Gold Review

18th March 2014

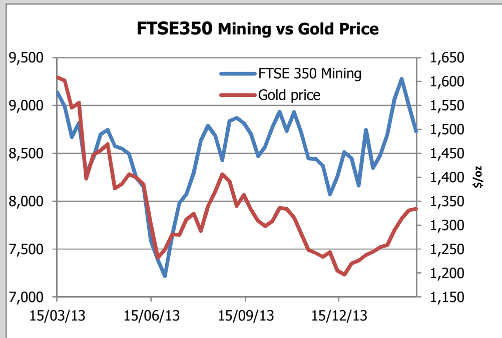
HYBRIDAN

A Patient Game

The uplift in the gold price since the beginning of the year, together with recent events in the Ukraine, may have generated expectations of a strong and sustainable rebound. Fundamentals still clearly point to a gold price above $2,000/oz. Despite an increase in exploration budgets new gold production has not been replaced since 2000 and lower average grades, higher input costs and legislation have driven all-in-costs well above spot price for majority of gold producers.

However, we foresee further volatility for a period before a sustained recovery in the gold price can be arrested. Given its capital intensity, mining industries tend to have long cycles and it can some time before the industry adjusts to changes in demand. The 15% decline in gold demand in 2013 after strong volumes recorded in 2012 and the resulting decline in the gold price is not being matched by the supply, which fell just 2% in 2013. If anything, mine production in 2013 increased by 5% and is expected to rise further this year. The imbalance widened in Q4/13 with demand falling 28% y-o-y and supply rising by 2% y-o-y. The recent increase in the gold price will only add to the complacency. Ironically, the industry needs the gold price to remain low to persuade more gold companies to abandon their high-cost projects or output targets and also make recycling less attractive.

While demand from most end-use sectors has been buoyant, in particular, consumer demand, the outflows from ETF funds continues to hold back demand. For investors in gold equities, the situation necessitates selectivity – deciding which gold companies are likely to survive the volatility and prosper when supply and demand are in equilibrium and gold price stabilises at much higher levels.



Source: Fidessa

- **Gold equities bounce back**

  Most gold stocks have rebounded since the beginning of the year reflecting the improvement in the gold price which fell as low as $1,192/oz before Christmas and is currently $1,355/oz. There is a lag before the supply side fully responds to the price, many gold producing companies are planning to increase output in 2014 based on investment decisions made a few years ago. This is not sustainable. As Randgold Resources recently observed that grade input costs and legislation have driven all-in-costs as high as $3,000/oz, with less than 5% of gold production above water at the current gold price.

- **Conroy Gold and Bullabulling remain our top picks**

  We continue to believe that even if the gold price recovers strongly, investors need to be selective when investing in gold equities. We propose a portfolio of low-cost gold producers such as Randgold and Pan African Resources and a selection of junior exploration stocks such as Conroy Gold and Bullabulling, which continue to offer most upside potential based on valuation and location of their operations. We also believe Ariana offers good value given the valuation and lower geographical risk associated with Turkey.

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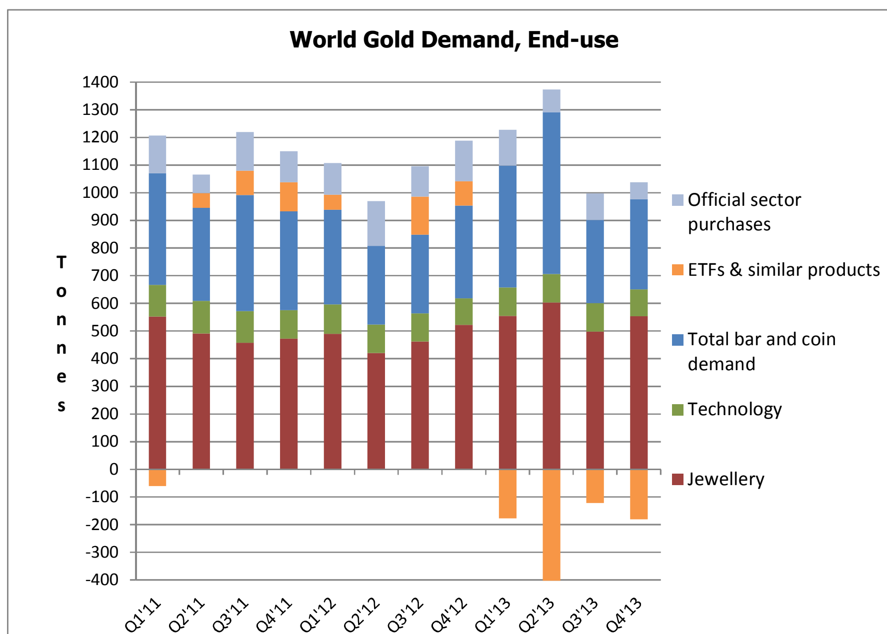
1. Gold Demand

1.1 Investment demand offsets consumer demand

2013 proved to be the year of the consumer, with gold jewellery demand close to pre-crisis levels and investment in small bars and coins hitting a record high. The result was annual gold demand of 3,756 tonnes, valued at US$170bn. However, outweighing the impressive consumer demand were the effects of ETF outflows and lower central bank buying, resulting in 2013 demand 15% below the strong volumes recorded in 2012.

Consumers put on an impressive show of strength last year, generating a 21% increase in demand for jewellery, small bars and coins (collectively referred to as 'consumer demand') to a historic high of 3,864 tonnes. Much of the growth was concentrated in the first half of the year, unsurprisingly given the sharp declines in the price in April and June, which prompted a swift and strong reaction from consumers in the more price-sensitive markets such as India and China. The second half of the year saw this trend continue as the impact of lower prices was felt more globally, particularly in the jewellery sector.

