Finding Low-Risk Miners in Today's Minefield: Adrian Day

The Gold Report www.TheAUReport.com 09/11/2013

COMPANIES MENTIONED

- Agnico-Eagle Mines Ltd.
- **Almaden Minerals Ltd.**
- Altius Minerals Corp.
- Callinan Royalties Corp.
- **Franco-Nevada Corp.**
- Gold Royalties Corp.
- **Midland Exploration Inc.**
- New Gold Inc.
- **Pretium Resources Inc.**
- Reservoir Minerals Inc.
- **Royal Gold Inc.**
- **Virginia Mines Inc.**
- Yamana Gold Inc.

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Adrian Day is finding that the glass is definitely half full these days. While the founder of Adrian Day Asset Management believes that volatility in precious metal stocks will continue, he also believes that gold's extreme bottom is behind us and macroeconomic and geopolitical conditions will continue to support gold. In this interview with *The Gold Report*, Day is downright exuberant on gold stocks and discusses royalty companies, prospect generators, majors and juniors that can mitigate risk.

Source: Brian Sylvester of *The Gold Report*

The Gold Report: Gold had a somewhat remarkable August. What's your view? Is the bottom behind us?

Adrian Day: I think it's behind us. The principal reason gold has rallied is the sense that the decline was overdone. We got an extreme bottom, and then gold started to slowly move back up. All Federal Reserve Chairman Ben Bernanke ever said was that there might be a cutback in bond buying later in the year if the economy continued to improve. That's a rather mild statement, simply saying that additional bond buying might be reduced; nobody is talking about actually reducing the Fed's balance sheet.

During the last few weeks, gold has really responded to the situation in Syria. Gold declined when the British parliament voted down joining the U.S. strike effort. When the U.S. Foreign Relations Committee approved action, gold went up.

The third factor is short covering. The shorts both in gold and in gold stocks reached record high levels at the end of June and beginning of July. There's been a significant decline in the shorts since then, from 130,000 short future contracts held by speculators to about 71,000 in the last month, but that is still a very high level of shorts historically.

TGR: You take reasonably high net-worth clients and invest them in individually managed accounts, many of which are anchored by gold assets. How are you managing the risk inherent in gold equities?

AD: If you're involved in gold, it's going to be volatile. There is no way around that.

We manage the risk by buying companies that are low risk. For the senior companies, that might mean diverse assets around the world not exposed to one political jurisdiction, or it might mean more royalty companies, which have a low-risk business model by definition and strong balance sheets. We buy companies that don't have any significant negatives. In the junior space, I've always thought that certain well-picked juniors with good balance sheets can be low-risk investments even if the stock price is volatile.

TGR: How does the Fed's monetary policy factor into your management of gold accounts?

AD: The comments from the Fed that caused gold to go down gave us the opportunity to buy quality gold stocks at much lower prices. The reaction to Fed comments was overdone. The most I've heard any analyst mention is Fed bond buying going from $85 billion ($85B) a month to $65B a month. That is still $65B of additional money creation every month, an enormous amount of stimulus for the economy.

TGR: You talked earlier about investing in low-risk or lower-risk gold assets. You've had a lot of investment success with precious metal royalty companies. Are these companies still worth the premium investors have to pay for them?

AD: I'd say yes. A company like Franco-Nevada Corp. (FNV:TSX; FNV:NYSE), which with a $6.5B market cap is the largest royalty company, has a very low-risk business model. The royalty companies make an investment, and once they do they're not responsible for anything going wrong. Just think of all the things that have gone wrong in the mining business over the last few years. When the capital expenditure (capex) on Barrick Gold Corp.'s (ABX:TSE; ABX:NYSE) Pascua Lama went from $2.5B to $8.5B, Royal Gold Inc. (RGLD:NASDAQ; RGL:TSX), which owns a royalty on Pascua Lama, didn't have to pony up a penny. It's not responsible for all the court hearings and the capex increases, the additional taxes levied by the local government, the environmental protests, and so on. That's the beauty of the business model. Essentially, you don't have the risk of mining, and mining's a very, very high-risk business.

