Sprott | A Message from the CEO

A Yuletide Present

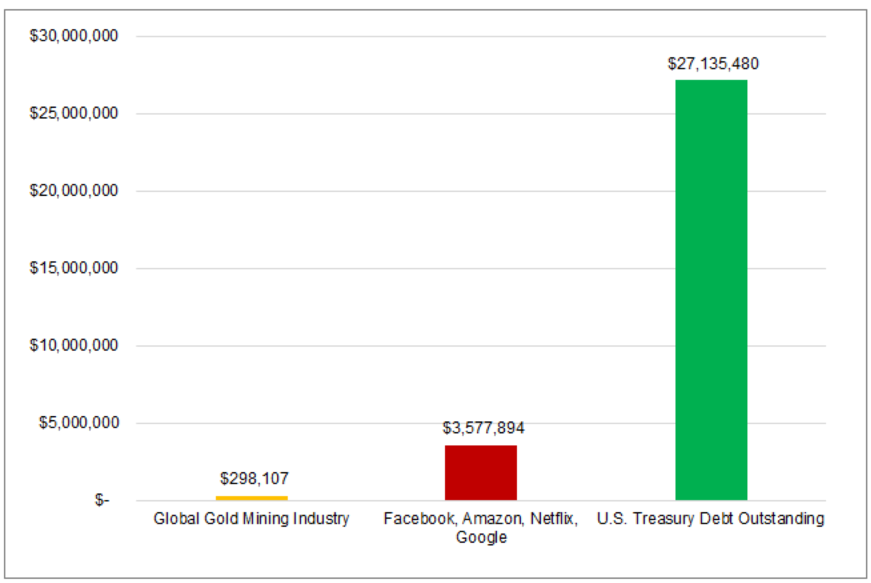
BY PETER GROSSKOPF | FRIDAY, DECEMBER 11, 2020

Investing in gold and silver mining companies is challenging but offers substantial rewards. Of all the sectors I have covered, it is hands-down the toughest area in which to perform. Nevertheless, astute investors have been able to amass substantial wealth by owning and trading gold mining equities.

We believe that today's gold mining share prices provide investors with excellent opportunities for yuletide purchases.

The reasons why the gold equities sector is challenging are numerous. It is a small sector by any standard. We estimate that the aggregate market capitalization of the world's top precious metals miners and royalty companies is approximately $300 billion (Figure 1). At this size, it cannot sustain the attention or volume requirements of the world's larger asset managers. The aggregate value of the up and coming gold miners is so small that position sizes become illiquid even for smaller investors.

Figure 1. Market Cap of Global Gold Miners vs. FANG Stocks and U.S. Treasury Debt



Source: Bloomberg. Data as of 10/31/2020. Excludes miners below $10M in market capitalization.

What Volatility Takes Away...

The volatility of gold mining equities attracts a disproportionate component of market timers who are inherently short term. The common measure we use is that gold mining equities are three times as volatile as the price of bullion, reflecting both the present value of their discounted underground reserves and the leverage of their operating margins to gold price moves. The annual volatility measure for larger miners is about 50% and for smaller companies more than 60%. Not many investors tend to hold investments with such high volatility due to the "alpha" required to justify an investment on a sharp ratio "value-added" basis.

This volatility ties directly into the need for the disciplined allocation to purchases. One can have good stock picking skills for gold miners and sustain greater losses from poor allocation decisions, usually by chasing performance.

