GRANT'S
INTEREST RATE OBSERVER®

Vol. 39, No. 23e 233 Broadway, New York, New York 10279 • www.grantspub.com DECEMBER 10, 2021

Optionality, Inc.

In the perfect business, fixed costs are low, margins high, operating risk negligible and optionality inherent. Behold, then, the almost perfect precious-metals streaming and royalty business. Triple Flag Precious Metals Corp. (TFPM on the Toronto Stock Exchange) is the subject at hand.

To declare an interest, your editor is an inveterate gold bug, and Elliott Investment Management, L.P., a progenitor of, and the controlling stockholder in, Triple Flag, subscribes to *Grant's*. So make what you will of the conclusion of a not purely disinterested analysis: We're bullish.

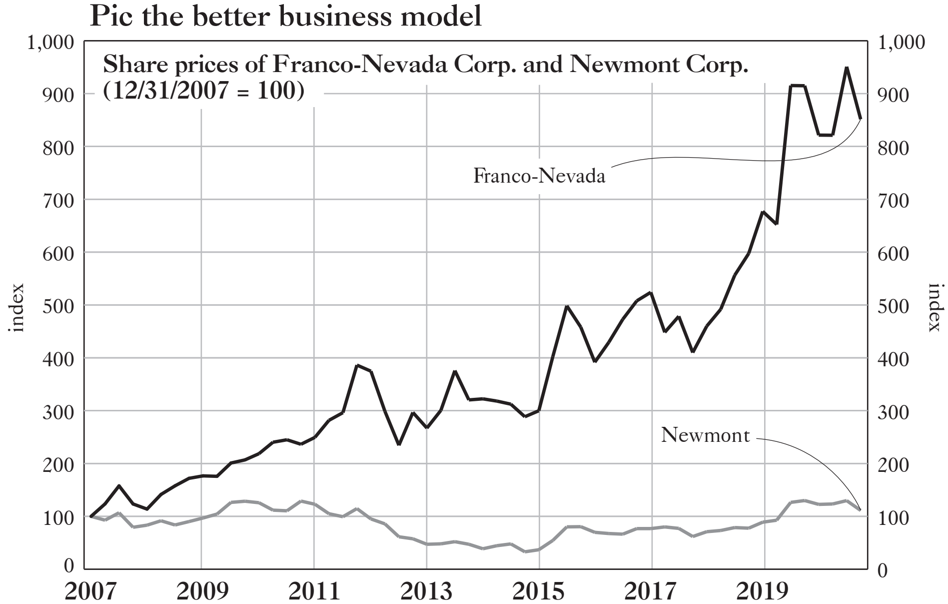
The perfection of the business model was not so evident in 1985 when Seymour Schulich and Pierre Lassonde raised $2 million in a public offering for the company they founded, Franco-Nevada Mining Corp., Ltd. Sell us a percentage of the value of the future production of your property, they proposed to capital-needy miners, and we will collect a revenue-based royalty while you bear the geological, operational and financial risks (expropriation risks would be shared if they arose). If, the pitch continued, the mine on which we hold the royalty agreement proves to be longer-lived and more productive than it first appeared, we'll pocket our contractual share of that increment. And if the gold price should happen to rise, we'll bank that windfall, too.

"Yes," said the first royalty customer, Western States Minerals Corp., in 1986. Franco-Nevada bought 4% of the revenues of a small Nevada mine for $2 million. "It was, indeed, a small piece of land," Lassonde affectionately recalls. "Less than a year later, Western States sold out to Barrick [Gold Corp.], which promptly discovered the now famous Goldstrike mine. The royalty has paid out $1 billion and is still very much operating. With the current mine plan and gold price, we see total payout of over $1.5 billion...for a $2 million investment....It's the best deal I've ever made in my lifetime."

By 2002, Franco-Nevada had sold itself to Newmont Corp. for $2.5 billion. Restless under the new regime, Schulich, Lassonde et al. in effect reacquired their business in 2007 at a cost of $1.2 billion. Today, the post-Newmont Franco-Nevada, with a stock market capitalization of $25.8 billion, is the undisputed leader of the streaming and royalty industry of which Triple Flag is a recent, but by no means the newest, entrant. As for one of the undisputed champions of all monetarily themed business models (except, perhaps, for the Fed's), please compare the share price of Franco-Nevada 2.0 with that of Newmont over the past dozen years. To simplify only a little, producing miners bear the risks while the coupon-clipping streaming and royalty recipients earn the rewards. What remains to be seen is if the newcomers can begin to measure up to the Midas standard of Franco-Nevada.

