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Thinkpiece

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Sacred Cows

An Iconoclastic View of the Junior Mining Royalty Space

Key Metrics

	Rating	Ticker	Price	Market Cap. $mns	Dividend	Yield
Abitibi Royalties	Neutral	RZZ.v	$9.95	$124.65	$0.000	0.0%
Ely Gold Royalties	Neutral	ELY.v	$0.10	$7.91	$0.000	0.0%
Metalla Royalty & Streaming	Neutral	MTA.v	$0.70	$52.22	$0.018	2.6%

Sacred Cows

An Iconoclastic View on Mining Royalties

- + Royalty companies came along as a light at the end of the tunnel during the darkest days of the mining slump, 2011-2016
- + They enabled some junior miners to survive the grim period by providing funding for exploration or license renewals
- + The royalty players provided novelty to a mining space which was decidedly lacking in new ideas
- × A royalty agreement is not the same as a royalty
- × Investors are confusing royalty agreements with streaming agreements
- × Most royalty agreements do NOT advance development of a project
- × Some royalty agreements provide NO money whatsoever to the company
- × Many portfolios come with significant padding of distant, unlikely projects
- × We have lowered RZZ.v from LONG to NEUTRAL and removed the position from the Model Mining Portfolio

Safer than Houses

For promoters in the mining industry to claim that they have found the "next big thing" is nothing new. In recent times the two "newest things" have been battery metals (as if Cobalt hasn't been used for thousands of years) and royalty companies. The latter category is not exactly new but neither is it all that old. They first came to prominence with the successes of Silver Wheaton (now Wheaton Precious) and Franco Nevada, that evolved as hybrid royalty/streaming companies around the turn of the century.

The lean years for promoters post-2011 have produced a swathe of royalty companies that were able to raise capital whilst conventional developers/miners went begging. The irony was that the capital raised by the royalty companies went, in part, to developers/explorers so was a lot less of a sure thing and was more of an option on a bunch of wannabe projects. "Sure things" should be made of sterner stuff.

The Nature of the Beast

The promoters of royalty companies would argue their uniqueness in the mining world but in reality royalties are a concept that has been around for thousands of years with the original concept being payments to the rulers of a country/empire for use of some land, assets or concessions.

In the daily life of the average consumer royalties that impact most and which they pay indirectly and those on artistic output, whether books, music or performances.

Let's draw some parallels between a book/music publishers and a royalty company.

The explorer is somewhat like the creator of the intellectual content (the author) and then the developer/miner is somewhat like the printer/publisher/bookseller. The author ends up with a royalty and can decide to keep that or on-sell it. The acquisition of the royalty can happen very early on as a means of funding the explorer while undertaking their "art", in that case the royalty is like a publisher's advance. This is a key simile because just as some authors receive an advance and never finish the book, or the end product is unpublishable or doesn't sell, so can a royalty on an exploration property fall afoul of the explorer going bust, or not finding anything or not finding anything economic or being undercut but falling metals prices. To take the analogy to the extreme, the royalty holder on a book can end up an unhappy camper if the book ends up being pulped or remaindered. Likewise the owner of a song royalty can find the song falls off the playlists, or worse never gets on the lists, and thus is not a revenue earner.

To employ the music industry analogy some transactions might be liked to Michael Jackson's very canny acquisition of the rights over the Beatles catalogue or David Bowie's securitization in a bond of his royalty flows. However some other transactions look more like securing the rights over the backbooks of Alvin Stardust or Suzi Quattro. Having the book publishing royalties over Stephen King or Agatha Christie is far preferable to holding the catalogue of royalties on Dornford Yates.

The Good, the Bad and the Indifferent

Royalty companies would have the investing public believe that they are providing the investor with a curated list of quality royalties. Except for the very largest players, the current crop of royalty wannabes are prone to buying portfolios that represent at best a job-lot of exposures to properties that range from the prospective to the remote and fanciful.

