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Good dog

Inanimate objects, never having lived, can hardly die, though gold investments are making a stab at that morbid impossibility. Thus, the CBOE Gold Miners ETF Volatility Index registers the lowest value since its 2011 debut. At eight or so times forward cash flow, gold-mining stocks are the cheapest in 33 years, according to Scotiabank. In relation to the price of the metal, the shares are near the cheapest in 20-odd years, based on the NYSE Arca Gold BUGS Index (HUI) to gold ratio.

Now in progress is a return to the scene of our analytical crimes, with a particular focus on a pair of especially disappointing gold-mining stocks. In preview, we remain bullish on Detour Gold Corp. (DRGDF in New York, DGC in Toronto), though for different reasons than the ones adduced in the [June 13, 2014 edition of *Grant's*](#). And we turn our back on previous pick-to-click New Gold, Inc. (NGD in Toronto and New York), which has exhausted even your editor's patience (he will retain half his personal position, partly as penance but also in fear that as soon as he washes his hands of the company, it will torment him by doing something right).

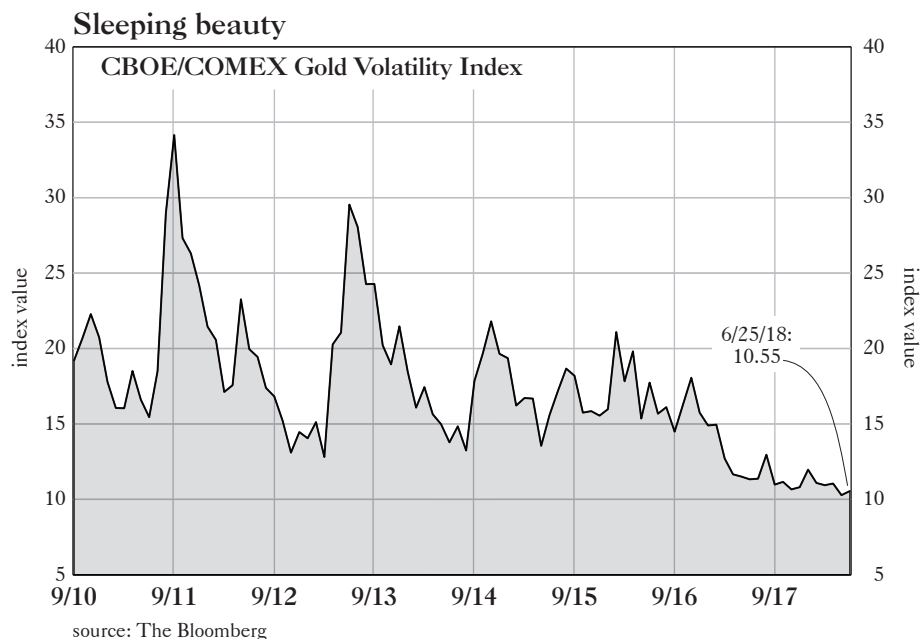
Gold is an investment in the likelihood of things not going according to plan. It's the asset for any who doubt that the central bankers can safely undo what they have done—or that politicians will forbear from spending us into the poor house. Gold is rare, unhackable and self-explanatory ("Here: This is money" suffices in many diverse cultures). Not in 3,000 years, as far as we know, has the metal

traded at zero, though the same can't be said for mining speculations.

Though they may wish it otherwise, the readers of *Grant's* need little introduction to New Gold; the Toronto-headquartered owner of the Rainy River mine in northwest Ontario featured in these pages [as long ago as 2012](#). Suffice it to say that Rainy River was always a speculation, both on the price of gold and the capacity of management to bring it to fruition. Each contingency has proven formidable. Gold production, average grade and earnings have lagged. "Guidance" from the front office (with its fast-changing cast of characters) is chronically overoptimistic. Priced at five times projected (and adjusted) earnings before interest,

taxes, depreciation and amortization, the shares look like a steal, but it's a perception filtered through undependable projections.