2013 also witnessed an unprecedented flow of gold from western vaults to eastern markets, via refiners in North America, Switzerland, and Dubai. This flow was a function of large-scale selling of more tactical ETF positions among western investors as macro sentiment in the US improved. Gold flooding onto the market as a result was used to feed the voracious appetite for physical metal among consumers in India, China and numerous Asian and Middle Eastern markets. These shifts resulted in the shipment and transformation – on an epic scale – of 400oz London Good Delivery (LGD) bars into smaller denominations more suitable for consumers' pockets.



Source: World Gold Council

ETFs generated further outflows in the fourth quarter, taking the total for the year to 881 tonnes, compared with inflows of 279 tonnes in 2012. Three quarters of these outflows were absorbed by growth in annual consumer demand of 678.4 tonnes –

the largest year-on-year increase since our records began and a demonstration of the strength of physical demand for jewellery, bars and coins.

1.2 China sets the pace in consumer demand

Demand for gold in China set a remarkable new record of 1,065.8 tonnes in 2013. We have previously discussed the strength of the response among Chinese consumers to the price action in Q2/13, and it was that quarter which had the strongest impact on the annual demand numbers. While some slowdown naturally followed such a powerful surge, demand picked up again throughout the fourth quarter as attention turned to the Chinese New Year, a traditional occasion for gift-giving. The impact on the Chinese gold industry of the extraordinary growth in 2013 demand has been marked, with significant growth in both manufacturing and retail network capacity.

1.3 India confronts import restrictions

Indian consumers again expressed their strong affinity with gold in 2013: demand of 975 tonnes was the third highest annual volume. This was in spite of the government introducing a range of measures to limit demand. Higher import duties, strict import quotas and restrictions on gold-related lending and coin sales led to a contraction of supply to the domestic market as the government attempted to reduce the current account deficit.

In considering Indian demand over the course of the year, it is important to understand the impact of these particular dynamics on the domestic gold price. After dropping sharply in line with the international gold price in April, the Indian rupee price of gold soon decoupled from the US dollar price due to a combination of local currency weakness and demand/supply pressure. As supply restrictions took hold, premiums were pushed up, thereby inflating already high local prices (compared to the international price). Indian consumers therefore missed the opportunity to buy gold at lower levels during the second half of the year, unlike consumers in many other markets.

Official statistics show a 63% year-on-year decline in gold imports between July and October 2013 (latest data available), following the introduction of the government's measures to limit gold imports. However, the Indian gold market is fed by a number of alternative sources, including recycled gold, domestic production and unofficial imports. As the underlying level of demand among Indian consumers remained robust, the sharp decline in the official import of gold into India led to an increasing amount of this demand being met by gold imported through unofficial channels. By its very nature, this element of the market is opaque and so difficult to quantify accurately.

There is optimism that the gold import measures are having the intended consequence of reducing the current account deficit in India. Nevertheless, import restrictions are likely to remain in place at least until the end of the first quarter of 2014 and perhaps beyond, keeping supply from this source constrained. Unofficial gold will undoubtedly continue to supplement official inflows, as latent demand among Indian consumers remains healthy. This has been confirmed by consumer research conducted on behalf of the World Gold Council, which shows that consumers in both India and China intend to spend either the same or more on gold jewellery over the next 12 months. The caveat with India would be that the first half of 2014 may not match the exceptional levels of demand seen in the same period of 2013.

1.4 Western markets pick up in Q4/13

Although the focus for much of 2013 has been on eastern markets – in particular India and China – the fourth quarter was notable for an improvement in consumer demand in western markets, especially in the jewellery sector. Unlike the eastern markets, jewellery consumers in Europe and the US did not react immediately to the sharp Q2 price drop. This was primarily a function of the length of time it takes for lower international prices to feed through to the retail level, unlike in India and China where prices are adjusted on a daily basis to reflect changes in market rates. However, the sustained environment of lower prices, coupled with improving consumer sentiment and the onset of the main Q4 buying season resulted in a pick up across a number of western markets.

A fourth consecutive quarter of year-on-year growth in jewellery demand in the US generated annual demand volumes close to levels last seen in 2010, and the first annual increase since 2001. Improving economic conditions were reflected in retail sales and a shift back towards higher carat items, particularly at the lower end of the scale. Annual imports of gold jewellery into the US increased for the first time since 2005, with significant volume increases in imports from India, China and Italy.

Also showing an encouraging improvement in jewellery demand was the UK market, where consumers displayed preference for higher carat items. Hallmarking statistics from the Birmingham Assay office (BAO) show an increase in the number of articles being submitted for hallmarking throughout the course of the year as the gold price fell. According to the BAO, "December… was particularly strong, up 30.9% …as the lower gold price fed through to the consumer."

1.5 Record increase in jewellery demand

2013 recorded the largest volume increase in annual jewellery demand since 1997 and marked a return to pre-crisis levels. Q4/13 saw a sixth consecutive quarter of year-on-year growth with demand of 554 tonnes, 12% above the five-year quarterly average. The sector saw continuous growth throughout 2013, with the bulk of the increase coming in the first half of the year. During the second half of the year, the volume of demand increased by 66.8 tonnes (7%) from the same period of 2012 and it is interesting to note that the US and the UK generated a combined 14 tonnes of this growth. Although the fourth quarter is traditionally strongest in these markets, due to the Christmas effect, these numbers are significant given their size and direction – the first year-on-year increase in Q4 demand in both markets since 2001.

