capital Markets.

Maria Smirnova: Whitney, you have been an active investor for several decades. When did you first become interested in gold and gold equities as a generalist value investor?

Whitney George: I have been in the investment business for nearly 40 years. I began my career as a retail securities broker in November 1980, just when Ronald Reagan was elected. At that time, investors were very interested in natural resources investments especially energy and gold. Investors were falling in love with gold mining stocks and the gold price was peaking. In 1980, gold prices had climbed to $850 an ounce (1/21/80), having risen from $37 at the end of 1970. I started off buying shares of gold mining companies like Homestake Mining Company, which at that time was one of the largest mining businesses in the U.S. and its oldest having opened in 1876 (it was later bought by Barrick Gold in 2001).

Unfortunately, as you can see in Figure 2, between December 1980, when I entered the business, and June 1982, the price of gold dropped in half from $635 to $300 an ounce. This meant that my first experience with gold and gold equities was losing my clients money. This was difficult to swallow early in my career. Buying gold at a peak moment, and then watching it fall and erode my first clients' assets, was an experience I did not get over quickly. I avoided gold and gold mining equities for another 20 years. During those two decades, the price of gold was range bound between $300 and $400.

Figure 2: Gold Price History ($US, 1970 – 3/31/2019)



Source: Bloomberg.

Maria: When did you take another look at gold and gold equities?

Whitney: I next revisited the mining industry in the late 1990s, when gold was about $300. As a value investor and generalist, and given my first experience with gold, mining stocks were not an area I looked at often.

I was also a dedicated Warren Buffett fan, and Buffett has never been positive about investing in gold. What encouraged me to take another look at the sector, was a seminal meeting I had in 1999 with a mining company executive, Bobby Godsell of AngloGold[1]. At the time, South Africa was the world's largest gold producer, followed by the U.S., Australia, China and Canada.

Godsell described his strategy at AngloGold in very general industrial or business terms that made sense to me.

Maria: What was unique about AngloGold in the late 1990s?

Whitney: As a pure industrial idea, AngloGold piqued my interest. AngloGold was founded in June 1998 under Godsell's leadership, and it represented the consolidation of the many fractional South African gold interests of Anglo American. Godsell helped identify AngloGold's highest quality mines to keep, and identified others to dispose of or to sell back to the South African government for black empowerment initiatives.

Godsell described AngloGold's mines as "factories." He looked at each mine in terms of its returns-on-invested capital, and he was very focused on low-cost production. AngloGold's stock was trading at 6 times earnings with a 6% dividend yield. The company was growing more profitable even as gold prices fell. South Africa's currency, the Rand, was dropping even faster than gold, and both helped AngloGold's mining costs decline steadily.

I did identify other promising South African mining companies like Goldfields, but I was nervous given the complications associated with Apartheid (which did not end until 1994), and so I started looking elsewhere.

Maria: Did you invest outside of South Africa?

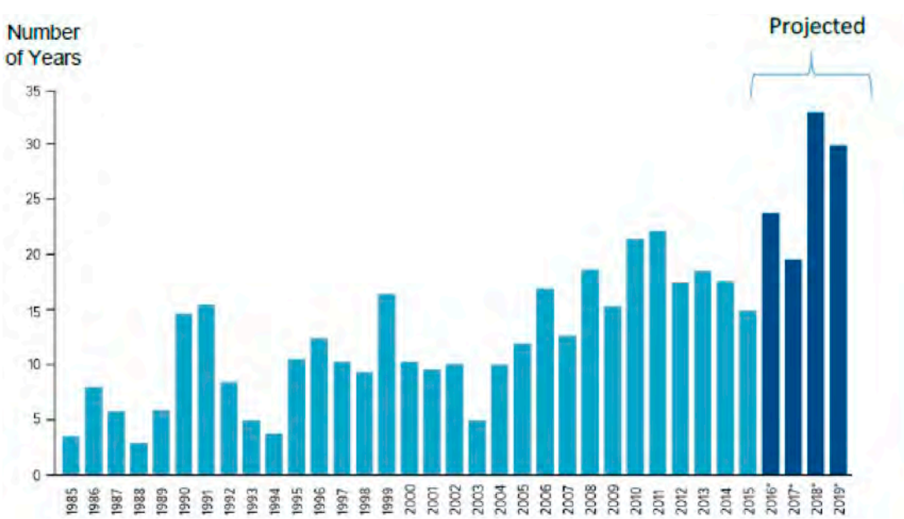
Whitney: I found Canadian company Goldcorp, which was being run by Rob McEwen. Goldcorp was running its Red Lake Mine, one of the largest gold mines in Canada and the world (located in northwestern Ontario) and it contained some of the world's richest grade gold ore. At the time, Goldcorp was producing gold for $75 an ounce, when gold was valued at about $300, and it was a well-run, very profitable business.

