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Bad actor no more

Evan Lorenz writes:

Fast-rising bitcoin is capturing the mind share that gold bullion used to claim. Yet, while both digital gold and its analog equivalent have racked up solid gains in 2020, the same can't be said for every company that mines them. In preview, we're bullish on the small and underappreciated Jaguar Mining, Inc. (JAG on Toronto), which digs for gold—the old-fashioned kind—in Brazil.

You'd suppose that digital miners, at least, would be making hay, given the 164% year-to-date surge in the crypto's price (putting gold's 19% advance in the shade). That isn't precisely the case.

Bitcoin "miners" keep their fingernails clean but consume enormous quantities of computing power in the service of solving mathematical puzzles that somehow serve to verify bitcoin's ledger of transactions. As much as 72% of this curious activity takes place in China, but its Communist party is cracking down on cryptocurrencies. For instance, according to the news site CoinDesk, the government has ordered the freezing of bank accounts through which bitcoins have passed. The resulting cash crunch has left miners struggling to pay their staggering electric bills.

CoinDesk also reports that the mainland miners are putting their digital pickaxes in storage and speculates that the inability of Chinese miners to sell their crypto for fiat may have fed the vertiginous bitcoin rally. It hardly sounds like a positive development for the blockchain.

Anyway, interest in gold peaked even before the first lockdown orders were issued last spring. On Feb. 18, large speculators were long a net 388,803 futures contracts, the largest such position since at least 1995, according to a Commitment of Traders report from the Commodity Futures Trading Commission. As of Nov. 17, speculators had cut back, by 38.1%, to a net 240,797 contracts. Retail investors only belatedly got the memo, as the metal held by SPDR Gold Shares, the largest precious-metals ETF, crested at 1,278.8 tons on Sept. 21 and has subsequently fallen by 58.7 tons.

Central banks, too, are contributing their mite to what we judge to be a mere pause in the long-term bull gold market. For the past decade, the likes of the Central Bank of Russia have been heavy accumulators of bullion, but their buying subsided this year and became net selling (to the tune of 12 metric tons) in the September quarter.

The shift in flows and sentiment has weighed on gold-mining shares. Since topping out on Aug. 5, the NYSE Arca Gold Miners Index has slumped by 24.9%. Is Mr. Market looking through bumper second- and third-quarter earnings results to forecast a lower gold price?

The projected supply of bullion would seem to argue otherwise. "We live in a world where for every ounce that we're taking out of the ground, we're only discovering 0.2 ounces," James Rasteh, the chief investing officer at Coast Capital Management, L.P., tells me. "Last year, we spent three times as much capital looking for gold as we spent 20 years ago, and we found only 5% as much gold as we had found 20 years ago. The quality of the content we're finding is quite low. And, because it takes 15 to 30 years for any discovery to turn into a mine, we're in a world where 10 years from now, we'll be producing 50% less gold per annum than today."

Over a shorter horizon, the Federal Reserve may provide a boost to the legacy monetary asset. On Nov. 19, Treasury Secretary Steven Mnuchin directed Federal Reserve Chair Jerome Powell to return the unspent cash in 9 of 13 emergency Cares Act lending programs that the Treasury had supported with loss-absorbing billions. At the same time, fractious federal politics reduce the likelihood of additional fiscal stimulus. Perhaps the Federal Open Market Committee, when it meets on Dec. 16, will accordingly issue new dollops of EZ money.

Absent a trap door opening up under the gold price—a risk never to be entirely discounted—some miners would appear to be outright bargains in an otherwise overvalued stock market. Jaguar Mining, for example, changes hands at 5.7 times trailing earnings, or 4.1 times enterprise value to Ebitda, and boasts a 5.3% dividend yield.

There's no mistaking Jaguar for behemoths like Newmont Corp. or Barrick Gold Corp. It's a junior miner with 64,000 hectares (158,147 acres) of mineral rights in Brazil's Iron Quadrangle, a prolific greenstone belt that's beckoned prospectors for more than 300 years. This gives the company the second-biggest land package in the region after AngloGold Ashanti Ltd.

Jaguar operates two properties,

source: The Bloomberg

the Turmalina and Caeté gold complexes, and maintains another, aptly called Paciencia, in care and maintenance mode. As of Dec. 31, 2019, Jaguar had 505,000 ounces of proven and probable reserves, augmented by 1.5 million ounces of measured and indicated reserves.

Third-quarter extraction of 24,094 ounces of gold put Jaguar on track to reach 100,000 ounces of production this year. It sounds like a lot and, for Jaguar, it is, but it happens to be less than one-tenth of Barrick Gold's third-quarter production of 1.16 million ounces. In the September period, Jaguar's cash costs ran to $614 an ounce, its all-in and sustaining costs to $1,011 an ounce—each handily below the quarter's average bullion price of $1,896. And if fortune smiled on the gold price, the milling capacity in place could accommodate almost double current production levels.

Some might chalk up today's low valuation to karmic justice. Jaguar's 17-year history as a public company is a chronicle of red flags and red ink. One thinks back to the company's public debut in 2003. Naturally, Jaguar selected the reverse take-over technique, which entailed less regulatory scrutiny than a customary IPO. In 2010, management was talking up an annual production target of 600,000 ounces by 2015. The front office fell a little short—90,421 ounces was the actual 2015 figure, for which disappointment a 2013 bankruptcy filing bears some responsibility. Suffice it to say that a planned sale to Shandong Gold Group Co. Ltd. of China for the grand total of $1 billion never happened and that the Jaguar market cap, which stood at C$936.3 million at year-end 2009, dwindled to C$13.3 million six short years later.

