Mergers and Acquisitions in the Gold Sector - Historical development, status quo and expected trends

In this article, we will look at the gold sector and why we believe M&A activity in the gold sector will remain high in the coming years. There are many reasons for ongoing consolidation, and as an example the reasons become apparent when looking at the rationale of the recently announced merger of Agnico Eagle and Kirkland Lake - more on that later.

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Market concentration

First, let's look at market concentration in the gold sector, comparing the universe of gold producers with copper producers (similar results apply to other industrial metals).

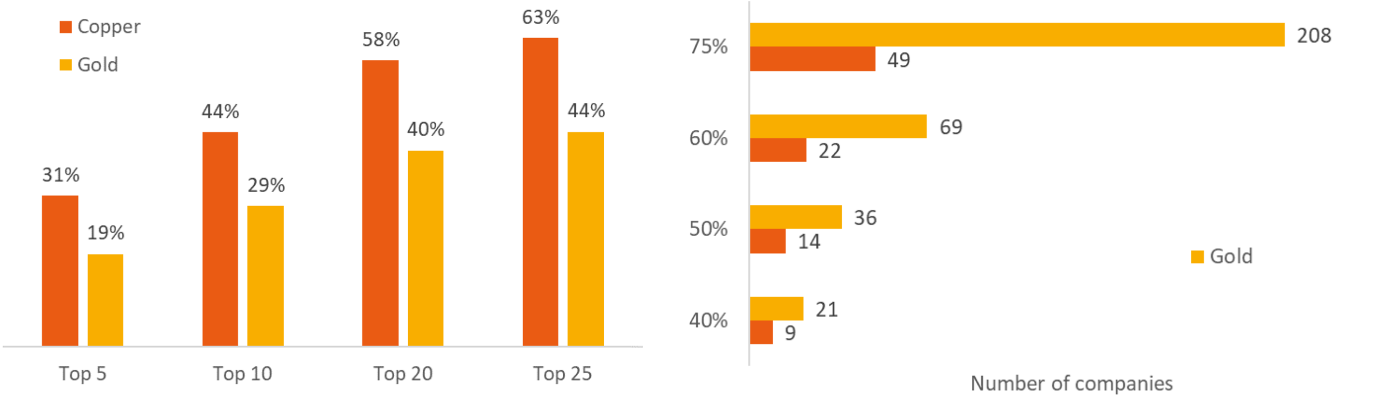


Figure 1 - Share of global mining production

From the comparison of producers from both sectors, it can be quickly seen that the concentration is significantly greater for copper producers (for example, the top 10 copper producers account for 44% of global primary production, compared to only 29% for gold producers). This difference is still significant, although there have been a few mergers within the top 10 gold producers in recent years. For example, Newmont and Goldcorp in 2019 and Barrick and Randgold in 2018.

The difference in concentration among medium to small producers is even more significant: While the 22 largest copper producers produce about 60% of global copper production, more than 3 times as many companies (69) are required to produce the same share of global gold production. For 75% of the production, it becomes even more obvious with 49 copper producers and more than 4 times as many gold producers (208 companies).

The difference is of course also reflected in the Herfindahl-Hirschman Index (HHI) of 264 (Copper) to 124 (Gold). The HHI is a metric often used in economics to measure a company's concentration).

In our view this significant difference in production concentration is a first clear indication of further consolidation pressure, not least to realize possible synergies, economic of scales and cost reductions.

Exploration spending and reserve crisis

Another important aspect is the continuous reduction of reserves and resources through ongoing production. We want to illustrate this by looking at the reserve development of major gold producers (>1m oz Au per year) over time.

