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Bid wanted—please!

Once upon a time, the phrase "gold mine" had a happy connotation, as in: "Apple Inc.—now there's a gold mine!" Lately, though, you hear the once magical words and what you're likely to think is, "margin call." Gold-mining shares are in a steep bear market. Valuations are deflated, and sentiment is coal black. Now unfolding is a bullish reappraisal.

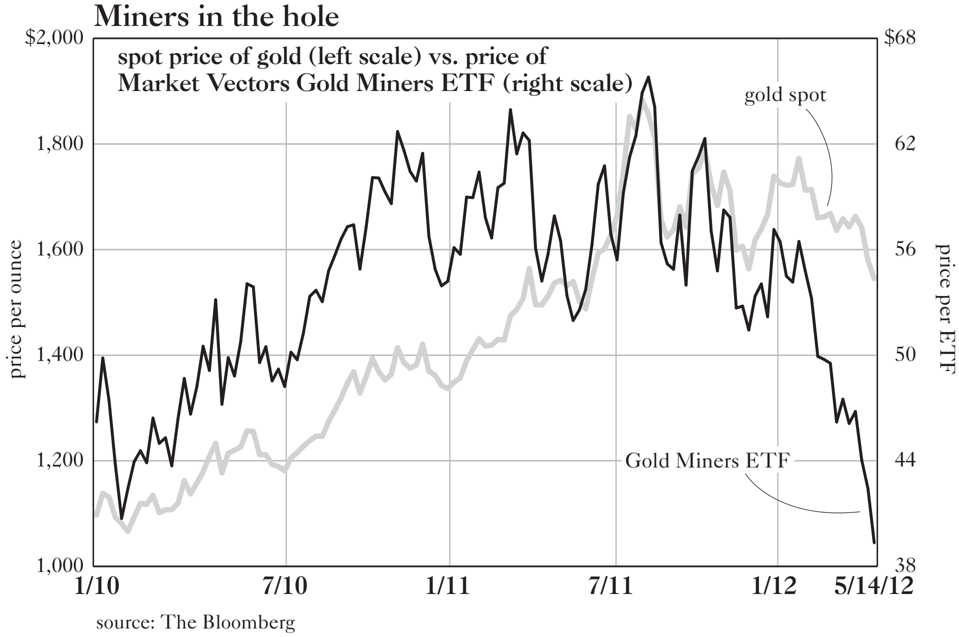
Many ask: Is the gold bull market over? We say not. It is our opinion, and we don't mean to seem dogmatic about it. Gold is a peculiar asset. In times of financial stress, sometimes people buy it—and sometimes they sell it. They sold it in the 1997 Asia crisis. They sold it in the wake of the 2008 Lehman crack-up. And they sell it these days as Washington, D.C., gains the upper hand over JPMorgan and the Indian rupee declines against the U.S. dollar. India, lest we forget, is the world's No. 2 gold consumer, behind China. As the two great BRICs lose economic altitude, Indian and Chinese gold holders may begin to use their coins and bangles and bars as sources of liquidity rather than as stores of value. "Gold has had three interim tops in this run," notes John Doody, editor of the excellent *Gold Stock Analyst*: "$725/oz. on May 12, 2006; $1,011 on March 17, 2008; and $1,895 on Sept. 6, 2011. After each, there was a pullback and a consolidation, and it took just over two years to re-reach that top, which was then followed by a march onward to a new high."

We remain bullish on gold, first and foremost because real interest rates are negative in this country and elsewhere, second because central banks are wedded to radical monetary nostrums, third because one of the world's major fiat currencies, the euro, is on the ropes and fourth because the money-printing impulse appears to be trumping austerity in Europe.

We have lots more reasons, not even counting the seasonals, which we do not scorn, the bulls needing all the help they can get. Thus: "The low point for gold during the year, just on a cyclical basis, is usually May-June. This year, I think there's an 80% chance it will stay above $1,500/oz. But there's a 20% chance that it could go below that." The speaker of those words is Pierre Lassonde, Canadian money-maker par excellence. Lassonde is chairman of Franco-Nevada Corp. (FNV on both the Toronto and New York exchanges), and a board member of New Gold (NGD on both the Toronto and American exchanges).

"Money-maker" is a phrase still more golden than "gold mine," but you rarely hear it applied to the people who manage gold mines. It is, however, applicable to Lassonde. "He is a genuine exception in the gold mining company world," Jean-Marie Eveillard, former co-manager of the First Eagle Gold Fund, told *Grant's* in 2004, "where sometimes I get the feeling that half of them are crooks and the other half are idiots."

