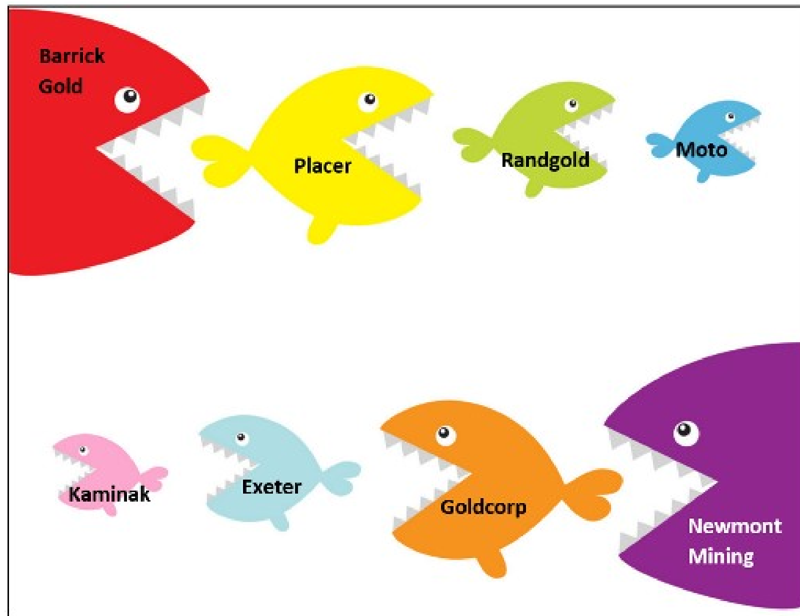
EXPLORATION insights NEWSLETTER
JOE MAZUMDAR | BRENT COOK

Mega-mergers create fewer but larger apex predators

by Joe Mazumdar

This week, Newmont Mining (NEM.NYSE) announced its intention to digest Goldcorp (G.T, GG.NYSE) in an all-share transaction, where 1 share of GG would be worth 0.326 shares of NEM. The friendly bid provides a modest premium (17-18%) to Goldcorp's previous close and values the Vancouver-based gold producer at ~US$10 billion.

The combination will create the apex predator in the gold sector.



(Climbing up the food chain, *Source: VectorStock and Exploration Insights*)

The transaction was the second significant merger in the gold sector following on the heels of Barrick Gold's (ABX.T, GOLD.NYSE) assimilation of Randgold (delisted) during the Denver Gold Show.

At the time that Barrick announced its no premium bid for the African-focused gold producer, we saw the potential that the merger could "spark further corporate activity that will serve to fill the valuation gap of target companies, which is a positive for the industry." Although we discussed another seven M&A transactions in 2018, the mega-mergers are the ones that get everyone's attention because they show how the large companies are both adapting to and altering the ecosystem of the precious metals sector.

In April 2017, Goldcorp's multi-faceted transaction to carve out a significant footprint for itself in the Maricunga mining district of central Chile through the acquisition of a few large,

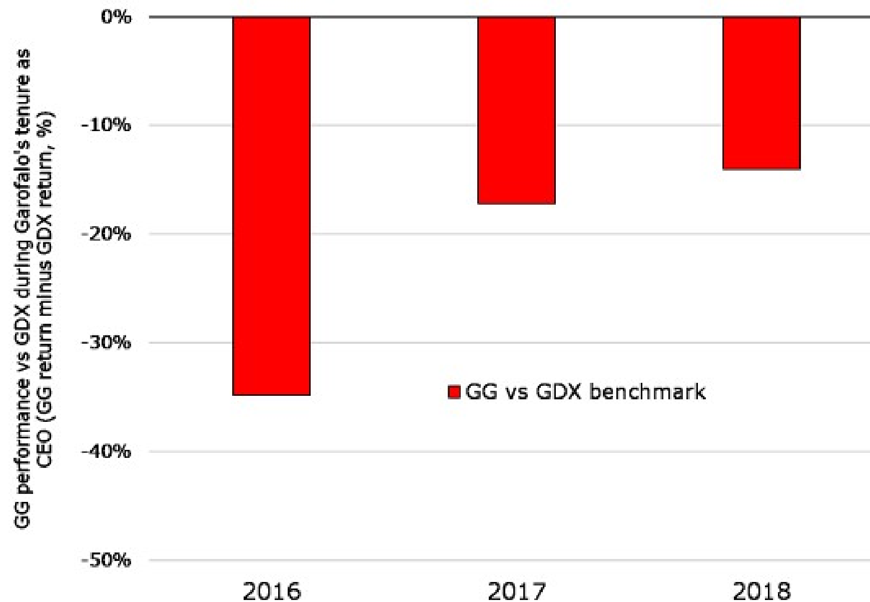
but low grade, gold-copper assets (Caspiche, Cerro Casale, and Quebrada Seca), was seen as going "against the grain", and didn't look propitious.