Maria: Do you tend to evaluate mining companies through a different lens?

Whitney: I have learned over my career that all businesses are cyclical. Most investors see a business as a "growth" business if it has been growing for a long time, and progressed without any disruption. But it doesn't matter whether you are evaluating a technology or a finance business, for example, all businesses have their cycles.

For mining companies, business cycles can be very long. It takes many years to find ore deposits and then turn them into productive mines. As shown in Figure 3, the discovery-to-production period has gotten much longer. For the mining industry, its business cycles can span 2-3 generations, and play out over decades. To invest in this sector takes commitment, patience and understanding.

Figure 3: Number of Years Between Discovery and Production is Increasing



Source: SNL Metals & Mining. U.S. Global Investors IAMGOLD.

Maria: Gold declined in the late 1990s bottoming at $250/ounce in 1999. Can you discuss the wave of consolidation in the gold mining industry at the time?

Whitney: In the 1990s, the mining industry was struggling and there were too many companies running single mines. This triggered a wave of consolidations, rollups, and acquisitions that lasted into the early 2000s. Kinross Gold was a notable example. Founded in 1993 by Robert Buchan, Kinross represented the amalgamation of three companies: Plexus Resources Corporation, CMP Resources and 1021105 Ontario Corp. Another example was Newmont Mining.

After gold fell below $400 an ounce in 1996, Newmont began aggressively snatching up smaller U.S. domestic miners and slashing costs. This all culminated in the large 2001 acquisition of Normandy Mining, Australia's largest gold producer, and Canadian Franco-Nevada Mining. This vaulted Newmont to the top spot in gold reserves and production, ahead of its rival AngloGold. Newmont, AngloGold, and Barrick represented the top three gold miners at that time (2002).

This wave of consolidations helped mining management gain much-needed cost efficiencies, which is a healthy business practice when you are in a difficult part of the business cycle. Because they had improved the quality of their businesses, when gold prices began to rise in the 2000s, these mining companies became very profitable.

Maria: Do you see similarities between today's M&A activity and the previous period in the 1990s?

Whitney: We are experiencing the logical industry-consolidation activity that we saw in the late 1990s to the early 2000s, which followed a prolonged period of disinterest in gold. In those early days of the last wave, there were no premium mergers at the start—buyers were not willing to acquire a company above its market price. This is where we are today.

Gold has experienced a tough period for the past seven years since prices peaked in late 2011 at about $1,900. This period of weaker prices has increased pressure from shareholders on companies to cut costs and slash debt. Investors are not very interested in gold right now. Capital is very hard to come by. The gold mining sector is still highly fragmented, and investors are no longer willing to invest in single mine companies because of the high risk. There is impetus for smaller mining properties and companies to merge into larger organizations.

We've already seen aggressive consolidation among the majors (large-cap companies) like the Barrick-Randgold deal, which closed on January 1, 2019. Newmont followed with a bid for Goldcorp, as it vied with Barrick to regain its top position. Most recently, Barrick and Newmont agreed to an innovative joint venture in Nevada, which will represent the world's largest gold producing operation. Australia's Newcrest Mining has bought a majority interest in Canada's Imperial Metals and is working on a joint venture deal with Greatland Gold.

These are the early innings of what we believe will be a new, prolonged M&A cycle. We see tremendous potential especially in the junior mining space, given that smaller gold mining companies are trading at a material discount to larger mining companies.