...Contrarian Positioning Gives Back

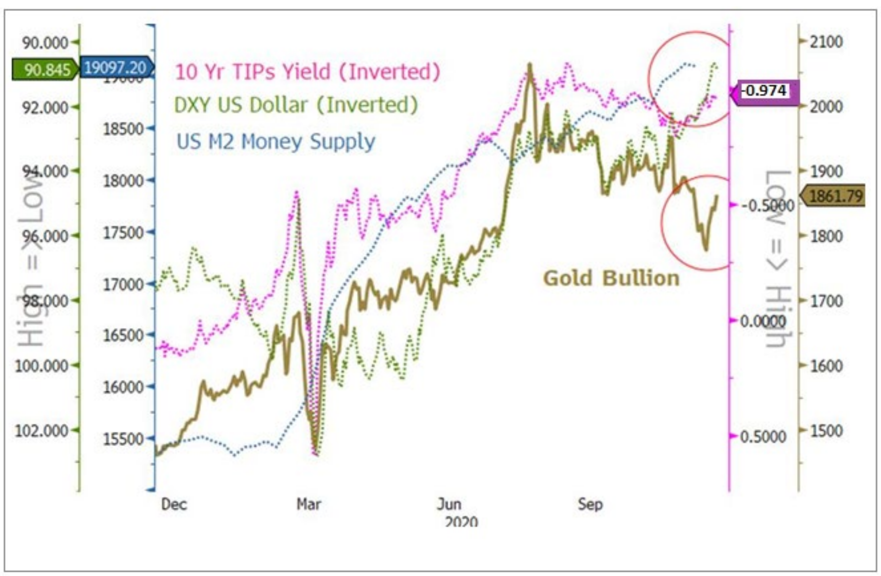
However, volatility also creates extraordinary buying opportunities, such as we have seen in this recent pullback. That means buying miners when the sector has disappointed and when operating margins or projects at a company are challenging, or while gold is being shunned in favor of investments benefiting from economic growth and investor confidence like we have experienced this past month.

Update on Gold

The gold price is driven mainly by three numerical factors (Figure 2): money supply (M2),[1] the U.S. dollar (DXY Index)[2] and real interest rates (10 YR TIPs yield).[3] Its most important historical determinant, however, is that gold reacts inversely to investor confidence.

We believe the market conditions for gold are currently favorable, largely driven by the voracious need for fiat money supply growth and its increasingly direct correlation with all financial markets. We have published several recent commentaries (see Insights), which aptly summarize our current thinking on gold.

Figure 2. Market Conditions are Supportive for Gold



Source: Bloomberg as of 12/07/2020.

Technical analysis can also provide valuable clues to when the contrarian timing for mining equities is right. Eric Sprott always believed that moves of more than 20% from a pullback indicated that the coast was clear. I watch relative strength indicators closely because extreme readings are usually predictive of reverse moves. As gold was being punished in late November, its sentiment indicators dipped to the 20 range (as measured by the CBOE Gold Volatility Index),[4] which has reliably marked buying opportunities, while S&P 500[5] equities, driven by the "everything bubble" reflation trade, have recently risen to the high 80s (as measured by the Daily Sentiment Index),[6] which is close to a notable sell signal.

The Quest for Performance

Investors in the gold equities sector require experience and prowess for success. Generalists are at a disadvantage because the shortfall between the promises and realities of projects can be significant. Those portfolio managers who either are, or have access to, trained technical professionals with real on-the-ground experience running or buying mines are usually the best positioned for picking winners.

To illustrate some of the challenges in evaluating gold equities, few industries involve a wider range of crucial variables. Mine plans are complex, involving estimations of grade (geology), tonnage (operations/engineering), recovery (metallurgy), an array of cost inputs and many factors imposed on the mine like weather, government policies, remediation, etc. Management teams in the sector are pathologically optimistic, employing the opposite philosophy of other industries that tend to "sandbag" guidance. Sadly, investment house research is not valuable because it is motivated by selling stocks, not buying them.

The performance of expert gold investors cannot always be adjudicated over the Morningstar-provided periods of one to three years. The main job of the best managers in our sector is to protect value during inevitable corrections and to identify those companies which are adding value through per share accretive activities such as reserve additions, mine construction and completion, and judicious M&A (mergers and acquisitions). Those with more appetite for risk, and sometimes less knowledge, tend to outperform during strong bull markets, since operating leverage works both ways. These factors make investment manager selection difficult.

Many larger investors in the sector use an index to gain exposure to the gold mining equities. The GDX ETF[8] is the bellwether at $16 billion as of 12/01/2020 and has attracted the lions-share of flows to the sector. The issue with GDX and its junior counterpart GDXJ is that they are so large that they require frequent rebalancing and suffer arbitrage and dislocation from attractive holdings. We believe our own gold miners ETFs, SGDM and SGDJ, are better-used for short-term beta exposure.