Take a company like Franco-Nevada. It is the best of this type of company, with an 86% pre-tax margin. It's got $900 million ($900M) in cash with an unused line of credit and no debt—a beautiful company. Is it worth paying the premium? I say yes.

Franco-Nevada's major producing assets are all continuing to produce as expected. The company loses the revenue in gold going from $1,700 to $1,300/ounce, but none of its major producers, on which it holds royalties, are in any risk of closing or scaling back. In addition, Franco has lots of potential that is not factored into the company's projections or the stock price. For example, Franco has an option to buy a royalty on Taseko Mines Ltd. (TKO:TSX; TGB:NYSE.MKT), whose New Prosperity mine has been severely challenged by environmental problems. Once Taseko gets the permits, Franco will buy the royalty. If it doesn't get the permits, Franco won't buy the royalty—there's a lot of upside there.

A lot of senior companies are struggling. They're closing mines, delaying projects; there are capex overruns and huge write-downs. A lot of juniors are also struggling because they don't have the cash. A company like Franco, which has the cash, is in a beautiful position to invest in other companies that need the money and to get a royalty in return. It did this with Pretium Resources Inc. (PVG:TSX; PVG:NYSE) on the Valley of the Kings and with Midas Gold Corp. (MAX:TSX) on its Golden Meadows property. Those are small royalties, but they are two very low-cost royalties on good projects.

TGR: You mentioned Royal Gold, which was scheduled to start receiving cash from Mt. Milligan in northern British Columbia. Once it's operating at capacity, Royal Gold was supposed to be making roughly $100M a year in cash flow from Mt. Milligan. Where's that asset right now?

AD: Mt. Milligan is one of the reasons that Royal Gold stock declined the way it did. The stock was over $100/share a year ago and is now at around $55/share. Right now, it's a reasonable value based only on its existing projects. If you think of all of the upside that it has—and the upside comes from the very assets that caused the stock price to go down—then Royal is very inexpensive, in my view. The $100M a year from Mt. Milligan, by the way, is at today's gold price. At $1,500/ounce gold, it would be over $140M a year, or north of $2 per share.

Royal Gold had a series of mines that had problems and caused the company to have stock problems. As these things are fixed, Royal Gold will have a lot more leverage on the upside in the near term than Franco does.

TGR: Do you see any value left in the gold and silver royalty space?

AD: Royal Gold is definitely a good value. It's selling at 20 times free cash flow, but these stocks tend to be very high priced. If you add Mt. Milligan, which will be operating next year, you're probably looking at 10 times its forecast cash flow, which is pretty cheap for this type of company.

I also think there's a lot of value in some of the smaller royalty companies or companies that are morphing into royalty companies. Virginia Mines Inc. (VGQ:TSX) is one of my long-term favorite companies. It is still essentially an exploration company. It has used the prospect-generator model for many years, meaning it generates prospects and brings in joint venture partners, which is a low-risk exploration model. Then Virginia discovered the Eleonore deposit that it sold to Goldcorp Inc. (G:TSX; GG:NYSE), which is now building that mine. Eleonore will be producing in the last quarter of 2014. That's going to change Virginia from a pure exploration company to much more of a royalty model because for Virginia this means anywhere from $25–35M a year, for 17 years, in cash flow.

That's a fairly wide range, but this is a complicated royalty where the maximum royalty doesn't kick in until about the third full year of production. As the aggregate production increases, the royalty moves up and revenue increases. If you look at the net present value (NPV) of the Eleonore royalty, the discounted value of that future cash flow stream, you'll see that it's worth over $300M. That is the entire market cap of Virginia, so everything else you're getting for free. Virginia has $41M in cash. It has other deposits that are fairly advanced, including a base metal project called Coulon, which is continuing to advance. Most of its projects are gold, but not all of them.

TGR: What do you make of the deal Virginia just signed with Altius Minerals Corp. (ALS:TSX.V) to explore the Labrador Trough, which is famous for its iron ore deposits?

AD: It's a positive, but it's not in the immediate term. The project puts together two very entrepreneurial, very strong companies, both of which have strong balance sheets, good exploration teams and excellent reputations. I think we may likely see more of these deals with Altius.