According to its published financials, New Gold does have some staying power. At last report, it held \$191 million in cash and \$81 million in inventory plus receivables minus current liabilities. A total of \$1 billion in debt (single-B-rated) is outstanding with \$300 million of bonds due in 2025, \$500 million in 2022 and \$230 million in 2020. Capital expenditure in 2018 is expected to reach \$250 million, which will curb cash generation. The market expects \$123 million in free cash flow this year and \$58 million in proceeds from an asset sale. EBITDA covers interest expense by 6.9:1.



New Gold shares trade at C\$2.67—near the post-financial crisis low of C\$2.52 in 2015 and far from the C\$13.88 all-time high in 2011—for a market capitalization of \$1.2 billion. Add another \$800 million in net debt, and enterprise value stands at \$2 billion.

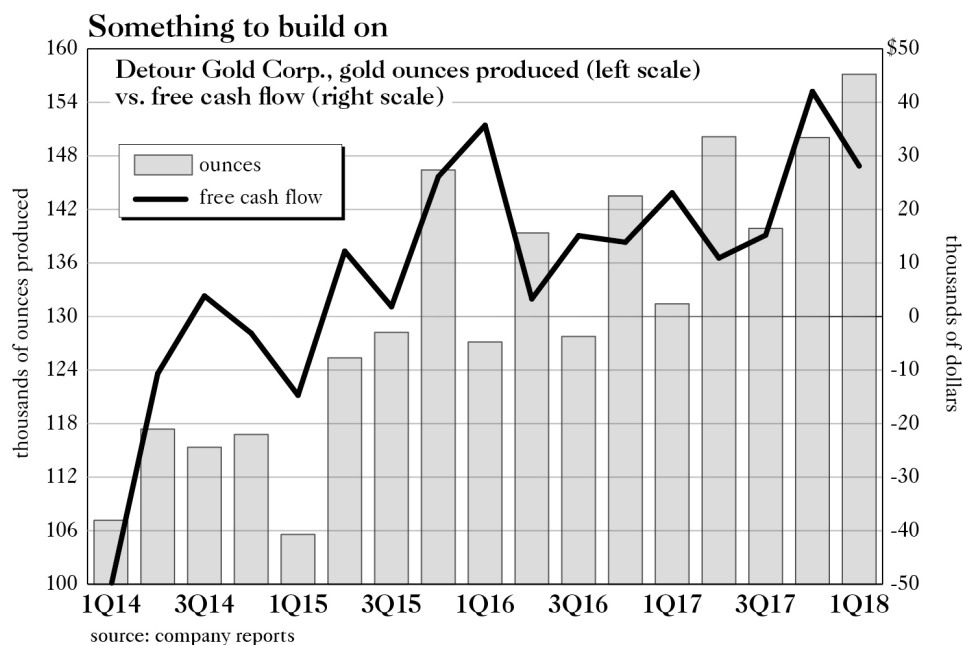
One metric of value in gold mining is enterprise value per ounce of proven and probable reserves. On this measure, New Gold weighs in at \$136 an ounce, the 15th cheapest among 39 miners tracked by the *Gold Stock Analyst*. Seven of this cohort have yet to start production. (The NGD calculation is based on 14.8 million ounces, of which 8.2 million are attributable to Blackwater, a gold mine that would cost \$2 billion to bring into production.)

Most analysts are not bullish on NGD, and the last recorded insider transaction was a sale (C\$725,040 worth by director James Estey in September at C\$4.77). Following the surprise resignation of CEO Hannes Portmann in May, Raymond Threlkeld, a member of the board and former interim COO from December 2016 to September 2017, took over. It was Threlkeld who headed Rainy River Resources Ltd. when New Gold bought it in 2013. Maybe, now, he can sell it to someone else (the debt, of course, is an impediment) or arrange for a fast, sharp, upside jolt in the gold price. The latter, preferably.

"It is not an easy business," observes Marcelo Kim, partner and portfolio manager at Paulson & Co., Inc., of the gold-mining industry. "Every year that you produce is one year less of reserve life that you have, but I would say that there are companies that do create value in this industry regardless of the gold price, and there are some stocks that over time have significantly outperformed the gold price. Given the opportunity to find some of those, that is why you ultimately decide to stay in some of these equities."