One company cannily acquires royalty exposures on the basis of paying the maintenance fees/renewals for properties that down-at-heel miners would otherwise be losing due to depleted (or bare) treasuries. The company refers to these cheap and cheerful acquisitions as "lottery tickets". Their management is realistic and not putting any value upon these royalty "acquisitions". However, helping almost-bust juniors hang onto their properties may be delusional as their precarious status makes the continuance of the project rather unlikely and the chances of the junior going bust are heightened.

The problem is when some companies start to believe that all the dross that they pick up in the mining equivalent of a charity consignment shop are actually viable as future projects, and thus revenue earners for the royalty company. How can a project that is not even mentioned on a junior explorers' website, because it is a second- or third-line priority, be worth mentioning on a royalty company's list of realistic potential revenue earners? It is an oxymoron to regard a property as a potential revenue stream when the holder of that property is NOT doing any work on the property and is not likely to do any work, in many cases. If the junior goes bust or lets the license lapse then the royalty is not worth the paper it is written upon.

Conjuring with some Royalty Companies

The companies we know best amongst the junior royalty players are:

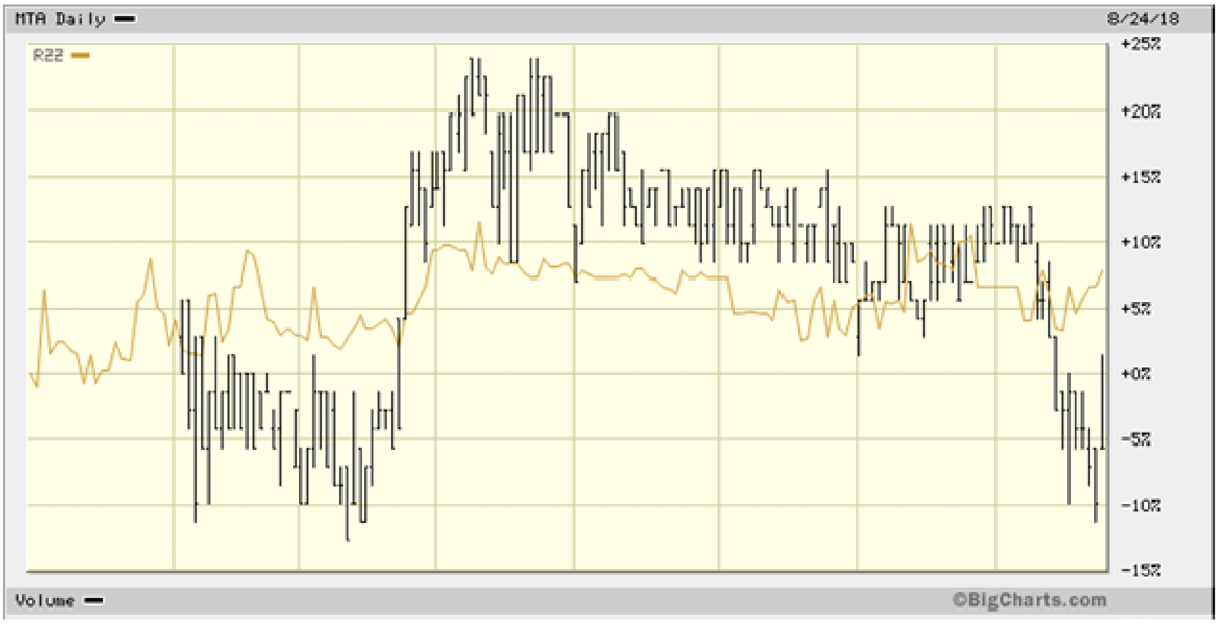
- Abitibi Royalties Inc.
- Metalla Royalty & Streaming
- Ely Gold Royalties

Two other mid-tier junior royalty companies are Sailfish (TSX-v:FISH) and Almadex (TSX-v: DEX), both with market caps in the $50mn range and neither of which have any producing royalties.

Abitibi Royalties was based upon a royalty over part of Osisko's Canadian Malarctic mine with an accretion of earning and non-earning royalty agreements. Some of these royalties have been accumulated at a bargain price due to purchases from either distressed (or disinterested holders of the royalties and through a novel approach of picking up royalties through paying the staking fees for companies in danger of losing said properties through not having the wherewithal to maintain the properties in good standing.