Miners in the hole



source: The Bloomberg

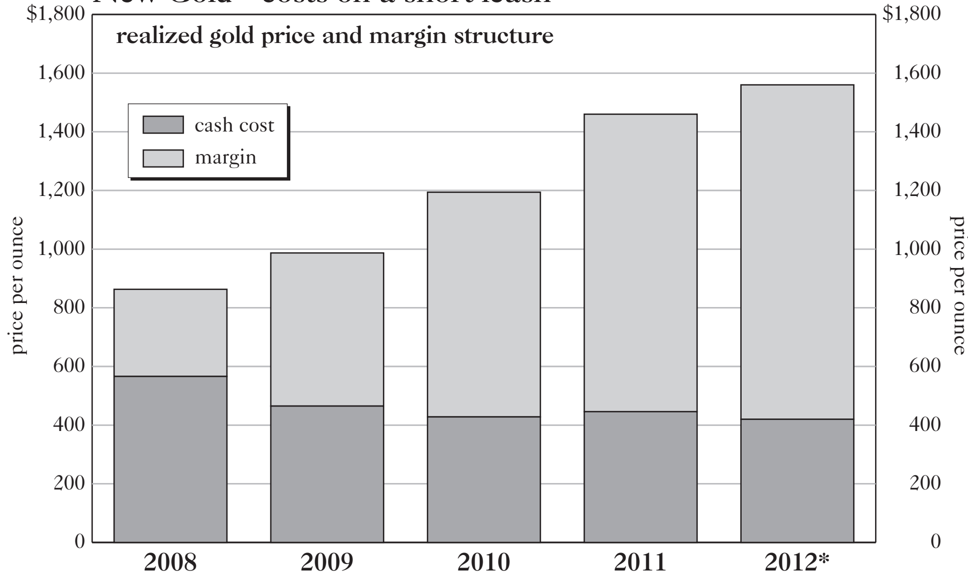
Lassonde, along with his partner, Seymour Schulich, performed the feat of making money for the investors in Franco-Nevada during that company's original incarnation, even during the gold bear market of the 1980s and 1990s. They achieved this distinction not by mining gold but by securing royalty interests in companies that did. They achieved results much less than stellar in their 2002 merger of Franco-Nevada with Newmont. But, post-Newmont, they have regained their golden touch with a second iteration of Franco-Nevada; in the past four-and-a-half years, the stock has delivered total returns of 27% a year.

However, it was New Gold about which colleague David Peligal chiefly buttonholed Lassonde on a telephone call last week. New Gold is an intermediate-stage gold producer. Unlike Franco-Nevada, it risks capital to mine for gold—and to prospect and develop new mines, and to buy up attractively valued junior-mining outfits as well. It has three producing assets, three development-stage assets and a stock market capitalization of $3.4 billion. The capitalization has been substantially higher. A $7 stock, NGD was once—as recently as September—a $14 stock. Pro forma an April sale of $300 million in 7% unsecured debt to refinance C$187 million in 10% secured notes, the balance sheet shows cash and equivalents of $326 million against debt of $382 million.

By way of preface, Peligal asked Lassonde to comment on the slaughter of the gold stocks. Blame risk aversion, came the reply. "If you look at the entire market," said Lassonde, "the majority of people are going into bonds or going into cash. They're just shell-shocked by the cherry bombs that are exploding left, right and center. And God knows that in the mining business, we've had lots of those in the past three years, in the form of capital costs explosion and operating costs getting out of hand. The public is saying: 'I don't want to hear any more about that. I'm just going to buy an ETF. All I'm going to get is an ounce of gold, but at least I know I'm going to get my ounce of gold when I want it.' So it's a huge risk-aversion choice. That's No. 1."

Peligal asked if higher dividends would mollify the cynical and disillusioned public investor. No, Lassonde answered: "It doesn't really matter whether the gold companies pay higher dividends. What they need to do is give shareholders total returns, which they haven't done. They've diluted their shares by buying companies and then the cap-ex has gone up. So they've issued more shares to get money to build their projects. When you look at total value per share, it hasn't moved in five or six or seven years. So why would you pay more today? You wouldn't. And that's been the big problem."

New Gold—costs on a short leash



*cash cost from midpoint of management's guidance, as of May 15
source: company reports

As for New Gold, its three working mines are expected to produce 425,000 ounces of gold in 2012. The assets consist of the Peak mine in Australia, the Mesquite mine in California and the Cerro San Pedro mine in Mexico. They are merely for starters, Lassonde said: "When you look at Cerro San Pedro in central Mexico, it's a nice little jewel. It was built for $80 million and cash flow is like $120 million per year at these gold prices. But it's a 10-year life, and it's only around 120,000 ounces of gold per year and about two million ounces of silver per year. It's a small mine. It's a cute little thing, but we need to take that cash flow and build from it. The same with the Mesquite mine in California. Nice little mine, fairly high cash cost, but very low cap-ex and good cash flow."

The New Gold story line isn't about cute little mines producing not quite half a million ounces of gold in 2012, though what the company has achieved in operating efficiencies is rare enough. Unusually for an industry that has suffered relentless cost inflation, New Gold has been able to stabilize and even reduce its cash costs. Credit goes both to the nature of its assets and also to the profitable byproduct commodities it produces.