Detour does not exactly fit that description, though it has other virtues. On June 21, Kim and his boss, John Paulson, fired a rocket at the Detour board demanding that it "explore all strategic alternatives, including a sale of the company."

"We thought it would be a great vehicle to have leveraged to the gold price, but where it all fell apart was



in the execution," Kim tells colleague Fabiano Santin. Paulson got involved eight years ago. "So today, given the choice between seeing if someone is willing to pay a fair price for the asset or being stuck with a management team that will take another year-and-a-half to two years to hire a new team and build credibility with the market—we'd rather take the first option."

Detour Lake mine, a large-scale, open-pit operation in northeastern Ontario with about 15 million ounces in gold reserves, one of the largest producing gold mines in Canada, is the crown jewel. It's a low-grade (slightly below 1 gram per ton of rock) and long-lived mine that's expected to produce for another 22 years. It was 27 months in construction and has been five years in production. In the 12 months till March 30, Detour generated \$745.5 million in revenues, \$303 million in adjusted EBITDA and \$92 million in net income. The company has a \$1.5 billion market cap and shows \$107 million in net debt.

Four years ago, bulls envisioned sustainable costs in the neighborhood of \$850 an ounce. They—we—misunderestimated. Today's costs rather top \$1,000, and the company expects them to reach \$1,200-plus this year before dropping to \$975 in 2019 (management had previously floated lower figures). Like New Gold, Detour has overpromised and underdelivered. And, Detour's C-suite, like New Gold's, can't seem to stay put.

"They've got the Keystone cops running it, and in my opinion they have never gotten the kind of top-notch talent that you would need because it is not easy," a mutual-fund manager gripes to Santin. "It is a low-grade, big-scale operation, and you need super high-quality mining people to make that sort of thing work."

There's no mistaking Detour for a semiconductor fab. Managerial failures have dogged the company—missing pit equipment, heavy rainfall that delayed access to a high-grade Calcite zone at the bottom west end of the pit, a problematic conveyor belt at the processing facility, power issues with the semi-autogenous grinding mills that limited production to below its design rate—all these have increased costs and lowered cash generation. "They've lost all credibility, no one believes them, no one believes they can execute," Kim says.

Since starting production in February 2013, Detour has paid down \$265 million in debt, half of what it owed in 2014. It has done so partly by increasing free cash flow to \$91.2 million in 2017 from \$25.4 million in 2015, and partly by issuing \$123 million in equity in 2015. Liquidity is ample. A \$200 million term loan matures in 2020; another \$60 million taken under the revolver falls due in 2021.

Analysts, once bitten, seem twice shy; they're erring on the conservative side. They forecast 611,000 ounces of production in 2018 (more or less in

the middle of management's range), with costs at the upper end of guidance. Nor is Mr. Market turning cartwheels. Enterprise value is quoted at 4.8 and 5.2 times estimated 2018 and 2019 adjusted EBITDA, respectively. For comparison, Newmont Mining Corp., the world's largest gold producer, commands 8.5 and 8 times 2018 and 2019 adjusted EBITDA. With gold at \$1,250 an ounce, Detour reckons its net asset value at C\$3 billion at the lower range of estimates.

Removing C\$140 million in net debt and dividing by 176.9 million shares, Detour would be worth C\$16 a share, or 40% above the last quoted price.

So why has no one stepped up to buy it? "Generally," John Hathaway, co-portfolio manager of the Tocqueville Gold Fund and a fellow owner (and sufferer) with Paulson, "this is a very friendly, clubby space. So there is that sort of cultural overlay. The other thing is that every mine is unique. They are not cookie-

cutter assets. If you going to launch a bid, you want to be darn sure and have done tremendous due diligence on it."

Thirteen sell-side analysts rate Detour a buy and seven a hold; there are no sells. There's been no insider activity since minor purchases at much higher prices in 2017. Detour, then, resembles New Gold without the debt. A dog, but a good dog.

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