Gold Miners History

Gold and silver were historically the realm of the prospector and the speculator. The history of the oldest miners is populated with stories of bonanza discoveries, spectacular promotions and a wild-west atmosphere. While some senior mining companies grew to become respectable industrial citizens, smaller miners were left to drill, build and promote with little reference to facts. Those speculators who got rich in the sector did so by backing promotions early and getting lucky on either timing or discovery. A large percentage lost money. Family offices specializing in the sector had much better results because they employed geologists and mine-building teams.

By the 1980s, and with increasing scrutiny by the regulators, the junior mining industry began to evolve. Institutional shareholders began to invest by the early 1990s, and some high-quality growth companies were founded, such as Agnico Eagle and Franco-Nevada, both of which have performed strongly over the past 20-30 years. Generally, most gold stocks in those days were at one end of the barbell or the other, run mostly for promotion or as an old-boys club by resource giants.

In my opinion, it took most of the 1990s for the gold mining industry to become more modern, with governance and management standards that approached other sectors. The industry still required reinvention. Most acquisitions and development gold projects were under-engineered for cost control and under-estimated the increasing burdens of government, environmental and community involvement. Billions were lost when the gold bull market of the 2000s gave way to the six-year bear market of 2011 to 2016, in which gold equity indices were down close to 75%. Shareholders demanded change, the C-suite was largely replaced and gold companies finally committed to independent board oversight and alignment of compensation policies. Today, these mining companies are focused on disciplined cost management and acquisitions.

Picking Winners

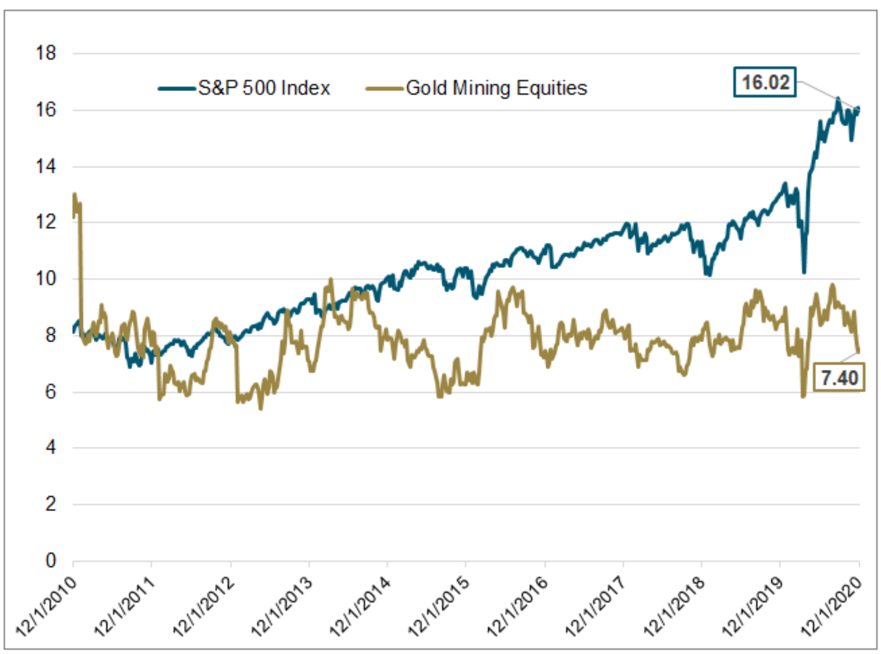
At Sprott, we rely on a broad team led by very experienced portfolio managers, in the fashion of a collective basket of mining DNA (see Sprott Gold Team). Combined, they are able to follow and overturn most of the rocks in the sector, in my opinion, they have superior access to management teams, entry points and ultimately, opportunities. Most importantly, they also know what doesn't work — the bad eggs and bad projects that the industry is unfortunately known to recycle from time to time. The 80-20 rule applies, where 20% of one's winners and losers drive more than 80% of the outcome. My conclusion is to stick with a more narrow, high conviction portfolio.

Today's Opportunity

Having covered the sector for over 30 years, I have seen my share of the good, the bad and the ugly. After two great performance years, in which gold mining equities outperformed the S&P 500 Index, these stocks are still relatively inexpensive.

