AUTHORIZED REPRINT

THE NORTHERN MINER

GLOBAL MINING NEWS · SINCE 1915

NOVEMBER 25–DECEMBER 8, 2019 / VOL. 105 ISSUE 24 / WWW.NORTHERNMINER.COM

Tocqueville's Hathaway sees 'tremendous opportunity' in gold equities

INTERVIEW | Seasoned investor assesses current market trends and peers over the horizon

BY NORTHERN MINER STAFF

John Hathaway, chairman of Tocqueville Management Corp. and co-manager of the Tocqueville Gold Fund, joined Anthony Vaccaro, The Northern Miner Group publisher, at the November 2019 Precious Metals Summit in Zurich to discuss the state of the gold investment space. The following is an edited transcript of the interview. The full video is available at www.northernminer.com.

Anthony Vaccaro: *You have had 25 years as a leading investor in the precious metal space and your investment career started in the 1970s. What can history teach us about where we are in the gold equity cycle?*

John Hathaway: Gold stocks have been laggards since 2011 [compared to the S&P 500 Index], and by a huge factor. That suggests to me that we are more in a buying range than not. On the other side of it, stocks look very high. They are expensive. They have been driven by monetary policy and zero interest rates, etc. This is the widest gap between the gold mining complex and the S&P 500 in about 25 years. And to me, it smells of opportunity.

AV: *My understanding is right now market breadth is extremely narrow, but price averages are near all-time highs. That is a bit anomalous. Are there other points in history where you have seen this happen, and how did that play out?*

JH: Yes. In the early 1970s, there was a phenomenon of the Nifty Fifty, which were the 50 stocks anointed by JP Morgan. In those days, I worked with a firm called Spencer Trask, which was one of the gurus behind these growth stocks. The investment thesis was that it never mattered what you paid for growth because growth would always bail you out.

John Hathaway, chairman of Tocqueville Management Corp. (left), and Anthony Vaccaro, The Northern Miner Group publisher, at the 2019 Precious Metals Summit in Zurich. PRECIOUS METALS SUMMIT

And, in fact, we called them "desert island stocks" because you could go to a desert island for 20 years, and you would come back, and your portfolio would be just fine. They were also called "one-decision stocks," because all you had to do is buy them. The problem was it was the wrong decision. You should never have owned them in the first place.

Back then it wasn't at the scale that we have today. But there was a kind of a mania and the market averages were propped up by these 50. They were such stalwarts as Avon Products, Polaroid, Eastman Kodak and Simplicity Pattern. Those four come to mind. Most of them are not even around today. So had you been on a desert island and then come back, even 10 years later, your portfolio would have been obliterated.

This is not to disparage Amazon or Facebook or any of these investment darlings, but what we're seeing today in market behaviour is investors crowding into a smaller and smaller

number of stocks. And we're starting to see them come apart one by one. Amazon is still doing OK. Google is probably doing OK, and Facebook, in terms of stock performance. But we're starting to see, one by one, they're getting picked off. And certainly, you see the unicorns like WeWork getting obliterated, and Uber and so forth.

It's very similar to what we saw in the behaviour of the market in 1974. History rhymes and there's a repeat factor. And that's where we are today. Beneath the surface, you see a lot of termites at work. And the market breadth isn't that great. This quarter, FactSet is reporting a decline across the board in earnings, a little over 2%.

AV: *Another metric that has come up is on initial public offerings (IPOs). Roughly 75% of IPOs this year have had negative earnings. The number was very high last year. Again, with this idea of history rhyming, when is the last time we have seen those levels of negative earnings?*

JH: It's reminiscent of the dot-com bubble. I love the metrics, like WeWork's metric was "community-adjusted earnings before interest, taxes, depreciation and amortization (EBITDA)," whatever that is.

AV: *What is that?*

JH: I don't know. Even the SEC wouldn't let that go through. This is reminiscent of the dot-com bubble.

AV: *A big topic here is generalist investors and what it's going to take for them to come back to gold. Some leading luminaries in the investment space are saying positive things about gold, such as Ray Dalio, David Rosenberg and Rick Reade from Blackwater. But we still haven't seen that move in terms of a healthy revaluation of gold equities. Why not?*

JH: I can think of a couple of reasons. One is that there is probably still a hangover from the bad experience investors have had, going back to the peak in 2011, about corporate governance and capital allocation decisions. The industry is far better today on those counts than it was in 2010 and 2011.