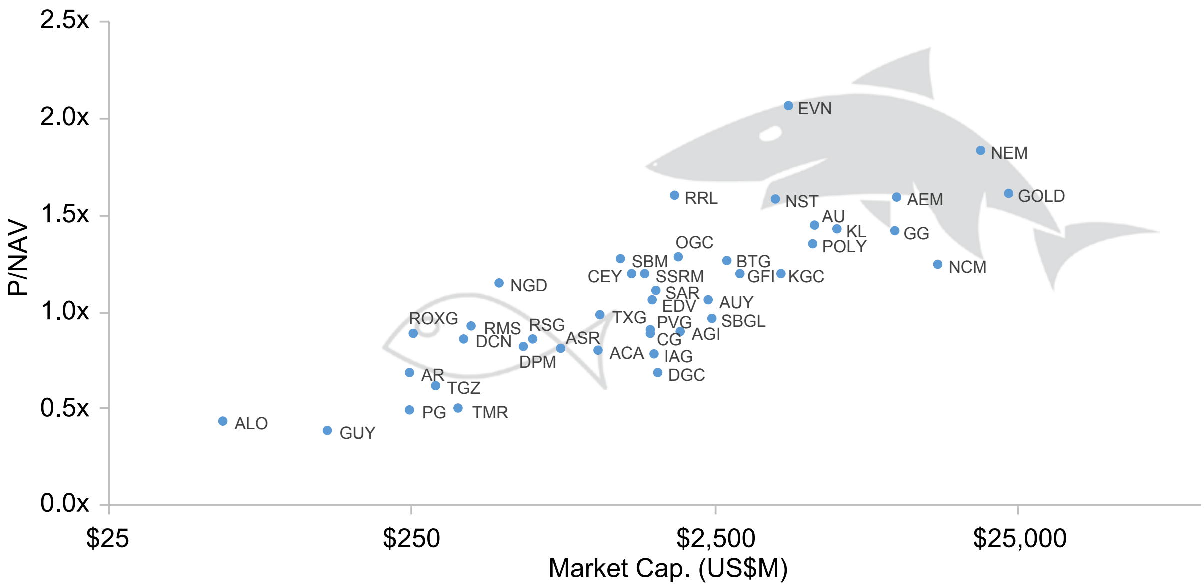
Maria: What is driving the current wave of consolidation?

Whitney: Mining companies are under constant pressure to replace reserves. It is far easier for management to increase production through acquisitions, than through the long exploration and development process. Across the industry right now, exploration, sustaining and development capital are at historically low levels.

Once the price of gold trends higher and we see renewed enthusiasm for the mining industry, investors will want to see growth. The only way to get growth rapidly is through mergers and acquisitions. We then might see a repeat of what we experienced in 2003-4 through 2011, when mining companies were given higher valuations which allowed them to buy reserves from lower-priced entities and claim it to be accretive. This represents the “silly” season which tends to appear at the end of an M&A cycle, and which creates the kinds of mistakes we saw going into 2011 when miners overspent on deals during the decade-long boom that ended in 2011.

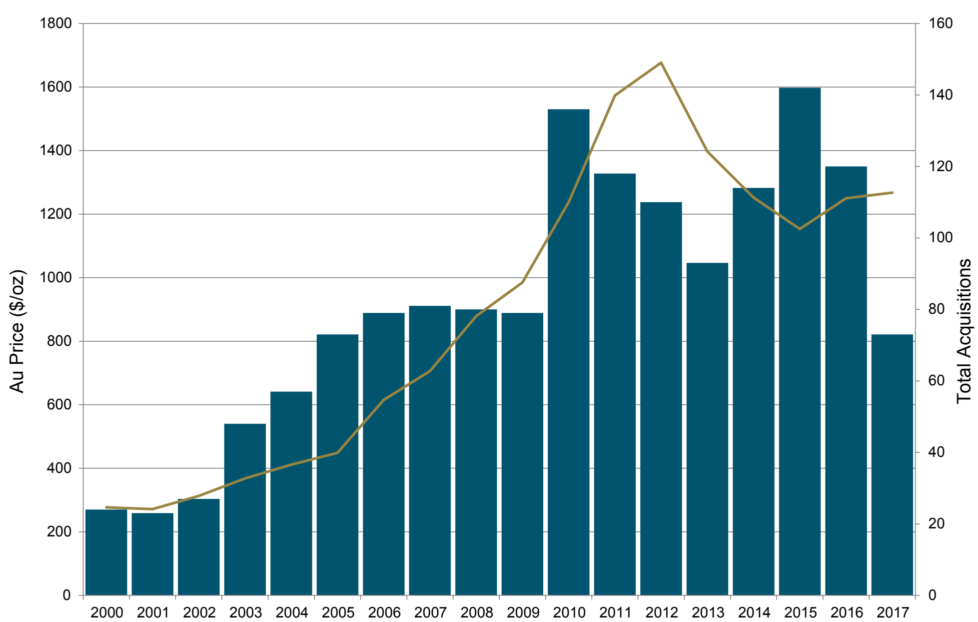
Figure 4: Tremendous Consolidation Potential Among Gold Miners

