Gold finger

Roger Montgomery asks: Is there a safe goldmine?

IF THE IDEA OF INVESTING IN GOLD mines sounds like an oxymoron, I understand. But I also believe there's a relatively superior way to buying gold companies if the white-knuckled ride on the volatility express is not for you.

At Montgomery Investment Management we own gold producers that in total comprise a small proportion of The Montgomery [Private] Fund. They have key characteristics that allow us to remain separate from market noise and continue our business-as-usual approach to investing.

We also believe these characteristics are responsible for the profitable outcomes in all our gold holdings in recent times. The way we undertake research is key to finding potentially profitable candidates. In sharing this with you I will discuss a goldminer called Red 5 (ASX code: RED) we believe has prospects better than many.

You can employ three relatively straightforward steps to focus your energy away from volatile prices to the underlying business. We will focus on the business that owns the asset.

Is Red 5:

- A company with a long mine life?
- Currently producing?
- Enjoying a rising production profile?

The first thing we look for is a long mine life. Hundreds of miners listed on the ASX have resources so small that if they ever started mining operations, their resource would be depleted in just a few years.

A resource with a mine life of less than five years is destined to remain a small business unless the company is actively drilling to expand its resource base and find new ore deposits ("ore" is just a type of rock that contains minerals).

A company that, for example, has a site producing gold while another is being developed and another under exploration can ensure continuity. Without the potential for a long mine life – and many have been operating for longer than their original estimate – the volatility and risk-reward is simply not in our favour. What we want is a small business today with the potential to be a big one in three to five years. And for that to happen in the gold sector, they need a big deposit. Those mines with at least half a million ounces in gold reserves is where we start. If you want to raise the bar a little, look for more than 1 million ounces as a reserve.

This is an important first step. From a list of literally hundreds of explorers, developers etc, we are left with fewer than 30 investment ideas. In Red 5's case, its reserve is estimated to be 850,000 ounces, so based on forecast production of 75,000 ounces a year in 2013, mine life is in excess of 10 years. We look for a mine life of more than eight years.

First we look for a long mine life

The second question is whether or not the miner is close to or in production. While stellar profits can be made by buying early in an explorer's life before it develops into a fully fledged goldmine, we prefer a more careful approach and de-risk our portfolio even further by waiting for a company to pour its first gold bar.

This is an indication that the company will soon be selling gold and hence will begin to generate cash flow. This will enable the mine to stand on its own two feet rather than having to rely heavily on additional financing. Red 5 reached this milestone on February 6, 2012, so it passes this test.

The third question is whether a rising production profile exists. A smaller mine becoming larger with growing production may offset a falling gold price, and a bigger producer with a higher cash flow over a long mine life is also, all things being equal, worth considerably more.

Red 5 is forecast to produce 18,000 ounces of gold in 2012, 75,000 in 2013 and 125,000 in 2014. So a mine with no 2011 earnings could see net profit after tax (NPAT) of $5.8 million this year, $80m next year and more than $100m the year after. Not many businesses offer such growth in a short time frame. The risks in gold are high, so potential rewards must be high too.

By focusing on these three core questions, you will bring your potential investment list to fewer than 15. All will have long mine lives, large gold reserves, near-term production, cash generation and the potential to become a much larger business.

Finally, these characteristics lend themselves to a valuation – albeit a valuation that counts for nought if the gold price plunges. Red 5, for example, is trading below our current estimate of intrinsic value and that is why we own it in The Mortgage (Private) Fund in proportion to its risks.

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