Past is Prologue is Steve Letwin’s third paper on the evolving gold industry. Condemned to Excellence in 2012 called for operational excellence given the reality of declining grades. Time to Reinvent the Wheel in 2013 warned that production would decline with a prolonged period of cutbacks and that more innovation was needed to drive the industry forward. Three years later, there are strong signs that a new gold cycle has begun and growth is no longer taboo. In Past is Prologue, Steve Letwin talks about the unique hallmarks of the next up cycle and how growth going forward will be dictated by the industry’s past.

Past is Prologue
Growth in the Next Gold Cycle

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July 6, 2016
Past is Prologue

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By the end of 2013 the gold price had plunged 35% from its peak in September 2011. The world’s top gold producers had lost $200 billion in market value. The pressure on the industry to grow during the 12-year bull-run in the gold price was replaced with an urgent need to scale back and preserve cash. Over the past few years, the industry has made significant progress reducing costs, and was still planning for the worst in the first quarter of this year when heightened global economic uncertainty drove the gold price 25% higher from its low of $1,050 an ounce in December. In the run-up to the Brexit vote, gold continued to climb. On June 24th, gold surged $60 an ounce following the Brexit shock which precipitated a plunge in the stock markets and a drop in the euro and the pound. With concerns that Brexit may have sparked a new financial crisis, the rise of negative interest rates, and prospects of a Trump presidency, gold, now trading above $1,360 an ounce, has become increasingly attractive as a safe haven in a time of uncertainty.

The Beginning of a New Up Cycle for Gold

Source: Bloomberg. IAMGOLD Corporation

Numerous factors are behind the growing economic uncertainty and fear in the financial markets - the Brexit shock and its implications, the unprecedented nature of the U.S. presidential election, terrorism, and the Federal Reserve’s wafting on the future direction of interest rates. All of these things support a new up cycle for gold, but what is unique this time are negative interest rate policies, Brexit, China’s evolving gold strategy, and a production outlook that is flat to declining. While there is good reason to believe that we’ve seen the bottom of the last down cycle, we shouldn’t count on another super cycle - where gold surged 500%+ - nor should we expect the price to follow a straight upward line.

In a rising gold price environment, growth in our industry is no longer a forbidden word. Investors are hungry to see growth in our sector again. However, growth will not come easily. Three years of severe cut backs have left the industry with a scarcity of new resources and a low level of undeveloped projects. The options for growing production, let alone maintaining current levels, are limited. Some producers have more options than others. Gold producers having an advantage are the ones with organic growth opportunities from development projects that were put on hold during the downturn, existing assets with expansion potential, and exploration projects that are beginning to bear fruit. Growth in the next cycle will be a strong reflection of the industry’s past.
Past is Prologue

Unique Hallmarks of the Next Up Cycle

Since surging in the first quarter of this year, the gold price has been moving upwards reflecting heightened economic uncertainty with Brexit and the prospects of a Trump presidency. The AMEX Gold BUGS Index, comprising 15 of the largest gold producing companies, is up 137% year-to-date\(^2\). While the signs are positive for a higher price, only time will tell whether the upward trend is sustainable.

The previous up cycle was triggered by a weaker US dollar, unwinding of gold hedges, a cap on central bank selling and rapid economic growth in China\(^3\). As we head into the next up cycle we do so with negative interest rate policies; the Brexit shock; China, the world’s largest producer, consumer and importer of gold, taking steps to exert more influence in the gold market; and an anticipated flat to declining production profile for the gold industry.

Negative Interest Rates

The rattling of the world order from all directions has instilled great fear and uncertainty in the financial markets. Negative interest rate policies reflect an extreme aversion to risk. Extraordinarily low-interest rates are not new, nor are real negative interest rates, but negative nominal rates are absolutely unprecedented in monetary policy\(^4\). Nearly half of the world’s sovereign debt trades with negative real yields\(^5\). Negative yields in Japan and Switzerland have maturity dates extending out ten years\(^6\). And in June of this year, the German 10-year bond began trading at rates below zero for the first time\(^7\).

The collapse in bond yields is being driven by monetary policies intended to counter slow economic growth. The thinking is that if central banks charge commercial banks for depositing money, then the commercial banks will be incented to lend more money to their customers, thereby stimulating the economy. Although negative interest rates on deposits are mainly limited to the rates central banks charge commercial banks, Switzerland’s Alternative Bank Schweiz AG became the country’s first bank to charge customers for their deposits earlier this year\(^8\). In the two months that followed, the number of new accounts opened exceeded the number of accounts that had been closed\(^9\). When it makes more sense to stuff money under a mattress to avoid deposit fees, gold as a safe haven investment becomes even more attractive. However, the idea of negative interest rates is so preposterous that it will take time to register with the market.

