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# Make Money in Gold with Prospect-Generator and Royalty Companies: Adrian Day

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**COMPANIES MENTIONED**

- **Almaden Minerals Ltd.**
- Altius Minerals Corporation
- Barrick Gold Corp.
- Esperanza Resources Corp.
- Eurasian Minerals Inc.
- Evrim Resources Corp.
- **Franco-Nevada Corp.**
- **Goldcorp Inc.**
- Lara Exploration Ltd.
- **MAG Silver Corp.**
- **Midland Exploration Inc.**
- Miranda Gold Corp.
- Nevsun Resources Ltd.
- Reservoir Minerals Inc.
- Riverside Resources Inc.
- Royal Gold Inc.
- **Sunridge Gold Corp.**
- Virginia Mines Inc.
- **Vista Gold Corp.**

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**Adrian Day, principal of Adrian Day Asset Management, which manages portfolios for high-net-worth clients, believes that it is time for the gold pendulum to swing away from the excessive pessimism in the market and finds that now is an exceptional time to buy gold equities. In this exclusive interview with *The Gold Report*, Day explains why gold is ready to rebound and why prospect-generator and royalty companies are king.**

Source: Brian Sylvester of *The Gold Report*

***The Gold Report:*** Some investors think that we won't see gold stocks come back in a big way. What do you say to them?

**Adrian Day:** With regard to the seniors, we are not going to return to the valuations that gold stocks have traditionally enjoyed, gold stocks selling for 40, 50, 60 times earnings. With regard to the juniors, we've had this sentiment before. The juniors are incredibly volatile, and we go through these periods of excessive optimism and excessive pessimism. At the end of 2008, clients called me, wanting to go 100% to cash because they thought these juniors were finished. The key is to buy quality companies with quality management and strong balance sheets and then, even if it takes another year or two, you know they're going to survive.

**TGR:** In July, Petroliam Nasional Berhad (PETRONAS) and CNOOC Ltd. (CEO:NYSE), large Asian oil companies, paid a combined $20 billion (B) for two Canadian oil and gas companies, Nexen Inc. (NXY:TSX; NXY:NYSE) and Progress Energy Resources Corp. (PRQ:TSX), both of which were thought to be undervalued. Do you believe some of that Asian wealth could find its way into mining takeovers?

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**AD:** Not surprisingly, energy is the prime target because that's the basis for producing every other resource. But China, Korea, Japan and other Asian countries are looking also at bigger copper assets because there's a shortage of supply long term, and these countries are at that point in their economic development when copper is at its highest demand. They use copper a lot for construction, real estate and infrastructure.

**TGR:** Lupaka Gold Corp. (LPK:TSX; LPKGF:OTCPK; LQP:FSE) and Andean American Gold Corp. (AAG:TSX.V; ANMCF:OTCPK) merged because each company has something the other needs. Do you expect to see more mergers like that?

**AD:** One of the problems we've seen in the past decade, not just in gold but also in a lot of resources, is big companies buying small ones for no reason other than to get bigger, and overpaying for the privilege. That is changing. But where there is a syngergy, then yes, we will see more mergers.

**TGR:** Canada's *Globe and Mail* published a story July 13 that Kinross Gold Corp. (K:TSX; KGC:NYSE) was a likely target for Barrick Gold Corp. (ABX:TSX; ABX:NYSE). Do you believe there's any truth to that?

*"A company that pays a dividend consistently is doing something right. "*

**AD:** I would be surprised. Barrick has a new CEO; there is investor concern about its acquisition of Equinox Minerals Ltd. (EQN:TSX; EQN:ASX) last year—I would think that new management would want to consolidate before it starts getting aggressive buying something else, and Kinross would be considered reasonably aggressive. Barrick has quite a lot on its plate right now with Pascua Lama and Pueblo Viejo. Pueblo Viejo left a nasty legacy from its last incarnation, so it will be a slow start up.

**TGR:** In your book *Investing in Resources: How to Profit from the Outsized Potential and Avoid the Risks* (Wiley, 2010), you said that majors often focus on a single property when they're looking at takeovers, and you even suggested some takeover targets: Sunridge Gold Corp. (SGC:TSX.V), Nevsun Resources Ltd. (NSU:TSX; NSU:NYSE.A), Esperanza Resources Corp. (EPZ:TSX.V), Vista Gold Corp. (VGZ:NYSE.A; VGZ:TSX) and MAG Silver Corp. (MAG:TSX; MVG:NYSE). None of those companies has received takeover offers yet. Do you believe those companies remain targets?

