The Straight Goods On Gold Mining Stocks

Description

The stunning rise in the price of gold has been very well documented. Historically, the only way that investors had to practically invest in this commodity was by purchasing shares of gold miners. For this reason, gold producing companies used to trade at premium multiples to both their mining peer group and the market in general. For instance, Barrick Gold (TSX:ABX,NYSE:ABX) sauntered through the 1990's, a period that saw the price of gold actually decline by 27%, with an average P/E multiple of 37.0. This compared to the S&P 500's (a better gauge of "the market" than the S&P/TSX Composite) average P/E multiple of 21.6 for the decade.

Competition

Barrick's world, along with its gold mining peers, changed forever on November 18, 2004 with the introduction of the SPDR Gold Shares ETF (NYSEMKT:GLD). The SPDR Gold ETF allowed investors to gain direct exposure to the commodity without having to worry about all the practical complications of holding physical gold. Investors suddenly had an alternative for their gold investing dollars.

Because they had been the only game in town, gold miners were never all that worried about doing shareholder friendly things like paying dividends or protecting capital. As long as they were finding and producing gold, it was all good. The competitive angle introduced by the ETF meant that if gold miners wanted to remain as the go to vehicle for investors, they were going to have to pick up their game.

Guess what? They didn't. Gold miners continued to more or less behave as they always had. Overpromising and under delivering was (and continues to be) an issue that plagued the industry and investors were no longer forced to put up with it. Gold company stocks were exchanged for shares in the newly created ETF.

We can see this dynamic at work by simply looking at the returns of the gold companies and the ETF. Over the past five years the gold sub-sector on the S&P/TSX Composite has declined by 10.8% while the commodity has increased in value by 90%!

The issues

Two of the most significant issues that have nailed several of the world's largest gold miners have been cost overruns and a spare no expense, growth by acquisition strategy. There are no two better examples of these issues in play than Barrick, the world's largest gold miner, and Kinross (TSX:K,NYSE:KGC), Canada's third largest gold company.

Barrick has been working for years to bring a project located on the Chile/Argentina border into existence. The mine is known as Pascua Lama and although it holds a massive resource with 17.9 million ounces of gold, the logistics of building this project have basically brought Barrick to its knees. This came to a head in July 2012 when Barrick announced that they were adding another year to the Pascua Lama construction schedule and that the mine is now going to cost $8B to build. This compared to an estimate of an all in cost of just $3B in 2009! Talk about a cost overrun!

Kinross provides evidence of the problem with growth. In the summer of 2010 Kinross paid $7 billion to acquire Red Back Mining which was best known for its Tasiast mine in West Africa. Like Pascua Lama, Tasiast is going to be a big mine with proven and probable resources of 7.5 million ounces of gold, however, like Pascua Lama, bringing this mine to life has been nothing but headaches for Kinross. Because of the issues Kinross has had, they were forced this past fall to take a $2.5 billion writedown on Tasiast, two years after paying $7 billion for it!

This habitual ability to destroy capital has essentially left investors with no choice but to go the ETF route for their gold exposure.

Time well spent

A recent presentation by Nick Holland, CEO of Goldfields, a South African gold producer, indicates that finally the miners might be getting the message. At least he has. Holland does a fantastic job of openly and honestly detailing the issues that the industry has faced, and what can be done to turn the tide. He also makes it very clear what you as an investor need to believe if you are going to allocate a portion of your hard earned dollars to a gold miner. I only wish that all CEO's were as brutally frank as Holland.

Given the historically discounted valuations that exist in this space (Barrick's P/E is currently 10.2), if the gold mining industry is able to take Holland's advice and right the ship, this could be one of the market's hottest corners in the coming years. If you have an interest in gold, do yourself a favour and take the time to go through this presentation. It could potentially make, or save, you a lot of money!

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Fool contributor Iain Butler does not own shares in any of the companies mentioned in this post. The Motley Fool has no positions in the stocks mentioned above.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:B (Barrick Mining)
2. NYSE:KGC (Kinross Gold Corporation)

3. NYSEMKT:GLD (SPDR Gold Trust)
4. TSX:ABX (Barrick Mining)
5. TSX:K (Kinross Gold Corporation)

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