



## Franco-Nevada Corporation, An Intriguing But Expensive Play on Gold

### Description

**Franco-Nevada** (TSX:FNV, NYSE:FNV), the world's largest gold royalty company, recently reported a solid bump in its third-quarter 2013 financial results. This was despite the gold price now being down by 23% for the year. It appears that even in this operating environment, Franco-Nevada is still capable of performing, even when gold miners are slashing capital expenditures, reducing costs, and putting projects on hold.

There may be a rush of [equity raisings](#) by gold miners as they try to muddle their way through a looming cash crunch. So let's take a look at what makes Franco-Nevada such a strong performer in such a difficult operating environment.

### Recent successes

Even with softer gold prices and gold accounting for 61% of total revenue, in the third quarter, Franco-Nevada reported a modest 4% quarter-over-quarter increase in revenue (to \$99 million). But its stunning 60% spike in net income caught my attention. Unlike many miners, Franco-Nevada is still well-positioned to deliver value for investors in an environment where precious metal prices will remain soft.

Franco-Nevada was able to achieve this quarter-over-quarter growth in revenue and net income by virtue of its diversified asset base. Not only does the company earn revenue from gold, it also derives 21% of its revenue from oil and gas.

Oil and gas revenue jumped 23% quarter-over-quarter; it was up 150% from the year-ago quarter, helped by crude prices hitting a one-year high in August 2013. But with crude prices continuing to soften since then — to now as low as \$93 per barrel — I expect Franco-Nevada's revenue from oil to continue falling for the remainder of 2013.

That does make it a far more appealing gold investment than many of the gold miners that have seen their cash flow and profitability crash. But let's step back: What is a gold royalty company, how does Franco-Nevada work, and is it a superior investment to the gold miners?

### What is a gold royalty company?

A royalty company provides upfront capital to miners to help with the development of gold mines, so as

to bring them into production. In exchange for providing this upfront capital, they receive a royalty on future production. These royalty deals are structured on a percentage of total sales, which essentially means that even if costs go up, there is no adverse impact on the royalty company.

They also engage in what is known as “streaming,” where for a smaller upfront fee they purchase the right to buy a quantity of the gold produced at a fixed price over the life of the mine. This also shields royalty companies from rising costs, which is one of the key issues now affecting miners, with many facing a cash crunch in the softer pricing environment. They are also able to better manage the risk of softer gold prices than miners, because royalties are typically bought at far lower levels than the gold price.

Franco-Nevada is able to further diversify its asset base than miners, while having significantly lower overhead costs, because it only needs to manage administrative costs and not be concerned by the actual capital expenditures required to be a sustainable producer. As such, Franco-Nevada can continue to remain profitable at gold prices that miners cannot.

### What are Franco-Nevada’s assets?

Franco-Nevada has a diverse asset base with more than 200 gold and mineral royalties and streams as well as 200-plus oil and gas royalties. It’s well-positioned to weather any sustained softness in the gold price while being able to maintain profitability. I believe this certainly makes it a superior investment to the majority of gold miners in the current environment.

### Is it attractively valued?

But this leaves another question for investors: Is Franco-Nevada undervalued and is it now an attractive investment? For the year, its share price is down by 25%, but it still appears expensive when its enterprise value-to-EBITDA of 17 is considered.

This is also significantly higher than many of the major gold miners:

Company	Enterprise Value (EV)	EV-to-EBITDA	P/E Ratio
Franco-Nevada	\$5.6 billion	17	87
Barrick Gold	\$31.4 billion	5	NA
Goldcorp	\$21.2 billion	9	14
Yamana Gold	\$7.9 billion	7	24
Eldorado Gold	\$4.6 billion	8	26
New Gold	\$3.2 billion	9	15

Source: Company filings, Yahoo! Finance, and YCharts.

Franco-Nevada also has a significantly higher trailing-12-month price-to-earnings ratio than any of the miners listed. The miners appear to be superior values, but with softer gold prices, many of these companies are starting to feel the cash crunch.

Already **Barrick Gold** is having to raise equity. It is issuing \$3 billion in shares priced at \$18.35 each so as to fund debt repayments and repair its balance sheet, significantly diluting the value held by existing shareholders and making it a far more expensive proposition than these ratios indicate.

Unlike many of the smaller and more cost-effective producers like **New Gold**, Franco-Nevada also

pays a dividend yielding 1.6%. This is not a spectacular incentive for investors, but it will certainly continue to reward them for their loyalty until the gold price recovers.

### Foolish final thoughts

Franco-Nevada provides investors with a means of obtaining exposure to gold while mitigating many of the risks traditionally associated with investing in miners in a softer pricing environment. But even with the dividend, the diverse nature of its revenue streams, stronger financial performance and lower level of risk, it's not a good enough bargain in my eyes.

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*Disclosure: Matt Smith does not own shares of any companies mentioned.*

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