The first thing to know about Triple Flag is the headcount. The number is 12. The second thing is that, because the company bears no operating costs,

Pic the better business model



source: The Bloomberg

operating cash flow and free cash flow are one and the same. The third thing to know is that the CEO's three children were each born in a different country. This is a fact that reveals a) the source of the Triple Flag corporate name and b) how peripatetic is the career path of a top executive in the industry in which the Triple Flag CEO, Shaun Usmar, age 51, has spent 25 years.

Born and educated in South Africa (and, later, at the Kellogg School of Management at Northwestern University, Chicago), Usmar spent time at BHP Billiton plc, Xstrata plc and Barrick before founding Triple Flag. As the CFO of Barrick, from 2014 to 2016, he helped to restructure that company's notoriously overleveraged balance sheet. It's probably no accident that Triple Flag is debt-free.

Founded in April 2016, TFPM went public in May of this year, issuing the 15% of shares that the original investors and executive team did not possess (Elliott et al. hold 80%, the insiders, 5%). The first earnings call, on Aug. 12, pertaining to the June quarter, afforded the front office the opportunity for some fact-based boasting. Thus, from a standing start in 2016, management had accumulated interests in 15 producing mines and 60 exploration and development assets. Growth in gold equivalent ounces compounded over the four years ended 2020 at a rate of 24%, fastest in the industry. However, it could not be said that Mr. Market was overwhelmed by the results. On the day of the call, the company was quoted at $600 million less than the founders' $1.7 billion investment.

The September quarter, too, invited some discreet managerial chest-pounding. Thus, revenue weighed in at $37.1 million, up from $24.5 million a year earlier. Operating cash flow summed to $29.5 million, up from $19.2 million—and, as noted, such is the nature of the sweet business model, free cash flow, too, summed to $29.5 million.

"Gold equivalent ounces" is the industry convention for presenting its top line. It's a number defined as the sum of streaming and royalty revenue divided by the average gold price for the relevant reporting period. In the third quarter, Triple Flag's GEO leapt to 20,700 ounces from 12,821 ounces the year before. Cash costs per ounce, reflecting the past year's inflation, rose by 5%, to $166 from $158, but note the attractively low base.

Optionality is the one-word secret of Franco-Nevada's success, and it's the elixir that Triple Flag, too, is searching for and, its management says, finding in some improbable places: the Altan Tsagaan Ovoo gold mine in the northeastern steppes of Mongolia, for instance.

To reach the ATO's paydirt, you fly to Ulaanbaatar, Mongolia's capital, then drive for 11 hours (or fly for two). According to James Dendle, Triple Flag's vice president for evaluations and investor relations, the opportunity came to Triple Flag from the idea network that constitutes one of the company's principal assets. Some 25 unsolicited deal proposals drop over the corporate transom every quarter, he said. The hit rate is about one in 32.

Because Mongolia is well outside Triple Flag's customary stomping ground, Dendle tells colleague James Robertson, Jr., "we were reserved in our engagement. But as we try to do, we were open-minded and started doing our due diligence and began to see tremendous merit in the project. It was really interesting. There's a few elements of optionality beyond the sort of initial mine that the company identified and we saw straightaway. The ATO project was previously owned by Centerra Gold, but they sold it. They didn't really think they could make it work. What it really took was a smaller-scale company that wasn't looking for necessarily a monster, 500,000 ounce per year mine to take it forward and develop it."

Triple Flag invested $28 million in 2017 in exchange for the right to buy a fixed share of ATO's output at a contacted price. New geological findings indicate that the opportunity is considerably bigger, and longer-lived, than originally thought. What had appeared to be a mine with a two-year life now is appraised as a mine with a 12.5-year life. The project has already returned $60 million to Triple Flag, Covid-related production problems notwithstanding, and analysts expect that the ultimate payoff will be close to $116 million.