Please Note: Major gold miners are represented by the predatory shark image on the right; while junior gold miners are represented by the small fish on the left.



Source: RBC Capital Markets. As of 07/23/18.

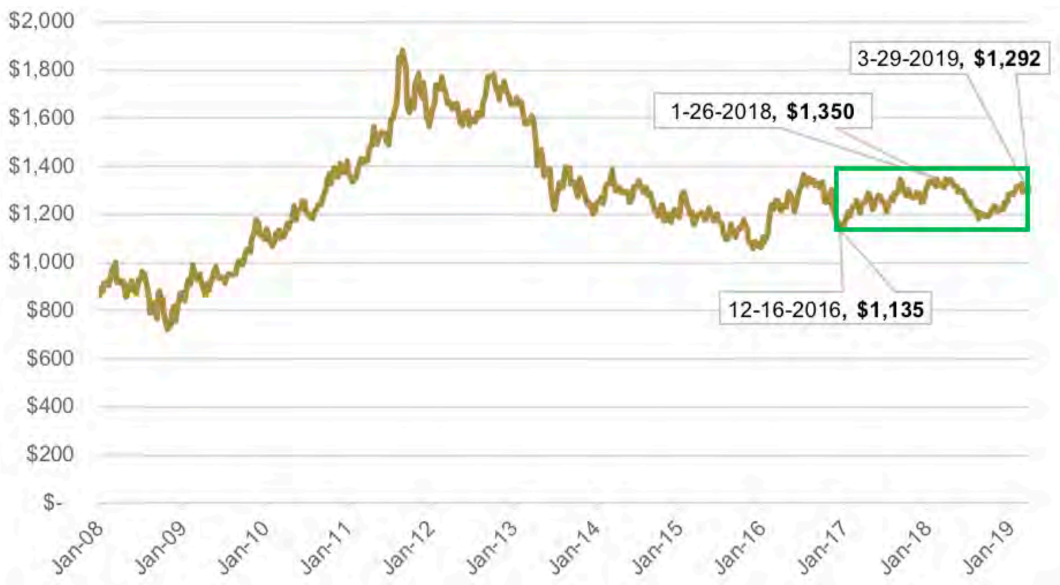
Figure 5: Number of M&A Deals vs. Spot Gold Price (2000-2017)



Source: BMO Capital Markets Metals & Mining Report 12/17/2018.

Looking ahead, gold price stability will help provide support for increased M&A activity. Gold has been relatively stable over the past two years, as shown in Figure 6, especially since the end of 2016. A stable gold price over an extended period, allows buyers and sellers to come together. After a big price decline, the sellers want yesterday's prices and the buyers want today's prices, and the two sides won't come together.

Figure 6: Recent Gold Prices Have Been Stabilizing (2008-2019)



Source: Bloomberg.

Maria: From a portfolio management and stock picking perspective, what is the best way for investors to take advantage of M&A activity?

Whitney: A prudent way for an investor to gain access is through experts in the space who are dedicated entirely to investing in mining stocks. Investors should work with managers who have been following the sector for decades, given the mining industry's extended business cycles. These managers will know where the best assets are and who owns them; they will benefit investors by finding companies that are making excellent acquisitions or that have the potential to be acquired.

This is a key reason why we created our new joint venture with Tocqueville, and John Hathaway's gold investment team (see press release).

Maria: Can you provide some details on Sprott Hathaway Special Situations Strategy?

