Gold Producer Categories

In my tenure as an analyst on the gold stock circuit, I've been blessed to have experienced some pretty neat things that have given me an inside look at the gold mining industry. And by far the most exciting of my adventures have been tours of actual gold mines.

I've descended deep into the bowels of the earth to tour a small subterranean mining operation that follows a series of rich gold-bearing veins. I've also had a behind-the-scenes tour of a robust open-pit surface operation. Ultimately whether big or small, after going on a mine tour you don't have to be a gold bug to be in awe of what goes into that shiny gold necklace that Aunt Jenny is wearing.

I briefly tale my escapades not to simply reminisce, but to tie in with the topic of this essay. One common question I get from investors is, does size matter? There are so many gold stocks out there and their market caps span such a wide range, what am I getting into when I touch down on different sides of the scale?

The simple answer to this question is yes, size matters. With gold's wild success there is a growing contingent of miners that seek to leverage its fortunes. And when picking which of these miners to invest and/or speculate in it is important to understand what you are getting into. What am I getting when I buy a small gold stock with a single small-scale underground mine? What am I getting when I buy a large gold stock that operates massive large-scale mines?

In recent months at Zeal we've updated our thread of research on gold producing stocks in order to feed our acclaimed reports that detail our favorites. And in the process of doing so we update our custom database that holds detailed information on this universe of stocks.

When picking our favorites we like to end up with a diversified mix of gold miners that rank from smaller high-risk/reward companies to the biggest and best in the world. And there certainly is a wide range of stocks to choose from.

One of the ways we address this question of size, and achieve our desired diversification, is to split up the stocks into 3 different peer-level categories. Senior, mid-tier, and junior producers. I consider the seniors those miners that produce greater than 1m ozs of gold per year. The mid-tiers produce between 200k to 1m ozs. And the juniors produce up to 200k ozs. This exercise gives me an excellent high-level survey of each category and ultimately helps in my selection process.

Interestingly, in terms of quantity the least of these categories is the senior producers. There are less than a dozen 1m+ oz primary gold producers in the world. And I say primary because there are large conglomerate miners that

produce over 1m ozs of gold per annum, yet don't qualify for this scrub since gold is not their primary source of revenue.

But even though their numbers are few, these seniors by far produce the largest amount of gold of the 3 categories. This elite group of gold mining behemoths combines for nearly *half* the global mined supply of gold. And when parsing out the various characteristics within each of these categories, stability is one of the first things I think of with the seniors.

This stability is multi-faceted as it covers such areas as portfolio, pipeline, and financial. As for portfolio most seniors have geographically diverse operations, with mines scattered all around the world. And this diversification serves as a big hedge to geopolitical risk as some of the world's biggest and best gold deposits reside in historically unstable countries.

Now miners already do business in a hostile marketplace regardless of locale. In my conversations with mining execs I've been told more than once that even before they approach local and federal agencies about permitting, they are already pitted as environmental hazards in the making. It is hard enough to jump regulatory and engineering hurdles just to procure mining permits.

And then when you throw in government instability (from local to federal), ad hoc changes to laws, and economic travails, a lot can happen over the 10 to 20 years that a mine may be scheduled for operation. There are many anecdotal examples of ex-post-facto rule changes to mining code, permitting, and taxation that have devastated profitable operations.

Miners have also seen adverse affects from violent indigenous uprisings, coup d'états, and labor strikes in politically unstable countries. And some governmental changes have even led to the outright nationalization of a country's natural resources. This is something all miners must be leery of, but the seniors usually have the flexibility to withstand a major geopolitical event at one of their mines and still survive to see the next day.

As for pipeline, gold miners are in a constant battle to renew reserves. Since gold is finite and difficult to find, as it is mined it reduces the overall mining life of a company unless those ounces going out the door are replenished. And there are only three ways for this to happen.

First is a rising gold price that can convert known resources into economical reserves. Second is via organic discovery at existing operations or grassroots exploration projects. And lastly is via mergers and acquisitions. And this last method is where pipeline and strong financials can work together.

Gold exploration is very capital-intensive. It can take tens if not hundreds of millions of dollars to discover and advance exploration and technical studies far

enough to deem the mineralization in a deposit economically feasible to extract. And this is before a mine is even built. Of course a solid technical team of well-trained geologists and mine engineers helps, but money plays a big factor in this.

The seniors have the ability to pay the technical teams and fund the exploration programs that are necessary to delineate reserves. But they also have the option to buy reserves, i.e. acquire projects or companies that meet their needs.

And if the capital for acquisitions is not readily available in treasury, the seniors can usually raise it in both the debt and equity markets. Most of their balance sheets are rated high enough to where they have the ability to acquire cheap debt. And their share prices and market caps are typically high enough to attract a broader range of institutional investors. Even all-stock deals are easier to get done as there is usually plenty of share capital on the shelf.