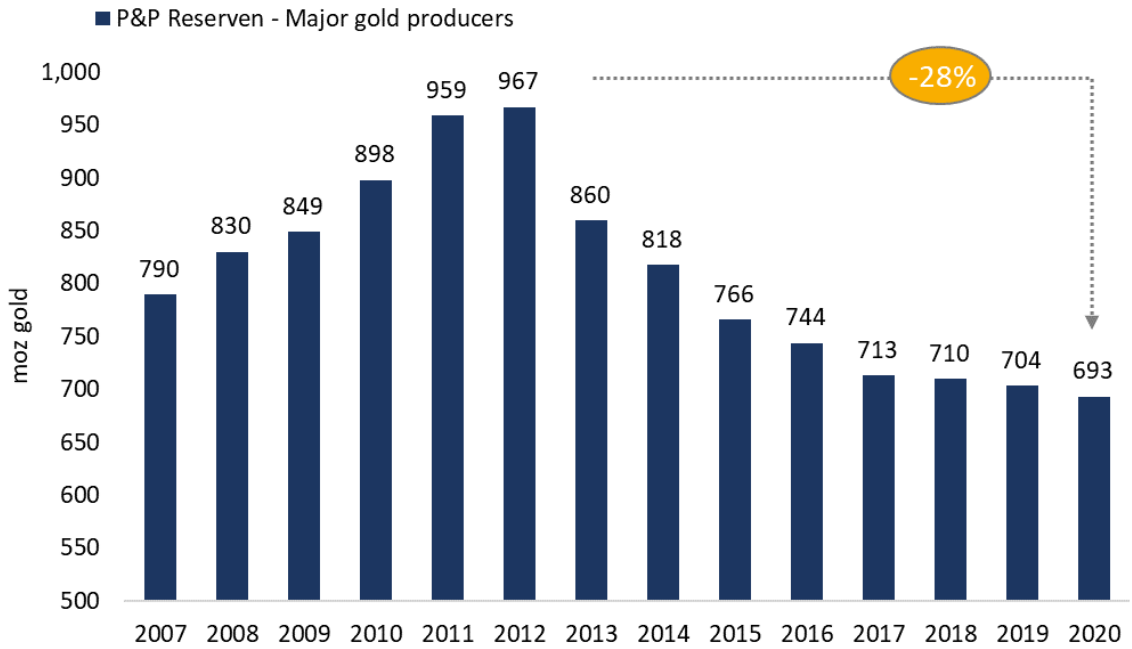


Figure 2 – P&P Reserves major gold producers

Since the peak in 2012, the reserves of these major producers have fallen by almost 30%.

The reasons for this are manifold; however, one main cause can certainly be seen in the lack of greenfield exploration activity rather brownfield, which led to the fact that hardly any new deposits were discovered in the years 2013 until today.

After the sharp drop of the gold price in 2012/2013, the gold producers were forced to cut their expenditures and focus primarily on keeping production profitable, in some cases with highly indebted balance sheets. Among other things, exploration spending has been a victim to this pressure to cut costs. This is particularly evident in the following chart, which compares global exploration spending with the development of the gold price:

