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Mine disaster

On Monday, Jan. 30, shares of New Gold, a middling-size Toronto-based mining company, opened at $3.66 and closed at $2.94. Next day, the same stock (NGD in Toronto and New York) opened at $3.05 and traded as low as $2.39. From Monday's peak to Tuesday's trough, the shares gave up $671.7 million in market capitalization, or 36% of Monday's initial value. Gold is the topic at hand, the metal and the accident-prone NGD. In preview, we remain bullish on the metal. As to the shares, they are lemons. Speculation on lemonade to follow.

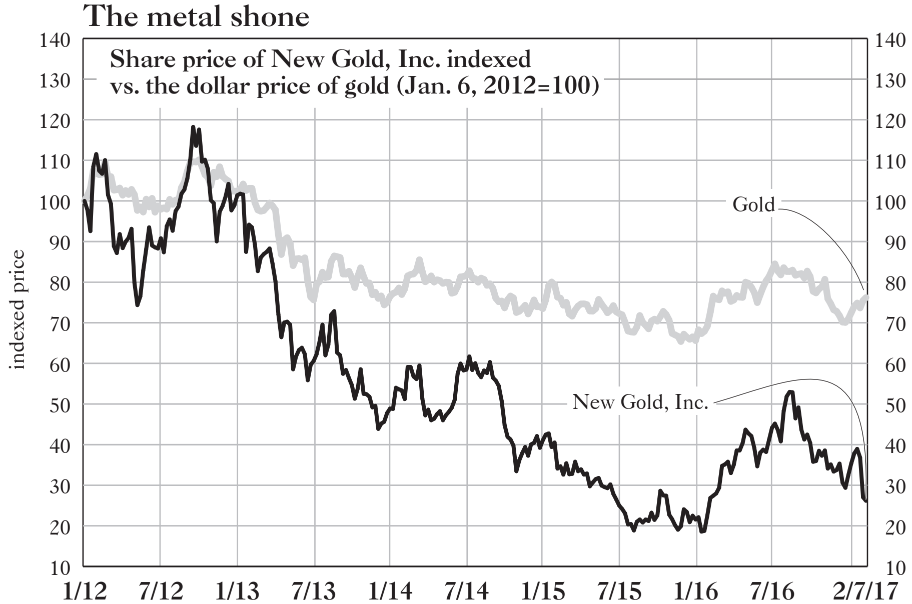
New Gold has featured in these pages more than once (see, for instance, the issue of June 13, 2014). It features, too, in your editor's investment portfolio. We have thought of the company as a low-cost, option-laden play on the mismanagement of the world's monetary system. Vexingly, lapses at New Gold itself loom larger today than do the ones at the Federal Open Market Committee.

New Gold's latest troubles are concentrated at Rainy River, a costly, development-stage, open-pit project in northwestern Ontario, now (supposedly) in its final phase of construction. When completed, the mine is expected to double the company's "annual cash flow and double our average mine life." The words between the quotation marks belong to the former New Gold executive chairman, Randall E. Oliphant, speaking on the Oct. 28, 2016 earnings call. He departed last week, a sacrifice to the news that costs will run almost $200 million over budget and that mining operations will begin in September, not June, as Oliphant himself indicated as recently as that October call.

It fell to the brand new CEO, Hannes Portmann, to speculate on the financial consequences of Rainy River's delayed start and continued cost overruns. He said—addressing analysts on Jan. 30—that a financial hole in the sum of $195 million would have to be plugged, and he reviewed some courses of remedial action. They include an asset sale, the monetization of future mine production (as in a royalty-streaming arrangement) and the sale of subordinated debt or issuance of new equity. S&P Global Ratings chimed in with a downgrade of New Gold's corporate credit rating to B from B-plus and a demotion of the ratings outlook to "negative." The agency, citing reduced liquidity and, hence, greater susceptibility to future cost overruns, touched on the management-credibility issue which Mr. Market was at that moment attending to in his own inimitable way. At his maximum displeasure with NGD, the old gentleman was exacting a $600 million penalty for a $200 million problem.