A second thing is that these stocks have been in hibernation for a long time. And we're [Tocqueville] probably one of the last men standing in terms of active management in this space. Exchange-traded funds (ETFs) and passive management have been a factor. One of the things it suggests to me is that the flows in and out of the precious metal stocks are enabled and abetted by the availability of an instrument like GDX [VanEck Vectors Gold Miners ETF].

And so investors, if they are generalists who want exposure here, don't have to do any homework on the underlying companies. And what we have noticed as generalist investors, as value investors, is a huge valuation gap between the big-cap names such as Newmont, Barrick, Newcrest and Agnico. Those are four that come to mind. They probably account for 35–40% of the weighting in GDX.

There are obviously other names represented, but if you go down the scale to the mid- and smaller-cap companies, it is not hard to find companies with valuations that are in the single digits in terms of multiple enterprise value to EBITDA, many of them generating free cash flow. I've been doing this now for 20-plus years, and I don't remember any time when you could find those kinds of values.

There was a time in the late 1970s when you could find very good quality companies trading at single-digit price-to-earning multiples with dividend yields that were 3% to 5%. We don't have that in the gold mining space, but you're beginning to see companies pay dividends. But the value proposition today, the big cap stocks to me are cheap relative to gold. But beneath the surface, the mid- to smaller-cap stocks are even cheaper.

And, again, it spells tremendous opportunity. If I were a generalist, which I'm not now, but I would have looked at this. But the problem is that gold has gotten a stigma. And certainly, to be supportive of it within an investment discussion in a large generalist firm, you immediately isolate yourself. If you recommend a stock like Facebook to your peers and clients, and the stock goes down, you're fine because everybody else is doing it. But if you recommend — let's take one of our favourites — Torex to your peers and colleagues and it goes down, you could be out of a job. Because gold is the third rail of investment ideas. And all of this feeds into why the stocks are cheap and why the opportunity today, as a generalist contrarian, is the best I have seen it since I have been at this.

If you look at the earnings revisions this year for the largest 20 S&P companies, on the left-hand side of the chart, at the beginning of the year, it's a steady path downward. But if you look at the earnings revisions for the gold mining firms, it's a steady path from the left-hand side of the page to the right-hand side upwards. And they kind of cross over.

Earnings for gold mining companies are going up. The gold price is higher. Costs have been relatively contained. And the sell-side analysts have generally been scrambling to up their estimates. It's a phenomenon where nobody seems to take notice. I mean, even though the stocks are up, well into the 20% to 30% area, they're still way behind where they ought to be, given where the gold price is.

AV: *If the general investors don't take notice, then rival executives might be taking notice. Let's turn to mergers and acquisitions (M&A). Fifty percent of iron ore production comes from just four companies. Fifty percent of copper production comes from just 10 companies. But 45% of gold production comes from 25 companies. When you hear stats like that, is there still more M&A needed in the gold sector?*

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CHAIRMAN, TOCQUEVILLE MANAGEMENT CORP.

JH: The M&A that we've seen lately has been mergers of equals. Barrick gets together with Randgold. Newmont gets together with Goldcorp. I'm not saying they're equal, but they are big mergers with not a lot of incremental value add for the shareholders of either company, and it will all work out over time.

Once the dust settles when these large companies sort out their portfolios and probably divest a couple of their mines or reconfigure into different companies, you will see M&A where you have a good deal of accretion not only for the company being bought, but for the acquiring company.

Mine lives in the mining industry are the lowest in three decades. And so they're running out of headway for future production. We have seen big cutbacks in exploration and development. The spend is down. You certainly see within the mining companies a lot of termination and cutbacks on mining, on exploration.

We also have seen that it's so much harder today to put a new mine into production because of barriers from environmental, social and corporate governance kinds of things, and the reluctance of investors to fund the business. Because most of the funding now comes from streaming companies and very little in the way of bought deals, like what I remember 15 years ago. The capital just isn't there to build a couple of billion-dollar new mines. We're on a glide path lower, in terms of production for the industry.