Metalla has two producing streaming deals and one royalty deal. It has 18 other royalties, of which three are designated to be in development Hoyle Pond Extension, Joaquin and Timmins West Extension).

The larger two stocks have had a wildly differing performance in recent times.



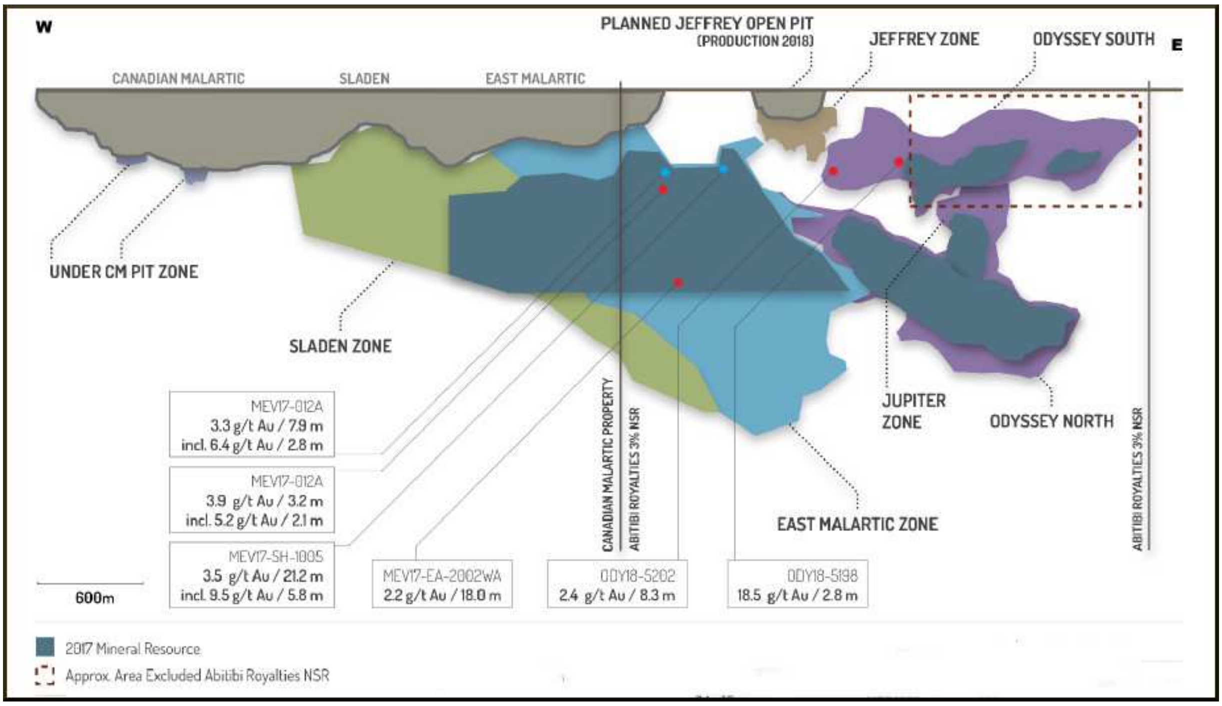
Ely Gold is, to put it nicely, the 120-lb weakling of the junior royalty space. Ostensibly it looks like a bargain but a past encounter with the management team makes us wary. It is concentrated on Nevada which could be a good thing or a bad thing, depending on one's perspective. Its current portfolio includes 20 Deeded Royalties and 20 Optioned Properties. These range across fully-permitted mines, mines under construction and development projects that are being permitted for mine construction. None however, in comparison to the other two royalty companies we look at, is generating cashflows.

That said the market cap is low, the company has cash of around $2mn (according to its latest presentation), it holds gold equities to the value of $1.2mn and then there are the royalties. We would note however that in three projects, County Line, Isabella Pearl and Mina Gold, the developer is Gold Resources (NYSE:GORO) which is a name that has, to put it tactfully, a colourful history. The first two of these projects lack a NI 43-101 resource so we would not be describing them as “development” properties by any definition we would use.