New Gold owns four producing mines, one each in Canada, the United States, Australia and Mexico (the latter, called Cerro San Pedro, is nearing the end of its working life). The company has a second Canadian development project, besides Rainy River, called Blackwater, in British Columbia, as well as a 4% gold revenue-streaming interest on the El Moro project in Chile (of which Gold-

The metal shone



source: The Bloomberg

corp, Inc. and Teck Resources are the equity holders).

Last year, New Gold produced 381,663 ounces of gold, 1.3 million ounces of silver and 102 million pounds of copper. For the trailing 12 months through September (full-year figures are due on Feb. 15), the company earned $13.6 million, or $0.02 a share, on revenue of $712.5 million. Third-quarter earnings before interest and taxes ($17.7 million) covered interest expense ($13.5 million) by 1.3 times.

We just called the difficulties that sank the share price a "$200 million problem." There are risks other than Rainy River. One is the price of copper. When the simmering Chinese credit crisis finally reaches a boil, base-metal prices could tumble (*Grant's*, indeed, is expecting such an occurrence; see the issue dated Jan. 13). Copper revenue contributes between 25% and 30% of New Gold's top line.

Inherent in any mining operation is the risk of a malfunction in Mother Earth herself. At Rainy River, underground ribbons of peat and clay, gravel and boulders (so-called peat and basal till) have raised costs and set back construction. On the Feb. 18, 2016 earnings call, an analyst pointed out a potential geological issue at the New Afton copper and gold mine: "The press release," he noted, "talks about stabilizing the tailings pond . . . . [W]hat kind of risk might be involved with that?" Discussion of "dewatering" and the "propagation of the post cave for C-zone" and subsiding soil duly followed. Management admitted to no material problem then (such as might imperil the viability of the mine or require new millions for capital outlays), nor does it today: "I have just spoken to our Geos," a spokesperson tells colleague Harrison Waddill, "and there are no land-subsidence issues at New Afton."

Anyway, New Gold is a problem child. So much potential, yet—in the moment—such disappointment. Will little Johnny ever grow up to become a profitable member of gold-producing society?

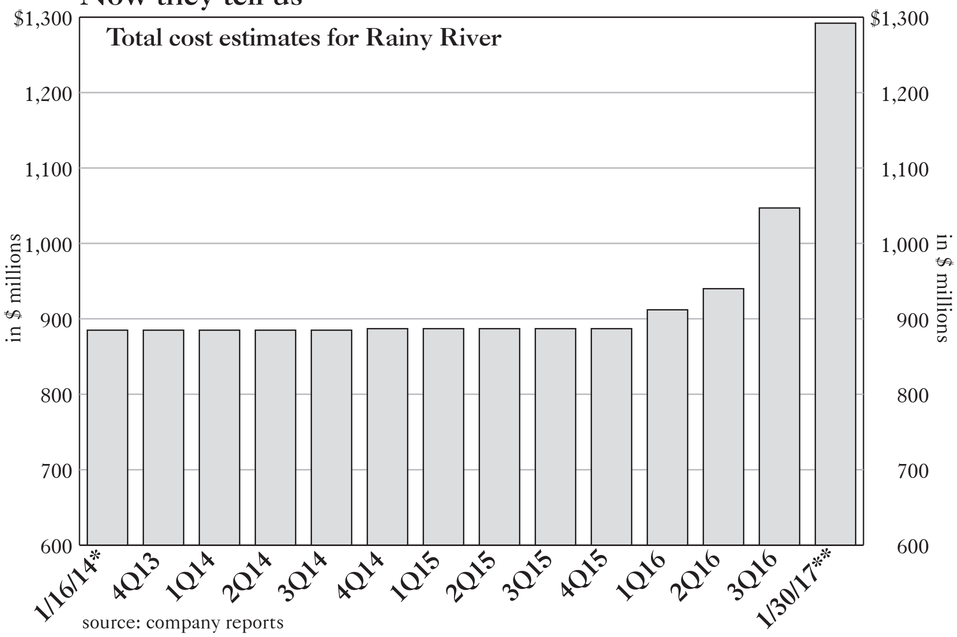
Neither Wall Street nor Bay Street seem to hold out much hope (out of 17 analysts polled by Bloomberg, three say "buy"). The stock was no universal favorite before the Jan. 30 bombshells. The delays and cost overruns have exhausted many a well-wisher and hardened many a doubter. "My instinct," a knowledgeable gold investor emails us: "Be careful as all is not well here. Big cost overruns and lack of ready cash to meet them." We heard much the same from others just as experienced. Certainly, New Gold would have made an exquisite sale in June at $6 a share. Today, at $2.83 a share, might it not make a speculative purchase?

