ETF Securities Equities Research:
Gold to outshine gold miners

Summary

- Stronger Q1 2016 earnings coupled with the rising price of gold helped improve sentiment towards gold miners, driving the rally so far.
- Lower all-in sustaining costs are reflective of declining capital expenditure. While it boosts current profitability it is detrimental to sustaining the long term growth of gold miners.
- For the gold miners rally to continue, the current pace of margin expansion will require gold prices to be at $1510 by Q2 2016.
- Gold will likely reflect deterioration in economic or political uncertainty quicker than gold miners and hence we favour the metal versus the equity.

Gold miners tighten their belts too much too fast

Gold miners have skyrocketed since the start of the year, staging a 81.6% rally. That is the strongest 6-month rally we have seen in the sector. We believe stronger Q1 2016 earnings results coupled with the rising gold price improved sentiment, helping drive inflows towards this beleaguered sector. However, we believe the rally has run out of steam. For the purpose of this report gold miners refer to the constituents of the DAXglobal Gold Miner’s Total Return index.

The greatest success in gold miners’ financial restructuring has been a reduction of excessive debt loads. Gold miners’ debts becomes hard to service when gold prices were trading at a lower price. They have achieved the debt reduction by selling non-performing assets, rejecting future capital expenditure, reducing their workforce and cutting dividends. The chart below illustrates how record high debt levels dragged the performance of gold miners lower.

While reducing their debt has improved current operating margins and cash flow, it will come at the expense of future profitability. Gold miners’ production has been in decline since 2007. We believe there will come a point, when the aggressive debt reduction via postponement of future exploration projects and sale of non-performing assets will dent future growth prospects.

Lower Capex detrimental to future profitability

In 2013 the World Gold Council (WGC) established a new cost disclosure framework by introducing “all-in sustaining costs” (AISCs) as an extension to cash costs. As the term implies, AISC focuses on all costs incurred in sustaining production for the complete mining lifecycle, from exploration to closure. AISC is currently at $857, well below its 5-year average of US$1019 and has been trending lower over the past four quarters. In response to declining gold prices over past years, capital expenditure has been curtailed extensively – 21% drop over the prior year. We believe the curtailment of capital expenditure is the chief reason behind the consistent decline in AISC. A stronger gold price environment in 2016 has widened the gulf between gold mining costs on an AISC basis and gold prices, boosting gold miner’s profitability by 80% on average over the prior quarter in Q1 2016. While declining capital expenditures translate into lower AISC, improving short term profitability, it comes at a cost to longer term growth.
Where does gold need to be to extend the miners current rally

Despite gold’s stellar performance, returning 19.3% so far in 2016, gold miners’ have clearly outperformed, returning 81.6% over the same time frame. Gold miners’ outperformance reflects the sectors’ inherent profit leverage on gold prices. Based on historic observations, the 55% y-o-y gain in the gold miners’ index implies that Q2 2016 profit margins will rise to 19%, up from 10% in Q1 2016. We are doubtful that profit margins have improved that much because, once again based on historic relationships, it would indicate a gold price of over US$1510/oz by the end of Q2 2016. We believe that gold miners’ prices look over-extended and we expect a pull-back based on fundamentals.

Gold miner’s valuations unfavourable

With a correlation of 0.72, rising gold prices have clearly been a catalyst for the rally in gold miners. Gold miners beta varies across the cycle with the beta at 1.44x (in a rising gold price environment), which is considerably lower than the beta when gold prices are falling.

The price to earnings ratio over Q4 2015 and Q1 2016 were at 60x and 51x respectively and has currently declined to 38x as earnings recovered more than prices rose. We believe more attention needs to be paid to other valuation metrics in this capital intensive industry. The price-to-book ratio (P/B) is a valuable metric as it incorporates the value of assets. P/B has risen in the past quarter as a 53% surge in asset write-downs and impairments have reduced the book value, without a commensurate reduction in the price. The price-to-book ratio increased to 2.4x in Q1 2016 from 1.4x in Q4 2015, which is above the 10-year average at 2.2x, highlighting that gold miners have become more expensive.

Mounting risks support gold

We believe that gold will likely reflect deterioration in economic or political uncertainty quicker than gold miners and hence we favour the metal versus the equity. Economic and political uncertainty is elevated with the vote on the EU referendum, the Spanish and US elections and slowing global growth, weighing on investors’ minds. Gold miners are exposed to a number of unknown risks such labour disputes, power outages, political upheavals and adverse currency movements that cannot be discounted. While gold miners have been prudent to reduce their debt, we believe the priority to clean up their balance sheets will come at the cost of future growth opportunity. While rising gold prices and falling AISC have provided the dual benefit of improving gold miner’s profitability. We caution against being too optimistic over falling AISC as it is more reflective of declining capex which will likely to impact future profitability. From a valuation perspective, we believe gold miners are moderately valued and don’t favour a compelling reason to buy at this point in time.
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