Total Jewellery demand by Country (tonnes)

	Q4'12	Q4'13	% change	2012	2013	% change
Greater China	145.6	160.5	10%	551.9	711.4	29%
India	153.0	150.7	-2%	552.0	612.7	11%
Middle East	34.0	33.3	-2%	153.5	178.5	16%
USA	40.1	48.4	21%	108.4	122.8	13%
Russia	19.9	21.2	7%	69.6	73.3	5%
Turkey	6.5	7.0	8%	61.5	73.3	19%
Indonesia	6.5	8.4	29%	30.8	37.9	23%
Europe	22.3	24.1	8%	43.6	43.6	0%
Vietnam	2.0	2.2	10%	11.4	11.9	4%
Japan	3.8	4.2	11%	16.7	17.6	5%
South Korea	2.1	2.0	-5%	10.1	9.7	-4%
Thailand	0.3	0.4	33%	3.0	3.5	17%
Other	87.3	91.4	5%	283.6	313.3	10%
Total	**523.4**	**553.8**	**6%**	**1896.1**	**2209.5**	**17%**

Source: World Gold Council

The US dollar value of annual jewellery demand fell from 2012's record level – unsurprisingly in the environment of significantly lower prices. However, the magnitude of that decline – of only 2% – clearly illustrates the strength of the consumer demand in volume terms.

A longer term perspective shows that an increasing share of global collective wealth has been allocated to gold jewellery since 2003 (with the exception of 2009, during the worst of the financial crisis). In 2013, gold jewellery value was almost 0.14% of global GDP compared with less than 0.08% ten years previously. Significantly, jewellery's share of global GDP in 2013 was one fifth higher than 1997, which was the peak year for gold jewellery demand in tonnage (3,294 tonnes).

A notable shift in 2013 was the increasing preference for higher carat jewellery. This trend became more entrenched as the year progressed, benefitting from the quasi-investment element to jewellery purchases, particularly as the upsurge in demand in Q2 and Q3 led to a shortage of retail investment products. In the US, where the top end segment has been relatively robust, this trend was more noticeable at the lower end of the market, with mass retail brands shifting away from ultra-low carat items to increase their stock of 14-carat jewellery.

Fourth quarter 2013 jewellery demand across eastern markets was likely tempered by the magnitude of buying in previous quarters, which on account of falling prices, had "cannibalised" a proportion of future demand. Additionally, expectations that prices had stabilised released the pressure on consumers who no longer felt they had to make purchases immediately to take advantage of lower prices.

Q4 jewellery demand in India was little changed from Q4 2012, the slight contraction being a function of supply disruptions. Local premiums rose sharply during the fourth quarter, to a high of around US$200/oz, before dropping back in the closing weeks of the year. The effect of lower prices clearly outweighed that of rising premiums as Diwali purchases were robust, generating the healthy Q4 number. However, the second half of the year was considerably weaker than the exceptional first half, equating to a robust full year total for the sector.

In the fourth quarter, a stabilisation of Chinese jewellery demand was the likely consequence of following three record quarters. The slowdown was reflected in local market premiums, which briefly dipped to a discount in mid-October as demand subsided before resuming again in earnest during November and December in preparation for the Chinese New Year festivities.

China's pattern was replicated across the other Asian and Middle Eastern markets: the strength of demand in the preceding quarters, combined with a levelling of price expectations, caused demand to tail off in October before a fresh surge of growth in December. Although a similar pattern of demand was noted in Turkey, the factors driving demand in that market were slightly different. A strike at the mint between July and September led to a shortage of coins in the market, of which jewellery demand was the beneficiary. This had the effect of boosting the already seasonally strong third quarter numbers. However, the reverse effect was seen during the fourth quarter as the resumption of coin minting, once the strike had ended, saw consumers satisfy their demand for gold coins, to some degree at the expense of jewellery.

Japan proved to be the exception to the regional trend as growth in jewellery demand was concentrated in the second half of the year. This was partly a result of a more encouraging economic environment, with the consequent boost to consumer sentiment, and partly a function of the looming increase in domestic sales tax (from 5% to 8%), which takes effect from April this year. The prospect of the higher sales

tax has encouraged consumers to make pre-emptive purchases, where possible, to avoid paying the higher rate.

A fourth consecutive increase in annual Russian jewellery demand saw that market reach a five-year high, fuelled by continued expansion of the middle class. Demand here emulated the pattern in the US and UK, with growth being concentrated in the second half of the year. However, a slowdown in the pace of growth was symptomatic of both a deceleration in the domestic economy and depreciation of the rouble, which limited the impact of the decline in the international gold price.

1.6 ETF demand drags total demand down

The main feature of gold investment throughout 2013 was the contrast between ETFs, which acted as a source of supply to the market as sizeable institutional positions were sold (-881 tonnes), and demand for bars and coins, which surged to an all-time high (1,654 tonnes). This pattern was repeated during the fourth quarter of the year, although the demand for small bars slowed following the exceptional pace of demand in the first three quarters.

Notwithstanding the surge in bar and coin purchases, annual investment demand was down 50% in 2013. The US economy and monetary policy stance continued to occupy the minds of professional investors, with a further 180.3 tonnes of gold flowing out of ETFs during the final quarter.

Total bar & coins demand by Country (tonnes)

	Q4'12	Q4'13	% change	2012	2013	% change
Greater China	73.6	67.8	-8%	296	409	38%
India	108.9	68.0	-38%	312	362	16%
Europe	66.9	60.8	-9%	276	265	-4%
Thailand	15.1	20.0	32%	78	137	75%
USA	16.5	15.0	-9%	53	68	26%
Vietnam	16.3	18.2	12%	65	80	23%
Turkey	6.8	26.3	287%	48	102	113%
Middle East	9.4	12.1	29%	33	53	58%
Indonesia	4.9	4.5	-8%	22	30	36%
South Korea	0.5	1.6	220%	3	8	189%
Japan	-3.9	0.8	-121%	-10	4	-137%
Other	30.9	31.9	3%	112	138	23%
Total	**345.9**	**327.0**	**-5%**	**1289**	**1654**	**28%**

Source: World Gold Council

Turning to the consumer side of the market, there was continued overlap between demand for small bars and coins and demand for high-carat jewellery, given the latter's role as an investment proxy. This was particularly noticeable in markets such as China, India and the Middle East where higher purity jewellery is standard.