Drilling Down into Abitibi

This royalty company was initially spun out of Golden Valley Mines (TSX-V: GZZ) and listed as a public company in 2011 with GZZ still holding 49% of the equity. The flagship royalty in the portfolio is 3% NSR on the eastern portion of the Canadian Malartic mine (owned and operated by Agnico Eagle and Yamana Gold), which includes the Jeffrey Zone and the Barnat Extension where production activities are expected to commence in 2018 and 2020. The NSR also includes the Odyssey North discovery and other portions of the Odyssey Project, as well as portions of the East Malartic property, which was a historical gold producer.

The complexities or working out what one actually “gets” with a royalty deal is exemplified by the cross-section below. One can see the dividing line in the middle that separates the royalty held by Abitibi (to the right) and that held by another party that contains the bulk of the open. Then one can also see the section in the top right corner which is a cut-out from the Abitibi royalty area and belongs to others.



The company, besides this keystone royalty, holds two other classifications of royalty assets. The second one is what it calls Near Mine royalties. This is premised by closeology as far as we can discern. Some are held by majors but that in itself is not a guarantee that a project will be even worked on, let alone built. Beyond these it has a grab-bag of lesser royalty agreements it picked up through staking the money for some property renewals by distressed juniors and acquisitions of minor portfolios, called the Abitibi Royalty Search Program. For fiscal 2017, Abitibi invested $20,978 ($93,624 for fiscal 2016) to acquire NSR royalties in three projects; one in Saskatchewan and two in Ontario. These amounts were expensed because the company did not expect to receive royalty income in the foreseeable future.

The curious "other" asset in the portfolio is a massive holding of shares in Agnico-Eagle and Yamana Gold that at the time of the last annual report (31st of December 2017) amounted to a value of $35.91mn. This made up most of the investment portfolio of the company. All well and good but it is not a royalty. Over and beyond that the recent market rout has taken Agnico-Eagle from around $63 to as low as $45, and Yamana has tumbled from over $4.20 per share to a recent low of below $3.50. Curiously the stock price of Abitibi has not shown anything like this degree of fluctuation considering the destruction of value in the company's investment portfolio. Are shareholders watching? Do they care? Do they know?

This stock does not pay a dividend which is a serious drawback to its credibility. It thinks seemingly that a stock buyback program is good enough. Sorry, no… We made this clear at the investor lunch in London at which we encountered them. There is nothing worse than a Canadian management telling shareholders that they know better how to manage the investor's money than the investor does. It's "nanny state" remade as "nanny corporatism".

Upon reflection, we have resolved to lower our LONG rating on Abitibi to a **NEUTRAL** rating and removed the Long position in the stock from the Model Mining Portfolio.

Drilling Down into Metalla

As mentioned earlier, the company has two producing streaming deals and one royalty deal. It has 18 other royalties, of which three are designated to be in development Hoyle Pond Extension, Joaquin and Timmins West Extension).

Circling back to what Metalla refers to as its exploration properties, the company curiously refers to one of exploration properties as a development property (the TVZ Zone of Goldcorp). However the latter is part of the Hoyle Pond Extension which, as noted, was listed as a development property. We also note that the Solomon's Pillar property listed in Exploration is an asset of Sage Gold, which is currently in financial difficulties having received a Notice of Intention to Enforce Security under section 244 of the Bankruptcy and Insolvency Act.

Metalla had some turbulence in 2017 due to the actions of the Tanzanian government with relation to the royalty that it holds on the New Luika Gold Mine of Shasta Gold. The stock soared to over 80cts on the news of the acquisition of the stream and then plunged back to below 50cts just as precipitously. In reality this was much ado about nothing as silver production at this mine has been averaging 25,000 ozs per quarter and Metalla is only entitled to 15% of the silver by-product stream, ergo around 15,000 ozs per annum. The pricing of the stream is 10% of the spot silver price. Metalla bought this stake in the stream and an option to invest in a second gold stream for US$2mn. We have found no details as to what this option on a gold stream might be.

