The sad case of the gold miners

Gold is considered a precious metal because it has been used for a long time in the minting of gold coins and jewellery, in addition to as tender and a means of preserving value. The volume of all the gold mined in history is estimated to be 190,000 tonnes, and, at the current price of USD 1,276 per ounce, this means its price is approximately USD 7.8 trillion. For comparison's sake, that is about 8.6 times the market capitalisation of Apple.

Of these 190,000 tonnes, approximately 89,000 tonnes have been turned into jewellery, 40,000 tonnes belong to private investors, 31,000 tonnes to states, and the remainder is held in various other forms. Because gold is practically indestructible, almost all historically mined gold is still in existence. Underground gold reserves (that is to say what has not yet been mined) are estimated at 57,000 tonnes. A quarter of the world's gold is still waiting to be dug out.

Annual gold mining output is currently somewhere between 2,500 and 3,000 tonnes. These numbers from the World Gold Council would seem to indicate that gold mining does not have too long a future ahead and that companies which extract gold will profit greatly from this situation. Does this mean gold miners are good investments? No, they are not.

Let us start with a look to history. Over the past 10 years, the price of gold has increased by approximately 50%. The price of the GDX, which is the ticker for an ETF copying an index of gold miners (NYSE Arca Gold Miners Index) decreased by 50% in the same period. That is a rather interesting fact: The price of the commodity the companies within the index are mining is rising even as their stock prices are sinking. When we look at the development of share prices for the largest gold miners over the past 7 years, we can see that the price change for only one of them – Rangold Resources – exceeded the rise in the gold price. The price changes of the others not only lag behind the change in the gold price but are deeply negative. The stocks of Eldorado, AngloGold, Kinros, Yamana, and Goldcorp have declined by 60–85%.

Over the past 7 years, the dozen largest gold miners in the market obtained more than USD 40 billion from the market through issuing new shares and partially by issuing further debt. In the same period, only about USD 12 billion was distributed as dividends and the enterprise value of this group of companies decreased by USD 85 billion, predominantly due to asset depreciation. That is essentially an economic loss created over 7 years. This stands in contrast to the amount of USD 550 million that is the sum of remuneration the bosses of these 12 companies received over these past 7 years.

The gold miners' basic problems are chronically low returns on capital and negative free cash flow. Costs of capital are relatively high for gold miners, because theirs is an industry operating with large investments having time horizons long into the future, there is high debt, the entire industry is exceptionally cyclical, and all the companies are typical “price takers”. Investments made by the majority of miners have returns far below their costs of capital, and so they destroy value instead of creating it. We estimate the average return on capital for the entire group of these companies to be 3%. It is interesting that the market is still willing to finance this sector.

Over the past 7 years, operating cash flow of the big 12 was about USD 100 billion, investments about USD 130 billion, and the increase in debt was USD 30 billion. But the volume of gold production has not changed. The entire sector spends more cash than it takes in, and as a whole its production volume is stagnant. The only miner which does not correspond to this evaluation, as mentioned above, is Rangold. Its returns on capital are above its costs, and therefore there is little wonder that its share price, too, is developing the best among all the other miners.

Is it possible that this situation could change in the future? I highly doubt that. The entire mining industry (together with ocean shipping) is the greatest example of what can be termed an “insiders’ game”. That is a situation wherein insiders – in this case the companies’ managements – have a large information superiority over the outsiders, which includes shareholders. This information advantage is joined with other characteristics typical of this industry such as giving preference to the volume of mining and other investment projects before creating free cash flow, inappropriate motivation and remuneration for management, and fragmented shareholder structure, the latter of which often includes more speculators than long-term investors. This results in an extraordinary asymmetry between what the companies’ managements take home versus the returns to the shareholders.

People associated with this industry probably will not change. The only thing that could theoretically bring about change is a more active approach by shareholders and pressure on companies’ managements. So far, nothing like this can be seen and therefore it is probable that gold miners’ stocks will continue to be miserable investments also in future. If you believe in gold, then buy gold but not gold miners. If you believe that gold will go down, don’t short gold but instead short the miners. Alternatively, one can go long GLD/short GDX in combination. Or just avoid the whole thing altogether.

The only consistently profitable mining industry is dentistry.

Invest with care!

Daniel Gladiš, 18 November 2017

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