**AD:** Many of them. But with the prices that we've seen recently, several juniors with attractive properties have essentially taken themselves off the market for now. Exeter Resource Corp. (XRC:TSX; XRA:NYSE.A; EXB:FSE) is a good example, with its big property up in the Andes.

I think Sunridge is still a potential target. It's got a very attractive property. It's got low capital expenditures (capex). It's fairly advanced. It's done prefeasibility studies on all five deposits. The stock itself is extremely cheap. And it's got a lot of cash. Two potential downsides: It's in Eritrea, and that scares many companies, and it's mostly copper, not gold. Sunridge's numbers are astonishing. The one deposit, Debarwa, has a net present value of $71 million (M), so it's small. But it's got an internal rate of return of 41%, a payback of 1.1 years and a 140M capex.

MAG Silver is another target still; it has a joint venture (JV) with Fresnillo Plc (FRES:LSE), which would be a natural buyer.

No one is likely to buy the whole of Vista, but its individual projects are targets. And we've already seen some JVs. Yellow Pine is now part of Midas Gold Inc. (MAX:TSX). Vista owns a significant chunk of shares in Midas. In Mexico, Vista brought in a JV partner on the Concordia project.

**TGR:** You suggest in your book that anytime the ratio of the Philadelphia Gold and Silver Index (XAU), which is the gold and silver index traded on the Philadelphia Exchange, to the gold price is five times or higher, it's a good time to buy gold companies. As of July 23 the ratio was almost 11:1. Does that mean that rule of thumb needs an adjustment, or does it mean that it's an exceptional time to buy gold companies?

**AD:** A little bit of both. The S&P/TSX Global Gold Index is now at its cheapest level relative to bullion since 1986, the beginning of the bear market. The XAU Index of senior North American gold and silver stocks is now cheaper than the S&P. I can't remember a time when the gold stocks were cheaper than the broad market. Look at Barrick, for example, which is the largest gold producer. Seven times earnings multiple, 2.5% yield, 1.3 times book value. It's got 27% debt to assets, which is low for a capital-intensive industry. Even if you didn't know what the company did and you were a value investor, you would be looking at it.

*"Royalty companies tend to be low risk; they also give you exposure to the upside through production increases and exploration success."*

We have to recognize that, for the most part, gold companies have not been well-managed companies over a long period of time. They've generated horrible returns, overpaid for acquisitions and management has issued too much dilutive equity. Ten years ago, if you were a generalist interested in gold, you looked at the big mining companies and you hoped that the gold price would bail you out and take care of all the problems. Now there's competition from the exchange-traded funds (ETFs). An investor can buy an ETF and get direct exposure to gold without worrying about cost overruns, overpaying, dilution and everything else. The more the big companies fail—whether it's Kinross; Agnico-Eagle Mines Ltd. (AEM:NYSE); Newmont Mining Corp. (NEM: NYSE); Barrick and the Equinox acquisition; Goldcorp Inc. (G:TSX; GG:NYSE), the latest to announce a big reduction in its annual production and a huge increase in its costs—the more big investors simply turn to gold itself.

We shouldn't forget that mining is a difficult business. But mining companies have not been their own best friends, and investors are becoming more and more unforgiving of corporate errors simply because there is an alternative now. Over the last 12 months, the big companies seem to be getting the message. The move toward mining companies paying dividends, for example, is part of their response to the accusations of fiscal irresponsibility. We're not going back to the days of the XAU selling at 60–70 times earnings multiples, because now there's competition, ETFs, which there wasn't in the past.

**TGR:** How does a 30% rise in the gold price mean a 140% increase in the margin of a major producer?

**AD:** If the price at which you sell your product goes up at a faster rate than your costs, that's when you get the leverage. For example, when gold is selling at $800/ounce (oz) and your costs are $600/oz, you've got a 20% margin. If gold goes to $1,200/oz and your costs go up to $800/oz, you've now got a 50% margin. In the last five years, we've seen costs go up dramatically: for energy, which is the major component for mining; labor; mercury; truck tires; currencies. For instance, if a Canadian company has mines in Brazil and Australia, until recently, those currencies were both going up a lot more than the Canadian dollar. The margins were pretty static from 2001 all the way through to the end of 2008—we didn't get any leverage expansion at all.