The bullish narrative rather focuses on a fourth mine, New Afton in British Columbia, which is slated to begin production this summer, and more particularly on a pair of mines still in development. They are the Blackwater project in British Columbia, the prospective crown jewel, and 30%-owned El Morro in Chile. "Blackwater and El Morro," Lassonde enthused—"those are two world-class assets. Absolutely world-class. They're going to be in production for 20-plus years. Very low cash costs. Blackwater will be 500,000-plus ounces per year, possibly a lot more. The exploration is far from complete. El Morro, you look at the numbers."

Paying for acquisitions with newly minted stock is a stratagem that often rewards the investment bankers more than it does the stockholders. Then, again, New Gold last year spent 59.5 million of its own shares to finance Blackwater, via purchases of Richfield Ventures Corp., Silver Quest Resources Ltd. and Geo Minerals Ltd. Here, the results to date are incontestable. "If you look at the ounces of gold at this point—it's not proven and probable because we're not there yet—but when New Gold bought Richfield, Blackwater had approximately 2.0 to 2.5 million ounces of resources indicated," Lassonde said. "Today, depending on the cutoff grade that is used, between the Blackwater deposit and the adjacent Capoose property that were acquired under these three transactions, there's over 10 million ounces of gold equivalent. In the last year, the company has spent close to $75 million drilling. So a lot of money put into drilling these deposits, but we've almost quadrupled the ounces of gold in the ground. Obviously, it's been a very accretive acquisition for the shareholders of New Gold."

Growth is what a certain kind of gold-stock investor demands, though the market nowadays seems impartially hostile to all gold stocks, the ones that grow and the ones that don't. Reached by phone, Schulich said he felt that even when managements attempt to grow, the lengthening interval between permitting and the start of production also weighs on valuations. Anyway, until Blackwater and El Morro make their scheduled production appearance in 2017, thereby doubling the company's gold output to one million ounces a year, growth may be at a premium at New Gold. And until the forecast acceleration in gold production does occur, copper will be contributing something like one dollar in four to the corporate top line. Inasmuch as base-metals earnings command an even lower multiple in the market than do gold earnings, such a high copper contribution to revenue is another burden that NGD is lugging around.

"Management is very aware of the profile of the company," Lassonde said in response to Peligal's growth question. "We're going to have growth in 2012. And we're going to have growth in 2013, because New Afton will have less than six months of production in 2012. Next year will be a full year for New Afton." Over its estimated 12-year life, New Afton is projected to yield an annual average of 85,000 ounces of gold and 75 million pounds of copper. At current prices, such output would deliver $255 million of after-tax cash flow per annum, more than doubling existing cash flow.

"At this point," said Lassonde, continuing on the growth theme, "it looks like 2014 and 2015 will be flat. Hopefully, in 2016 and 2017, El Morro and Blackwater will come in sometime in that period. That would represent very strong growth. So there is likely to be a two-year flat spot. However, just to give you the opportunities inside the company, at Blackwater the company now has 900 square kilometers of land. Between Blackwater and Capoose, there's a trend there of about 25 kilometers that has never been explored. It definitely looks like there is a trend there. For 2012, we're going to spend $100 million in exploration in that camp. This is a significant amount. The story in that camp is far from being finished. It could provide a lot more growth in the meantime in terms of resources and reserves.

"In El Morro," Lassonde proceeded, "they haven't drilled there since the times of Noranda, about six to seven years ago. Goldcorp just started to drill again, so I think you're going to see a significant increase in the reserves and resources of El Morro over the next 12 to 18 months. This should give the shares another boost. But, in terms of production, management is well aware of that."

New Gold is in the fortunate position of having the financial flexibility to act. Cash on hand, proceeds of last month's $300 million bond issue and—post Afton—annual operating cash flow on the order of $500 million—will together provide the wherewithal to seize opportunity. "I can't assure you of anything," Lassonde added, "but what I will say is that management is very well aware of it and would like to be in a position to do something."

The New Gold insiders own 15 million shares out of 462 million outstanding. Lassonde owns 6.5 million of the 15 million, while Schulich, his longtime co-venturer, owns more than 20 million shares, or just under 5% of the whole company. Clearly, both Lassonde and Schulich feel the public investors' pain. Peligal asked Lassonde where the market had got the New Gold story wrong. One analysis that has come across Peligal's desk showed New Gold trading at roughly 50% of after-tax net present value, if one incorporates future Blackwater production.

"I'm not sure that's really the case," Lassonde replied to the proposition that the market misunderstands. "I think people like the story. What's happening is that if anyone was on margin, they're getting a margin call. They're selling out. It's out of fear. Randall Oliphant, our executive chairman, was in Europe two weeks ago, and he spoke with maybe 40 portfolio managers. They all get it. But the gold funds are getting redemptions, so they have to sell. What do they sell? They usually sell the ones that are liquid, because those are the only ones they can sell. New Gold is very liquid; thus, it has suffered from the fact that it was one of the best performers. . . .

"Of all the intermediate gold-mining companies out there," Lassonde wound up, "my view is that between the management and the asset, it's the best story out there. If you want to own an operating company, it's the best." Thus speaks a money-maker.

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