Chinese retail investment followed a similar pattern to jewellery demand, with momentum tailing off in the fourth quarter as demand was satiated by the earlier buying frenzy. However, interest was rekindled in December in the approach to Chinese New Year, reflected in a slight rise in local price premiums.

The fact that demand for gold bars and coins in India in 2013 almost equalled the 2011 record was fully due to the strength of demand in the first half of the year, in advance of the government's import restrictions. High local prices and supply constraints prevented consumers from expressing their underlying demand for these products. However, anecdotal reports suggest that stocks of coins were withheld in

the third quarter as government guidelines were interpreted as a ban on coin sales, before subsequently being released in October and November 2013 (coinciding with the Diwali festival) after the guidelines were clarified. High local premiums enabled banks to sell these coins at discount.

Japan is particularly worthy of mention in the context of retail investment as net annual demand for these products was positive for the first time since 2005. After seven years of negative net investment demand, Japanese investors generated net positive investment demand for three consecutive quarters. This was confirmed by a report from Tanaka Kikinzoku – Japan's largest bullion retailer – which stated that sales of gold bars had reached a five-year high of 37.3t. Inflation-hedging was a key driver of this upsurge as 'Abenomics' (the policies of PM Shinzo Abe) seemed to be stimulating domestic inflation. The weaker yen also underscored investment demand, as the local price recovered well from the lows hit mid-way through the year.

Among the other regional markets, record levels of investment demand were seen in Thailand and Indonesia, while Vietnam and South Korea posted strong growth rates. Common among these markets was the reaction to lower prices, particularly in the second quarter, which stimulated opportunistic buying. Domestic premiums in Vietnam remain stubbornly high at around US$200/oz, but investors nevertheless continue to prefer the inflation-hedging and wealth preservation properties of gold. The strength of demand in these markets is also, to some extent, a likely reflection of unofficial cross-border flows into India.

Although western investment demand did not react to the price drop with quite the same vigour as in the eastern markets, US bar and coin demand was an impressive 26% higher compared with 2012. Coin demand surged as the gold price fell during the first half. The US mint reported a 14% increase in annual sales of American Eagles by weight, with a 29% increase in the number of coins sold. This reflected the popularity of coins in the smaller denominations (quarter-oz and tenth-oz coins), which registered their highest annual sales since 1999 and the Y2K-related spike in demand.

In European markets, Germany was alone in seeing a rise in investment demand. The investor mindset in Germany is one of strong conviction in the need for an allocation to gold. Lower prices during the year provided the perfect opportunity to take such positions, with gift-giving motivations boosting the fourth quarter number. Investment demand for Europe as a whole was only 4% below year-earlier levels and remains within the higher range established in 2008 with the onset of the financial crisis.

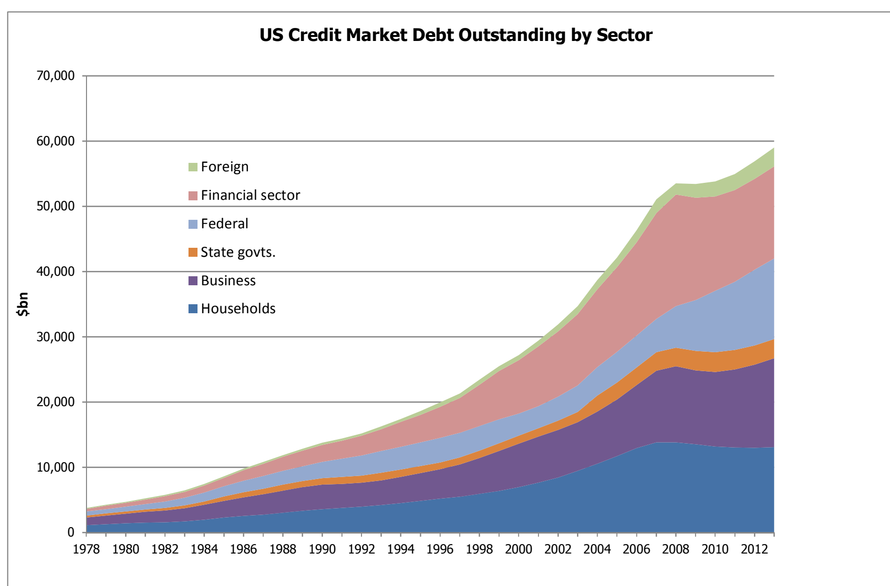
1.7 Central banks slow pace of purchase

Central banks made net purchases of 369 tonnes of gold in 2013, adding a further 61 tonnes in Q4/13 – the twelfth consecutive quarter of net central bank demand. The pace of purchases slowed towards the end of the year due to the heightened volatility of gold and a slower rate of foreign reserve accumulation. Although 32% lower than the previous year, this is a healthy outcome – particularly in light of 2012 being the highest level of demand for almost 50 years.

Russia, Kazakhstan, Azerbaijan and Korea, all saw significant increases in official reserves, while a number of other central banks made smaller purchases during the year. The list of countries which saw a reduction in their reserves by the end of 2013 was lower by comparison, with reported net sales totalling around 10 tonnes for the year.

