The Shocking Truth About the Gold Mining Industry

Description

In early 1848, a man named Samuel Brannan opened a small store at Sutter's Fort, California. When gold was discovered in the nearby mountains, Brannan traveled back to San Francisco and proceeded to tell the crowds he encountered, "Gold! Gold on the American River!" By the end of that year almost every man had left town to pan for gold near Sutter's Fort.

Most of those miners never made their fortune and returned home poor and discouraged. But by selling shovels, picks and supplies to miners, Samuel Brannan became California's first millionaire.

The same principle applies today. In spite of soaring precious metal prices over the past decade, the mining industry has posted billions in losses. It's not the prospectors and the miners who make a fortune in a resource boom, but the bankers and the merchants.

The truth about the mining business

You probably won't hear this from any resource analyst and certainly not from any Vancouver power broker, but mining is a terrible business.

Finding, building, and operating a mine is tough. You can run into environmental disasters, labour unions, and government regulations. Once you find the gold, you then must dig it out and shift through tonnes of muck just to process a few ounces.

And you're not done yet! Once the gold is out of the ground you have to grade it, transport it, and refine it. And you can be sure every middleman, government, and landowner wants their cut of the action. When you own a gold miner, especially the smaller names, you're crossing your fingers and hoping they can find and produce gold at a profit.

The numbers are abysmal. Last year Canada's top five gold miners wrote off a combined $18.8 billion in assets. And if you were to consolidate every junior firm in the world into a single company, that entity would lose $2 billion in a good year.

Of course, you can make great money if a gold miner hits it big. But it's the one-off gold strikes that keep this whole game going. Generally speaking, investors would be better off skipping over the industry entirely except in unusual circumstances.

How to invest in the bankers of the gold mining industry

Like the California gold rush, the true fortunes were made by the people who supplied and financed the resource boom. That's why the smartest investors stick to different types of businesses — metal royalty and streaming companies.

These firms are the bankers of the resources industry. In exchange for a large, upfront payment, miners will agree to sell a portion of their metal production at steep discounts to a streaming company. In some cases, these streamers can buy gold and silver at 50%, 75%, even 90% discounts to prevailing market prices.

This is a much better model than traditional mining operations. Royalty and streaming metal companies don't have to worry about fluctuating production costs. This avoids the typical risks associated with operating a gold mine and gives investors low-risk exposure to commodity prices.

Best of all, royalty companies are not subject to cash calls to fund exploration. And because they do not provide operational or mine development management, these firms can assemble a large and diversified portfolio without significant corporate overhead.

Thanks to this superior approach, royalty and streaming metal companies have outperformed their mining counterparts. Over the past five year, an equally weighted basket of the three largest firms doubled in value. This handily beat the **Market Vectors Gold Miners Index,** which fell 30% over the same period.

Company (Ticker)	Market Cap ($billions)	5-Year Return	Yield
Franco-Nevada (TSX: FNV)(NYSE: FNV)	$7.77	109.48%	1.68%
Royal Gold (TSX: RGL)(Nasdaq: RGLD)	$4.74	37.21%	1.26%
Silver Wheaton (TSX: SLW)(NYSE: SLW)	$8.95	153.59%	1.23%

Source: Google Finance

There has never been a better time to add streaming metal companies to your portfolio. As a result of weak precious metal prices, hundreds of junior gold miners are struggling to generate enough cash to keep the lights on. And with their share prices down the tubes, many venture companies can no longer tap the equity market to raise cash. This has allowed streaming metal players to sweep in and buy up assets at fire-sale prices.

Late last year Franco-Nevada purchased a 2.5% royalty on **Kirkland Lake Gold's** properties in exchange for $50 million. Kirkland owns some of the best gold properties in Ontario. However, with little cash and a depressed equity value, the company couldn't finance construction and had to bring in a partner like Franco.

Even the larger, better capitalized names are turning to streamers for financing. Last year, Silver Wheaton announced a U.S. $1.9-billion acquisition of gold streams from Brazilian mining giant **Vale**. The fact that an enormous company like Vale is giving up future cash flow to secure capital shows how challenging industry conditions are right now.

Foolish bottom line

Not much has changed since the California gold rush. The prospectors and miners continue to go broke in their search for resource riches. Yet the merchants and the bankers crank out profits year after year. That's why royalty and streaming metal companies like Franco-Nevada and Silver Wheaton are superior choices for precious metal investors.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NASDAQ:RGLD (Royal Gold, Inc.)
2. NYSE:FNV (Franco-Nevada)
3. TSX:FNV (Franco-Nevada)
4. TSX:WPM (Wheaton Precious Metals Corp.)

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Author
rbaillieul