Piling up low-quality and marginal assets in a volatile gold price environment generated billions of dollars' worth of impairments for a number of gold companies and, in my view, would not increase the company's net asset value per share, which was CEO Garofalo's stated goal.

During Mr. Garofalo's three-year tenure as CEO, his team (Fig. 1) has managed to clip ~US$1.6 billion of the company's market capitalization. In our recent review of 26 North American-listed gold producers, which included several royalty/streaming companies, we saw that Goldcorp was the only one in its peer group with a negative working capital position (US$190 M). Furthermore, it carried US$2.3 billion in debt, generated negative free cash flow over the first nine months of 2018 (US$200 M), and had one of the largest accumulated deficits ahead of Barrick.

(Figure 1: Goldcorp's executive team, except Mr. Harbridge, will be well compensated under the Change of Control provisions, *Source: Investing.com and Exploration Insights*)

The company's share price has fallen ~20% since early December 2015, underperforming the major precious metal companies benchmark (GDX) by 60% in the same period, which shouldn't come as a surprise given its consistently negative annual underperformance, (Fig. 2).



(Figure 2: Goldcorp's annual underperformance, *Source: Investing.com and Exploration Insights*)

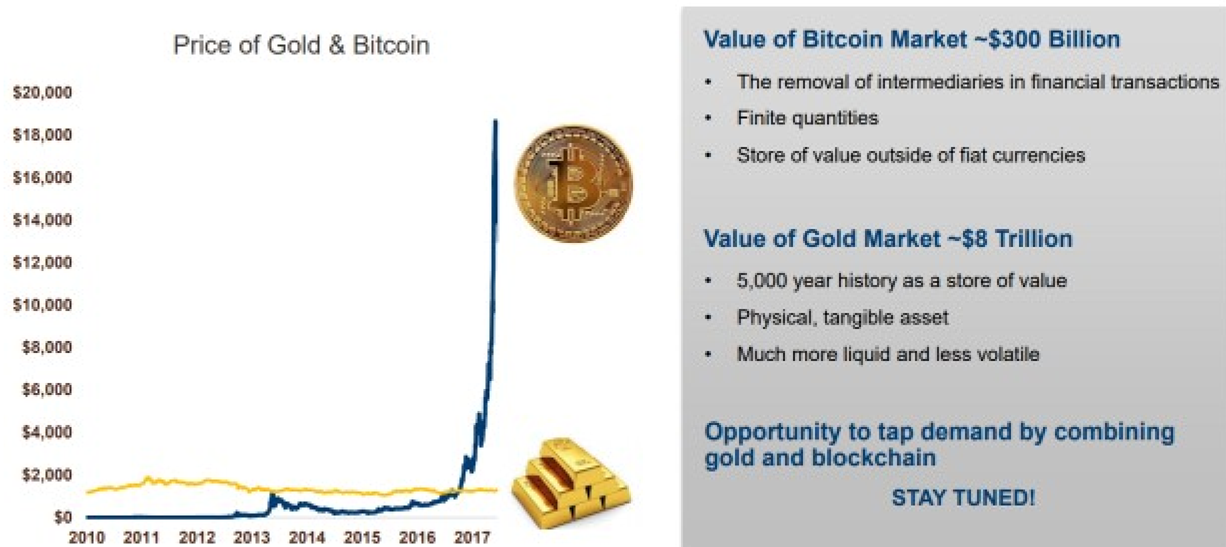
The returns, and thus the company's low valuation, reflect investors' lack of confidence in the executive team. The cheap valuation is no doubt the reason Newmont considers the combination *"...to be immediately accretive to (its) net asset value and cash flow per share."*

Incidentally, the acquisition will also be accretive to Goldcorp's executive management team thanks to the various *change of control* clauses. According to a document dated March 2018 (Table 1), the total compensation due to termination without cause or a change of control for five of the executives would be ~C$28 million, based on a share price of ~C$16.