**TGR:** What about dividend yields? Are your clients seeking yield?

**AD:** My clients are certainly seeking yield, but I don't buy gold stocks for dividends.

**TGR:** Even with Newmont at 4%?

**AD:** If I don't like the company, no. And in order to grow their very capital-intensive business, gold companies need the cash themselves, so why are they giving dividends? But dividends can exert a certain financial discipline on companies. And to quote my friend Doug Casey, dividends are an outward sign of inward grace. So, a company that pays a dividend consistently is doing something right.

**TGR:** What are your favorite large-cap gold companies?

**AD:** By far, Franco-Nevada Corp. (FNV:TSX). It's not the cheapest, but I like the model. It's a royalty company, and royalties tend to be low risk; they also give you exposure to the upside through production increases and exploration success. Franco-Nevada has top management, $1B in cash on the balance sheet, diversified assets and a very good pipeline. Its recent revenue increases have come from the increase in the price of gold, and also from acquisitions. Interestingly, they've also come from old legacy assets that are finally generating revenue. Some of these are new properties coming into production, on which Franco-Nevada has a royalty, so it starts earning money. But they're also net profit royalties rather than net smelter. Finally, the mine becomes profitable so it starts earning some money from the royalty. Franco-Nevada has about 210–220 mineral assets, not counting oil and gas, about 40 of which are currently producing. CEO David Harquail said that another 24 of them have "reasonable potential" to commence production in the next five years. The problem is, even though the dividend payment has gone up consistently over the years, the stock price has gone up more, so the yield is not particularly attractive.

Of the others, I like Goldcorp, despite the lower production estimates of this year. It's got a very good balance sheet, $1.2B. It's got a very strong pipeline, which includes a 30% interest in Barrick's property we were talking about earlier in the Dominican Republic, Pueblo Viejo. It includes Eleanor in Québec, which is a property on which Virginia Mines Inc. (VGQ:TSX) has a royalty. We own 5% of Virginia.

Barrick is cheap right now. The management change is positive. People know Jamie Sokalsky—he's been with Barrick a long time. The company needs to make the corporate strategy clear to the market, because buying, arguably overpaying for, a copper company in Africa when you're a gold company and you've just spun out all your African assets really has people scratching their head.

The gold stocks are very underowned and oversold right now. There's very negative sentiment. One of the ways you can look at that is by looking at the calls. Traditionally, if you buy a call on a gold stock, you pay an enormous premium. You're not doing that anymore—you can buy calls one or two years out at very reasonable prices. So, that's an indication. When gold moves back up to $1,700/oz, toward $1,800/oz and generalists start to look at gold again, a lot of the money will go into SPDR Gold Shares (GLD), the largest gold ETF, but a lot of the money will go into the big stocks like Barrick; Newmont, which has a dividend and a huge long-term pipeline; and Yamana Gold Inc. (YRI:TSX; AUY:NYSE; YAU:LSE), which has a lot of growth potential.

**TGR:** Let's focus this on another segment of the business that you like: the prospect-generator model. In your book, you illustrate your point by noting that some prospect generators actually end the exploration season with more money than when they started due to the various JV agreements that they have in place. What is this model, and how do the good prospect-generator companies make it work?

**AD:** As the name implies, these are exploration companies that generate prospects. They then tend to JV those projects with companies with money to spend. The generation of prospects, while not easy, is not high cost. When the prospect generators get to the high-cost point of exploration and development, they look for a partner to spend the money. I like the model because it enables the exploration company to maintain its balance sheet. It doesn't have to keep going back to issue new dilutive equity, and it's able to build portfolios of exploration projects. Consider companies that have been around a little while, like Virginia and Almaden Minerals Ltd. (AMM:TSX; AAU:NYSE), and have interest in not just three or four properties but 10 and 20 properties. It's a little bit like owning shares in lots of lottery tickets instead of just one whole lottery ticket. It increases your odds of discovery in what is a very long-odds enterprise, looking for a gold discovery. It's said that only 1 in 5,000 anomalies ever becomes a mine. The prospect-generator model doesn't guarantee success, but it means that the company can stay alive to fight another day.

How do the good prospect generators make it work? They maintain discipline to the model so that they maintain their balance sheets, and they strike good JV agreements, meaning they maintain the greatest share of their property while incentivizing the other company to spend money.

