3 Signs the Gold Mining Industry Has Bottomed

Description

It's the 'buying opportunity of a generation ahead for gold,' **Dundee** president and chief executive Ned Goodman told attendees at a luncheon speech at Toronto's PDAC conference on Monday.

Investors would be forgiven for being a little skeptical.

The industry resembles a war zone. The **SPDR Gold Trust** (NYSEMKT:GLD), a good barometer of spot gold prices, is off 30% from its peak in late 2011. And last year alone Canada's largest mining companies wrote off a combined $18.8 billion in assets.

Yet for the savvy investors, there is opportunity amidst the carnage. And while the situation looks bleak, the stage could be set for a massive rally in the gold mining industry. Here are three signs the sector has bottomed.

1. The economics say so

According to precious metals giant **Royal Gold** (Nasdaq:RGLD), it cost the industry $662 to recover a single ounce of gold in 2011. By 2012 that figure had risen to $1,000. Today it's estimated to cost at least $1,200 for the industry to produce each ounce of gold.

At current gold prices the industry cannot generate an acceptable return for shareholders. Miners cannot recover their cost of capital. As commodity investing expert Rick Rule told Motley Fool Canada last month, that means either prices have to rise 'or the lights go out'.

As the low grade miners close down mines and cut back production, a floor will be established underneath metal prices. That will allow higher tier operators, companies with the financial strength to weather the storm, to make a killing if gold rates move higher.

Additionally, we have also seen a bump in merger and acquisition activity. In January, **Goldcorp** (TSX:G)(NYSE:GG) launched a $2.6 billion bid for **Osisko Mining** (TSX:OSK). This was followed afew weeks later by **Hudbay Minerals'** (TSX:HBM) (TSX:HBM) bid for **Augusta Resources** (TSX:AZC)for $540 million.

A rash of hostile takeover bids is a tell-tale sign of extremes at either end of the commodity price cycle. At the peak, companies make big acquisitions because capital is almost free. At the bottom, miners make acquisitions because assets are being given away. That's exactly what we're witnessing here today.

2. The bar is set really low

Actually the bar has been taken down completely. After tens of billions of dollars in writeoffs, investors have lost all faith in the sector.

Relative to the price of gold, the Market Vectors Gold Miners Index is trading at its lowest valuation relative to the yellow metal in 20 years. According to almost any valuation metric you choose, the industry is trading at levels we haven't seen in a decade.

Of course, low valuations don't themselves ensure a profitable investment. But they do suggest that the market's collective expectations for the industry are set awfully low. And any bit of good news, be it through higher metal prices or operational improvements, could send share prices soaring.

3. Miners are getting their act together

Gold prices do not necessarily need to appreciate to drive returns. Across the industry miners are improving profitability through cost cutting initiatives and better capital allocation.

Take **Barrick Gold** (TSX:ABX)(NYSE:ABX) for example. Thanks to reckless spending, the company lost $10.3 billion in 2013. Barrick was the epitome of everything that went wrong in the mining industry during the last bull cycle.

However, the company is starting to regain traction. Thanks to a combination of asset sales, mine plan adjustments, cost cuts, and equity issues, Barrick has substantially bolstered its profitability and balance sheet. As a result of these initiatives Barrick's net debt dropped by nearly 20% last year and analysts estimate that the company could generate $1 billion in free cash flow annually by 2015.

This is a theme we're seeing across the mining industry. The focus is now on generating sufficient returns for shareholders rather than production growth. While that might sound like common sense, it's an attitude that has been sorely lacking from the sector over the past decade.

Foolish bottom line

A wise investor once told me that success in investing is really just about stepping up when others will not. And after the disastrous performance the mining industry has posted these past few years, few are stepping up to the plate today.

Mr. Goodman might be right. This could be the buying opportunity of a generation in the gold mining industry.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:B (Barrick Mining)
2. NYSEMKT:GLD (SPDR Gold Trust)
3. TSX:ABX (Barrick Mining)

Category

1. Investing

Date
2025/08/15
Date Created
2014/03/06
Author
rbaillieul