	Garofalo	Attew	White	Ripley	Bergeron
Termination Without Cause or Following a Change of Control					
Severance Payment	2,700,000	1,300,000	1,300,000	1,200,000	1,120,000
Severance STI Payment	3,375,000	1,040,000	1,040,000	960,000	896,000
Unvested PSUs[1]	2,346,471	431,864	1,403,298	1,856,178	1,667,861
Unvested RSUs[1]	1,989,772	668,563	421,589	457,448	414,440
Unvested Stock Options[1]	Nil	Nil	Nil	Nil	Nil
Benefits[2]	47,927	27,538	23,744	27,538	27,538
SERP[3]	568,677	95,809	245,030	673,749	Nil
TOTALS	**11,027,847**	**3,563,774**	**4,433,661**	**5,174,913**	**4,125,839**

(Table 1: Total compensation for a *change of control* calculated for the end of 2017 at a share price of C$16.03, *Source: Management Information Circular, March 2018*)

Current estimates for the CEO alone are between US$8.5 and 9.0 million, including ~US$6.9 million in severance/pension and US$1.8 million in shares at the offer price. Maybe he will take his payment in bitcoin, as I understand he is a fan, (Fig. 3).



(Figure 3: GG management proposing the opportunity to tap demand by combining gold and blockchain, *Source: Goldcorp Corporate Update, January 2018*)

Not a deal that I have to do…but one I wanted to do

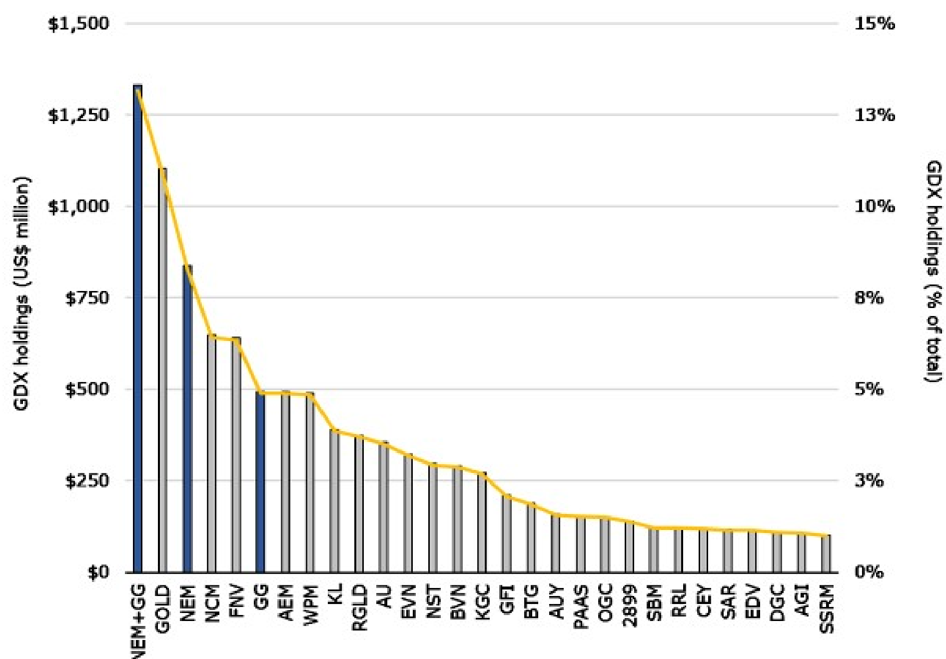
In a joint conference call held last Monday between Garofalo and Newmont's CEO Gary Goldberg, the latter emphasized that the acquisition of Goldcorp was not a deal he *had* to do. He may have been suggesting that he was not compelled by history to correct a past omission. The background for his confession may lie in Newmont's failure, rightly or wrongly, to keep pace with its Toronto-based rival over the decade following Barrick Gold's acquisition of Placer Dome in October 2005 for US$9.2 billion.