Whitney: The strategy invests in a concentrated portfolio of global mining companies that explore for metals, develop precious metal resources, build mines, and operate mines with special emphasis on likely takeover candidates.

The strategy capitalizes on the combined strengths of two gold-investing industry leaders. Hathaway and his gold team are responsible for portfolio management and are working with Sprott's gold team to perform a fundamental level of detailed research. Together, we are trying to identify promising individual deposits and assets, and in some cases help to unlock the value embedded in these assets.

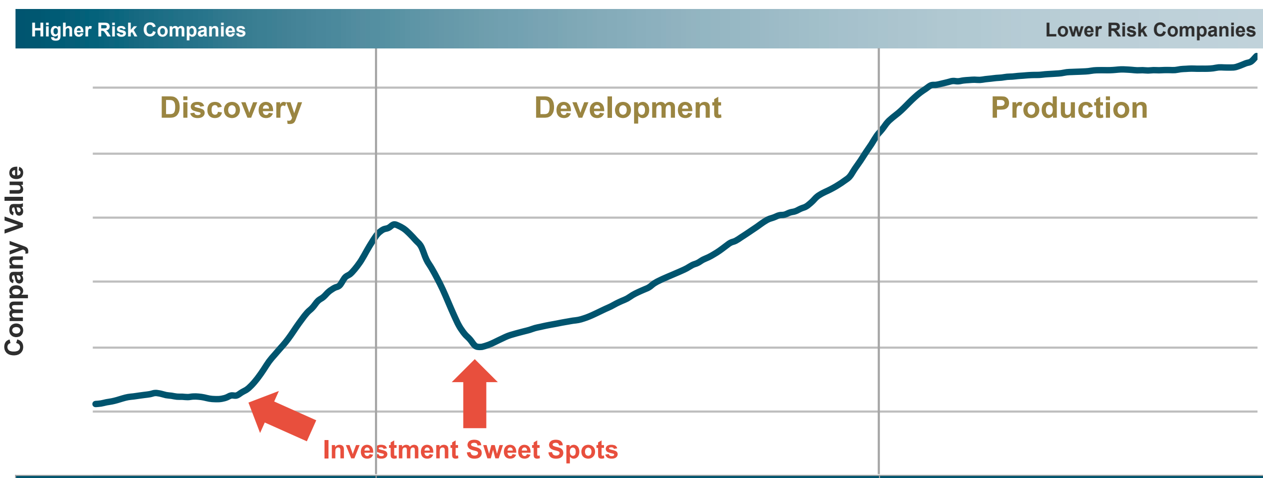
Maria: What are the unique skills of each manager?

Whitney: John Hathaway has been following the mining sector for decades. He is a long-term investor and has exceptional relationships with industry leaders and company managements. He is viewed as a patient provider of committed capital, which is desperately needed in this long cycle business. Hathaway and his team tend to focus on the investment "sweet spot" located in the Development to Production stage when cash flow is being generated, as shown by the right arrow in Figure 7.

Sprott has complementary investment capabilities to Hathaway/Tocqueville. We have a team of geologist and technical engineers that focus on identifying promising assets and companies in the early stages of Discovery and Exploration, the "sweet spot" shown by the left arrow in Figure 7. Given our nimble size, we are able to forge relationships with smaller companies more easily than a large organization that is required to invest billions of dollars of capital to work, and is forced to own large-cap names. Finally, Sprott's lending franchise performs an enormous amount of due diligence as part of the process of financing growing mining companies.

The skills that Sprott offers Hathaway/Tocqueville and his team are not what a typical portfolio manager and a team of analysts have access to. This is a unique combination in the industry.

Figure 7: Life Cycle of Gold Mining Companies



	Valuation Parameters	
Geologic Potential	Ent. Value/Au Reserve Ounces	Ent. Value/Production
Ent. Value/Au Resource Ounces	Price/Net Asset Value	Price/Net Asset Value
Ent. Value/Au Reserve Ounces	Price/Cash Flow	Price/Cash Flow