1.8 Investment demand is key to future demand

It is clear from our discussions above that for gold demand to recover it is critical that investment demand recovers. The recent decision by the Fed to taper its bond purchases has undoubtedly affected investment sentiment. However, a $10bn reduction seems minute compared with the overall impact of loose policies being pursued by central banks the world over. As the graph below shows, the Federal government and the Federal Reserve in the US have succeeded in counterbalancing the deleveraging in the households and financial sector since Q3 2008.



Source: The Federal Reserve, Bureau of Economic Analysis

As we have argued, it is hard to unwind the debt without causing an economic collapse. In September 2008, the economic system stopped functioning as panic over the credit crunch grew. Even a small correction in debt can cause huge damage. Between April and September 2008, total US household debt fell by $61bn, a mere 0.1% of total US debt.

However, as the graph above shows the private sectors in the US are starting to build debt again and this is the reason why the Fed is beginning to taper its bond buying programme. While growth in US private sector debt is still below its historical average of 8%, some areas like corporate debt are already growing at 9% per annum and it may not be long before all private sector debt is growing strongly. This has allowed the Fed to take its foot off the pedal but be ready to increase its bond buying as soon credit growth slows.

Gold cannot possibly be expected to keep up with the fast growth in paper and electronic money floating around the world. You can't print gold after all, you need to find it, dig it out of the ground, refine it, etc., a hugely expensive and time-consuming process which practically ensures a stable rather than exponentially growing supply. Once investors realise that the central and other banks are in the game indefinitely, gold and silver will lurch higher and faster than anyone anticipates.

2 Gold Supply

2.1 Supply continues to fall led by recycled gold…

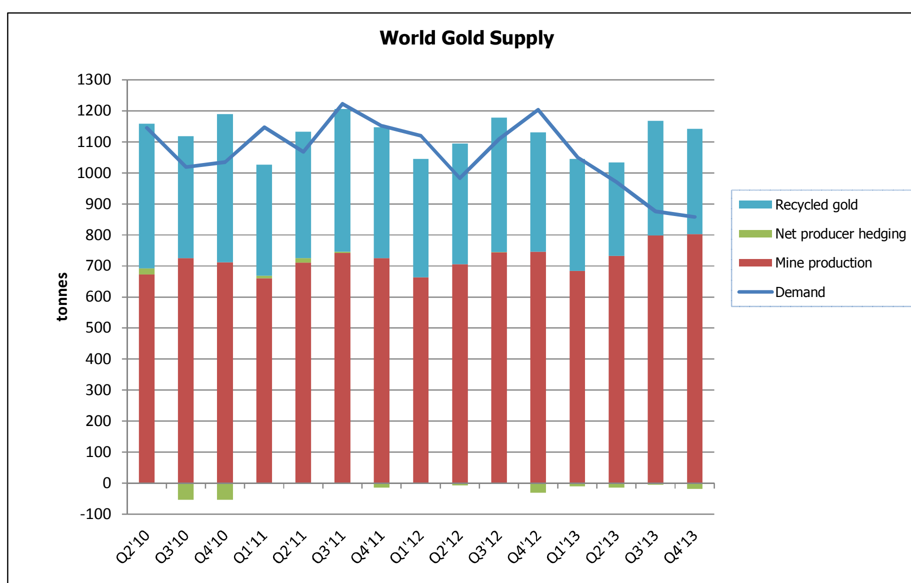
Continued shrinkage in recycling activity outweighed modest growth in mine production, which fed through to a decline in the overall supply of gold during 2013. Insignificant levels of producer de-hedging had a limited impact on the numbers. The annual supply of recycled gold declined for the fourth consecutive year to the lowest level since 2008. The scale of decline was the same for industrialised markets as for developing countries, although the drivers of behaviour differed. While price is not the only factor that determines the level of recycling, it is a key driver and its influence was clearly on display during 2013. The sharp Q2 fall in the price, and subsequent weakness, resulted in a considerable decline in recycling in most of these markets. The decline in India was more modest, not only due to a divergence in the local gold price from the US dollar price (surging to record levels in the third quarter) but also because the tightness of supply from the restrictions on gold imports meant that recycling was to some extent required to fill the gap. In consumer research conducted by the World Gold Council, the number of respondents confirming that they had sold gold in the past 12 months increased throughout the third and fourth quarters as import curbs pushed up the local price premium. China was the outlier among the developing markets as recycling activity increased. As prices recovered from the June lows, consumers took the opportunity to take profits on some of their existing holdings. The surge in demand seen in 2013, with consumers making opportunistic purchases at lower prices, does increase the prospect of a resurgence in recycling should prices rebound with any conviction.

2.2 …but mine production is rising…

Annual gold mine production grew by 155 (5%) in 2013, the bulk of which came through in the second half of the year. The fourth quarter saw a clear continuation of the trend that was in place throughout much of the year: new mines either coming on stream or building up to full capacity and growth in production of existing operations.

Production continued to ramp up at a number of new operations in Canada (Detour Lake and Canadian Malartic), which accounted for growth of almost 20% in supply from that market. In Indonesia, production at Grasberg continues to recover to more normal levels following the disruption of preceding years, resulting in growth in that market. China also made a significant positive contribution, due to an increase in output from the smelting industry. Indonesia, Australia, Russia and Brazil also featured on the list of countries adding to annual supply.

Among the countries seeing a reduction in supply, South Africa was the most prominent, although the pace of decline slowed as strike action proved less disruptive than in 2012. The US also generated lower levels of supply, chiefly as a result of lower grades. Net producer hedging activity, the second component of total mine supply, again had a minimal impact on supply in 2013. De-hedging of existing positions amounted to just 50 tonnes, with little or no evidence to suggest that the lower price environment will encourage producers to embark on any notable hedging programmes. The fact that the outstanding global hedge book stands at below 100 tonnes, the lowest for over a decade, provides a further indication that hedging will contribute little to gold’s supply profile going forward.



