



Could This Company Be the Next Franco-Nevada?

Description

Nolan Watson is a force in the Vancouver business community.

At the age of 19, he graduated from the University of British Columbia and joined Deloitte's mergers and acquisitions group. With that experience under his belt, Mr. Watson left the consulting world to join **Silver Wheaton** (TSX: SLW)(NYSE: SLW) as the company's first employee.

By 26, he was promoted to chief financial officer, becoming the youngest CFO of a NYSE-listed company ever. Quarterbacked by business titan Ian Telfer and with Watson at the financial helm, the company's market capitalization grew tenfold to \$3 billion.

At 29, he was looking to replicate that success in a new venture. In 2008, Watson founded a new firm called **Sandstorm Gold** ([TSX: SSL](#))(NYSEMKT: SAND), a streaming company modeled on Silver Wheaton but for gold deals. Five years later, the company has a diversified portfolio of cash-flowing metal streams, no debt, and a \$115 million war chest.

Last week I had the chance to speak with Watson about his business, the state of the mining industry, and his outlook on precious metal prices.

Robert Baillieul: For some of our readers who might not be familiar with this particular segment of the industry, could you describe at a high level what a streaming company is. What are some of the advantages of your business model compared to typical mining companies or just holding precious metals in a vault?

Nolan Watson: A streaming company is one that goes and acquires the rights to a certain percentage of a mine's production for the entire life of the project at a fixed price. It's not entirely dissimilar to a royalty company, which people may be more familiar with in the oil and gas industry. As the mine operates we get to buy our percentage, which we will sell at spot, whatever price that may happen to be on the day we sell it.

A good example is we have a contract where we buy 17% of the mine's production for the life of the mine. It produces about 90,000 ounces per year. We're making 15,000 to 16,000 ounces. We buy

those ounces at \$400 and we sell them at spot which is \$1,300. At \$900 per ounce times 16,000 ounces, that's about \$15 million per year in free cash flow. Then we just use that free cash flow to go and acquire other streams and royalties.

What we're trying to do is to become a free cash flow-generating business in the mining industry that is not exposed to a lot of the risks that mines typically have. Mines are notorious for overrunning on their capital costs, overrunning on their sustaining costs, overrunning on their operating costs, and all of the various production challenges that they have.

We don't have any of those cost overruns concerns so long as the mine continues to operate. Our only concern is if the mine stops operating. We're trying to provide an above average risk-adjusted return to our shareholders by getting the same exploration upside that mining companies get but without the downside operational risks.

Another difference between Sandstorm is that we're able to diversify quickly. We have already acquired 35 streams around the world and about 13 or 14 of which are already operating and cash flowing. That provides more diversification than what you would get with the average mining company.

[In a streaming metals company] you get positive cash flow, lower risk, the same upside, and diversification. We're trying to appeal to a different investor set than what you normally get in mining. We're trying to appeal to more generalists investors. Those who maybe don't want to take on the risk inherent in mining but still might have the belief that gold is going to go up. They still want to be exposed to a company where they believe they can get a return in the gold industry.

RB: In your company's last conference call you said you were once again in the market for new streaming deals. What got you off the fence and what kind of deals are you looking for?

NW: On conference calls for the past 18 months I had expressed my short-term pessimism on the industry. Because we were short-term bearish, we were going to use the opportunity to just accumulate cash rather than trying to catch a falling knife.

We now have accumulated quite a bit of cash. A couple of years ago we had \$30 million to \$40 million in cash. Today we have \$115 million in cash and that balance is growing fairly quickly.

I'm now more bullish on the industry going forward and the price of gold in the medium term. Maybe not so much in the short-term, but over the medium term I'm quite excited about where I think the gold industry is going to go. We want to use our American dollars to go buy gold ounces in the ground.

RB: You guys are competing against a lot of the bigger names – namely **Franco-Nevada** ([TSX: FNV](#)) ([NYSE: FNV](#)) and your old firm Silver Wheaton. How do you guys compete against larger firms that have a significantly lower cost of capital?

NW: I think the benefit of the position that we're in is that we're a \$700 million market cap company whereas Franco Nevada is closer to a \$8 billion market cap company. They're 11 times our size.

The best way that we deal with that competitive advantage is just by doing transactions that are not material to them. We focus on deals \$20 million to \$80 million in size. We have considered stepping up and doing larger transactions but we haven't actually done so yet. In those smaller transactions we

don't really have to compete with them.

We would have to compete with them if we wanted to do \$100 million or \$200 million transactions. Quite candidly, those are challenging to do because their cost of capital is so incredibly low. They only effective way that we could compete on larger transactions would be to be more creative, more flexible, and a better counterparty to deal with.

For now we're trying to stick to our knitting. [We're] sticking to deals that meaningful to Sandstorm shareholders without having to bet too big on any one transaction.

RB: There are a number of new streaming metal companies and private equity firms looking to target the smaller end of the streaming metals market. Is that something you're worried about?

NW: Private equity has an incredibly high cost of capital and operates in very short timelines. One thing about the mining industry is that it takes a long time from the moment you decide to build a mine to the time you're actually up and running and get the cash flowing. It takes several years usually.

The cost of capital for mining companies is 12%. Whereas private equity is looking for the ability to buy an asset and sell it three years later for a 25% IRR [internal rate of return]. That opportunity is just not available in most situations in the mining industry. It's certainly not in the streaming industry.

We've seen a lot of private equity firms say the streaming thing looks great and we liked to do it too. They come in and do nothing and then they leave. I've seen that over and over and over again. Right now I don't see any serious competition coming from them.

Coming up next...

In part two of my conversation with Nolan, we discuss the state of the mining industry and his outlook for precious metal prices.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:FNV (Franco-Nevada)
2. TSX:FNV (Franco-Nevada)
3. TSX:SSL (Sandstorm Gold Ltd.)
4. TSX:WPM (Wheaton Precious Metals Corp.)

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