

# GRANT'S

INTEREST RATE OBSERVER®

Vol. 31, No. 2b

Two Wall Street, New York, New York 10005 • www.grantspub.com

JANUARY 25, 2013

## Gold by the share

For the unwanted title, “Most Forlorn Hope in Investing Today,” *Grant's* confidently nominates the four little words, “Gold stocks will rally.” In 2011, the gold price advanced, but the Philadelphia Stock Exchange Gold and Silver Index fell—by 20.2%. In 2012, the gold price also advanced, but the XAU again declined, by 8.3%. Now unfolding is an investigation into the persistent divergence between gold and the companies that mine it. For bullish special mention, we single out a pair of speculative exploration companies, Northern Dynasty Minerals (NAK on the New York Stock Exchange, NDM in Toronto) and Pretium Resources (PVG in both New York and Toronto).

The trouble with the gold-mining business, writes former President Herbert Hoover in “Years of Adventure,” the first volume of his superb three-volume memoir, is that it hasn't paid, it doesn't pay and it won't pay. A mining engineer at the turn of the 20<sup>th</sup> century (he was president for a single joyless term beginning in 1929), Hoover contended that “gold mining is an unprofitable business in any country.” Especially unprofitable is gold mining in the countries that steal the mines.

Fast forward now to the July 2012 appearance of Nick Holland, CEO of Gold Fields Ltd., before the Melbourne Mining Club. Gold mining, Holland declared, is “suffering from a management credibility discount.”

Investors in the room must have felt a strong urge to cheer. “What Do Investors Want from a Gold Mining Stock?” was the title of Holland's talk, and he answered his own question:

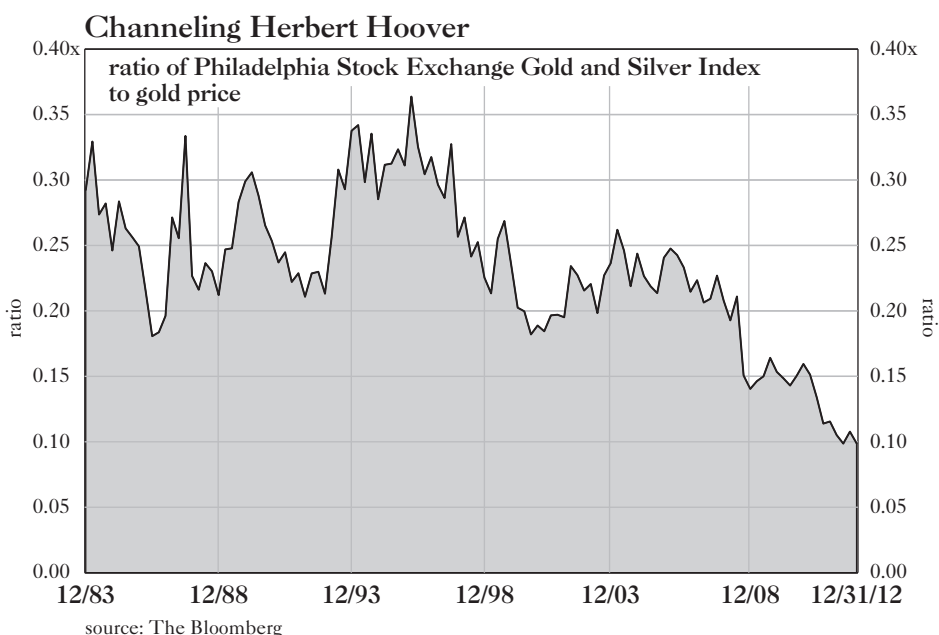
Why, to gain leverage to the gold price through enlightened management of operations and capital. How poorly have eight major producers—Anglo-gold Ashanti, Barrick Gold, Goldcorp, Gold Fields, Harmony Gold Mining, Kinross Gold, Newmont Mining and Newcrest Mining—delivered the goods was the focus of his remarks.