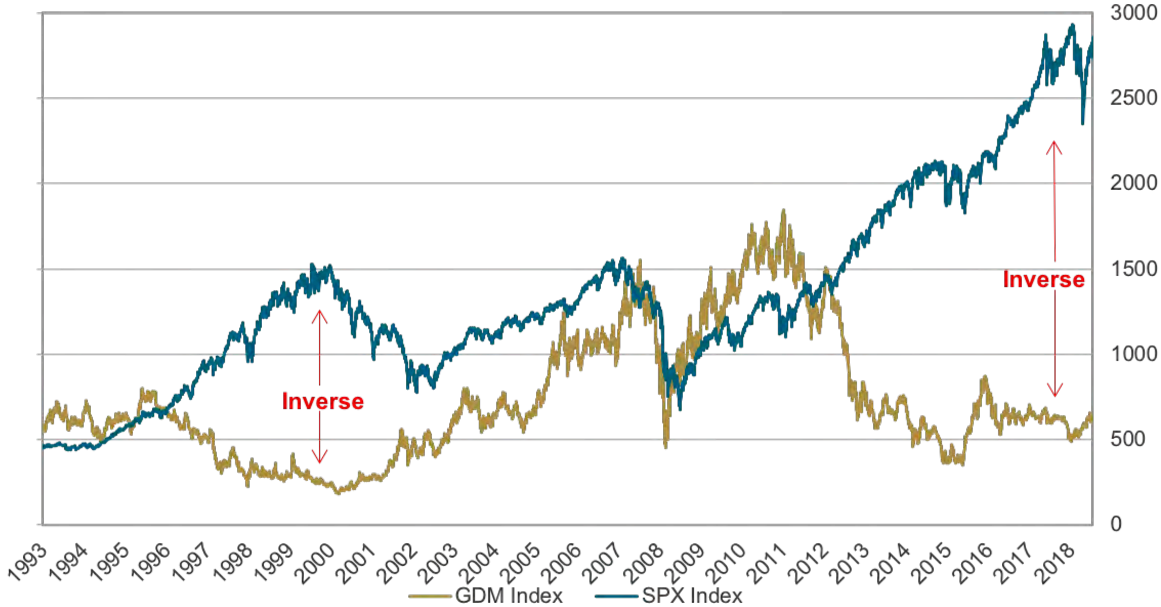
Source: Tocqueville Asset Management.

Maria: How do you view the current investment opportunity presented by gold mining equities?

Whitney: Most equity markets are forward looking and are early predictors of events that unfold. There is no reason why gold mining equities will not foreshadow a recovery in gold prices. History demonstrates that gold mining equities have the ability to outperform during significant corrections in U.S. equities. As shown in Figure 8, since 1996, there have been only two periods of extended inverse performance between the NYSE Arca Gold Miners Index (GDM)[2] and the S&P 500: 1996-through-2002 and 2012-through-the-present. In the first instance, gold shares slumped as the internet bubble hit full frenzy through March 2000. Then, as the S&P 500 fell 52%, gold stocks tripled. Since 2012, gold shares have suffered from the sharp decline in the gold price and the self-inflicted damage caused by ill-timed acquisitions.

The gold mining industry has learned some tough lessons and has been fighting to rebuild its credibility and financial health ever since. The M&A boom currently underway is another sign that the larger mining companies are not waiting for a higher gold price to lift them higher—they are focusing on what they can control—mergers, acquisitions, divestitures and joint ventures have the potential to unlock tremendous opportunities and value for shareholders.

Figure 8: Gold Mining Equities Extreme Dislocation from S&P 500



Source: Bloomberg. As of March 31, 2019.

About Sprott

Sprott is a global alternative asset manager with a defining focus on precious metals and real assets investments. Through our subsidiaries in Canada, the U.S. and Asia, Sprott is dedicated to providing investors with world-class investment strategies that include exchange-listed products, active equity strategies and highly-specialized real asset investments. Our deep sector expertise creates investment and financing solutions unparalleled in the industry.

For more information, please visit **sprott.com**

Sprott

sprott.com

[1] Robert Godsell was the CEO of South African gold mining company AngloGold Ashanti from 1998 to 2007.
[2] The NYSE® Arca Gold Miners™ Index (GDM) is a rules-based index designed to measure the performance of highly capitalized companies in the Gold Mining industry; the inception of the Index is 9/17/93. The Standard and Poor's 500 Index (SPX) is a capitalization-weighted index of 500 stocks.

0419292 04/19_ART_SGR