Operations sputtered into 2019. Desperate for cash, Jaguar entered into a $7.85 million bridge loan with Auramet International LLC. The facility had onerous terms: a 14% coupon, a 1% fee and a maturity of just 120 days. For collateral, the lenders secured the company's entire Brazilian assets.

Then came, at mid-year 2019, Eric Sprott, to lead a $25 million private placement, with Sprott himself taking down $16 million and the Tocqueville Gold Fund (which presently became the Sprott Gold Equity Fund) subscribing to $4.6 million. Today the founder of Sprott Asset Management, L.P. holds not quite 49% of Jaguar's equity.

Jaguar used the cash to repay the Auramet loan and to make needed investments in its two producing mines. Following the recap, Vernon Baker, a 35-year mining veteran and the former manager of Goldcorp, Inc.'s Cerro Negro mine in Argentina, became Jaguar's CEO.

Baker seems to be pushing the right managerial buttons. Production leapt to 24,094 ounces in the third quarter of 2020, from 16,365 ounces in the first quarter of 2019, while the all-in sustaining cost per ounce slumped by 29.2%, to $1,011, and free cash flow rose to $14.8 million from negative $4.4 million. As of Sept. 30, the balance sheet shone with $35.7 million in net cash. CFO Hashim Ahmed tells me that $50 million of cash is the goal, with such funds to be earmarked for the odd capital project and to meet the demands of unscheduled rainy days.

On Nov. 9, Jaguar marked its return to health by initiating a dividend and announcing a share-repurchase program as well as a new exploration ini-

Jaguar Mining at a glance

all figures in $ millions unless otherwise noted

	TTM*	2019	2018	2017	2016
revenues	$145.7	97.2	94.9	105.2	120.5
net income	$50.7	-0.1	-16.0	-2.8	-82.8
gold production (oz.)	88,614	74,084	75,048	84,152	96,608
all-in sustaining cost ($/oz.)	$1,050	1,349	1,244	1,212	1,099
cash	$39.0	10.9	6.3	18.6	26.3
debt	$3.2	5.6	8.3	17.5	22.6
total assets	$228.5	200.9	178.7	183.7	192.8
cash flow from ops.	$67.7	24.4	21.2	15.0	37.8
capex	$-30.9	-32.2	-29.0	-23.5	-28.2
free cash flow	$36.9	-7.9	-7.8	-8.5	9.6

* 12 months ended Sept. 30, 2020.

source: company reports

tiative. Ordinarily, an unveiling like the latter is little more than an expression of bullish corporate intent—it can take a decade or more to bring newly discovered gold reserves into production. Jaguar, however, is in a unique position to foreshorten the timeline. For instance, says Ahmed, "Jaguar has competitive advantages because we have a tailings facility [i.e., the infrastructure to deal with mine waste]. We are currently investing in a dry-stack tailings facility…so that gives us almost an unlimited life on our tailings." He adds that the company has already identified two new potential locations with high levels of gold in the surface soil.

"They've embarked on a serious exploration program, for the first time ever really," Chad Tappendorf, a partner at Coast Capital, another one of the firms that took part in last year's recapitalization, tells me. "They've always been struggling to optimize cash flow with the assets. Any new discoveries that they find go right into the mill. There is a small amount of capital to upgrade the mills, but, if you find a new discovery, you don't have to build another $100 million mill. The economies of scale are quite significant."

On the last point, as noted, Jaguar is using only about half of the capacity at its existing mills. "By operating at 100% utilization or doubling the production, we would reduce our operating costs by 25% on a per ounce basis," Ahmed reports by email. "The reason being that almost half of the production costs are fixed and half are variable."

Of course, there are risks to expanding production. "A mill can only operate at a rate that allows for sustainable ore extraction," writes Barry Allan, who rates Jaguar a hold for Laurentian Bank Securities, Inc. "A problem of the past was trying to mine ore too quickly without completing the necessary development of future working areas and not providing the ground support (backfill) that maintained mine integrity once the ore was extracted. Hence, underground mining areas in the high-grade zones at the Turmalina mine failed, causing Jaguar to scramble to find alternative mill feed—no other areas had been developed. This led to a series of very poor operating quarters that compromised the balance sheet."

I asked Ahmed about the risks of undue haste. Without finding new ore bodies, Jaguar could ramp up production by perhaps 5%–10%, he replied. "How we would do that is that we've got some high-grade structures. So, by not increasing the tonnage, but just by merely increasing the grade, we think we can get 5% to 10% extra."

If the Jaguar drilling program succeeds, the shares could rerate well before the incremental ounces start stacking up. Wesdome Gold Mines Ltd., a junior miner in Canada, produced 70,272 ounces of gold in the first nine months of 2020 at an all-in sustaining cost of $995 per ounce, comparable to the 68,585 ounces Jaguar extracted at $991 per ounce over the same period. Yet, Wesdome trades at 26.4 times trailing earnings and commands a C$1.4 billion market cap, owing to promising discoveries in its Kiena mine complex in Quebec. Jaguar trades at the aforementioned 5.7 times earnings and has a C$436 million market cap.

Gold may or may not be heading for a major correction. If it were, Jaguar, with net cash and with an all-in sustaining cost of around $1,000 per ounce, appears well-positioned to survive. Over the past 12 months, insiders bought stock worth C$430,214. Not one executive sold a share.

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