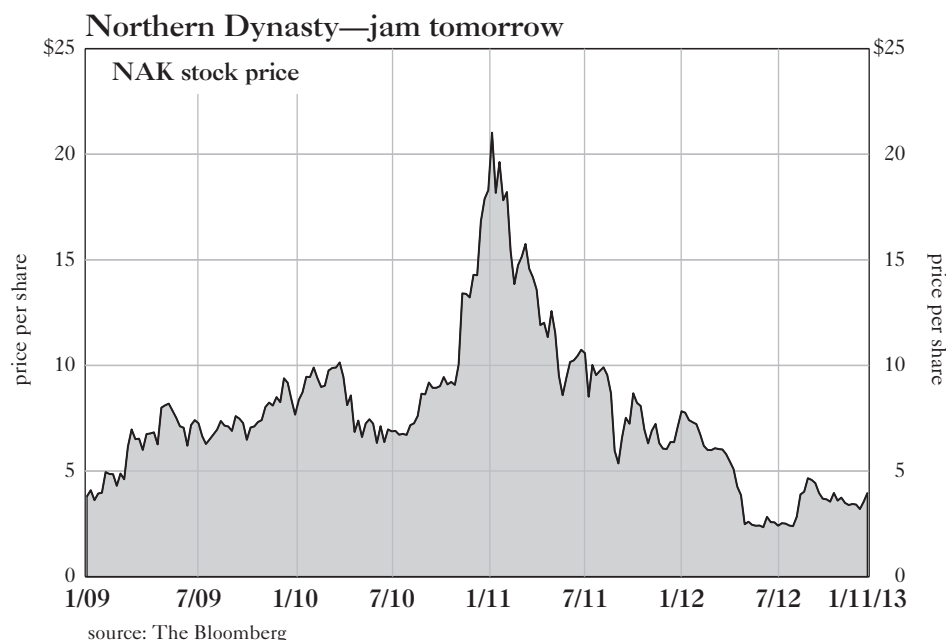
“I've been going to investor conferences over my last 15 years at Gold Fields,” Holland led off, “and there's one consistent theme in the presentations of all of the large gold producers—including us—that production is going to the moon. But if we had actually met all our production promises over the last five years, then we would not have dropped output on a compound annual

basis by 2% between 2006 and 2011”—a period, he added, when smaller producers bumped up their production by 6%.

Neither have the majors fattened their margins the way they ought to have done. Between 2006 and 2011, the miners' EBITDA grew at a compound annual rate of 8%, while the gold price sprinted ahead at a compound annual rate of 21%. Still less, Holland continued, did the managements wisely apportion the owners' capital. Between 2002 and 2011, as the gold price advanced by 20% a year, spending on mergers and acquisitions on a dollar-per-ounce reckoning compounded by 17%, while capital spending per ounce zipped along at a compound annual rate of 32%.

The majors might not be so adept





at gold production, Holland went on, but they are masters at multiplying their share counts. Thus, since the first quarter of 2008, the XAU has lost 1.8% per year, while the number of shares outstanding at the eight big miners has grown by 5.4% a year. “Investors are fed up with promises of jam tomorrow,” Holland concluded, “and they are sending that message to the industry.”

To judge by the recent spate of write-downs and sackings (at Rio Tinto, CEO Tom Albanese walked the plank on account of a \$14 billion erasure of corporate value), the helpful message might be getting through. But another, less helpful message is also apparently registering on the collective investment brain, namely that the gold bull market is kaput. Goldman Sachs’ Jan. 16 prediction of a price of \$1,200 per ounce by 2018 is a sign of the times. The miners have struggled with rising metals prices. How would they fare with falling metals prices?

They won’t have to, we believe. Because, in our opinion, the great monetary drama is still unfolding, the bear market in fiat currencies—i.e., the bull market in real money—has further to go. Possibly we are wrong about this; it’s an opinion. But there’s no arguing about the state of morale in the gold-stock investing world. It’s at rock bottom. What better setting, inquires colleague Charley Grant, to seek out expert guidance to identify a pair of possibly underappreciated mining shares?

Trey Reik, chief investment officer of Bristol Investment Partners,

is our expert—he’s been investing in gold and gold-mining shares for the past decade—and the aforementioned Northern Dynasty Minerals and Premium Resources are his picks to click. They’re ours, too.

Northern Dynasty’s claim to fame is that it’s the co-owner of an immense, if undeveloped, gold and copper deposit in a peaceable and seemingly law-abiding part of the world—the United States. The question is when, if ever, production will begin.