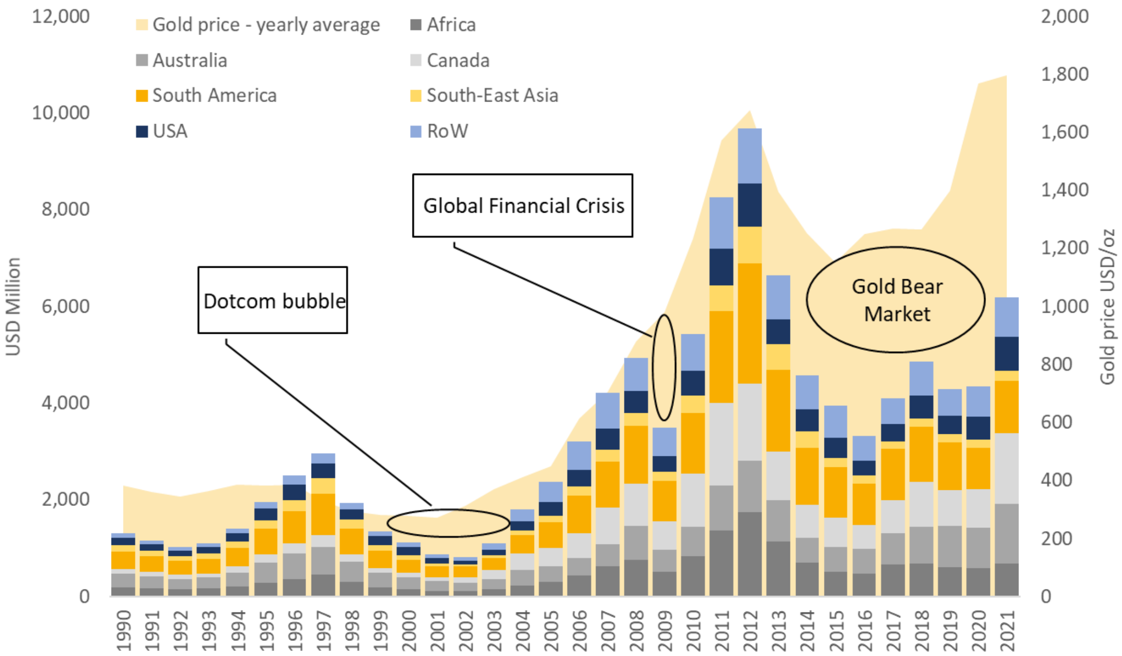


Figure 3 – Gold exploration budget and gold price development:

To make matters worse, exploration companies found it very difficult to finance themselves in the capital markets between 2012 - 2019. Thus, producers also lacked their "extended exploration arms" during the 7-8 years of the gold bear market.

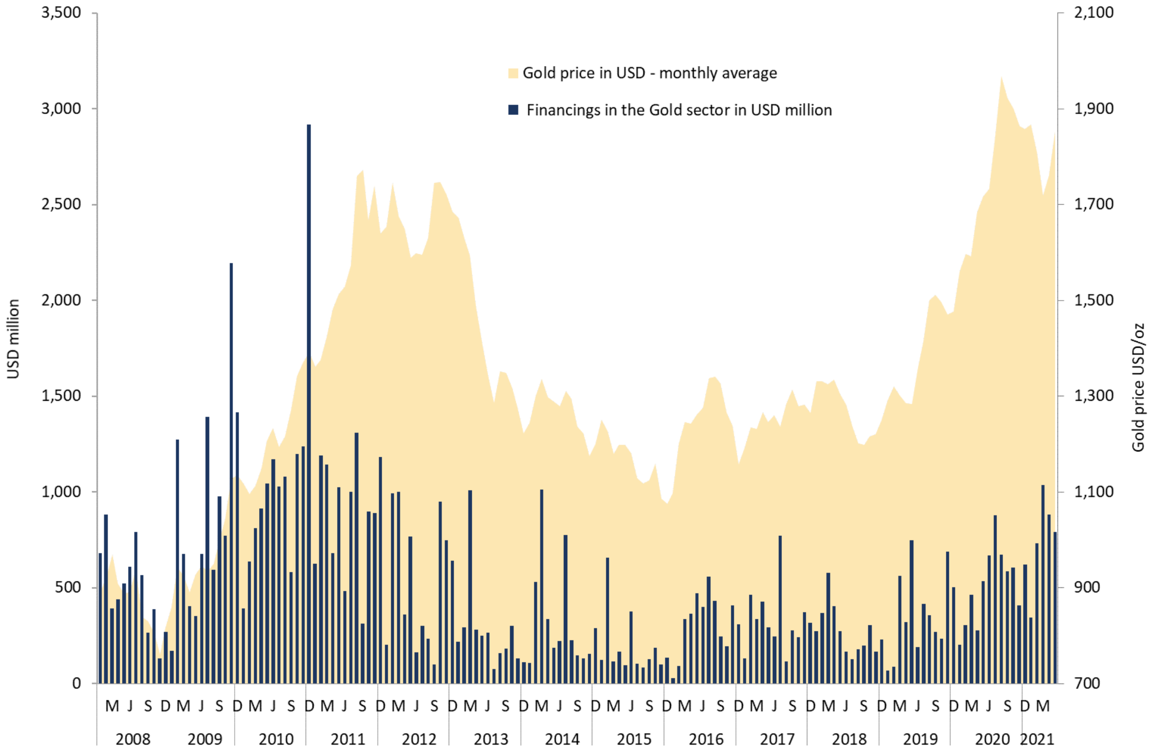


Figure 4 – Financings in the gold market

Incidentally, the picture is very similar for exploration spending (all industrial and precious metals) - so it is a phenomenon that is likely to pose enormous problems for the entire industry, especially in a still imminent, further increasing demand pressure for commodities worldwide.