Your editor, sitting on a largish position and not inclined to sell (not before telling the noble readers of *Grant's*, certainly), is perhaps over-eager to make lemonade. If he is wrong to hold on, it will be because, as the ancients said, "the first loss is the best loss" or "an object in motion stays in motion." If he is right, it may be on account of a sudden, providential lift in the gold price, i.e., blind luck. Or, perhaps, because of reasons adduced by Pierre Lassonde, chairman of Franco-Nevada Corp., a one-time vice chairman of Newmont Mining Corp. and a former New Gold director (he left the board early last year).

Lassonde kindly came to the phone to talk. He says that he's still a sizable NGD holder and that he's heartened by the Jan. 30 management changes: "The board did what had to be done and held the CEO accountable. Hannes Portmann [Oliphant's successor] understands very well that accountability has to be back as priority No. 1. From what I understand, in his first few days in office he's already taken action. They've let go/replaced people. That actually started a month ago (I just found out). They let four people go at the mine site about a month ago. They've replaced them. They've hired what I call a German shepherd, a former SNC-Lavalin construction manager who is a real toughie [his name is Pierre Légaré]. Every penny that goes out, he sees it. So they've finally got someone with backbone, and the $200 million overrun [includes] $40 million of contingency because they just don't want to miss the mark this time around. So the odds are that it may not even be as bad as they told the Street."

The stock is cheap, Lassonde asserts. Certainly, it is cheaper than it was. Gold miners rarely look cheap on conventional metrics, and New Gold—at 57 times trailing net income—is no exception. With proven and probable reserves of 15 million ounces and an equity market cap of $1.4 billion, NGD changes hands at $96 per reserve ounce. Among 46 miners ranked on this criterion by Gold Stock Analyst, NGD is the 11th cheapest. Of course, proven and probable resources are not the same as gold. Nor is equity market cap identical to enterprise value (equity plus net debt). You could appear very cheap indeed if you leveraged yourself to the breaking point.