Large Portion of Sovereign Debt Carries Negative Interest Rates

![Diagram showing the distribution of negative interest rates among sovereign debt.](image)

Source: Bloomberg; World Gold Council, As of 23 May 2016. Includes sovereign debt from Australia, Canada, Denmark, Euro area (investment grade), Japan, Sweden, Switzerland, the United Kingdom and the United States. Real yields computed as nominal yield minus the most recently available year-on-year CPI inflation rate. Totals may not equal 100% due to rounding.
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**Brexit Shock**
Despite polls showing the vote could go either way, Brexit was a shock. The British pound fell to its lowest level in more than 30 years, the euro continued downwards. Stock markets plunged. Shockwaves rippled throughout the world, throwing off question mark after question mark. Will Scotland, in its desire to remain part of the EU, break away from the UK? Will the rise of anti-establishment populism cause other European Union countries to mull over exit scenarios? Do we clearly understand the economic and financial implications of a crumbling EU should it come to that? With uncertainty the prevailing market sentiment and negative interest rates on the rise, gold’s role as an attractive investment and ultimate safe haven only increases.

**China’s Evolving Gold Strategy - What Should We Make of It?**
China’s love of gold and its desire to own more is clear. In July 2015, China disclosed its gold holdings for the first time since 2009. Over that period their gold reserves increased 57%, and today stand at approximately 1,800 tonnes. However, if the gold held by commercial banks, corporations and citizens was included, the amount that China owns, by some estimates, might be closer to 10,000 tonnes, with half owned by Chinese citizens. In 2015, China’s gold production dropped for the first time, with a decline of 0.4%, although consumption rose by nearly 4%. Although China reportedly produced 16 million ounces of gold in 2015, other data sources indicate production capacity of only 5 million ounces, and that includes mines that are not yet in the production stage. From the numerous conversations I’ve had with people during my dozens of business trips to China it would seem that the other 11 million ounces are coming from small scale operations for which there are no resource estimates, let alone reserves.

**Prospecting for Acquisitions**
With China’s extremely fragmented industry, limited domestic resources and growing demand, China is intent on bolstering its gold resources. Rather than build mines, China is buying, particularly in jurisdictions overseas that have good legal systems and stable governments. Both Zijin Mining, the largest gold producer in China, and state-owned producer Zaojin Mining have indicated that with gold prices not likely to trend lower, now is the time to acquire high-quality gold assets. In 2015, acquisitions by Chinese companies were valued at $483 million - four times the value in 2014.

**Aiming for More Power in the Gold Market**
The global spot price for gold is set in London, yet China is the world’s largest producer, consumer and importer of gold. That China might like a bigger say in the gold market reflecting their weight at the table, would be understandable. In April of this year, the Shanghai Gold Exchange launched a yuan-denominated benchmark, which is set twice a day based on a few minutes of trading among 12 fixing members. The six reference price members include two of China’s top gold miners and the world’s top jewelry retailer Chow Tai Fook. This statement on the Shanghai Gold Exchange website underscores their objective:

“We at the Shanghai Gold Exchange are committed to shaping the SGE into a precious metals exchange with significant global influence, transforming Shanghai into an international gold trading center, propelling China to a more active role in the global gold markets, and contributing to the prosperity and development of the global gold markets.”

One out of every three trades on the Shanghai gold exchange results in the actual delivery of physical gold compared to one out of 300 trades on the COMEX. Given the significant need for gold storage, China has purchased some of the world’s largest vaults for storing gold. A few years ago they acquired the largest gold vault outside of Fort Knox with the purchase of J.P.
Morgan’s former headquarters in New York\(^1\). And earlier this year ICBC Standard Bank bought Barclay’s gold vault in London\(^2\). Having vaults outside China provides foreign customers with a safe storage location closer to home.

While China’s evolving gold strategy is open to interpretation, it’s clear that they have amassed huge quantities of gold and are hunting for gold assets to boost their production. Some say China could drive the gold price up to $3,000 an ounce or more tomorrow if they wanted to\(^3\), although it would not be in their interest to do so while they are prospecting for assets. Although early days, we need to think about what the launch of the Shanghai benchmark will mean for our industry in the future.