Although the Denver-based gold producer has performed well over the past few years, the company appeared to have hit a wall regarding growth while trying to maintain a discipline of only executing projects that generate a 15% internal rate of return, (Fig. 4). Prior to the merger announcement, Newmont guided its investors to near term production of 4.9-5.2 million ounces and a long term profile of between 4.4 to 4.9 million ounces.

(Figure 4: Forecast projects - decline in existing operations = flat projected production profile, *Source: Newmont Mining*)

Part of Mr. Goldberg's desire to execute the transaction may be simply hubris to leave Newmont as the largest gold mining company in the world. He was scheduled to retire as CEO in the latter part of 2018 but will remain until the transition and integration of Goldcorp is complete for the ~20,000 combined employees.

Previously, I detailed the growth of passive funds, like the GDX and GDXJ ETFs, that attract generalist investors to the gold sector. The combined (NEM+GG) company would leap ahead of the New Barrick (GOLD) as the top holding of the GDX (>13%, ~US$1.3 B), (Fig. 5).



(Figure 5: GDX holdings as of January 17 in US$ million [bars] and as percentage of total[**yellow** line], including a combined NEM+GG, *Source: VanEck.com and Exploration Insights*)

Below is a high-level summary of my thoughts on the combination:

- Sustainable production overgrowth - The combined NEM-GG will be the largest gold mining company at an estimated market capitalization of US$25-26 billion, (Table 2). Although the combined production would be 7.5-7.6 million ounces, the guidance is for a long term profile of 6-7 million ounces. This suggests that a sustainable profile that generates positive free cash flow is, again, given priority over production growth.

	GG EOY 2015 (12 m)	GG Q3 2018 YTD (9 m)	NEM Q3 2018 YTD (9 m)	NEM-GG Combined Proforma
FY Production (Moz)	3.46	2.29	5.30	6 - 7
2P reserves (Moz)	40.7	52.8	68.5	105.3
Free cash flow (US$ M)	$997	-$200	$203	$3
G&A (US$ M)	$207	$101	$181	$376
Working capital (US$ M)	$282	-$190	$3,884	$3,694
Dividends (US$ M)	$370	$45	$226	$454
Dividend per sh (US$/sh)	$0.45	$0.07	$0.56	$0.56
LT debt (US$ M)	$2,476	$2,336	$4,043	$6,379
Divestitures (US$ M)	$788	$0	$23	$1,000 - 1,500
Market capitalization (US$ M)	$10,570	$8,974	$16,811	$25,784
Enterprise value (US$ M)	$12,764	$11,500	$16,970	$28,469
Shares out (M sh)	830.34	869.53	532.66	817.87

(Table 2: Production and financial results from prior to Mr. Garofalo's tenure at Goldcorp [GG EOY 2015, left], Mr. Garofalo's last quarterly performance [GG Q3 2018 YTD, 9 m, center left], Newmont's last quarterly performance [NEM Q3 2018 YTD, 9 m, center left], and my estimate for the pro forma company [full year, right], *Source: Goldcorp, Newmont Mining and Exploration Insights*)

