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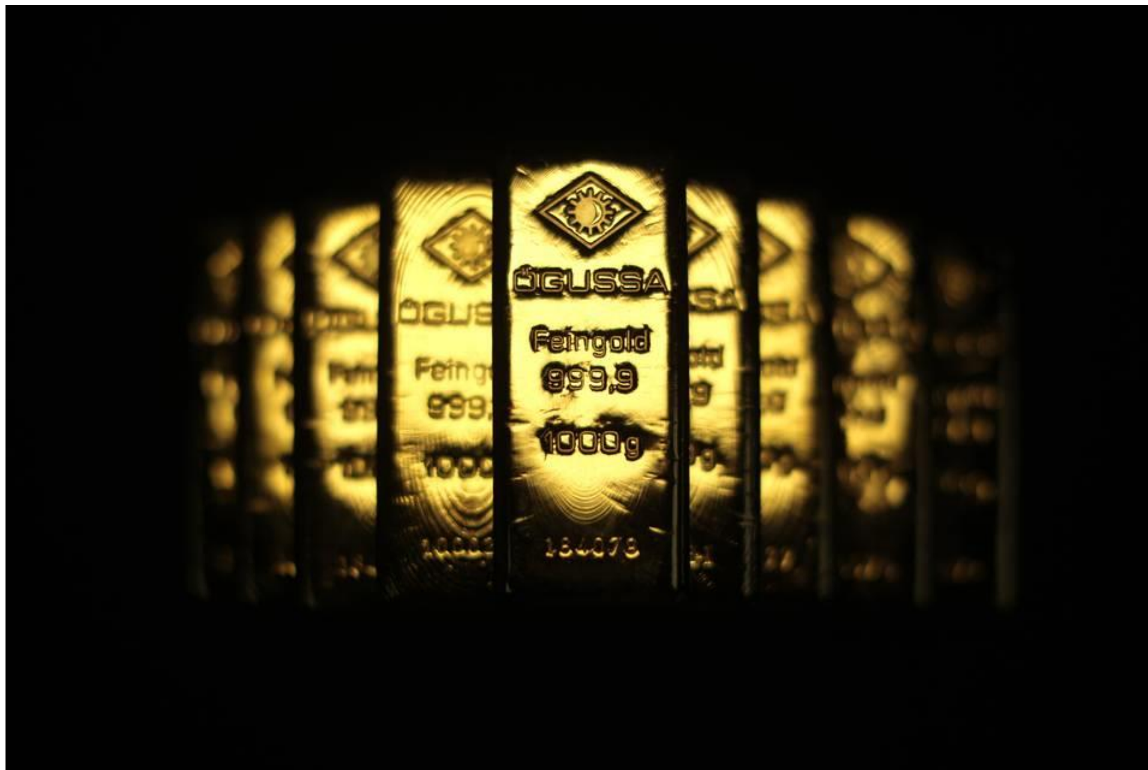
Gold Miners' Stocks Just Aren't That Special

Gold-mining stocks have been crushed thanks to the drop in the price of the precious metals. But some vestiges of gold fever remain



Beware gold bugs bearing cheap equities.

Thanks to gold's swift descent, mining stocks have been crushed in the past month. But bargain hunters should tread carefully. While faith in the metal may have dimmed, some vestiges of gold fever remain.

When gold was on the up, it was considered normal that mining stocks traded at a hefty premium to the net present value of their projected cash flows, as well as versus other diversified miners.

But how that value was calculated also difffered. Analysts and investors, particularly in the U.S. and Canada, routinely used a lower discount rate, of 5% or less, to value gold miners. Diversified-mining peers, on the other hand, typically were valued using a discount rate of 8% to 10%. That discrepancy often survives today.

Even if a lower rate inflates a miner's theoretical value, one reason this may persist is that as long as assumptions don't change, a stock's valuation can be measured against its history. But such thinking ignores the impact on absolute valuation. Using lower discount rates makes a big difference, especially as net present values have traditionally been more important in valuing gold stocks than other measures such as earnings multiples. BMO Capital Markets uses both 5% and 10% discount rates. Under its gold-price outlook, in a recent report, Barrick Gold's net asset value was over 2½ times higher using the lower rate.

Meanwhile, gold's claim to special status looks more dubious than ever. Aficionados argue that gold is like money and tends not to be correlated with other assets, meriting a lower discount rate.

Whether or not you think fiat currencies are ultimately doomed, it is clear that this logic is flawed for miners. Mining requires capital and providers of that capital require a return, argues ***Pawel Rajszel*** at ***Veritas Investment Research***. When big gold miners are paying 5% to 6% to raise debt, he notes, using a discount rate of 5% to value cash flows is clearly too low.

Gold miners have also recently proved lousy custodians of that capital, at a time when investors can easily get exposure to the metal via exchange-traded funds instead. Mark Bristow, chief executive of Randgold, has often bemoaned how miners squandered the gold rally through rising costs and poor investment. If anything, investors should require a higher return due to higher management risk.

Indeed, a low discount rate abets wasteful investment. More of the company's valuation shifts further out to the future, giving more weight to projections of both productivity and—that old standby—long-term price forecasts, which for gold tend to be optimistic due to expectations of rising marginal costs or financial armageddon someday. This encourages investment in gathering reserves in the ground, even if near-term price or cost trends point the other way.

Analysts' target prices for the biggest North American gold miners are 55% to 80% higher than today's stock prices, according to FactSet. Most of the biggest diversified miners, meanwhile, have target prices a more modest 13% to 20% higher. Clearly, there is still some gold-edged thinking out there.

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