Seeking Alpha α

The AISC And The GDX/GLD Ratio In The Gold Miners' Valuation

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by: Fun Trading

Summary

- Gold mining evaluation is a difficult exercise. I have identified two crucial components that can help in this difficult task.
- The All-in Sustaining Costs help in the determination of the profit margin.
- The GDX/GLD ratio or the GGR is an excellent indicator.
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Thesis

The most significant obstacle for evaluating a mining company is to gather and analyze conflicting data so the final picture presents a balanced view that makes sense and from which we can get a reliable valuation.

It sounds like an easily manageable exercise, but it is far from it and requires careful investigation and extensive knowledge that often stretches beyond the company's fundamentals.

We need to pick an invariable list of financial and technical components to understand the business's complexity and *identify early red flags* that almost every miner displays to some extent.

This fastidious exercise is well worth it because it generally opens your eyes to the potential weaknesses before they become a severe matter for your pocketbook.

A list of those data points includes the share structure, location of the assets, amount of resources and reserves, ore grade and nature, recovery rate, management, company guidance, growth potential, net debt situation, etc.

Gold Price, profitability and costs

However, one fundamental feature is that gold mining companies are tightly linked to the gold price. The business model is simple and straightforward. Gold miners dig the ground and produce gold at a cost and sell it to the market. Hence, unlike most other industries, gold miners' earnings rely on one exclusive variable component: *gold price.*

To make the system work financially, this process has to be *profitable*, which means that the company should generate sufficient cash flow from operations at the end of the cycle to repay the debt, dividend, CapEx, etc.

The costs of producing gold are mostly outlined during the mine-planning stages when experts select which gold-bearing ores to focus on, mine them, and extract the precious metal. However, they fluctuate in time depending on real expenses (Energy, workforce, tax, sustaining CapEx, etc.)

I will focus in this article on two crucial components that can help in evaluating a gold miner. The first is provided quarterly by the company, called the All-in sustaining costs; the second is the GDX/GLD ratio called the GGR. One relates to an intrinsic valuation, and the other registers the fluctuation between the mining companies and the gold price.

1 - The All-In Sustaining Costs or AISC

As I said above, the game's name is to mine gold at a cost lower than the price of gold sold.

The difference between costs to produce one Troy ounce and how much a Troy ounce is sold is called *profit margin,* and it must be sufficient to generate enough cash flow to generate a profit.

Until recently, the gold mining industry was not clear about giving the real cost of mining. Initially, the "cash costs," introduced in 1996, focused on the mining and processing costs incurred instead of focusing on the costs incurred in the entire mining life cycle from exploration to closure.

The issue was to find out the full costs of getting gold out of the ground to highlight the true miner profitability.

On June 27, 2013, the World Gold Council [WGC] published a note on the "All-in sustaining costs" and "all-in costs." Terry Heymann, managing director at WGC, wrote:

> It is expected that these new metrics, the "all-in sustaining cost" and the "all-in cost" will be helpful to investors, governments, local communities, and other stakeholders in understanding the economics of gold mining. The "all-in sustaining costs" is an extension of existing "cash cost" metrics and incorporate costs related to sustaining production. The "all-in costs" include additional costs, which reflect the varying costs of producing gold over the life-cycle of a mine.

Most of the gold miners are now reporting AISC since Q2 2013. Below I have indicated a chart comparison for 11 gold miners that I follow regularly.

All-in sustaining costs or AISC (by-product) formula

All-In Sustaining Costs = Cash Costs (including by-product credits) + Sustaining Capital + Exploration expenses + G & A expenses.

Note: These new metrics are non-GAAP (Generally Accepted Accounting Principles,) and there is no standardization.

The AISC is an extension of the cash costs (see table below). It is provided in *US$ per Troy ounce* of gold *sold.* It is an important distinction because the gold produced and the quarter's gold sold are often different.

General set of definitions used in the gold mining industry

	Costs	Definition
1	Cash Costs	Includes COGS (Labor+ Energy + Consumables) + Royalties (Net of By-products credits.)
2	Total Cash Costs	Cash Costs + Head office costs + Offsite costs
3	*All-in Sustaining Costs*	*Cash Costs + Sustaining Capital + Exploration expenses + G&A expenses*
4	All-in Cash Costs	Cash Costs + Exploration expenses + Head office expenses + Sustaining Capital
5	Total Costs	Total Cash costs + Depreciation & Interests + Taxes + Projecting Capex

By-products and co-products accounting consideration.

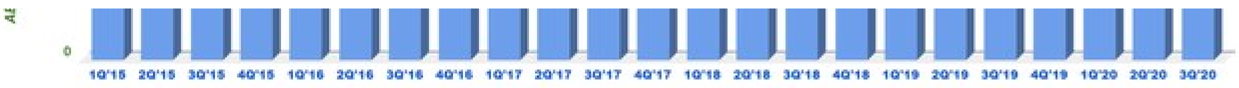
Most of the gold producers are using *by-product accounting.* It is used generally if the primary metal represents a notable percentage of the total output (70% or more). The "primary metal" can also be two metals (e.g., gold and silver). In this case, the mining company can subtract the by-product credits or use a *co-products accounting* that assigns operating costs to each metal produced based on its relative contribution to revenues.