At some point there will be a wake-up call, and that will come about because of higher prices in the metal. And these companies know it. Any CEO of a large company would agree with everything I have said. But they are still hiding under their desks and looking at life with a rearview mirror in terms of taking advantage of the situation. This is the time to be a buyer. They're very good at selling low and buying high. Don't write that down [audience laughs]. But today you can buy an existing property that's producing earnings and cash flow at a 35% discount to what it would cost you to start from scratch. This, obviously, is going to vary across the board, but it's that kind of discount.

M&A would be, obviously, accretive, the premium, to the target company. But it could also be accretive to the shareholders of a major making that acquisition. This is a time to be a buyer. But what are they doing? They're assuming reserves at US$1,200 an ounce, and very little makes sense at US$1,200 an ounce. They're not going to make any acquisitions. And then they will bump it up. And sooner or later, the investors, shareholders and the investment banking world will be all over them to make deals, and they'll cave in at higher prices.

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Our strategy has been to position these — in many cases — single-asset companies that are penalized because of the headline risk for a single-asset company. The best example today is Semafo in Burkina Faso. It's a terrible situation, but it's a great mine. The company generates free cash. They have to fix it, and it will get fixed. But, in fact, if Semafo was held in a larger company that had seven or eight mines, sure it would hurt the stock, but it wouldn't get the sort of dramatic, drastic reaction by investors to these, admittedly, very, very bad events.

We see many opportunities like this and they're not necessarily in a difficult place like Burkina Faso. They're in the U.S., Canada, Mexico. Almost any place I mention — other than the U.S., Canada or Australia — will be thought of as having some sort of headline risk. And if you're a single-asset company outside of those three jurisdictions you're penalized. And there are some companies, even in good jurisdictions, which have the same discount.

When you look at when gold was trading below US$300 there were different issues, the hedging was one thing. There was similar value — but not as good as there is today. And investor interest was absolutely zero when we started our gold fund in 1998, as it is today. There are many things that can change. But what you can see for sure is that the valuations back in 1998–1999 — and the valuations today — will change for the better right across the board, big companies, small companies. And we can only guess at what the reasons are.

But you have to start with the premise that the gold price is on a rise to higher levels, and I'm not talking about US$1,700 or US$1,800. Most people think in those terms, but I was on a panel with David Rosenberg at the Precious Metals Summit in Beaver Creek, and David thinks, "Look, bonds have hit a cycle high, stocks have hit a cycle high in terms of valuation, and gold hasn't." Would it surprise him for gold to hit US$3,000? He said, "Absolutely not." And he is not a gold bug. He is a very rational economic analyst, and he is looking at all the things that I can see and he sees them more clearly than I do, as to where we're headed from a macro point of view. And the outcome to me is very, very friendly for the gold price.

I wish I had a time frame, but it's years, it's not tomorrow. Generalist investors will come back because the space will do well in terms of earnings and cash flow. And then they will discover, "Well, gee, these companies have been adding value, even though it isn't reflected in their share price." And then you'll see the sell-side get more on their side and they will abandon their role as handmaids to the investment bankers and actually pick stocks — which they are not doing now. And so all of these things will take place over a period, maybe even a full decade. But we're in an upcycle in this space and we're still at the very early stage where people are super skeptical, and maybe largely because it's the third rail of investment ideas.

AV: *Your fund has held Newmont. What are your feelings about the merger with Goldcorp, the deal logic there and how it has played out?*

JH: I like Newmont. We have always held it. We have funds that require daily liquidity, and so we need to have some measure of names like Newmont that are liquid because you have to worry about the potential for redemptions. We don't own Barrick right now, but I would consider that to be one if we had inflows, which we haven't.

But our weightings in something like Newmont are a fraction of what they are for GDX. We have no weighting in Barrick. On the other hand, our weighting in Torex or Detour Gold is something like four, five, maybe even six times of its weighting in GDX. We're so skewed to the mid and smaller-cap names, where the value exists and where you would potentially

get much more of a lift from a better assessment by the mainstream investor of investing in precious metals.