The stream relates solely to silver by-product production from New Luika Gold Mine with minimum silver delivery obligations totaling 608,970 oz. Ag over a 6.75 year period.

This asset is a useful example exercise for valuation purposes. At current silver prices the stream produces approximately $199,000 per annum. If one were to issue a bond on such an asset, taking into account the propensity of the silver price to fluctuate widely and the actions of the Tanzanian government adding a strong element of country risk, a yield of 10% would not be unthinkable (i.e. a junkbond). Thus the asset is worth around $2mn at current prices or around $2.3mn at $17 per oz Ag.

Then we could turn our attention to the Endeavor Mine streaming deal. This primary Zinc mine in NSW is owned by CBH Resources (and ultimately by the Japanese company, Toho Zinc). The mine is very long running and is nearing the end of its mine-life. The website of CBH states, "The company holds approximately 30 kilometres of exploration tenements surrounding the mine and is actively exploring this ground with the intent of operating the site well beyond 2020". Metalla's website admits "Extraction of some 30 million tonnes has occurred with remaining reserves expected to support production out to December 2020".

Valgold

When JP Morgan was asked how he got so wealthy he responded "I sold too soon". The shareholders of Valgold, in a lesser way, can say they did the same. In the first half of May, Metalla announced that it would acquire all of ValGold's issued and outstanding common shares in exchange for Metalla common shares on the basis of 0.1667 of a Metalla common share for each ValGold common share. This represented a consideration of $0.13 per ValGold common share, or a 79% premium to the 40-day VWAP of ValGold common shares and 62.5% premium as of market close on May 9, 2018, on the TSXV. The undiluted equity value of the transaction was approximately $7.2mn.

Unfortunately the deal did not close until the 31st of July, by which time the price of gold had gone into its latest descent and MTA from around 82cts to 64cts more recently. However, by selling out during the offer period the average Valgold shareholder certainly did way better than back when their stock was in the 6-8cts price-range.

The acquisition brought along 2% NSR royalty on the Garrison Project which is under the purview of Osisko Mining (TSX:OSK) providing something of a parallel with Abitibi's exposure to the Canadian Malartic Mine, but not really. The Garrison project amounts to nearly 2mn ounces when the Inferred is added to the M+I.

Last Word

Finally, we would note that the company's last published accounts were the third quarter results for the nine months ended on the 28th of February 2018. The cash at the end of February was $3.37mn, with receivables of $955,000 and inventory (i.e. holdings of silver) of $616,000 However, at that time total loans payable were $8.6mn. This was before the Valgold takeover which brought the Garrison royalty on board. The company's latest presentation refers to around $5mn in cash and equivalents.

What the Lord Giveth…..

It's all well and good to talk of the current NSR on a property and what percentage it presents of the ultimate "action", however in many cases there are buybacks which are usually eminently affordable for the miner to acquire back. Indeed one might call it "taking candy from babies". It is a truism that if a mine is profitable and successful that its NSR will be bought back, at least as much as can be.

An example of this is the Timmins West Extension on which Metalla holds a 1.5% NSR Royalty on production (extension claim) subject to 0.75% buyback for USD $750,000. As the operator is the substantial Tahoe Resources, one can scarcely imagine that they will not snap up the half of the royalty within their grasp, reducing Metalla to a rather small rump holding. Meanwhile things look a bit more promising at Agnico-Eagle's Akasaba West project where Metalla holds a 2.0% NSR Royalty on production subject to 1.0% buyback for $7mn. Need we doubt that Agnico-Eagle will eventually move in to take this back in-house.

The lesson here is that the devil is in the details and royalties or parts thereof can be calwed back for a bargain price when the going gets good.