Circling back around to stability, most seniors have the financial and operational strength to weather such harsh economic conditions as those we are seeing today. While it is true the credit and equity markets have tightened up, the seniors still have the capital flexibility to acquire assets for cheap in today's environment.

Overall when viewed collectively, the seniors are the stalwarts of all the gold stocks. But even within this category there are those that are in better position than others. Some seniors have much stronger portfolios, pipelines, and financials than their peers. And those are the ones that are likely to perform best over the course of this gold bull.

Next are the mid-tier producers. And I consider this category the gold mining sweet spot. There are nearly twice as many mid-tier gold producers as there are seniors. But this is not nearly as many as you would think. In fact these miners only account for about 9% of gold's global mined supply. This shows the difficulty of breaking that 200k-ozs-per-year Maginot Line in the gold mining industry.

Mid-tier producers are in that sweet spot because they are typically movers and shakers. There is a lot of M&A and mine development activity as they strive to grow production and eventually eclipse that 1m-oz volume mark.

Some mid-tiers may have just one mine in operation. And this would obviously be of the larger-scale type producing over 200k ozs of gold per annum. But most of these miners have portfolios with more than one mine in production. Whereas the average senior may have up to 10 operating mines, sometimes more, the mid-tiers typically have 2 or 3.

But with multiple mines and steady cash flows from healthy production volume the mid-tiers have much better financials than the underlings in the category

below. As for financing the credit markets aren't as readily available as they may be for the seniors, but the mid-tiers usually don't have too much of a problem raising capital. They can usually find a way to fund the exploration budgets that are necessary to bolster their pipelines and eventually feed portfolio growth.

Many mid-tiers are also in the sweet spot due to the fact that they are prime acquisition targets. While the average market cap of the mid-tiers is about $1.5b, this number is skewed to the high side thanks to 3 or 4 market darlings that have robust pipelines. In actuality nearly three-quarters of the mid-tiers have market caps under $1b with about half numbering less than $500m.

These sub-$1b mid-tiers with established mining ops are very tempting to seniors and even fellow mid-tiers with aggressive growth plans of their own. With how difficult it is these days to find gold and build mines, quite often the easiest thing to do is just buy them. If the price is right it is a lot less risky to seek production growth via M&As.

Moving on to the junior producers, here is where you'll find the largest population of gold stocks. In this category there are dozens of gold miners that make their small but valuable contribution to the gold trade. And like the mid-tiers and seniors, there is a wide range of activity on the junior front.

Most juniors operate just one gold mine, with only a handful producing at a rate that exceeds 100k ozs per year. With this lower production volume cash flows are obviously on the low side, which doesn't leave much surplus capital to advance a pipeline. Even the most profitable of juniors is hardly able to make enough capital to self-fund costly generative programs.

And getting capital from an alternate source is even harder. The credit markets are virtually frozen for the juniors right now as banks reel in lending. And with share prices so low thanks to the stock panic, any equity financing of substance would be very dilutive. Not to mention finding investors to subscribe to new shares is not as easy anymore.

As for risk, investors must be much more prudent when picking stocks in this category. And the risk factor is apparent for these one-mine weak-financial stocks considering the discount they are trading at relative to the larger miners.

With the data for these stocks at my fingertips the best way for me to explain this discount is a simple calculation I was able to run. Quite often gold stock analysts measure valuation based on a market-cap-to-reserve ratio and even the inverse of reserve-to-market-cap. But I was curious as to how the markets value current production.

By dividing market cap by annual production volume you get a value in dollars of market-cap-per-ounce-produced. Both the mid-tiers and seniors have very

similar values, at around $4400 of market cap for every ounce produced. But the average junior was less than half this amount, at $2100.

Now these results aren't anything groundbreaking and should be taken with a grain of salt at the individual company level since this formula doesn't consider reserves or pipeline strength. But taken in context it provides a sense of how the markets value these stocks. Quite logically, juniors are riskier than mid-tiers and seniors, therefore their production is not valued as high.

Also in surveying the universe of junior producers, I found that the quality of a company is only as good as the quality of its mine. Unfortunately when looking at some of these mines, quality is hardly the word that comes to mind. While it is a great accomplishment for any of these miners to have graduated into producerdom, lack of quality is why it is so difficult for most juniors to graduate to the next level.

Some of the mines we see in this category were hastily brought into production and either lack the ability to make money and/or longevity. Simply put, many mines are producing at a loss because operating costs can't be kept under control. Lack of thoroughness and planning in preliminary geological studies and mine engineering are apparent when they can't make a buck even at today's higher gold prices.