I believe the industry is in the beginning stages of an up cycle. Fear and uncertainty has been mounting due to many economic and political factors. Unlike past cycles, negative interest rates, Brexit and China’s desire for more power in the gold market will stand out as three unique hallmarks this time. The fourth hallmark is a dwindling supply of gold, which is clear when you look at the outlook for future gold production. To better understand why production growth in the next up cycle will be different from the past, you have to understand how the morning after the last one changed everything.

**The Morning After**

Overnight, the desire to achieve rapid growth was replaced with the need to preserve cash. The tentacles of the survival plan were far reaching - operating and capital costs were reduced, operations were restructured and downsized, exploration budgets were cut, development projects were deferred or scaled back, operations were disrupted and some shut down.

**Operating and Corporate Costs Have Been Reduced**

The industry has waged a tough war on costs. Average all-in sustaining costs for the major gold producers have declined steadily, falling 20% from 2012 to 2015. Even then, we’re not seeing the full benefit of the cost reductions as it can take many quarters to achieve the maximum impact. While the industry has done well to reduce costs, it continues to set new targets, with greater emphasis on technological innovation and productivity. Cost discipline in our industry has become a way of life.

**All-in Sustaining Costs**

Includes: Goldcorp, Barrick, Newmont, Kinross, Yamana, Acacia, Goldfields, Randgold, Agnico, Eldorado, AngloGold, Buenaventura and IAMGOLD
(Source: Scotiabank)
**Past is Prologue**

**Exploration Budgets Were Cut**
As operating and corporate costs were being reduced, exploration budgets were also being cut back. Discovery-oriented exploration budgets, which include grassroots budgets and 75% of late-stage budgets, were slashed from $6 billion in 2012 to $2 billion in 2015\(^2\). This will have a negative impact on the trend in new ounces in the coming years. Even when spending spiked from 2009 to 2012, new discoveries dropped dramatically as it can take a number of years before discoveries lead to resource estimates. The steep drop in exploration spending over the past three years means a slowing trend in new ounces in the coming years.

**Declining Pace of New Discoveries**

While this is the trend in general, not all budgets were reduced to the same extent. Some producers, such as IAMGOLD, chose to downsize the number of projects in their portfolios and advance projects with the greatest potential. IAMGOLD’s exploration budget in 2016 is 68% lower than it was in 2012, yet at our mine sites we have been able to upgrade more than 9 million ounces of resources to an indicated category, and through greenfield discoveries add nearly 1.7 million indicated and 1.9 million inferred ounces.

However, significant cutbacks in the industry’s exploration spending over the past three years, have resulted in a shortage of ounces to replace depletion. The gold reserves of the leading producers have declined by 15% since 2013.

**Gold Reserves Declining**

*Includes: Goldcorp, Barrick, Newmont, Newcrest, Agnico Eagle, Kinross, Yamana, AngloGold, Goldfields, Harmony and IAMGOLD*
CAPEX Spending was Slashed
With a slowdown in new mine construction and expansions, capital spending was slashed by billions of dollars. The industry’s largest producers reduced capital spending dramatically from $23 billion in 2012 to $8 billion in 2015. New projects were deferred, existing projects temporarily suspended, and some operations shut down altogether.

Of the 22 mine disruptions in 2013, nearly half were attributed to a lower gold price and financial constraints. Some were due to operational issues. The construction of Barrick’s Pascua Lama Mine in Chile was also halted in the same year. The impact of these disruptions would have been far greater were it not for 33 new production streams in that year, including new mines, re-openings and expansions. Since 2013, however, incremental production from new mines has diminished significantly. In 2015, only seven new mines commenced production, including one expansion.

Flat to Declining Production Ahead - A Hallmark of the Next Cycle
With building plans abandoned or put on hold, the industry turned to maximizing production from its existing operations, although this could never fully replace the ounces lost due to spending cutbacks. Looking out three to four years from now, the ability of the industry to grow production, let alone maintain current levels will be a challenge. In 2015, the combined production from the major gold producers accounted for a third of the 103 million ounces produced globally. By 2018, production for this group of companies is expected to decline by approximately 7%, reflecting a scarcity of new resources and the low inventory of development projects.
Growth in the Next Up Cycle Will be Different

Knowing how the industry has changed in the past three years, we can understand why growth in the next up cycle will be different. The shortage of new discoveries has left the pipeline relatively bare and there is a shortage of development projects on a significant enough scale to allow the industry to reverse the anticipated flat to declining production trend. A number of the largest producers have trimmed back production forecasts. For 2016, Barrick is targeting 5.0-5.5 million ounces, down from 7.7 million ounces in both 2010 and 2011. And Goldcorp is projecting 2.8-3.1 million ounces, down from 3.5 million ounces in 2015. Even if the gold price was to sustain a dramatic increase, it would take time to restore production to previous levels.