Risks

The risks for investor in the junior royalty space in general include:

- Prolonged weakness in the underlying metals
- Failure of the one of the players
- Buyback rights can gut the value of the royalty and reduce it to a rump
- An increase in the qualitative analysis of the underlying "assets"
- Financing difficulties restricting the ability of players to take up more royalties

- Overweighting to second-hand royalties that do not put money into explorer’s/miner’s coffers

The least likely risk is the failure of one of the players. The probable worst outcome here might be a company not getting a performing royalty (or losing one) and then the market shunning the company.

Prolonged weakness in metals prices are a situation which gave birth to the bulk of the latest crop of royalty companies. Frankly even if this situation occurred again there would probably be few (or no) new additions to the universe. The bigger danger is that low prices result in an early death of mines or their mothballing which would demonstrate to investors that royalty companies and streams are not free of the risks that the rank and file miners face from depressed prices.

Frankly most portfolios of royalties we have glanced at seem to have a large amount of gangue material as we would say in the trade. Little analysis has been done of the players with most banks/brokers prepared to recommend the names based upon the reflected glory of holding a royalty or stream from a major. More thorough analysis in the harsh light of day might produce a different analytical outcome.

Financing remains difficult and dilutive when it takes place. The only way to harvest the more attractive price is to be in production and the only way to do that is to finance mine-builds/reactivations.

Second hand royalty purchases put NO money into the hands of miners and in many cases direct capital out of the mining industry, which is counter-productive.

Conclusion

The great Hollywood mogul Samuel Goldfish (otherwise known as Goldwyn) once commented that “a verbal contract is not worth the paper it is written on”. Well may we remember this comment and adapt it the royalty space as “a royalty agreement is only as good as the intentions of the holder of the underlying property”. We all know that the office towers of Vancouver (and to a lesser extent Perth) are populated by many “fake” mining executives who have no intent on moving their properties forward. Beyond that there is a group with the intention to go forward but neither the skills/competence nor the on-going funding to do so. And then overlaid on this is the fluctuating fortunes of the mining industry and the metals that it aspires to extract. The royalty company is at the mercy of all these factors outside its control. And the junior royalty company is more vulnerable again than the major because it has less firepower, less pull and less to offer in terms of on-going support.

Investors seem to confuse the royalty companies with the streamers. The fame and fortune awarded to the likes of Wheaton Precious come from successful streaming deals, not from picking over the odd-and-sods of royalties on offer. Streamers are high-level enablers in the mining game. They make BFS’s and mine development happen and they are up close and personal with the miners in their “stables”. The royalty juniors could, theoretically, never need to meet the managements of the companies holding assets over which they have royalties. At best they might acquire a royalty that enables a PEA but mainly they fund exploration (or license renewals). At worst the royalty acquired is “second-hand” and thus adds nothing to the underlying company’s cash position.

The supply of royalties is technically finite with the limit being the number of projects in existence but that is thousands (live) or tens of thousands (including the semi-moribund). The number of projects that are actually “alive and kicking” is a subset of that and as all in the mining industry know those that actually get to production are a mere fraction of those live/actively pursued projects.

Every royalty company has at least one “earner” on the books, then several prospective earners and, disturbingly, most are also padded with the barely alive and semi-moribund to “make up the numbers”. This is all well and good if managements are honest about which are which, however recently a CEO of one of these companies commented “I would point to a portfolio of XX royalties, that are producing cash…”. No sorry, only one sixth of the XX were producing cash. One can deceive oneself, but one should not try to pass delusions to the investing public and even worse try it on an analyst.

The royalty companies seem to have bucked the downtrend of the vast bulk of miners in recent months and this is not only an unjustified Hail Mary Pass but also a singular failure to register that the retreat in the metals prices spells bad news for the royalties/streams on existing producers but also dire news for the prospects/valuations of prospective projects which become less likely to move to development/production. Even worse some of the current producers might end up being high-graded to their end of minelife or mothballed. Neither being a profitable outcome for those holdings royalties or streams on such mines.

The upwelling of this new variety of mining investment vehicle is a useful addition to the mining ecosystem but by no means should all plays be regarded as “better than the underlying miners” nor “as safe as houses”. They are neither. The old adage of *Do Your Own Due Diligence* applies here, as always.

Important disclosures

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