Global | Mining

11 January 2013

Global mining

Are gold shares poised to rally? Switching out of steel into gold

	Ticker	Mkt cap (USD mn)	Price (lc)	Rec	PT (lc)	Up/(Dn) side (%)	PER (x) FY1E	PER (x) FY2E	EV/EBITDA (x) FY1E	EV/EBITDA (x) FY2E	Div yield (%) FY1E	Div yield (%) FY2E
Philex Mining Corp	PX PM	2,007.0	16.60	IL	20.10	21.1	55.1	20.8	25.5	13.9	0.7	1.4
Zhaojin Mining Industry	1818 HK	4,453.5	11.84	OP	19.53	64.9	14.6	11.1	12.3	8.8	2.1	2.7
Zijin Mining Group	2899 HK	8,666.2	3.08	OP	3.80	23.4	10.4	8.0	5.5	4.4	2.4	3.1

Share prices as of 10 January 2013
Source: Companies, FactSet, Standard Chartered Research estimates

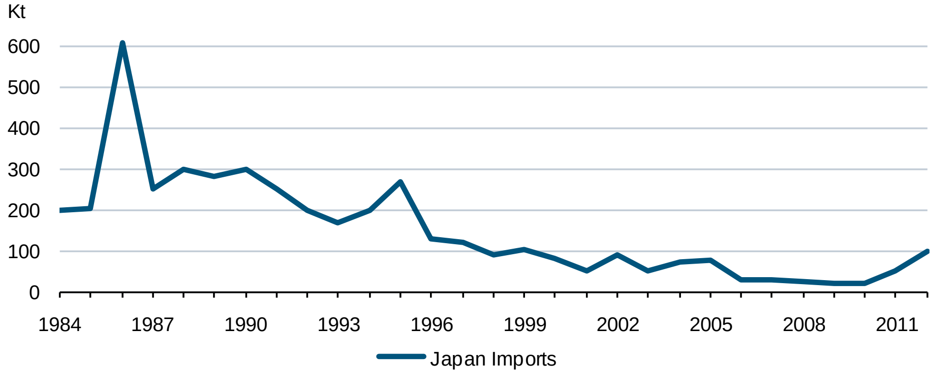
- Sentiment towards gold shares has worsened. Investors are no more bearish – indicating this is usually the best time to buy gold shares.
- China's November net gold imports were stronger than we had expected, while we believe Japanese gold imports could surprise materially in 2013.
- We recommend switching out of China steel names into gold. Our top picks are Zhaojin Mining Industry and Zijin Mining Group.

Being bearish gold is a crowded trade

It is no longer cool to be bearish on gold equities – it is now a crowded trade. The rush to the exit over the past three months has demoralised the gold bulls enough for us to believe the share prices appear ready for a significant rise. Many investors we talk to think gold is going lower and will test the USD 1,600 level in the near term. Comments such as, 'Why would you buy a gold company when the broader market is rallying?' are common. This is the kind of commentary we received on iron ore when we met US investors in late November, just when prices were about to rise substantially. The same could be true for gold now, in our view.

At the same time, bullishness on Chinese steel stocks is at a three-year high, and we are increasingly nervous that higher iron ore prices will impact margins in 2Q12, as steel prices are up only 20% from their lows. Our downgrade of the steel names on 10 Jan 2013 (*China steel - A better 2013 is priced in*, Wei Ouyang) comes after a 60% rise from the lows in October, while gold shares such as Zhaojin and Zijin have significantly underperformed over the same period.

Japan's gold imports since 1984 – Are we about to witness a resurgence in demand?



Source: lbma.org.uk

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Remain bullish on the cycle but steel stocks are ahead of fundamentals

After our report, *Climbing the wall of worry* (8 September 2012, Jeremy Gray), we think we are now in the second innings of a new commodity bull market that appeared to start on 22 June 2012 and has been stop/start ever since. The rally started in steel, then moved to copper, and is now firmly in the iron ore market. The next one could be gold, along with coking coal and nickel. Investors believe a bull market in equities cannot come in tandem with a bull market in gold shares. We do not think the two are mutually exclusive; the mildest bit of good news in gold prices could lead to a significant rally in gold shares. A move in gold prices back to above USD 1,700 per ounce could add 10–15% to many gold shares as the valuation suggests the market is discounting at a gold price of under USD 1,600 per ounce.