Mine finance entrepreneurs broke no speed records in trying to duplicate the pioneering Schulich and Lassonde business model. A second royalty company, Royal Gold, Inc.,

Gold royalty and streaming companies at a glance
all values for the third quarter of 2021

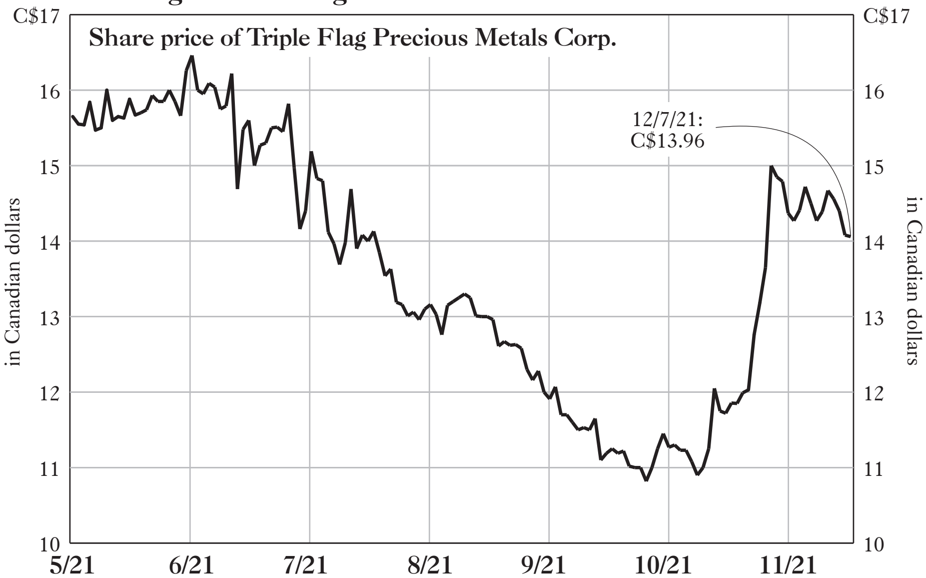
	market cap (in $ bns)	price/NAV	P/E	gross margin (in %)	GEO*	Ebitda margin (in %)	exposure to Tier I jurisdictions**
Franco-Nevada	$25.8	5.43	39.81	63.64%	146,495	85.30%	41%
Wheaton Precious	18.5	3.08	29.88	56.31	184,918	71.87	25
Royal Gold	6.6	2.82	24.49	84.39	97,400	79.12	44
Osisko Gold Royalties	1.9	1.08	27.40	67.54	20,032	41.48	80
Triple Flag	1.7	1.31	30.56	54.36	20,746	79.59	62
Sandstorm Gold	1.1	1.84	39.58	55.36	15,514	70.52	16
Maverix Metals	0.66	1.79	32.20	53.22	7,671	61.03	61

* Gold equivalent ounces mined in Q3.

** Includes the United States, Canada, Australia and the European Union.

source: company reports

Seeking more Mongolias



source: The Bloomberg

started in 1986, but it was not until 2004 that Wheaton Precious Metals Corp. (as it's called today) developed "streams," the financing method that Triple Flag employs at ATO.

A stream is an agreement to buy a share of the anticipated output of a mine in exchange for an upfront deposit and further payments at a predetermined price, or at a percentage of the market price, as the promised metal is delivered. The stream financier settles the transaction with the physical transfer of gold, silver, copper or what have you. The royalty investor, in contrast, receives contractually specified payments in cash, based (in Triple Flag's case) on a percentage of mining revenue.

The nearby table provides a sense of the scale, profitability, valuation and exposure to political risk of selected constituents of the streaming and royalty industry. Three majors—Franco-Nevada, Wheaton Precious Metals and Royal Gold—dominate the business, though not one, at last tally, employed more than 28 people. Beneath them is a trio of intermediate-size contenders, including Triple Flag. A cluster of juniors (not shown)—some, with tiny market caps, specializing in longshot plays—fills out the field. Note that TFPM's exposure to non-Tier 1 domiciles is smaller than that of any major, though larger than Osisko's.

Founded in 2014, a spinout of Osisko Mining Corp., Osisko Gold Royalties has 150 royalty and streaming agreements, 17 of which involve producing mines; Triple Flag, as mentioned, carries 60 and 15, respectively. Compared with Triple Flag, Osisko has larger land holdings and a more complicated portfolio (which retains some legacy mine-operating exposure) but produces comparable GEOs. It carries some debt, mostly in the shape of convertible bonds.

You'd suppose that competition from the likes of Triple Flag and Osisko would be compressing returns in the streaming and royalty industry. And you'd suspect, as well, that the miners, more canny about the value of the optionality of their revenue streams than they were in Franco-Nevada's salad days, would be finding cheaper alternative sources of funding than that proffered by Triple Flag et al. Perhaps, but the cost of equity capital to the gold mining industry is prohibitively high (gold stocks are historically cheap), and geological leverage mixes with financial leverage as well as oil does with water. From the miners' perspective, a stream or royalty has the advantage that one's financial obligation is denominated in the thing one actually produces—gold or silver—and not in the dollars that might or might not be available when one's debt falls due.