Gold Equivalent ounce.

Furthermore, in some cases, the AISC is indicated in *GEO (SEO* for silver) or Gold Equivalent Troy Ounce if the primary metals are gold, silver, or other basic metal like copper, lead, or zinc. In this case, the silver production sold is converted using a ratio of gold/silver of roughly *77.6 for Q3.*

It is the case for Kinross Gold (NYSE:KGC), Yamana Gold (NYSE:AUY), and many others that report GEO production.

AISC is an excellent ratio for valuing the quality of the producing mine assets. With Gold averaging about ~*$1,910*+ per ounce (see the chart of AEM below) in Q3 (probably going down to about *$1,880* in Q4)



Agnico Eagle (AEM) - Created by Fun Trading for Seeking Alpha.

And an AISC averaging *$985 per ounce,* the sector *profit margin* is running way up at *$926 per ounce.*

2 - The GDX/GLD ratio or GGR

Another great valuable gold-stock-valuation that we can access in real-time is called the GDX/GLD ratio or GGR.

It is not the only one, but I like it for its simplicity. This specific ratio helps many traders like me better identify trading patterns and time their buying and selling strategy.

In terms of pure valuation, the major gold stocks do not respond well to a traditional method using a conventional price to earnings multiple (P/E) ratio, which tends to undervalue them. Because of the specific nature of the gold miners, which are entirely dependent on the gold price, it is vital to use other ratios that better reflect their characteristics.

The GGR ratio seems to be an ideal choice for tracking the gold mining industry with gold, and it is a perfect ratio that is often used in technical analysis.

The GGR is calculated from two specific ETFs that can also be traded separately. The GDX could be eventually switched to the GDXJ, but I do not recommend it.

- VanEck Vectors Gold Miners ETF (NYSEARCA:GDX)
- SPDR Gold Trust (NYSEARCA:GLD)

1 - The VanEck Vectors Gold Miners ETF is the leading benchmark and trading tools for gold miners and streamers. Its components include all of the world's biggest and best gold miners. The top ten holdings are:

- Newmont Corporation 12.37%
- Barrick Gold Corporation 10.69%
- Franco-Nevada Corporation 6.52%
- Newcrest Mining Limited 5.23%
- Agnico Eagle Mines Limited 5.05%
- Wheaton Precious Metals Corp. 4.77%
- Kirkland Lake Gold Ltd. 4.09%
- Kinross Gold Corporation 3.43%

Thus, when it comes to a stock representing the gold mining industry, the GDX is quite significant.

2 - The GLD or SPDR Gold Shares is the largest physically-backed gold exchange-traded fund (ETF) in the world. It is an uncomplicated means to gain exposure to gold.

The GLD tracks the price of gold bullion in the over-the-counter (OTC) market, and each GLD share represents one-tenth of a Troy ounce of the price of gold. However, investors are not able to convert their GLD shares into physical gold.

> GLD tracks the price of gold by holding gold bullion in a trust kept in the form of London Gold Delivery bars of 400 ounces, held in an allocated account. The physical gold is held by the custodian in a vault in London or in the vaults of other sub-custodians.

The GGR is often used in Technical Analysis for Valuation purposes.

The daily ratio between the most dominant gold stocks [GDX] and the gold price [GLD] closed at *0.20* yesterday.

The GGR forms a descending channel pattern since the end of July.

> Descending channel patterns are short-term bearish in that a stock moves lower within a descending channel, but they often form within longer-term uptrends as continuation patterns. The descending channel pattern is often followed by higher prices, but only after an upside penetration of the upper trend line.

The line resistance range is now *0.220 - 0.222,* and the line support range is *0.195 - 0.197.*

The general pattern is still bearish and may experience a possible death cross when the 50-day MA crosses below the 200-day MA, which suggests that we are not at the end of the gold correction. However, RSI implies a slower decline from here.

Note: I have calculated that during the 5 years' general bullish trend, the GGR has averaged about *0.192.*

This technical analysis suggests that any significant uptrend from here should be used to make a profit, and we could safely start to accumulate again when the GGR is below *$0.195.*

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Additional disclosure: I trade short term GDX often

Comments (5)

The_Hammer

GOLD is hugging the support line with ma's moving south, is it time for accumulation?

16 Dec 2020, 03:26 PM

Chancroid

Premium

What tool do you like to use to observe ratios between GDX and GLD

16 Dec 2020, 02:42 PM

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Author's reply » @Chancroid

The ratio is quite good in terms of TA, and without entering the most complicated part, it helps pinpoint some divergence sell/buy. It is generally used in correlation with the stock or stocks that you are trading and their own TA.

Gold bullion and gold miners/streamers have a tight relationship, but it diverges showing selling or buying flags from time to time. It happened in April, I believe.

16 Dec 2020, 02:49 PM

Krypto

Premium

Excellent article on relevant industry comparisons.

16 Dec 2020, 02:00 PM

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Author's reply » @Krypto

Thank you very much.

16 Dec 2020, 02:07 PM