On the other hand, both the technicals and the fundamentals remain strong. Gold looks to be developing a base around $1,800 and the miners have just experienced a healthy 25% pullback. Sentiment tells us that this was a required correction. That said, as Figure 3 clearly demonstrates, gold equities are very cheap relative to broader equities. The S&P 500 Index trades at 16.3x EV/EBITDA while gold miners trade at 7.6x EV/EBITDA,[7] representing a 50% discount.

Figure 3. Gold Mining Equities are Inexpensive Relative to the S&P 500 Index (EV/EBIDTA)

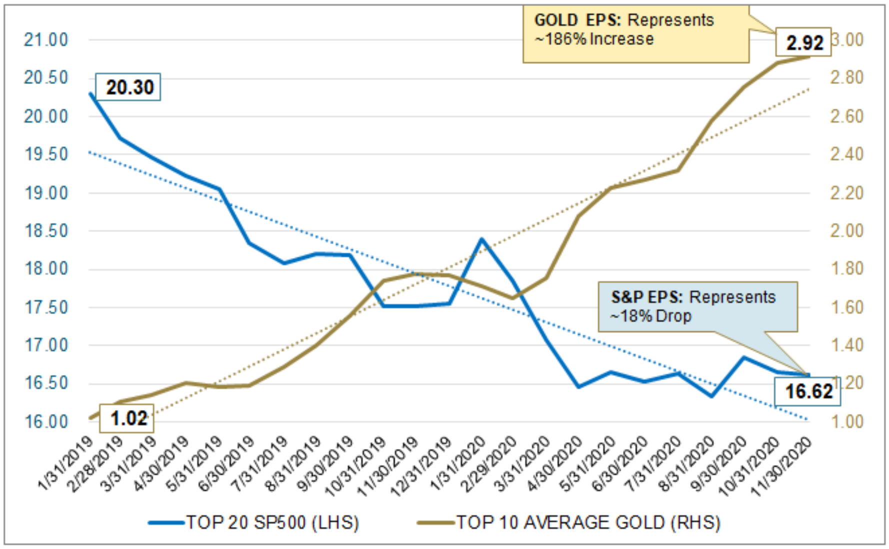


Source: Bloomberg as of 12/08/2020. S&P 500 Index is measured by the SPXEVEBT Index and Gold Mining Equities are measured by the GDMEVEBT Index.

Notably, the dividend yields of the senior producers have also begun to outperform the S&P 500 Index and the stocks are cheap when considering their free cash flow yields of over 10%. In our opinion, the sector's earnings will outperform consensus and lead the S&P 500 Index during an otherwise tough year. As Figure

4 shows, since the beginning of 2019, the S&P 500's earnings estimates have dropped by more than 18%, while the earnings per share for gold miners have risen by more than 186%.

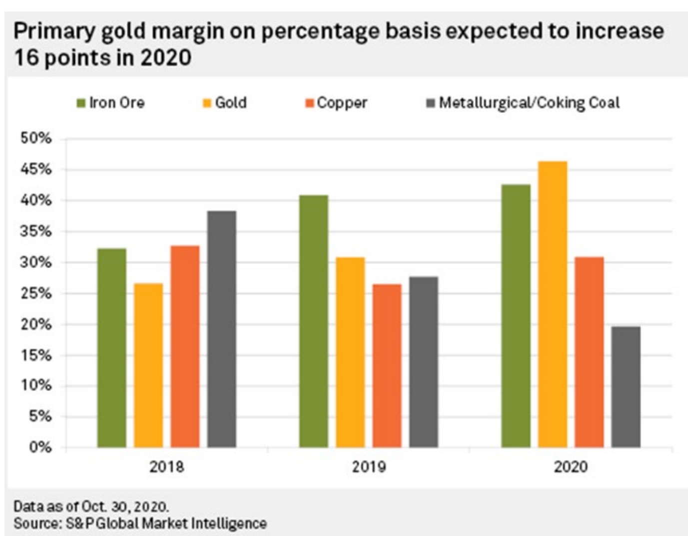
Figure 4. Gold Miners EPS Outlook is Very Positive



Source: Bloomberg as of 11/30/2020. Based on 1-YR Forward EPS revisions for the top 10 gold mining companies vs. the average for the top 20 S&P 500 companies. You cannot invest directly in an index. Past performance is no guarantee of future results.