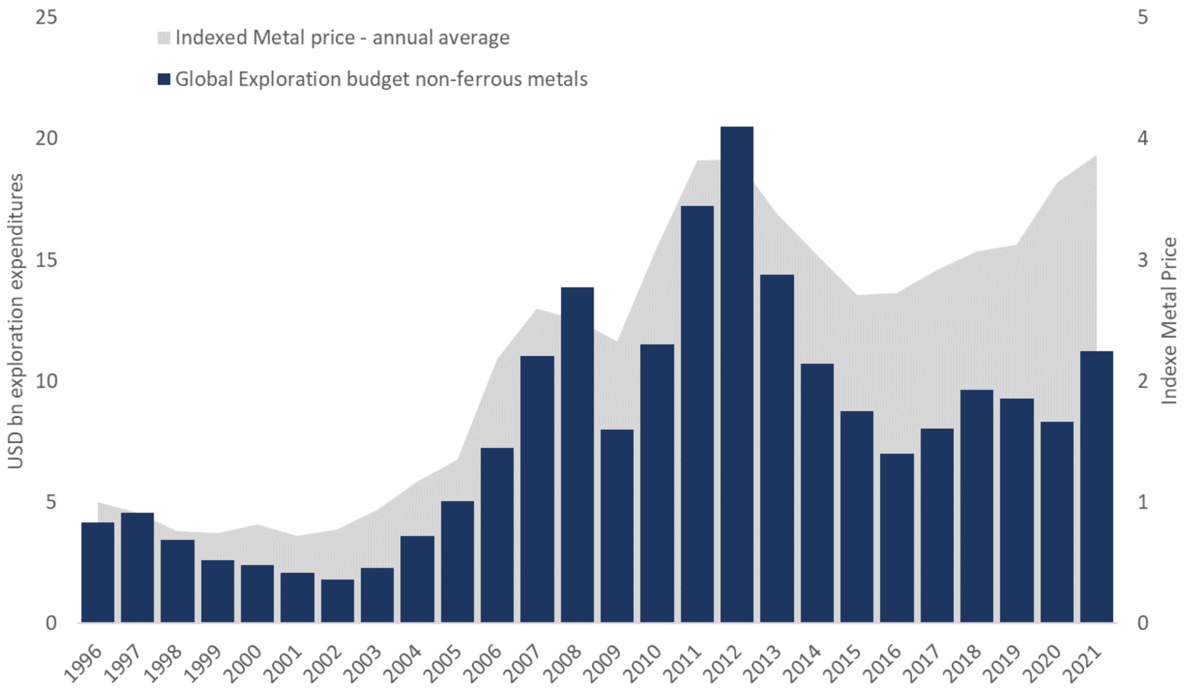


Figure 5 – Exploration expenditures all metals

Back to Gold. Reduced exploration activity by major producers and a lack of funding for traditional exploration companies has meant that new discoveries of gold deposits have fallen to an all-time low. This is partly explained by lower spending, but not only. Although this spending went up significantly in 2010 & 2011, there was no similar increase in new resource discoveries. Major Discovery: >2M Oz Reserve.