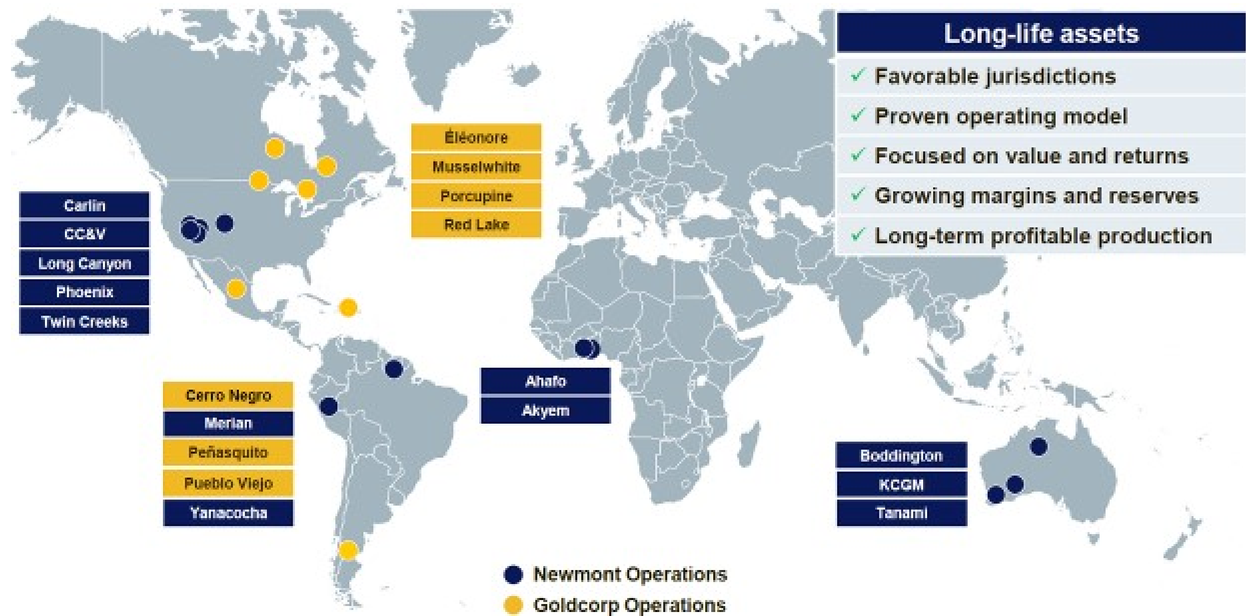
- Divestitures over a two-year period generating US$1.0 to US$1.5 billion in sales, with caveats - The smaller combined production profile is linked to proposed divestitures and, potentially, a more realistic reserve statement. I would think that marginal assets would be sold off first, especially if the holding costs are high. However, the deal between Goldcorp and Barrick on some of these marginal assets in Chile may not be easily broken since Barrick's interest in taking an entire project would be limited given the recent changes in the company's management team.

- Reserves affected by asset quality - I think the resulting reserves and development pipeline from the combination will not be a matter of simple addition (GG 52.8 Moz + NEM 68.5 Moz = ~121 Moz) given that 16 million ounces of GG's reserves are hosted by a pair of marginal deposits (Cerro Casale and NuevaUnión) in Chile, (Table 3).

		PROVEN			PROBABLE			PROVEN & PROBABLE		
	Ownership	Tonnage	Grade	Contained	Tonnage	Grade	Contained	Tonnage	Grade	Contained
Gold		*mt*	*g/t*	*m oz*	*mt*	*g/t*	*m oz*	*mt*	*g/t*	*m oz*
Alumbrera	37.5%	29.63	0.40	0.38	1.31	0.38	0.02	30.94	0.39	0.39
Cerro Casale	50.0%	114.85	0.65	2.39	483.95	0.59	9.23	598.80	0.60	11.62
Cerro Negro	100.0%	3.68	8.11	0.96	14.15	8.92	4.06	17.83	8.75	5.02
Coffee	100.0%	11.68	1.47	0.55	25.23	1.37	1.11	36.91	1.40	1.67
Éléonore	100.0%	3.65	5.97	0.70	14.14	5.61	2.55	17.78	5.69	3.25
Musselwhite	100.0%	3.59	6.57	0.76	7.31	6.46	1.52	10.91	6.49	2.28
NuevaUnión	50.0%	166.80	0.55	2.96	121.58	0.38	1.50	288.37	0.48	4.46
Peñasquito	100.0%	376.43	0.58	6.97	143.99	0.46	2.15	520.41	0.55	9.12
Porcupine	100.0%	13.42	1.64	0.71	216.71	1.07	7.42	230.13	1.10	8.13
Pueblo Viejo	40.0%	41.42	2.67	3.56	12.81	3.06	1.26	54.24	2.76	4.82
Red Lake	100.0%	1.53	10.24	0.50	7.66	6.30	1.55	9.19	6.95	2.05
Totals		**766.67**	**0.83**	**20.44**	**1,048.85**	**0.96**	**32.37**	**1,815.52**	**0.90**	**52.81**

(Table 3: Last reserve statement hosts ~53 million ounces grading just under 1.0 g/t gold. The low grade is driven by large, marginal deposits such as Cerro Casale and NuevaUnión, *Source: Goldcorp*)