Source: World Gold Council

2.3 …with many producers planning increased 2014 output

Our survey of the major UK-listed gold producing companies shows that the majority saw their 2013 output grow and at least some of these are planning to increase output further in 2014.

	Target Output	Output	Output	Output
oz.	2014	2013	2012	% change 2012-3
Polyus Gold	1,615,000	1,650,000	1,571,429	5%
Randgold Resources	1,160,727	910,374	794,844	15%
Polymetal	816,303	805,000	589,000	37%
African Barr	n/a	641,931	626,212	3%
Centamin	n/a	356,943	318,699	12%
Highland Gold	310,000	233,696	216,385	8%
Avocet Mining	n/a	118,443	135,189	-12%
Pan African Resources	n/a	100,172	44,926	123%
Medusa Mining	n/a	75,000	62,243	20%
Shanta Gold	80,000	64,054	5,748	1014%
Kirkland Lake	150,000	60,783	42,309	44%
Vatukoula Gold Mines	n/a	39,517	52,616	-25%

Sources: Company reports

Randgold Resources boosted gold production to a new record level and reduced total cash cost per ounce in 2013 while lining up its operations to exceed the million-ounce mark for the first time this year. The company reported production of 910,373 ounces for 2013, up 15% on the previous year, and forecast a continued rise in output over the next five years, with production in 2014 expected to increase by between 25% and 30% on the back of increasing grades at the Loulo-Gounkoto complex, improving recoveries and throughput at Tongon and the recently commissioned Kibali's first full-year contribution.

Polymetal exceeded its original annual production guidance and produced 1.28m oz of gold equivalent in 2013, up 21% year-on-year. Annual gold production was 805,000 oz, up 37% year-on-year. The company has re-iterated its production guidance of 1.3m oz of gold equivalent for 2014 and 1.35m oz for 2015.

For African Barrick Gold, on the production front, 2013 marked a turning point as it saw production increase year-on-year by 3% to 641,931 ounces, 7% ahead of the top of its guidance range. For 2014, it expects to see increased production of between 650,000 and 690,000 ounces of gold.

Highland Gold Mining has reported that production of gold and gold equivalents rose 8% to a record 233,696 oz in 2013, in line with guidance. Production for the year to 31 December 2014 is expected to increase to between 300,000-320,000 oz of gold and gold equivalents.

Shanta Gold, the East African gold production and exploration company, produced 64,054 ounces in 2013, marginally ahead of guidance of 63,000 ounces with an all-in-sustaining costs of US$1,049 per ounce, within guidance of US$1,000 to US$1,100 per ounce. It has reaffirmed its 2014 production guidance of 80,000 ounces at an all-in-sustaining cost guidance of US$900 to US$1000 per ounce reflecting impact of cost saving initiatives and increased production volumes in H2 2014.

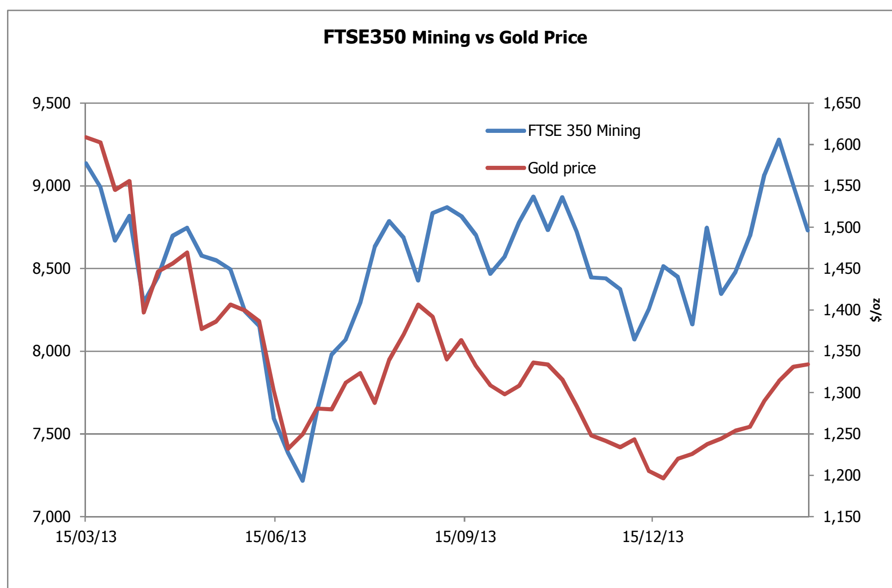
Kirkland Lake Gold is targeting production for the 2014 fiscal year of around 150,000 ounce guidance, compared with 91,786 oz. sold in fiscal 2013.

At current gold prices, gold output will almost certainly decline in the long-term as most producing mines are struggling to make money. We estimate that the average all-in-cost of gold production is now under the current spot price for just 10% of gold production. We do not expect 2015 output to be as buoyant as 2014.

3. Gold Equities

3.1 Performance

The start of the year bounce in mining equities is tapering off and in recent weeks there has been further sell-off particularly due to fears over slowing growth in China. For the moment though the gold price is holding firm but we continue to see volatility over the coming quarters due to rising production and uncertain demand.



Source: Fidessa

Nevertheless, the performance of gold stocks now looks much improved compared with three months ago. As the table below shows, the gold producing stocks, on average, are up 19% in the past six months reflecting the bottoming out of the gold price which feeds more quickly into P&L and balance sheets of producing companies than exploration companies.