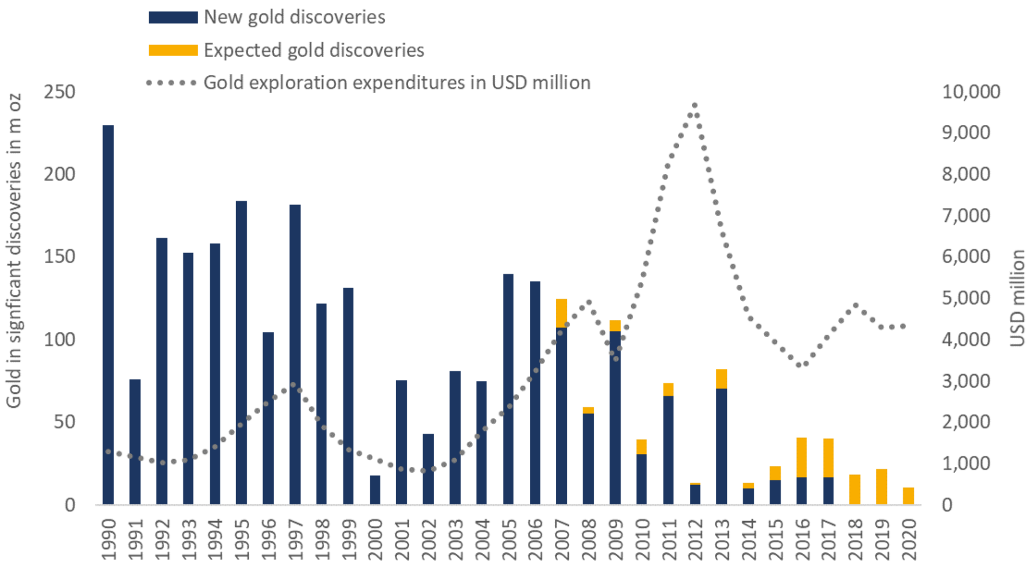


Figure 6 – New gold discoveries

<u>What is the reason for this?</u>

To put it simply, the more easily accessible, higher-grade deposits have been discovered and developed in recent decades or centuries. So today, exploration must be done with new and innovative technology (for example artificial intelligence & exploration under cover) in order to even discover new larger and economically exploitable deposits.

In the last decade, only 10 deposits with a total of 238 million ounces of gold have been discovered - that is less than 10% of the gold deposits discovered in the last 30 years. The trend is therefore very clear and will hardly be reversed anytime soon even with increased exploration spending.

<u>Mergers and Acquisitions</u>

Having looked in detail at the main reasons for increased M&A activity in the gold sector, we now want to show how and to what extent M&A activity has increased over the past few years. To do this, we first looked at the number of M&A transactions over time. For this purpose, we have considered all transactions with a volume of more than USD 25 million and only projects / targets that have reported at least measured and indicated resources.

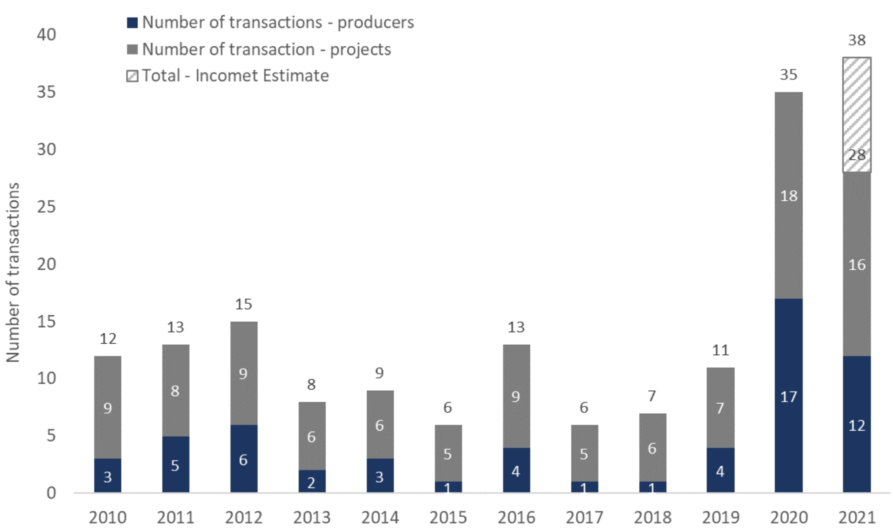
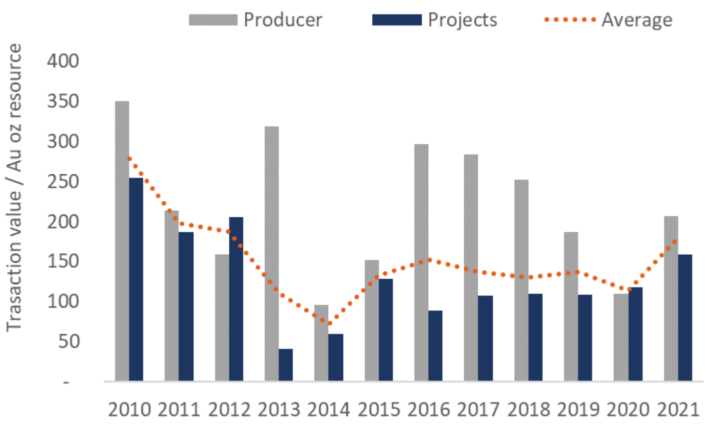