TGR: Does Goldcorp ever get to the point where it says, let's just buy this project instead of paying out the royalty?

AD: Yes. Virginia could sell that royalty in a heartbeat. A royalty objectively is worth more to the operator of the mine than it is to a third-party royalty company. Will it happen? I think people know full well that Virginia has a very strong and tight shareholder base. The likelihood is that a deal wouldn't happen unless it was a friendly deal. It's really a matter of Virginia's management deciding what makes more sense. I'm sure if it got a great offer it would sell it and if it doesn't get a great offer it won't sell it. Virginia doesn't need to sell it.

TGR: Is there further value in the royalty space beyond those two names?

AD: Callinan Royalties Corp. (CAA:TSX.V) is one of the smaller ones. It is a roughly $90M market-cap company. It's unusual in the royalty space in that it has a good dividend, 4.5%. Callinan is trading at only eight times earnings. The company does have a lawsuit going on with Hudbay Minerals Inc. (HBM:TSX; HBM:NYSE), but Callinan is a great company and has great management. It was set up by Roland Butler, who was one of the founders with Brian Dalton of Altius. The two founded and built Altius over the years and then when Altius got to a certain stage, I think Roland wanted to get back to his roots as an explorationist, rather than be in the deal-making business. Callinan has no debt and a 4.5% dividend yield. It offers lots of upside.

The other one I like a lot is Gold Royalties Corp. (GRO:TSX.V), which is a tiny company with just a $10M market cap. It's a great company, but some years off from getting to the size that is needed in this business.

TGR: Any other companies?

AD: We shouldn't forget that Altius, although it's not in the gold space primarily, has some gold projects and its progression is very similar in many ways to Virginia's. It has a royalty on Voisey's Bay, which pays all of its overhead. Altius also has a royalty on the Alderon Iron Ore Corp.'s (ADV:TSX; AXX:NYSE.MKT) Kami project in the Labrador Trough. If that comes on in 2016, which is expected, at $1.20 iron ore that generates $30M a year to Altius for at least the 25 years.

TGR: We talked about gold royalties as one way of mitigating risk in the gold space. Certainly another way is the major producers, although you wouldn't think that given their performance over the last couple of years. What are some names you're bullish on in the majors' space?

AD: Generally, I'm less favorable toward the major mining companies than I am toward the smaller miners or toward the royalty companies or the explorers. However, there are some good names. I like Yamana Gold Inc. (YRI:TSX; AUY:NYSE; YAU:LSE), for example. Yamana is a company that has grown larger by acquisition, but has also grown by using cash flow to make the acquisitions. It hasn't gotten ahead of itself by taking on huge amounts of debt or grossly overpaying. It has the lowest cash costs among all of the major miners. It's politically safe, in South America and Chile, Mexico, Brazil and Argentina, which isn't the most unsafe country. It's got a pretty good pipeline of projects. This year Yamana produced about 1.1 million ounces (1.1 Moz) and is looking to produce 1.7 Moz by the end of next year as it develops some of its existing projects.

New Gold Inc. (NGD:TSX; NGD:NYSE.MKT) is an interesting company, as well. Randall Oliphant, the ex-Barrick CEO, is the executive chair, and Pierre Lassonde is on the board. New Gold has four projects producing in Canada, Mexico, U.S. and Australia. By 2018 New Gold will probably have doubled its production. With low cash costs and a good balance sheet, New Gold is attractive.

TGR: What did you make of the takeover of Rainy River?

AD: That was a good deal. New Gold needed a nearer-term project. I don't think it overpaid. Rainy River is a project that it can probably build and get into production within two years.

TGR: Any other majors you want to talk about?

AD: Agnico-Eagle Mines Ltd. (AEM:TSX; AEM:NYSE) is a great company and is very well run. It has very conservative management and a great balance sheet. I think that it is quite inexpensive right now.

TGR: What are some of the smaller-cap companies that you are bullish on?