The resource in question is the Pebble Project, situated near Iliamna, Alaska, 200 miles southwest of Anchorage. Mineral deposits are defined in different ways, one of which is “measured and indicated resources.” An M&I deposit is one that’s been sampled to a point that an estimate can be made with a reasonable degree of confidence. By this reckoning, Pebble holds 67 million ounces of gold and 55 billion pounds of copper. Under the heading of “inferred” resources, a more hopeful category, Pebble contains another 40 million ounces of gold and 26 billion pounds of copper.

“This apparent and hypothetical treasure sits on state-owned land,” Grant relates, “and the land is zoned for the purpose of mineral exploration and development. However, ‘zoned for development’ is not at all the same as ‘being developed,’ or even ‘about to be developed.’ Cominco, now Teck Resources, explored the property from 1988 to 1997. Northern Dynasty secured the mineral

rights in 2001; it obtained 100% ownership in 2005. Two years later came the partnership with Anglo-American. Management says it hopes to secure a permit to produce by 2016, meaning that production might begin in three to four years. Northern Dynasty has an equity market cap of \$366 million.

“In exchange for its 50% interest,” Grant continues, “Anglo must invest \$1.5 billion in the project. ‘The fact of the matter is,’ Doug Allen, vice president of corporate communications for Northern Dynasty, tells me, ‘Northern Dynasty doesn’t have to raise equity, in good markets or bad, because we have this amazing partnership with a significant major who is committed to the project. We like to say very simplistically [that] we have two key assets: We have the world’s largest undeveloped gold resource and the world’s largest undeveloped copper resource. That’s asset No. 1. The second major asset we have is the partnership. They get the right to maintain 50% of the project upon investing \$1.5 billion, and it’s an all-or-none investment. If they spend \$1 less than \$1.5 billion, they get zero percent.’”

The Northern Dynasty share price, now quoted at \$3.88, up from \$2.27 in mid-June, topped \$21 in February 2011 on news of the completion of the so-called preliminary economic assessment, as required by law. But the stock market wasn’t the only party that noticed the passing of this corporate milestone. The Environmental Protection Agency perked up its ears, too, and before long there was a Robert Redford-narrated condemnation of the Pebble Project posted on YouTube.

If the market “hates uncertainty,” what must it make of a long-dated mining venture that, if it ever comes to fruition, will deliver its gold and copper into a world that, according to Goldman’s crystal ball, will have long since come to love paper money and the eggheads who print it?

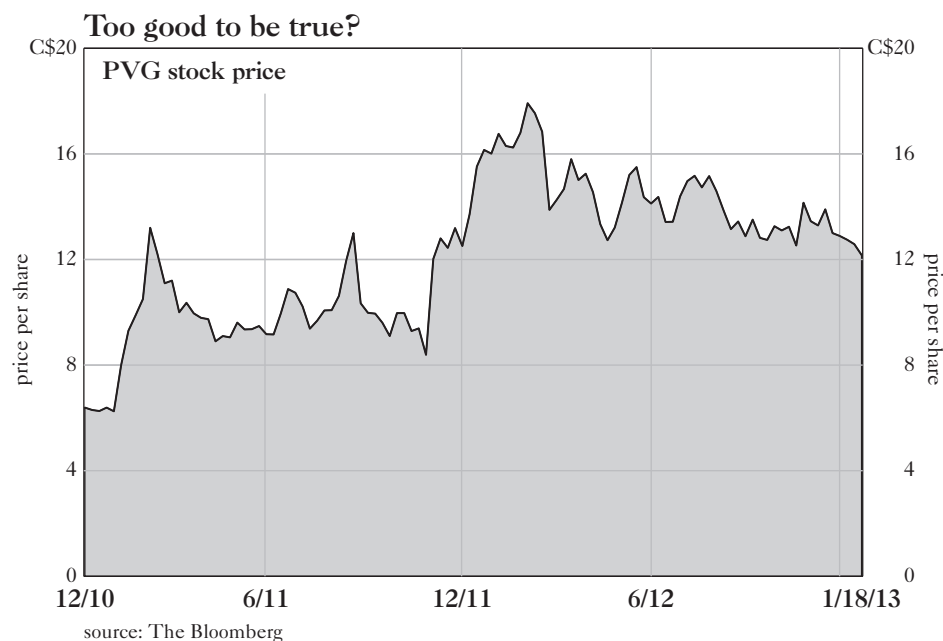
“I think the simple fact is there’s a high level of skepticism in the minds of investors as to whether or not Pebble can get a permit,” Allen says. “And we believe we can, because, ultimately, we believe the fishing industry and the mining industry can safely co-exist. . . . [W]e think the fact that the project is on American soil, under American rule of law, will mean that, long term, the project has excellent viability in terms of the issue of tenure,

and in terms of the rule of law and its application to resource development.”