*"Buy when nobody else is buying. If you buy quality junior gold stocks right now, you may have to wait a painful six months, but you'll end up being very happy you bought."*

**TGR:** What prospect generators are you most fond of at the moment?

**AD:** Midland Exploration Inc. (MD:TSX.V) is also out of Québec but is much smaller than Virginia—we own 5% of it. The market cap is a little under $30M. It's got five active JVs with companies like Agnico and Osisko Mining Corp. (OSK:TSX). It's got $4.5M in cash, which for a company of its activity is plenty—it doesn't need to raise any more money.

Almaden has great people; just as Virginia has André Gaumond and Midland has Gino Roger, the Poliquin father-and-son team is widely respected in the industry, both as technically competent and as honest. Almaden also has a super strong balance sheet. It's got about $22M in cash, $2.5M worth of gold bullion and about $15M in shares of exploration companies. It's got multiple projects, primarily in British Columbia and Mexico. At least two of those, Elk in B.C. and Caballo Blanco in Mexico, are advancing toward production in the near term. Ixtaca, a gold-silver project in eastern Mexico, is probably the most prospective property. The company has drilled 135 holes and counting. It is publishing its first resource estimate in September. That could potentially give the stock a good boost. Almaden right now is selling at $2.13/share; the market cap is $124M. I find that remarkably inexpensive. And the stock has come down a lot. Last July it was over $5/share. At $124M, with $40M in cash and near-cash and being cash flow positive, I think that's a steal.

Eurasian Minerals Inc. (EMX:TSX.V) has a very strong balance sheet and a wide portfolio of properties from Russia and Australia to Arizona and Haiti. I like Evrim Resources Corp. (EVM:TSX.V)—my management clients own 5%. It is only a couple of years old now. It acquired the Mexican assets of Kiska Metals Corp. (KSK:TSX.V) when Kiska started focusing on the Whistler property in Alaska. It's got four joint ventures now.

I like Miranda Gold Corp. (MAD:TSX.V)—my company owns 5% of that. Miranda is a good example of a company that can do everything right and still not yet have that big discovery. But if you buy Miranda now you're buying a relatively cheap company with a good balance sheet and exposure to a lot of highly perspective properties that other people are spending the money on. It just announced an exploration alliance in Colombia.

Riverside Resources Inc. (RRI:TSX) is mostly in Mexico. Good management. I could say good management and good balance sheet on all of these, by the way. Reservoir Minerals Inc. (RMC:TSX.V), which was a spinoff of Reservoir Capital Corp. (REO:TSX.V), is another one that my company owns quite a bit of—we're 5% owners. It just had a spectacular drill hole in a JV with Freeport McMoRan Copper & Gold Inc. (FCX:NYSE) in Serbia.The stock price doubled the day that was announced.

Altius Minerals Corporation (ALS:TSX.V) and Lara Exploration Ltd. (LRA:TSX.V) are two non-gold ones that are good.

**TGR:** We're seeing a big selloff in Western markets as Spanish bond yields are at record euro-era levels, and there are whispers that Germany could force Greece out of the Eurozone. Is now the time to head to the royalty model, which is likely the lowest risk play in the gold space?

**AD:** I've always liked the royalty companies because they are a low-risk model. In this business, you have enough risk to begin with, whether it's misappropriation or the geology not turning out the way you thought it was going to turn out. And I've always felt, if you buy really good quality companies, not just in resources, but in everything, where you are focused on the downside, the upside takes care of itself. When gold goes to $2,500/oz, the quality companies will move. You don't have to worry about it. That's one reason that companies like Franco-Nevada and Royal Gold Inc. (RGLD:NASDAQ; RGL:TSX) are not as cheap as some of the mining companies: They are lower risk and people are buying them right now.

**TGR:** Do you have any other advice for investors?

**AD:** Number one, understand what you know and what you don't know. If you're not a geologist, don't try to be one. Focus on the things you can understand, like a business model, management, balance sheets. Number two, stick with quality. I would rather pay up to quality then underpay for junk. Number three, buy when nobody else is buying. If you buy quality junior gold stocks right now, you may have to wait a painful six months, but you'll end up being very happy you bought.

*Adrian Day, London born and a graduate of the London School of Economics, heads the eponymous money management firm Adrian Day's Asset Management, where he manages discretionary accounts in both global and resource areas. His latest book is* Investing in Resources: How to Profit from the Outsized Potential and Avoid the Risks.

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