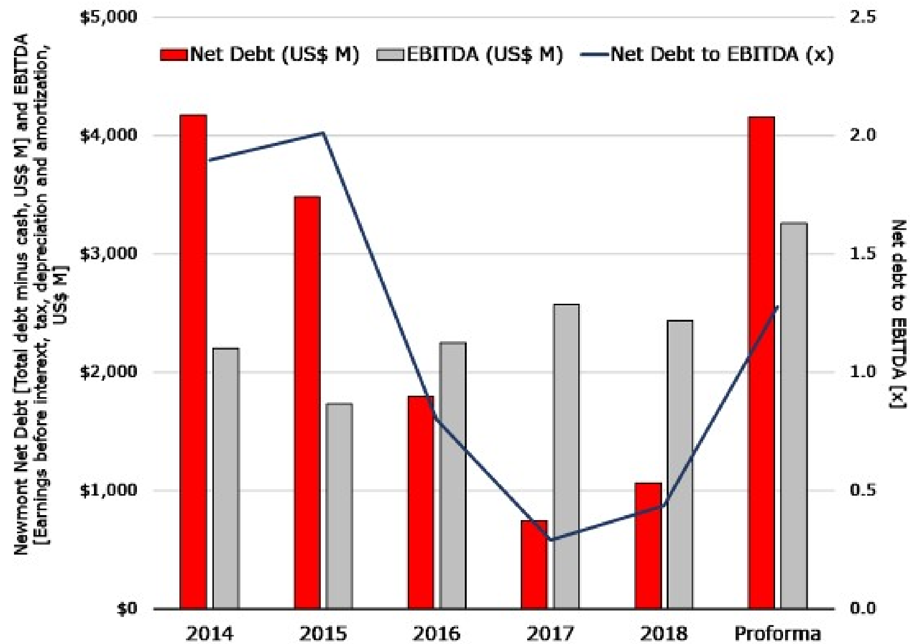
- Savings should zero in on corporate G&A - The NEM-GG combination proposes US$100 million in pre-tax savings; however, given the limited overlap between the companies' operating bases, (Fig. 6), savings should focus on corporate G&A expenses—Goldcorp alone was spending ~US$20 million a quarter (or US$120 million on an annual basis).



(Figure 6: Location of Newmont's [**blue**] and Goldcorp's [**gold**] operating assets, *Source: Newmont Mining*)

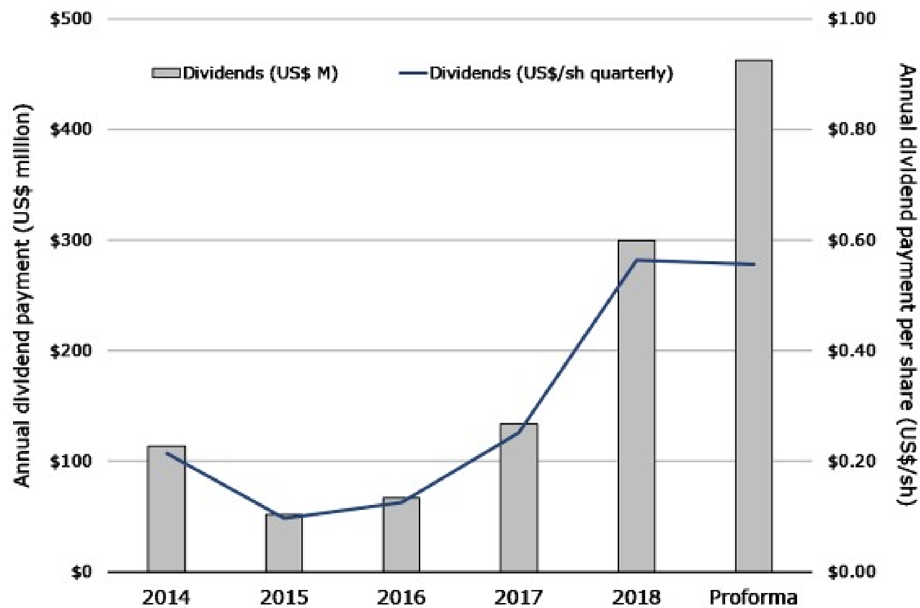
- One favorable outcome of the merger will be the ability to choose the best from a combined pool of ~20,000 employees given the human resource shortage in the industry, although the sticker shock for those moving from the former North America regional office in Elko, Nevada to Vancouver, British Columbia will be interesting to watch.

