Interview: Is This a Sign of Rock Bottom for the Gold Miners?

Description

Over the past two months, we have seen a rash of hostile takeover announcements in the mining industry. In January, **Goldcorp** (TSX:G, NYSE:GG) offered $2.6 billion for **Osisko Mining** (TSX:OSK). A few weeks later, **Hudbay Minerals** (TSX:HBM, NYSE:HBM) made a $428 million bid for **Augusta Resources** (TSX:AZC). The question for investors: is this a sign of the bottom for the troubled gold mining industry?

In part four of my interview with commodity expert Rick Rule, we discuss the current state of the mining industry. Below is the transcript of our conversation; it has been lightly edited for clarity.

Robert Baillieul: You have said that the mining industry needs 'Darwinian cleansing' and as many as 70% to 80% of junior companies could be worthless. How do you invest in the small-cap mining sector when as much as three quarters of the industry players could be heading for the dustbin?

Rick Rule: Well I wish that would happen. I don't think it will. The truth is that human nature being what it is there will always be somebody – self described investors but really speculators actually – that will think how low can a $0.05 stock go? The answer of course is that it can go to zero. But people don't pay enough attention to that.

My suspicion is that the managers of the truly brain dead, walking wounded juniors will to a surprisingly large degree figure out a way to survive. They'll raise enough money to continue to tell their story. They'll raise enough money to continue to pay the rent and pay their own salaries. The won't raise enough money to do any effective exploration. But they'll continue in the story business if not in the mining business.

A much healthier state of affairs in the longer term would be if the current bear market ran another two or three years. You could cleanse the industry of the 'D' and 'C' tier companies. That happened in the early 1990s. The results was that the market recovery in 1993 was astonishingly vivid. The number of stilos left to receive investor capital was substantially reduced. And while the management teams around today would suggest that the current environment is Darwinian, it hasn't been a ruthless as one would hope.

The truth is that the junior sector on a global basis is still overvalued as a collective. For example let's say you were merge every junior exploration company in the world – perhaps 3,000 or 5,000 listed vehicles though I don't know the number – into one company. Let's call it Junior Explore Co. That company, because of its extratornity general and administrative expenditure level, would lose in a very good year $2 billion. In a very bad year it would lose $10 billion.

Your readers need to ask themselves, how much they'd be willing to pay for a business that lost on average $3 billion or $4 billion per year? Would you pay five times losses? Eight times losses? 12 times losses? What's the correct price/loss ratio? That's a rhetorical question, of course.

What you need to understand about the junior industry is that the industry as a whole is a disaster. That means that the wealth creation of the best 5% of the issuers is so extraordinary and provides luster to the entire sector. And playing the game in the juniors really involves a really ugly process of separating the wheat from the chaff.

Speculating at just the wheat part of the sector is volatile enough although over a decade not particularly risky. But playing the junior sector without having the ability to do good fundamental analysis and good stock selection is suicidal.

Baillieul: We've seen a rash of hostile takeover announcements in the mining industry these past few months. In January Goldcorp recently offered $2.6 billion for Osisko Mining. Then last week Hudbay Minerals made a $428 million bid for Augusta Resources. Typically, a rash of hostile takeovers is an indicator of extremes in the mining cycles. Is this a sign of a bottom?

Rule: What you have said is exactly correct. Takeovers happen at opposite ends of the market cycle. Takeovers take place at market tops because capital is free. And takeovers take place at market bottoms because targets are very cheap.

By the way, the amalgamation trend is an unalloyed good in every sort of circumstance. What the industry itself needs to do is reduce its general and administrative by assets, or G&A, deployed. So the extent that Goldcorp or somebody else can grab another $10 billion in assets with no real increase in G&A, is good for the industry as a whole.

It's also good form the market because the sudden influx of cash in the market adds both liquidity and hope into an industry devoid of both. It's an incredibly good thing.

I not trying to pass judgement on whether the offers for both Osisko Mining or Augusta Resources are full and fair offers. I'm only arguing that amalgamation is good for the industry internally in terms of lowering the G&A charges relative to the assets administered and also good for the market by adding both liquidity and hope.

Baillieul: Executives in the mining industry don't have the best reputation when it comes to capital allocation. What do you look for when evaluating a management team?

Rule: Well, I wouldn't limit that comment to the mining industry. I have 35 years of experience in finance services. Let's start with the industry I know best, financial services. Certainly in my experience people look out for their own self-interest first. And you just need to expect that.

Pick an industry, any industry. One of the things that I look for in a junior miner, because the businesses aren't particularly complex, would be how does the CEO and the other insider executive compensation really work.

Are they large owners or are they relying on large salaries and options? If they're large owners it may be that the work will be geared towards the interests of shareholders because they're large shareholders.

If they aren't large shareholders, you would think in terms of them pursuing their own rational self-interest, that they would be more interested in salary maximation. Similarly if they had large options packages, but didn't have a large investment in the company, one might expect that they might take more speculative bets in the assets of the company because they didn't suffer the ill effects of the downside but that they participated in the benefits for any gains on the upside.

A rational review of the incentives available to managers will tell you something about how they will conduct themselves running the companies. I'm not confining this discussion to mining but to a whole range of management directed economic endeavours.

In terms of associating the potential outcomes undertaken by the management team, one needs to look at the beginning in terms of how the incentives are structured. Are they operating as owners or hired guns? And if they're hired guns whether their incentives come from salaries or stock options. I think that's really sort of a qualitative measurement of fundamental analysis.

Baillieul: Just in my own view looking across the industry, not naming any names, but I think a lot of investors are just realizing how important those qualitative factors are right now.

Rule: You're absolutely correct.

People were drawn to the industry in the last decade as a consequence of the narrative. They bought into higher nominal pricing with declining fiat currencies and higher real pricing as a result of population growth and development. And people became so seduced with the narrative that they forgot to look at these things as businesses. They bought the big picture and they got murdered in implementation.

If you overlay that as we've discussed before with the paradigm that you got rewarded by leveraging your company to commodity prices rather than capital efficiency. What we ask management teams to do was to become marginal and they did a heck of a job for us.

The difficulty is what we asked them to do and how we judged them. I think that's in the process of being corrected now. You're encouraging rational behaviour. You're encouraging rational behaviour in the context of a market that is 75% off, people are doing better, and they're doing it for less and they're doing it in a period where the expectations are dead. That confluence of events certainly signals to me that we are at or near a bear market bottom.

Coming up next…
America's tight oil boom created a fortune for investors in 2013. In part five of my conversation with Rick, we discuss his outlook on the global shale revolution.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:HBM (Hudbay Minerals Inc.)
2. TSX:OSK (Osisko Mining)

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