Figure 7 – number of Gold M&A transactions

It is immediately clear from the graph that the number of mergers and acquisitions has increased significantly since 2020. There has been an increased number of acquisitions among producers, which can be explained not only by the lack of concentration in the market but also by the more difficult travel in the last 18 months. Taking on a large project tends to require significantly more on-site due diligence than a producer where robust production and financial data is available.

We expect to see a similar number of transactions in 2021 and that this very strong activity will continue in the coming years. We may also see an increase in acquisitions of large projects, which producers will need in order to replace their diminishing resources and reserves in a timely manner.



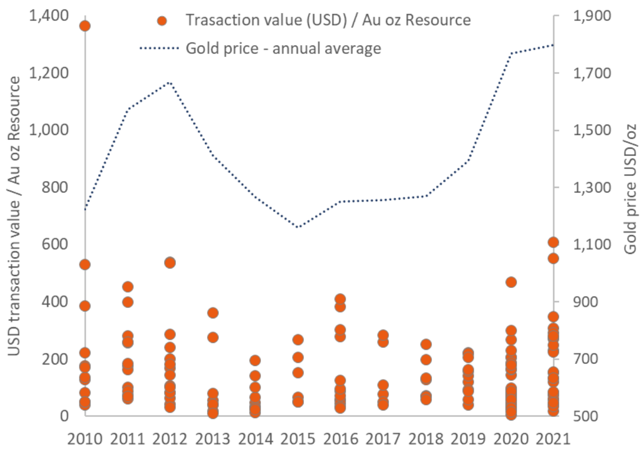


Figure 8 - Transaction values (in USD) in relation to M&I resources and reserves.

Apart from a few exceptions in 2016 (for example the emergence of Kirkland Lake), both the number of transactions and the purchase prices paid were at very low levels. With the pick-up in commodity and precious metal prices in recent years, the beginning has been made for higher transaction prices per ounce again. We expect M&A activity to remain at a high level and the willingness to pay higher purchase prices to increase further.

How can we benefit from this and what is our strategy in this context?

On the one hand, we invest in exploration companies that have the potential for a discovery of new resources and in companies or projects that have already completed important phases in their development (such as the confirmation of reserves or the submission of necessary permits). Such projects represent attractive takeover targets for the major producers during this development phase or when in production.

And, of course, there are also smaller and mid-sized, highly profitable, and growth-oriented producers in our portfolio that can either be considered as takeover candidates or benefit from high organic growth.

We mentioned at the outset the recently announced merger of Agnico Eagle and Kirkland Lake (this transaction by the way is not yet reflected in our data, as we only consider completed transactions) and the market comments, as well as the motivations that the companies have given, reaffirm our analysis: Both have emphasized that the pipeline of development and exploration projects was decisive, as well as the respective track record of discovering and declaring resources and reserves (i.e. replacing production). In addition, of course, synergies also play an important role, which are lost to a considerable extent by an industry that is currently still poorly concentrated.

It remains to be seen whether the management of the major producers will show sufficient discipline not to repeat the mistakes of 2010 & 2011: high leverage for acquisitions, losing sight of costs, etc. Due to the still high gold prices as well as the "lessons learned" from 2010/2011, it seems at least unlikely at this stage that the industry will get into excessive valuations and leverage again.

About Us

Incomet Capital is the investment manager of the Smart Gold Investments 79 precious metals fund, which focuses on both listed and unlisted high-growth mining companies in the gold and silver industry, with an emphasis on junior companies.

Our operational and technical experience, as well as our industry knowledge, enable us to identify high-quality but undervalued assets as part of our investment strategy, thus generating superior returns for our partners. Incomet Capital is a capital management company for alternative investment funds according to §2 Abs. 4 KAGB.

We welcome your questions and suggestions. We also always make our research and analyses available in our blog on the website.

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