Performance of Gold producing companies

		Market	Share price performance			
		Cap (£m)	1m	3m	6m	1yr
Polyus	Prod	5640	-0.1	-6.6	-3.7	-4.7
Randgold Resources	Prod	4583	1.7	5.5	25.0	8.3
AngloGold	Prod	4431	0.0	15.8	29.4	15.8
Polymetal	Prod	2188	1.5	-13.8	11.1	-24.7
African Barrick Gold	Prod	1065	3.9	-0.8	58.4	49.2
Hochschild	Prod	670	-7.7	9.7	61.2	-28.8
Centamin	Prod	657	0.7	11.4	33.0	28.7
Medusa Mining	Prod	273	8.7	5.0	20.4	-5.1
Pan African	Prod	267	-2.5	-1.6	15.4	9.1
Highland Gold	Prod	206	2.0	-9.5	9.3	-18.4
Petropavlovsk	Prod	173	7.3	-4.9	38.6	1.6
Kirkland Lake	Prod	161	1.1	12.3	68.5	-2.2
Shanta Gold	Prod	71	0.0	7.9	39.8	6.0
Amara Mining	Prod	34	7.8	-10.9	19.8	-24.3
Charaat Gold	Prod	26	0.0	5.9	9.2	-28.4
Caledonian Mining	Prod	24	2.2	11.3	-4.3	-12.7
Vatukoula	Prod	23	-4.9	10.7	8.5	-9.0
Minera	Prod	23	1.5	-7.3	-7.3	-28.4
Mwana	Prod	22	-6.1	-8.3	28.4	7.5
Avocet	Prod	21	0.0	25.0	-23.6	-37.3
Trans-Siberian Gold	Prod	13	0.0	-2.1	-11.3	-50.0
Orosur Mining	Prod	12	8.6	13.7	34.9	-1.7
Oxus Gold	Prod	12	2.8	12.2	10.6	42.0
Goldplat	Prod	10	4.3	-8.0	-13.2	-32.4
Central Rand Gold	Prod	9	-4.1	82.5	69.8	151.7
Peninsular Gold	Prod	6	1.8	19.1	-45.1	-52.1
Kolar	Prod	5	0.0	-5.4	-25.5	6.1
Galantas	Prod	4	0.0	0.0	83.3	-5.7
Average			**1.1**	**6.0**	**19.3**	**-1.4**

Source: Fidessa

Not surprisingly, gold exploration companies have lagged behind the gold producing companies as the gold price has rebounded. However, in absolute terms they have performed positively in the past three months.

Performance of Gold exploration companies

		Market	Share price performance			
		Cap (£m)	1m	3m	6m	1yr
Aureus Mining	Exp	87	3.0	13.0	-1.5	-14.6
Metals Exploration	Exp	84	2.1	11.6	4.3	-5.9
Patagonia Gold	Exp	82	0.0	-13.6	-13.6	-24.0
Solgold	Exp	65	-1.1	40.3	20.8	11.3
Condor Gold	Exp	35	-2.2	24.0	17.0	-31.4
Serabi Gold	Exp	34	0.0	2.5	-8.9	-14.6
Kefi Minerals	Exp	18	3.8	-1.3	-4.8	-33.1
Mariana Resources	Exp	15	-5.9	8.6	-3.8	3.4
Bullabulling	Exp	12	3.7	31.1	22.7	-12.9
ECR Minerals	Exp	8	-1.9	0.0	-27.4	-1.9
Papua Mining	Exp	8	0.0	0.0	-33.3	-52.0
Noricum	Exp	7	-5.3	9.4	-3.8	-30.9
Ovoca Gold	Exp	7	0.0	-7.6	-9.0	-21.8
Conroy Gold & Nat. Rsrcs.	Exp	6	0.0	-5.3	-14.3	-7.7
Ortac resources	Exp	6	4.2	2.1	-5.9	-33.3
Ariana	Exp	6	5.7	-14.6	-31.9	-7.9
Orogen Gold	Exp	5	0.0	-18.2	-26.2	-46.4
Nyota Minerals	Exp	5	15.7	56.9	10.9	-21.5
Sovereign Mines	Exp	5	0.0	-11.8	-28.6	-34.8
Goldstone	Exp	4	-4.8	5.0	-2.3	-31.1
Wishbone Gold	Exp	4	6.7	-16.7	-28.6	-25.0
Kalimantan	Exp	3	14.3	40.0	-33.7	-53.3
Scotgold	Exp	3	4.2	13.2	14.3	-49.0
Greatland	Exp	3	-4.7	6.0	6.0	32.5
Aurum Mining	Exp	2	0.0	-21.4	-38.9	-50.0
Connemara	Exp	2	0.0	-5.1	-9.8	-9.8
Touchstone	Exp	1	0.0	-3.4	-17.6	-64.1
Average			**1.4**	**5.4**	**-9.2**	**-23.3**

Source: Fidessa

We believe that the gold price will remain volatile in the short-term until supply adjusts to demand. To investors, we continue to urge caution and recommend selectivity. The optimal exposure should be a combination of low-cost producers such Randgold and Pan African Resources and exploration companies located in investor friendly countries. Poor infrastructure and political issues will continue to plague most exploration companies and if gold prices remain at current levels, we would expect many of these projects to be abandoned. Among the junior explorers, a few companies including Conroy Gold, Bullabulling and Ariana Mining continue to stand out in terms of valuation and risk/reward profile of their locations.

