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A Low-Risk Way to Invest in Gold Stocks

Adrian Day, a friend for many years, is one of the best market analysts around. He knows the mining business inside and out, as you'll see when you read today's guest article. And we should also mention that he's made a ton of money for his clients.

Gold mining is not an easy business, not even with today's record-setting prices. Major mining companies face several challenges: they must replace their production with new reserves every year; they are faced with increasing political, social and environmental problems of every type; and costs seem to rise almost as quickly as the price of gold.

Mining is a business where Murphy works overtime. It's no wonder that over the long haul, the mining industry

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has probably destroyed more capital than it has created.

One of the key issues for any investor in gold stocks is how to minimize risk. One type of company does this exceptionally well. I'm talking about a unique hybrid called a mining royalty company. Such a company owns the royalties on other companies' mines and exploration properties. These royalties come in various forms, but essentially, they represent some of the cash flow (or sometimes profits) from the mine.

Avoiding operational problems

The most typical form is called a "net smelter return" royalty. Typically, here the royalty owner gets paid first, right off the top. This avoids operational problems altogether. Water table floods? Not your problem.

Government wants to be a part owner? Not your problem. You just sit back and cash the checks.

Historically, royalties were granted by a mining company to the original landowner for the mining rights, and they were often sold by a rancher or framer who didn't recognize their value, or perhaps by long-suffering heirs who tired of waiting for the mine to start paying off.

Increasingly, today royalties are being used as a financing tool, whereby a royalty company will provide capital to an exploration or development company in return for part of the future cash flow. This could



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perhaps be a company that needs capital to bring a mine into production, but wants to avoid the conditions on which lending banks are insisting. It could be an exploration company with a cheap stock which wants to avoid additional dilution. Such deals can be a win-win for both the royalty company and the mining or exploration company.

Thus royalty companies have exposure to gold price upside and exploration potential, but without the risk. The upfront investment is known and fixed. Again, we don't have to worry about rising costs, dealing with politicians and environmentalists, or any of the numerous other problems besetting the mining industry these days.

Because they are not running the operation, for royalty companies tend to have very low overheads and correspondingly high margins. For Franco-Nevada, the largest gold-royalty outfit, 85% of revenue is free cash flow. Because of the low costs and the other attributes, royalty companies tend to have less downside, both as companies and stocks.

The downsides to royalties

Of course, all these advantages are not themselves cost free; there is a downside. In fact, there are two. The lower risk comes with less upside leverage as well. I would suggest, however, that two or three solid royalty



companies, while unlikely to be the very best performing stock over the short run, will probably outperform most mining stocks over the long term.

The second major disadvantage is that the royalty company is not in control of the properties from which it derives its revenue. Competing priorities at the major miner may lead to delays in the royalty property. It may not undertake sufficient exploration around the mine site. In the case of an exploration company, there may not be positive results; or perhaps the junior is not in a position to develop the mine.

In some cases, such as when a junior sells a property to a senior and keeps a royalty, that risk can be mitigated by what is known as an “advance royalty.” Under such an arrangement, the royalty owner gets paid a specified amount by a certain date, regardless of whether or not the mine is actually in production.

The king of the royalty companies

The benefits of a royalty company far outweigh the drawbacks, however, particularly if a royalty company has a broad portfolio of royalties. There are only a handful of such companies; my favorite is the oldest and largest, Franco-Nevada, a Canadian company which acquired the royalty on Barrick’s huge Goldstrike property in Nevada in the early 1980s.

The company subsequently merged with Newmont when the principals wanted to gain operating leverage at the beginning of the gold bull market. The combined company was not entirely successful and Franco-Nevada was subsequently spun off again. The management team and ethos, however, remained essentially the same.

The chairman of Franco-Nevada is the well-known industry leader Pierre Lassonde, an astute observer of and player in the gold market for 30 years. The CEO is the low-key but energetic David Harquail, another veteran of the former Franco-Nevada. Franco's primary focus is on gold, with a goal to have at least 70% of its revenues from precious metals. Currently, it's doing better than that, with 70% from gold and another 8% from other precious metals (primarily the royalty on Stillwater's platinum mine). This is a significant increase in gold revenues from 2008, when just under half came from gold.

The balance of the company's revenue comes from a copper royalty, plus several oil and gas royalties and acreage. Behind the producing royalties, led by its flagship Goldstrike royalties, Franco has a deep portfolio of exploration and development properties, with at least four significant gold royalties expected to start generating revenue in each of the next three years. This guarantees Franco ongoing growth for several years to come. Indeed, Franco expects to double its gold

revenues over the next four years, at current gold prices, just from existing royalties.

The political risk profile of its royalty properties is very low, with the overwhelming majority (currently 97%) of its properties in Canada, the U.S., Mexico, and Australia. The balance sheet is solid, with over half a billion dollars in cash and marketable securities and no debt or hedges. Management is tops in the industry, led by chairman Pierre Lassonde and CEO David Harquail, two astute investors who do not like to overpay and who eschew leverage.

The high proportion of revenues from gold and the strong political risk profile will allow the company to make a more speculative acquisition, or perhaps one in the base metals or a riskier political environment, if the potential is strong, without negating its high gold, low political risk profile.

That may not happen, but with the strong cash balance and smaller competition (the removal of International Royalty, and Royal Gold's near-term focus on digesting the acquisition and its balance sheet), Franco is in a position to act.

All in all, royalty companies offer investors a low-risk exposure to the gold market. They are companies that can be held for several years throughout the gold cycle. There may be better times to buy Franco-Nevada (FNV,



Toronto, C\$31.85) than today, and there may be specific stocks that could perform better. But if you have a long-term view, you will be happy you own this top-quality, low-risk company.

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