And unfortunately even some of these junior producers that *are* running quality mines have sold their souls to the devil. Since mine construction requires much larger capex than exploration, these companies must rely on bank financing to raise sufficient-enough capital. Unfortunately since juniors don't have much collateral they are at the mercy of whatever terms the banks deem necessary in order for them to trust the juniors with their money.

And this often translates into hedging requirements. Hedging is selling forward a portion of production and reserves at a fixed price. In essence this gives banks a payback guarantee regardless of the volatility of metals prices. But this is very dangerous and costly in a bull market, and the markets discount this when valuing a stock subject to such conditions. A much higher percentage of juniors hedge than the mid-tiers or seniors.

But alas, not all is as bad as it seems. Even within the realm of these micro-caps (average junior producer market cap is $150m) there is an elite group of junior gold producers that are well-positioned for success and should thus reward shareholders.

These elites are in fact operating long-life and low-cost mines that are unhedged. And some even have promising exploration and development projects that could someday translate into an expanded portfolio of mines. While many juniors with

low-quality mines will fail, these elites are the ones that will graduate into the mid-tier category or be acquired. Both paths will reward shareholders.

Another thing I was able to look at when comparing and contrasting these different categories was their collective performance over a designated period of time. I was curious to see how investors would have fared through the recent bad and good if they were married to one specific category.

I used the HUI gold stock index as a measure for choosing my start and end dates. And of course since it was the bad that came first I used the date from the pre-panic HUI high, July 14, as the beginning. For the end date I used October 27, which was when the HUI bottomed at its dreadful 6-year low.

Well as all gold stock investors experienced, there was nearly equal carnage across all three categories. The seniors saw the least damage with an average loss of *only* 65%. Next were the mid-tiers at -68% followed close behind by the juniors at -69%. Not much disparity here.

But disparity does show on the upside. From the October bottom to the recent highs it was the mid-tiers that paced the gold stocks. The average mid-tier producer was up 150%, followed by the seniors at 141%, and then the juniors at 116%.

While investors were likely pleased in any category, the sweet-spot stocks had the sweetest gains and the junior riskiness was apparent with their underperformance. This categorical performance information is interesting to say the least, and it might be worthwhile to extend this study over previous uplegs and corrections to see what it reveals. But that is for another day.

As for the stocks in which to invest in each category, personal preference and overall investment strategy comes into play here. Either way there is a bit of research involved to uncover the best of the best. For beginning gold stock investors and those who aren't interested in individual stocks, the GDX Gold Miners ETF is a good place to start.

GDX is comprised of a basket of 31 precious metals stocks, with the main focus of course on gold. Those stocks in the senior category hold the heaviest weighting at 61%. And GDX touches all the bases here, as every senior gold stock is a member of this ETF.

The mid-tier stocks also have a strong representation in GDX with a 22% weighting. The next highest weighting is a handful of silver stocks at 10%. And the remaining 7% is split between a couple of gold royalty stocks, a handful of junior gold explorers, and a couple of junior gold producer stocks.

Junior producers aren't represented well in GDX since very few meet the minimum $100m market-cap requirement. Also GDX is solely comprised of major-exchange US-listed stocks. And many of the quality junior and even mid-tier gold stocks have primary TSX listings with only pink-sheet listings in the US.

But if individual equities are your game, there are plenty of quality gold stocks in which to invest or speculate. At Zeal we perform painstaking research on gold stocks to feed the recommendations we make to our newsletter subscribers. If you seek high-potential trade recommendations and cutting-edge analysis, subscribe to one of our newsletters today!

You can also directly tap our research and purchase supplemental reports that comprehensively profile our favorite stocks in a given sector. Our 2 most recent reports happen to focus on junior gold exploration stocks and gold producing stocks. And the producer report is comprised of a good mix of senior, mid-tier, and junior gold miners.

The bottom line is gold stocks come in all shapes and sizes. These miners range from tiny one-mine operators to massive global powerhouses. But even though the end-product is the same on opposite sides of the scale, it is not feasible to scrub a $100m stock to a $5b stock. This is why it is imperative to divide them into peer-like groups.

It is much easier to see where a gold stock stands when compared and contrasted to fellow senior, mid-tier, or junior miners. Portfolio, pipeline, and financials are radically different between these categories. But even with these differences, there are winners in each group that are likely to shine above the rest.

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So how can you profit from this information? We publish an acclaimed monthly newsletter, Zeal Intelligence, that details exactly what we are doing in terms of actual stock and options trading based on all the lessons we have learned in our market research as well as provides in-depth market analysis and commentary. Please consider joining us each month at … www.zealllc.com/subscribe.htm

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