AD: I like some of the joint-venture type companies. One I like a lot is Almaden Minerals Ltd. (AMM:TSX; AAU:NYSE), which is essentially a prospect generator, although it has decided to keep 100% of the Ixtaca property, in Mexico. Ixtaca is large and relatively low grade. It's going to take a long time to build the ounces and develop the project. Every round of drilling has simply built the deposit.

TGR: Is Ixtaca a company-maker asset?

AD: Ixtaca is definitely a company maker. I suspect that Ixtaca is going to get to a certain size soon when one of the large companies operating in Mexico, it could be Newmont Mining Corp. (NEM:NYSE), for example, will decide to buy it. I don't believe that Almaden is going to build a property itself. But the project will reach a certain size where Almaden will be paid a multiple of its market cap for the project. Almaden has a good balance sheet, about $17M in cash plus about $2M in gold bullion, plus maybe another $1–1.5M of shares in small companies. The company is well financed and has good people.

TGR: What about another name in that space?

AD: Midland Exploration Inc. (MD:TSX.V): It's located in Québec and is another prospect generator.

TGR: Midland's also in the Labrador Trough now. What do you make of that?

AD: It's a continuation of the business plan of generating projects and then looking for joint-venture partners to bring in. Midland has a low spend rate. It's got about $4M in cash, so it's going to be around.

The thing about a lot of the joint-venture companies is that there's not necessarily any trigger to make the stock price go up. We're not depending on one thing in the near term to make them go up. I think they're just great companies that are very cheap.

TGR: Do you have another company you would like to talk about?

AD: One that we've been looking at is Pretium, which owns the Brucejack and the Snowfield projects. Brucejack has the very rich Valley of the Kings deposit. Snowfield is a very large but relatively low-grade project. The real interest for Pretium is Brucejack and particularly the Valley of the Kings zone, which had some astonishingly high grades. It's a very nuggety deposit, however, so the company is undertaking a 10,000-tonne bulk sample, which will be released before the end of the year. Assays released so far have shown very good overall grades, which is what we want. If the bulk sample confirms the grades that we've seen, then Pretium could move a lot higher, but that is a long way off.

TGR: Any other company that you would like to mention?

AD: I should mention Reservoir Minerals Inc. (RMC:TSX.V). Although it has several gold properties, its big project is copper, a joint venture with Freeport McMoRan Copper & Gold Inc. (FCX:NYSE) in Serbia. The deposit is just getting bigger and bigger. There is a possibility that Freeport will decide to make an offer on Reservoir.

TGR: Do you have any parting words about the space to leave with us?

AD: The reason to be positive on gold right now is, first, I think gold is cheap. The selloff was grossly overdone and it wasn't only the possibility of the Fed cutting back on stimulus, but at the same time we had concerns about China's economy. I think both of those concerns had been mitigated to a large extent. China's economy, looking at the latest manufacturing statistics, seems to have stabilized. Growth at 7.25% with low inflation is still pretty good growth and still translates into ongoing demand for gold from China.

I feel very positive on gold. If the Fed tapers less than expected, that should be seen as a major positive for gold. Even though there has been a mining stock rally, on a historical basis these stocks are just very cheap. On any metric you care to look at: price to earnings, price to cash flow, price to ounces in the ground, price relative to gold, price relative to ounces on production, etc., the major mining companies today are as cheap as they have ever been throughout this entire bull market other than for a few weeks at the end of 2008. In 2009 the gold stocks rebounded dramatically. I feel very positive, not just on gold, but also that the gold stocks are simply not reflecting the positives in gold.

TGR: You seem to be more hopeful than you have been in recent interviews.

AD: Let's not say hopeful. Let's say positive, exuberant. I'm very positive about the gold price and at the same time the gold stocks are just extremely oversold in my view, the good ones and the bad ones. I feel very positive about the gold stocks right now.

TGR: Thanks for your insights, Adrian.

Adrian Day, London born and a graduate of the London School of Economics, heads the eponymous money management firm Adrian Day Asset Management (www.adriandayassetmanagement.com; 410-224-2037), where he manages discretionary accounts in both global and resource areas. Day is also sub-adviser to the new EuroPacific Gold Fund. His latest book is Investing in Resources: How to Profit from the Outsized Potential and Avoid the Risks.

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