Most importantly, the industry appears poised to enter a renaissance stage. Gold can be discovered, built and operated for $1,100 per ounce by efficient miners. The resulting EBIT margin of circa 40% provides outstanding returns compared to most industries in today's low yield environment. Project financing and cost of capital have fallen to sub 10% and are again available in size for the first time in 10 years. Revenue growth is limited only by the number of mine-builds and acquisitions as can be handled by a responsible team. These conditions, for high-quality gold miners, amounts to a license to print money (Figure 5).

Figure 5. Gold Margin Outlook



Source: S&P Global Market Intelligence as of 10/30/2020.

John Hathaway, along with our portfolio management team and I all believe that a new mergers and acquisitions cycle is also close at hand. Besides the operating margins illustrated in Figure 4, compelling math exists to acquire development-stage assets at large discounts to their construction values. This is now triply attractive because 1) senior, multi-mine companies enjoy a much lower cost of capital; 2) juniors will grind through the "hard yards" of the multi-year development and permitting and community involvement timelines; and 3) juniors now trade at huge discounts to their Net Asset Values. Notwithstanding COVID-induced due diligence bottlenecks and CEOs who still talk discipline and have an unwillingness to concede that they need to "buy growth," I contend that this math is too compelling not to drive a robust consolidation phase within the gold sector.

Getting Specific

In summary, many high-quality gold equities have corrected into attractive valuation territory. I particularly like those with a proven culture and expertise in building large complex mines and then operating them well. Returns on invested capital are highly competitive at current gold prices, and underpin free cash generation and sustained dividend growth. When choosing among these miners for some portfolio diversification, I would try to uncover a factor that has held back their valuation — perhaps a management upgrade, new permitting, acquisition or project financing, or a turnaround at a key asset.

Also, a high-octane opportunity exists today among the acquisition targets for these producers. Quality development opportunities, as defined by resource grade, size, logistics and reasonable political jurisdictions, as well as skilled and experienced engineers, are all in very short supply. In my experience, two selection criteria are the most crucial 1) a project that "works" in an operating sense — these are much more difficult to find than you might think from the hundreds of targets — at an acceptable discounted valuation; and, 2) an upcoming catalyst for the surfacing of value. The latter could be a successful financing, an upcoming fully-detailed engineering study, a key permit, or simply that a Board is close to hitting the "sell button".

We believe that today's gold mining share prices provide investors with excellent opportunities for yuletide purchases. The process of selecting high-quality gold mining stocks to diversify portfolios is best overseen by an experienced team of gold equity managers.

[1]M2 is a calculation of the money supply that includes all elements of M1 as well as "near money." M1 includes cash and checking deposits, while near money refers to savings deposits, money market securities, mutual funds, and other time deposits.
[2]The U.S. Dollar Index (USDX, DXY, DX) is an index (or measure) of the value of the United States dollar relative to a basket of foreign currencies, often referred to as a basket of U.S. trade partners' currencies.
[3]Treasury inflation-protected securities (TIPS) are a type of Treasury security issued by the U.S. government. TIPS are indexed to inflation in order to protect investors from a decline in the purchasing power of their money.
[4]The Gold ETF Volatility IndexSM (GVZ) is a VIX®-style estimate of the expected 30-day volatility of returns on the SPDR Gold Shares ETF (GLD) .
[5]The S&P 500 Index (SPX) is an index of stocks issued by the 500 largest U.S. companies.
[6]The Daily Sentiment Indexes (DSI & DSIE) are top notch contrary opinion indicators. The DSI provides daily market sentiment readings on all active US markets daily at 4:00 PM Central Time.
[7]The EV/EBITDA ratio is a popular metric used as a valuation tool to compare the value of a company, debt included, to the company's cash earnings less non-cash expenses.
[8]VanEck Vectors Gold Miners ETF (GDX) tracks the overall performance of companies involved in the gold mining industry. VanEck Vectors Junior Gold Miners ETF (GDXJ) tracks junior gold miners.
[9]Earnings before interest and taxes (EBIT) is the same metric as operating income and can be used in calculating operating margin.

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