Here is a most generous interpretation of American regulatory procedure. Under the 1972 Clean Water Act, as we understand it, the federal review of a mining project is the sole responsibility of the Army Corps of Engineers. But the EPA can review the Corps' work and, for cause, revoke a Corps-granted permit. It seems that the EPA, under its former head, the greener-than-green Lisa Jackson, tried to do pre-empt the authority of the Corps in advance of a permit application, although the agency has failed to persuade many disinterested observers that it has a sound environmental case to make. The study it submitted against the Pebble Project took 15 months to produce at a cost of perhaps \$1 million and covers—in conceptual fashion—20,000 square miles of ground. In contrast, the Pebble Project's internal environmental study took seven years to produce at a cost of \$150 million, and it zeroes in on just 400 square miles (apparently, the relevant 400 square miles). Sitting here on Wall Street, we don't pretend to know if the EPA's study was as weak and “misleading” as certain of the agency's own consulting scientists labeled it. Rooting for gold and for Northern Dynasty, we are inclined to award this regulatory round to the company.

Reik calls Northern Dynasty, in which his firm owns a 3% interest, “the ultimate call” on the future of North American gold mining. “And gold,” he adds, “does not need to trade at \$2,250 for NAK to triple. If gold, in fact, as I expect, goes to \$2,250, all the better, because that is what will bring enthusiasm back to this sector.”

Pretium Resources, the other Reik pick that caught our fancy, is a \$1.15 billion market-cap exploration company based in British Columbia. Pretium is the owner of the evidently fabulously rich Brucejack-Snowfield projects, situated in northwest British Columbia. Reik characterizes it as “perhaps the highest-grade gold discovery of the past four decades.” Pretium was founded by Robert Quartermain, the former chief of Silver Standard Resources and now the



president and CEO of Pretium. Quartermain says he came out of retirement just to buy his former company's gold assets.

“I've been in the business for 35 over 35 years,” Quartermain tells Grant, “starting back in 1977 exploring for gold in the Northwest Territories of Canada, so during this career I have sat on a lot of drill rigs, have run companies. . . . But I'm a professional geologist by training, and an exploration geologist, creating shareholder value through discovery. I had retired in 2010, and then a few years ago, Silver Standard subsequently decided to sell this asset, which we call the Brucejack-Snowfield projects, and they had a couple of high-grade hits then. And back in 2009, one of the early holes had hit on the order of about 16 kilograms of gold per [metric] ton over a couple of feet, and that was enough to tweak me. So when they decided to sell it, I decided to buy it.”

Quartermain, though not exactly a disinterested observer, says he's never seen a deposit quite so rich as Brucejack. In November, Snowden Group released a study that reclassified 3.5 million gold ounces within the deposit to “measured and indicated” from “inferred”—a nice promotion.

The test results to date have been good enough to invite disbelief. Then

there's the small matter of finance. “We're in a capital-intensive business,” Quartermain concedes. “We're [a company] that needs to continue to access the capital markets as we continue to evolve the Brucejack project through to production.” To put the property into production will cost about \$436 million, according to the latest estimate. “Now we continue to refine that,” he says, “but we can do that either by debt, possibly some equity, but since we as a management group own almost 5% of the company, we're very careful to access the capital markets only when we need to.”

“Jam tomorrow,” indeed; not exactly a winning concept in a market so disbelieving as this one. To try to allay concerns that the drill results are simply too good to be true, or that the gold in the deposit cannot be mined economically, Pretium has commissioned a bulk sample of 10,000 metric tons from the heart of the high-grade area. “Pretium is an example of a company which, even without a gold-price increase, could trade at least 50% higher next summer if the bulk sample confirms Snowden's modeling of the deposit,” says Reik.

Not to mention the gold-friendly economic modeling of the Federal Reserve.

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