Besides, according to an April study by McKinsey & Co., the streaming and royalty business, despite its past half-decade of growth, "currently represents only a fraction of total equity and debt financing the mining industry: that is, an average 1% to 3% of debt and equity financing from 2017 through 2019." The consultant forecasts "significant growth" in the industry.

Optionality, the investor's prize, comes in the form of land and price alike. The more land that a streaming or royalty contract encompasses, the greater the odds for serendipity—the discovery of a new vein of ore or an entirely new deposit, events that, by lengthening mine life, as in the case of ATO, boost option value.

By Elliott Management's telling, the idea of Triple Flag sprang from Elliott's in-house admiration of Franco-Nevada. Paul Singer, the Elliott founder, is a hedged investor first; a value-seeking, argumentative activist investor second; and a central-bank-critic-cum-inflation-phobe only third. Seeking exposure to gold, he wanted exactly what Lassonde and Schulich had created—a "revenue entitlement, effectively, rather than a profits interest," a business so ingeniously conceived that it could run, as Franco-Nevada does run, with a head count the size of a Major League baseball team before the September call-ups.

"So it's kind of like a perfect business model," says Mark Cicirelli, portfolio manager and U.S. head of insurance at Elliott and a director of Triple Flag. "But what to do about it? Because Franco-Nevada tends to trade at 2 or 2½ or 3 times its net asset value, buying the stock doesn't necessarily achieve what we would have hoped. So, back in 2016, we decided to build our own hopefully future Franco-Nevada. And so we recruited Shaun Usmar, who at the time was the CFO of Barrick Gold. And he agreed with the vision that this is an amazing business."

Usmar, in turn, assembled a team, employees and consultants alike: mining engineers, geologists, finance people, mining-focused lawyers. "And over the past five years, Cicirelli goes on, "they built this portfolio through 17 distinct transactions, some of which were multiple assets at one time," of which three were among the 10 largest streaming deals in the industry over the past half-decade.

Some 80% of the net asset value of the company derives from operating mines, he continues, "so it's not a portfolio of speculative cow pastures that somebody might argue some day might be a mine. These are actually up-and-running mines. They're overwhelmingly in the first or second quartile in terms of their cost curve. So they're mines that will operate in almost any possible commodity price level. Mostly, they're byproducts of base-metal mines, so gold on copper or silver coming out of zinc."

But not even elegant business models manage themselves, as CEO Usmar would like to point out. He says that the stream and royalty business, though highly technical, is, in a sense, a kind of art: "No two guys necessarily will look at it the same way. People today talk increasingly about new entrants, but when we started there were new entrants from private equity. There were some out of Asia. A lot of those don't exist any more."

A striking feature of Triple Flag's Nov. 11 slide deck is a segment projecting 10-year production trends. If you, too, discount the 10-day forecast on your weather app, you might ask which of the dozen Triple Flag employees serves as corporate clairvoyant.

Actually, says Usmar, the 10-year guidance assumes only that the stream and royalty portfolio in place today continues to generate the cash flows it is expected to make in 2022. It's a kind of demonstration, he continues: "What we wanted to demonstrate is, you can see our track record as we've emerged. We built that from scratch. You can also see that's the highest compound annual growth rate in the sector—24% from inception to 2020.

"You'll see the sort of ongoing growth that's embedded before we transact," Usmar goes on. "You can see what we've done in the past five years. There's a reasonable chance we can continue to add to that. That profile is essentially funded, with around a $45 million funding obligation in the 6- to 10-year horizon, which is like a quarter-and-a-half of cash."

Triple Flag shares yield 1.74%, highest (by a couple of dozen basis points) in the group.

For better or worse, the Triple Flag front office is keenly attuned to its share price. On the third-quarter conference call, Usmar admitted that, at a daily average trading volume of 25,000 shares, the market in TFPM is far from liquid (only 8.5% of the issued and outstanding shares are in public hands). Even so, the board has authorized a small buyback program, and he acknowledged the incongruity of removing shares while, at the same time, striving to improve trading depth.

An analyst asked, in so many words, if the company would entertain a takeover bid. "We're not an entrenched management, plain and simple," he replied. And he said this: "Ultimately, there needs to be a better reflection of just some of our intrinsic value."

Between the proven ineptness of the Federal Reserve and the demonstrated competence of Triple Flag, we would say that, in the long run, the share price should take care of itself.

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