Now they tell us



source: company reports

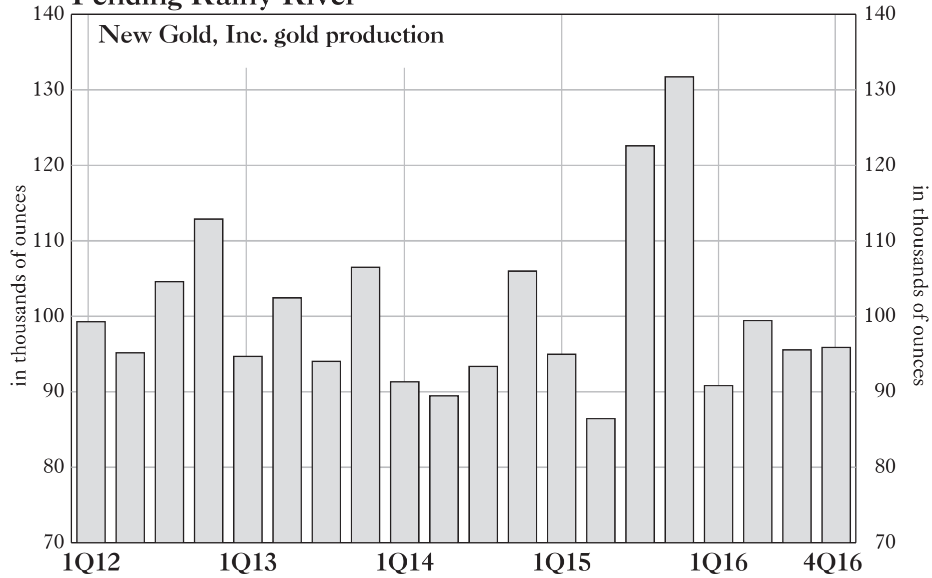
* feasibility study
** FY17 guidance

On the bullish side of the ledger, the world isn't finding much gold, especially in Canada. According to the new Tocqueville Gold Strategy letter, discoveries of gold ore bodies are at their lowest in 25 years, "while the time required to bring new ore bodies into production continues to lengthen, and now stands at nearly 20 years." Would no one want to buy Rainy River and all that comes with it?

"There are a number of companies that would look at it, and I'll tell you why," says Lassonde. "It's a very attractive company for a couple of reasons. One, it has growth built in. Rainy River will deliver a minimum of 350,000 ounces a year, and the reality is that the mill is overbuilt. It's part of the cost overrun. They just overbuilt the mill. So it will do more than that. It might even do 400,000 ounces. So how many 400,000-ounce projects can you get under your belt in the next year? Two, [New Gold] has another project with 10 million ounces called Blackwater. Now Blackwater does need $1,500 gold, but you're paying almost nothing for that optionality of 10 million ounces at $1,500 gold. Then you've got New Afton, which is an asset that, at these copper prices, is cash-flowing $120 million to $150 million a year." Nor is it any small thing that each of these assets is situated within the confines of the rule of law.

The first order of business is to plug that nearly $200 million hole, all may agree. If management were in a big hurry, says Lassonde, it could sell stock in a week. A royalty deal, say, on Blackwater, would take a month. The sale of the Australian assets, which might fetch $200 million to $250 million, could be done within three months. To make haste deliberately is the key: "The faster they can do that, the better positioned they'll be to deal with a bid that comes over. Because then they can probably do a 35% to 40% premium, but if they do it at $3.50 instead of $2.70, you can get $4-plus. At these prices now, you take 35% on top of that and you're talking the low threes. I think the first number has got to be a four, minimum." Which might be as much lemonade as the oval yellow fruit has to give at the current gold price.

Pending Rainy River



source: company reports

The premise of every gold speculation is that fiat money will depreciate against the senior precious metal. This publication believes it—it's an historical fact. Still, there are facts and facts. At some junctures, little cyclical truths count more than the big permanent ones in the market's scales.

With regard to the gold price, the eternal question is confidence. Do money-holding people trust the authorities to keep monetary depreciation in check—say, to a rate of change comparable to that of the warming water in which the proverbial frog is boiled to death? A stable or declining gold price expresses confidence or complacency. A rising one, the opposite.

See the afore-quoted letter of the Tocqueville Gold Fund for new reasons to buy the asset which that fund is in business to be bullish on. Cited, among other things, is the rising demand for gold as a settlement currency; the recent creation of a Sharia gold standard by the Accounting and Auditing Organization for Islamic Financial Institutions and the World Gold Council ("innovative and revolutionary," Mark Mobius, the Templeton emerging-markets investor, was quoted as saying of this potential new source of gold demand); and the tightening physical bullion market. As to the latter, Tocqueville relates, "GLD, the largest gold ETF, resorted to borrowing 29 metric tons in 1Q2016 from the Bank of England to connect the inflow of money flows with the physical metal necessary to back the trust instrument."

On top of which we would cite the national pension-funding crisis, which burst back onto the front page with news that the big California teacher fund, CalSTRS, is following the lead of CalPERS in reducing by 50 basis points (in two semi-palatable 25 basis-point gulps) its assumed rate of investment return. Taxpayers, teachers and California municipalities will be reaching deeper into their none-too-well-padded pockets to help narrow the widening actuarial funding gap.

There were reasons enough to seek a time-honored hedge against monetary disorder before America elected a man who might be regarded as the avatar of tail risk. We remain bullish on gold and even—with as much hope as confidence—on lemonade.

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