Another factor to consider is the financial condition of the gold producers. At no other time has the gold industry accumulated so much debt. From 2004 to 2014, the aggregate debt of the 10 largest gold producers increased from $1 billion to $41 billion. Since 2014, the industry has reduced outstanding debt by more than $6 billion to $34 billion. With cash flows under pressure, growth prospects limited, and a third of the debt outstanding due in the next five years, assets continue to be sold.
Addressing flat to declining production will be challenging for producers who have much more debt than they do cash. As debt matures refinancing is an option, but investors want a line of sight to the cash flow streams required to pay back the bonds. This is a Catch-22 for producers who need the funds before they can generate the cash flow. It’s likely to take several years of a sustained increase in the gold price to attract the capital needed for new projects, and even then those projects will be limited given the scarcity of new resources.

**Organic Growth Options Provide an Advantage**

The industry is likely to see a growing divide between companies with and without organic options to grow production. Growth options with the greatest potential include development projects with minimal risk, such as those that have advanced through the permitting process and are ready to go, as well as existing assets with expansion potential, and, for the longer-term, exploration projects that have advanced to a resource stage and beyond.

We shouldn’t underestimate the value of development projects that have been gathering dust for the past several years. In previous cycles, projects that were grounded in a declining gold price environment regained their lustre when the gold price reversed course. These include Osisko’s Malartic mine later sold to Agnico and Yamana, and the Detour Gold mine, both low-grade mines which are worth far more now than they were heading into the last down-cycle.

It’s time to start reassessing projects like these again, including IAMGOLD’s Côté Gold project in northern Ontario. The industry needs to think more in terms of incremental growth, scalable projects and expansion opportunities that can spread the capital outlay over a longer period of time. And we need to keep exploring. Those of us who maintained an active exploration program during the downturn will have an advantage over those who closed the door.

**Acquisitions Will Help Fill the Gap**

For those producers lacking meaningful organic growth opportunities, there will be a focus on acquisitions to fill the gap. We saw this in May of this year with Goldcorp’s proposed C$520 million acquisition of Kaminak. If we look back over the past few years, M&A activity has been mixed. In 2015, transactions with a deal size of at least $50 million increased from 2014 with 35 deals valued at more than $16 billion compared with 29 deals worth $9.5 billion the year before. However, for deals greater than $100 million, there was little change in the number of deals. Included in the 2015 transactions was Newmont’s $820 million purchase of AngloGold’s Cripple Creek and Victor Mine in Colorado.

In spite of the recent momentum in the gold price, M&A activity has been limited this year with only 6 deals worth $2.1 billion, of which the largest were the sales of Eldorado Gold’s Chinese assets to China National Gold and Yintai Resources for $900 million. The slowdown in M&A activity so far this year may reflect a market waiting to see if the momentum in the gold price is sustainable. With declining production profiles, limited growth options and China’s search for high-quality gold assets, we should eventually see an increase in the pace of M&A activity.
The Past is Prologue

Gold equities have rebounded this year with growing evidence that we are in the beginning of the next up cycle. Gold has traded 30% above its low point in December of last year, reflecting global economic uncertainty heightened by Brexit and the prospects of a Trump presidency. While many factors support a higher price, what may be the hallmarks of the next up cycle are negative interest rate policies, Brexit, China’s evolving gold strategy and an anticipated flat to declining production profile. Although growth is no longer taboo, it will not come easily. Three years of restraint have left the industry with a scarcity of new resources and a low level of undeveloped projects.

Producers who can dust off yesterday’s abandoned development projects, who have assets with scalable expansion potential, and who kept the exploration pipeline moving will have an advantage. IAMGOLD is such a producer. We’ve removed more than $175 million from our cost structure in the past three years, we’ve made significant operational enhancements at our mines, we have a Quebec-based long-life mine that is ramping up production, a development project waiting in the wings, scalable expansion opportunities and exploration projects that are yielding positive results. Our past has dictated our future, and in a rising gold price environment it only gets better. For every $100 increase in the gold price, our cash flow increases by $80 million, making IAMGOLD one of the companies most highly leveraged to the price of gold.

(All monetary amounts in this paper are in U.S. dollars unless otherwise noted)
Endnotes


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