Company	Type	Operating Region	Gold Resource	Cut off grade	EV/oz. of gold
			m oz	g/t Au	
Nyota Minerals	Exp	Ethiopia	1.9	2.3	2.8
Bullabulling	Exp	Western Australia	3.5	0.5	3.4
Ortac resources	Exp	Slovakia	1.3	0.4	4.8
Goldstone	Exp	Africa	0.6	0.5	6.7
Conroy Gold & Nat. Rsrcs.	Exp	Ireland & Finland	1.0	0.8	6.2
Ariana	Exp	Turkey	0.9	0.5	7.5
Condor Gold	Exp	Nicaragua, El Salvador	3.5	1.7	10.1
Serabi Gold	Exp	Brazil	2.5	0.5	13.5
Scotgold	Exp	Scotland	0.2	3.5	17.6
Mariana Resources	Exp	Argentina, Chile & Peru	0.5	1.0	29.2
Patagonia Gold	Exp	Argentina	1.9	0.3	43.8
Aureus Mining	Exp	Cameroon	1.7	0.5	51.0
Metals Exploration	Exp	The Philippines	1.4	1.7	60.6

Source: Company reports, Fidessa

3.2 Conroy Gold & Natural Resources

Since our last update, the company has reported progress on several fronts. In January, it announced that a review by independent consultants Tetra Tech Inc. of the results of the final mineralogical and metallurgical testwork programme on the ore grade material sent to Gold Fields/Biomin in South Africa, has validated the Preliminary Economic Assessment (PEA) process design criteria and operating costs. The final mineralogical and metallurgical testwork results were analysed and evaluated by Tetra Tech in advance of an anticipated prefeasibility study (PFS) enabling Tetra Tech to confirm the preliminary estimates for the processing plant. The review of the metallurgical testwork results confirmed the key process design parameters, including the amenability of the ore to bio-oxidative pre-treatment, and the suitability of the proposed BIOX® oxidation process. Other than a lower sulphur grade in concentrate, results were as anticipated in the PEA. The decreased sulphur grade implies savings in both capital and operating costs. In relation to these savings the capital cost for the proposed processing plant is now estimated by Tetra Tech at US$18.5m compared with the US$ 20.2m in the PEA and the process operating costs are estimated to fall from US$ 13.64/t to US$ 12.26/t.

In February, the company announced the results of a structural study at its Clay Lake gold target in Co. Armagh by independent consultant structural geologists, Dr Francis Murphy and Dr David Coller. The study has yielded important new geological information which adds further evidence that the Clay Lake gold target may have the potential for high tonnage and overall gold content. The structural study, which included field mapping and detailed core investigation, was designed to indicate the nature of the geological structure, in which gold had been intersected during drilling by the company. The results of the study showed that not only is a gold mineralised anticline present at the Clay Lake gold target, with intense shearing, but that a second gold mineralised anticline is also present to the northwest of the first anticline. Anticline structures are important because they can host significant volumes of gold and are thus a key target in exploration. The identification of the anticlinal structure is of particular significance as gold mineralisation tends to accumulate within the hinge, or top, of the anticline. The presence of a second anticline to the northwest, where gold mineralisation has also been intersected during drilling, is promising as this target could be similar to the first anticline where previous drilling by the company intersected 53m at 0.60g/t gold including 10.25m

at 1.37g/t gold. Taken in conjunction with the widths of gold which have been intersected in the Clay Lake target, the presence of anticlinal structures is a further indicator of the potential of Clay Lake target for high tonnage and overall gold content.

3.3 Bullabulling

Based on our calculations, on an EV/resource basis, shares in Bullabulling at the current level provide the most value among the junior gold exploration companies. Meanwhile the company continues to build the case for investment. This month, it reported that preliminary metallurgical test-work undertaken as part on the Bullabulling Gold Project definitive feasibility study (DFS) has identified potential for reducing processing reagent consumption and increasing gold recovery relative to prefeasibility study (PFS) estimates, with positive implications for cash production costs. The recent test-work was primarily undertaken to determine if nanofiltration of process water would reduce consumption of lime and cyanide during gold ore processing at Bullabulling. Estimated expenditure on lime and cyanide in the PFS exceeded $30m per annum, or $170 per ounce, providing scope for a significant reduction in costs if consumption was reduced.

Comparative leach tests were carried out on primary and oxidised Bullabulling mineralised samples using raw and nanofiltered water extracted from the existing bore field at Bullabulling. Average consumption of lime during leach tests carried out in filtered water was 64% lower than in raw bore water, with cyanide consumption 26% lower. There was no net change in gold recovery at the PFS specified leach residence time of 24 hours, however extending residence time to 48 hours increased gold recovery in all leach tests to a greater extent than was expected. It is anticipated that upgrading water quality through nanofiltration could be positive for gold recovery during full scale operations as it would enable higher pH levels to be maintained and assist in achieving optimum leach conditions.

Whilst the test-work results are highly encouraging, it must be noted that they are based on a limited number of tests and more definitive work is required to validate the preliminary results. There is no certainty that forecast reagent consumption will be reduced to the extent indicated.

3.4 Ariana Resources

Ariana is an exploration and development company focused on epithermal gold-silver and porphyry copper-gold deposits in Turkey. The company is developing a portfolio of prospective licences selected on the basis of its in-house geological and remote-sensing database, on its own in western Turkey and in joint venture with Eldorado Gold Corporation in north-eastern Turkey. Eldorado owns 51% of this joint venture and are fully funding all exploration work on the JV properties, while Ariana owns 49%. The total resource inventory within this JV is 1.09m ounces of gold.

In December, the company confirmed that following the submission of its final Environmental Impact Assessment (EIA) report for the Kiziltepe Sector of the Red Rabbit gold-silver project in Western Turkey, the Ministry of Environment and Urban Planning has now formally approved the EIA for the initial mine at Kiziltepe.

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