- More debt with little cash - Since Newmont will be taking on an additional US$3.3 billion in total debt with a small cash position (US$166 M) from Goldcorp, it will need to readjust the portfolio and follow through on the divestitures (US$1.0-$1.5 B) to continue to maintain a debt to EBITDA (earnings before income tax, depreciation and amortization) ratio of less than 1 to be able to borrow at lower costs, (Fig. 7). Newmont currently spends ~US$200 million a year on interest-related expenses to cover its current total debt of US$4.0-$4.1 billion.



(Figure 7: Net debt [red bars], EBITDA [grey bars] and net debt to EBITDA ratio [line] over the past several years including our pro forma estimate, *Source: Goldcorp, Newmont Mining, Investing.com and Exploration Insights*)

- Maintaining dividend policy also challenged - Conceivably to steer investors' attention away from the lack of production growth, Newmont's management put an emphasis on its ability to generate positive free cash flow: the company almost tripled its annual dividend to US$0.56 per share in March 2018. Its new share count after the merger will be ~818 million, which will require ~US$455 million a year in dividend payments to maintain the same policy, (Fig. 8). Paying sustainable dividends is an important aspect of the company's policy as it attracts a different class of investor.



(Figure 8: Dividend payments [US$ million, **grey** bars] and on a per share basis [US$/sh, **blue** line], *Source: Newmont Mining, Investing.com and Exploration Insights*)

Challenges remain, but bigger may be more attractive to generalists

Thee Barrick-Randgold mega-merger combined a high-debt-load/no-CEO company controlling several Tier One gold assets in areas of low geopolitical risk with another company led by an executive who emphasizes returns on assets located predominantly in geopolitically riskier jurisdictions in Africa.

On the other hand, the Goldcorp-Newmont mega-merger combined a major producer that was decimating shareholder value with a much better managed, larger company that has a long history and is well placed to survive well into the future.

Goldcorp's business plan for a 20% growth in production combined with a 20% growth in reserves while driving down its AISC (all in sustaining costs) by 20% did not generate much shareholder value over Garofalo's tenure, (Fig. 9). The big plans led to a negative working capital position at the end of September 2018, no positive free cash flow generation, and a significant debt position; therefore, the company's acquisition is an easy way out for its shareholders and executive management team.

(Figure 9: Company's 20/20/20 Vision, *Source: Goldcorp*)

For Newmont's stockholders, the merger is also a positive as it will define the company as the largest gold producer on the planet and the apex predator in the changing precious metals ecosystem. The combination will provide the management team a broader asset portfolio, predominantly in the Americas and Australia, and project pipeline to be optimized.