Sure, Newmont would be a good stock, and it will be. And Barrick will be good, and Newcrest. And we own Newcrest probably more than the other two, and Agnico and so forth. But where you really stand to get outsized returns is beneath the surface. And again we're one of the very few firms that's doing that. Now that we are joining Sprott, we have amplified research ability to due diligence, a lot of these kinds of things. We're going get even more skewed towards that strategy.

AV: *We have seen Barrick and Kirkland Lake increase their dividend. Newmont not yet. Is that the sort of thing that we're going to see more of to get the love back?*

JH: Absolutely. And they can because they're generating cash. Two years ago nobody would have dreamed, particularly in the executive suites of the gold mining industry, that we would even be at US$1,400, much less knocking on the door of US$1,500. And the industry has tamped down operating costs. The all-in sustaining cost of mining has been relatively flat for the last three or four years. And when you get a break out in the gold price, your margins go wide and you start to gush cash. And they're starting to bump dividends — exactly what they should do.

AV: *You have alluded to some of your larger positions: Detour, Torex, Wesdome, Pan American Silver, MAG Silver. Can you talk a little bit about the key factors that led to those investment decisions?*

JH: Every one was different. In our mind, Detour was a very underperforming asset, and we got involved in a proxy battle with the incumbent board. Paulson & Co. led the charge. We maintained cordial relations with the outgoing group. But it was clear to us that the asset was underperforming. And by the way, that's a trophy asset. It's a 20-plus-year mine life in Canada. Low grade to be sure, but a big land package and the possibility for much more discovery.

The headquarter count, at the time of the changeover of the board, was something like 40 to 50 people. This is in Toronto, very nice offices in Toronto — that always makes me suspicious. They're down to 15. They brought in a good new board. They have a new CEO who is a tough-as-nails operating guy. They were paying hundreds of millions to outside contractors. Now they have cut way back on that. And the operating costs of the asset have gone down substantially. They are generating free cash, and their debt has paid down substantially.

We're only halfway there ... in terms of where they could get. Just internal things like better equipment availability and less turnover of key mine people. It just all adds up. On its own the stock has the potential to double from here without a takeout. But sure as shooting, going back to this wind down of reserves and industry production, that is a trophy asset, and it's beyond me why somebody hasn't figured it out by now. But they will, and I'm happy to own it without a takeover right now because there's enough on the way of internal improvements that will carry the stock higher. But our exit strategy here, maybe two, three years out, is going to be a takeover at a big premium to where the stock is trading, hopefully, twice where it is now.

AV: *What about Pan American Silver?*

JH: Terrific company, smart management. They're generating free cash and paying a dividend ... there are three things.

First, they had a big discovery at La Colorada, an existing mine, but a different mining structure, a different geological structure. It will be a separate mine. They will announce preliminary reserves I think in December. And that's here and now, but I don't think sell-side investors have figured it out. I don't think even most investors have. But this is like another mine, and it's right on an existing asset that they own. Even they didn't know about it two years ago. So that's a big plus.

Then they took over Tahoe, a silver mine [Escobal] in Guatemala, which had been operating, but then was shut down because Tahoe's management lost the social licence. Lots of bad things about Guatemala, but not beyond being fixed. And that mine could generate, I believe in terms of tax revenue to the government, 5% of gross domestic product. It's too big for the Guatemalans not to have a self-interest. And Pan American management is essentially Latin-based, even though they're from Vancouver. They'll do a way better job working with all the local, federal and state authorities in Guatemala, and the community. The community actually wants this to happen to get it back and running.

And last there's their asset in Argentina. Of course, it's Argentina, so you're not paying anything for it. But one day Argentina won't be as bad as it is now. That's another blockbuster type of development that might be five, seven, 10 years away, or maybe never. But it's there in the portfolio, and it would move the needle dramatically.

So here's a stock that trades at a low valuation. It's not a takeover candidate. I think of this more as a management group, which is very skilled. They're zigging while everybody else is zagging. They're taking advantage of the landscape, as they did with Tahoe, to take advantage of a distressed situation. They knew it would be a while before they could get Guatemala back up and running. But part of our thesis is that not only will companies be taken over, but there are smart management groups that will take advantage of a situation when very few other people are. TNM