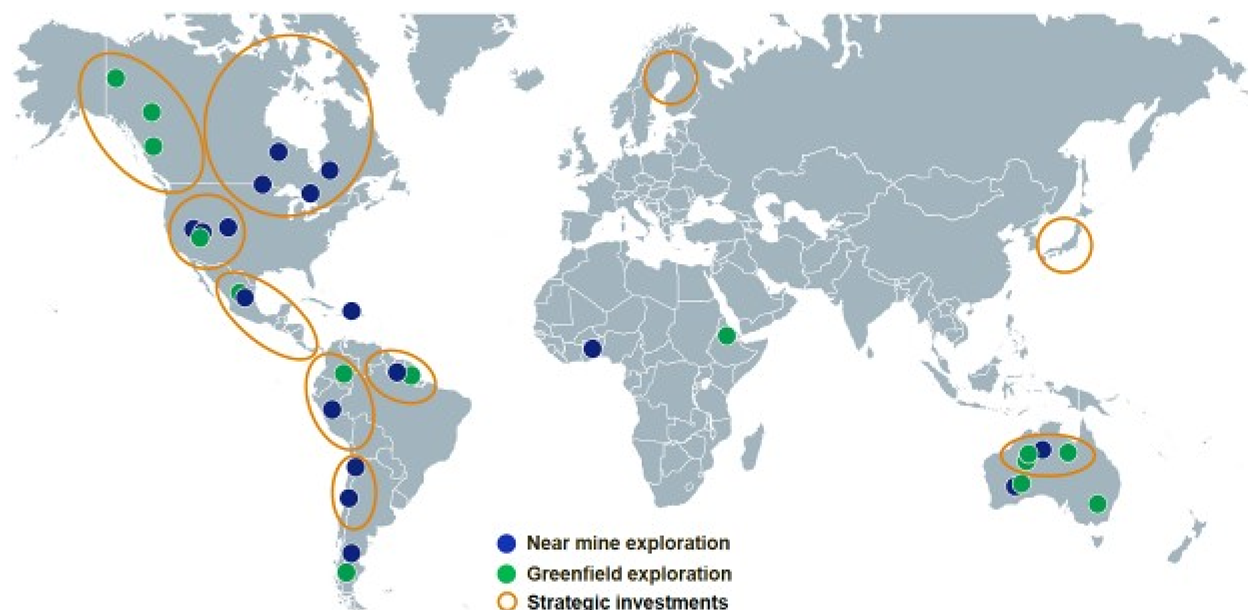
The fact that the combined production is set at a lower level than the simple addition of the two is important to manage expectations appropriately. The priority will continue to be generating free cash flow from assets with 15% returns or better. However, there are risks involved for the new company, including its ability to:

- manage the debt load,
- continue paying dividends,
- integrate the new assets and people, and
- divest some of the portfolio.

Ultimately, generalists, who tend to prefer passive ETFs, may be attracted to the merged miner due to its market capitalization, liquidity, dual-listing, dividends, manageable debt load, and low risk geopolitical asset portfolio. Also, it will be the only company listed on the S&P 500.

The focus for many, especially investment bankers, private equity groups, and smaller producers seeking growth, will be the divestiture of assets on the part of both the NEM+GG and GOLD mega-mergers. The likely acquirers will be junior to mid-tier producers with good working capital positions since both companies will prefer cash to shares, but I bet that Australian companies—due to their valuations and success in generating free cash flow—and private equity firms will also play a role.

This doesn't mean that the two behemoths will not continue to seek new opportunities, (Fig. 10), but there is plenty of work to do just to rationalize the portfolios and manage the pipelines over the next couple of years.



(Figure 10: Newmont's exploration assets including near mine [**blue** dot] and greenfield [**green** dot] exploration as well as strategic investments [**orange** circles], *Source: Newmont Mining*)

Disclaimer

This letter/article is not intended to meet your specific individual investment needs, and it is not tailored to your personal financial situation. Nothing contained herein constitutes, is intended, or deemed to be--either implied or otherwise--investment advice. This letter/article reflects the personal views and opinions of Brent Cook and Joe Mazumdar, and that is all it purports to be. While the information herein is believed to be accurate and reliable, it is not guaranteed or implied to be so. The information herein may not be complete or correct; it is provided in good faith but without any legal responsibility or obligation to provide future updates. Research that was commissioned and paid for by private, institutional clients is deemed to be outside the scope of the newsletter, and certain companies that may be discussed in the newsletter could have been the subject of such private research projects done on behalf of private institutional clients. Neither Brent Cook, nor Joe Mazumdar, nor anyone else, accepts any responsibility, or assumes any liability, whatsoever, for any direct, indirect or consequential loss arising from the use of the information in this letter/article. The information contained herein is subject to change without notice, may become outdated, and may not be updated. The opinions are both time and market sensitive. Brent Cook, Joe Mazumdar, and the entities that they control, family, friends, employees, associates, and others, may have positions in securities mentioned, or discussed, in this letter/article. While every attempt is made to avoid conflicts of interest, such conflicts do arise from time to time. Whenever a conflict of interest arises, every attempt is made to resolve such conflict in the best possible interest of all parties, but you should not assume that your interest would be placed ahead of anyone else's interest in the event of a conflict of interest. No part of this letter/article may be reproduced, copied, emailed, faxed, or distributed (in any form) without the express written permission of Brent Cook or Joe Mazumdar. Everything contained herein is subject to international copyright protection.