Gold shares were overbought in late September

In mid-September, we polled a number of gold specialists for their best gold ideas for the next 12 months. At the time, gold appeared to be on a breakout, with investors chasing many of these names. Since then, the basket has fallen 15% while gold is down just 7%. The sell-off in gold shares has largely come from investor frustration that gold has not rallied despite the stimulus from QE4 and European Central banks. Consequently, investors have erred on the side of caution, selling gold names to find beta in other sectors. In hindsight, our report *China gold: Another wave of re-ratings* (6 October 2012, Wei Ouyang) was too early but that does not mean that gold shares will not rally now. Both Zhaojin and Zijin have been watching patiently from the sidelines while China A shares have rallied sharply. Zhaojin is unlikely to achieve its 15% production growth target in 2013 but this is priced in, in our view. We believe the catalyst for Zhaojin in the short term will be gold prices and not the company's next set of results on 25 March 2013.

Fig 1: Investors' top gold ideas – Surveyed in September 2012

Australian gold Company	Ticker	Abs perf	Avg. grade	Gold ounces	Cash cost (USD per Oz)	Production (000 Oz) 2013E	2014E	2015E	2016E
Unity Mining LTD	UML AU	8.0%	12	343,000	982	50	50	50	50
Chaarat Gold Holdings	CGH LN	-19.2%	4	6,500,000	700	30	35	40	40
Dalradian Resources	DNA CN	20.5%	12.9	2,700,000	532	145	145	145	145
Goldquest MINING CORP.	GQC CN	-57.8%	-	-	-	-	-	-	-
Gold Standard Ventures Corp	GSV CN	-36.7%	-	-	-	-	-	-	-
Atac Resources	ATC CN	-30.0%	2.21	508,000	-	-	-	-	-
PMI Gold Corp	PMV CN	-3.4%	2.16	3,110,000	-	-	222	222	222
Saracen Mineral Holdings LTD	SAR AU	-19.6%	1.4	2,971,000	898	120	125	130	130
Gryphon Minerals	GRY AU	-36.8%	2.2	2,200,000	-	-	100	200	200
Beadell Resources	BDR AU	2.2%	1.33	6,390,000	618	180	180	180	180
Silver Lake Resources	SLR AU	-16.8%	4	4,600,000	600	50	250	300	300
McEwen Mining Inc	MUX US	-17.2%	1.54	4,275,536	698	193	250	290	290
Perseus Mining LTD	PRU AU	-29.2%	1.1	6,807,000	625	135	300	400	400
Evolution Mining	EVN AU	-8.5%	1.5	2,919,000	850	360	362	363	365
Alacer Gold Corp	AQG AU	-36.9%	1.95	19,547,000	734	420	420	420	420
Regis Resources LTD	RRL AU	-2.7%	1.8	15,240,000	495	685	790	845	845
Zhaojin Mining	1818 HK	-11.1%	2.5	17,940,680	713	493	542	598	623
Zijin Mining	2899 HK	1.6%	0.65	33,546,821	530	923	925	925	921
Medusa	MML AU	-12.4%	10.84	1,283,000	261	100	110	120	120
Average price performance		**-15.4%**							

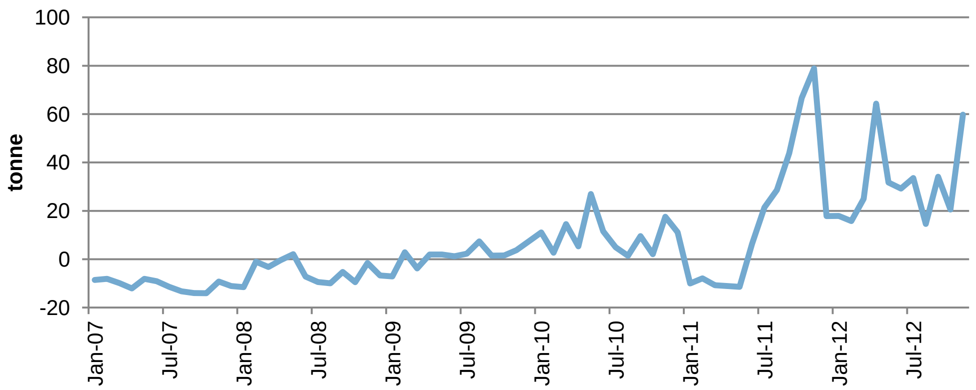
Only Zhaojin Mining and Zijin Mining are under our coverage
Source: Companies, Bloomberg

Figure 1 illustrates the performance of the gold basket since the survey in mid-September. This basket contains the names provided by gold investors, who consider these companies great investments. So far, the basket has underperformed the Hang Seng Index by 35%. We cover only Zhaojin and Zijin out of the companies mentioned in Figure 1.

Is Japan about to surprise on gold imports?

In the past 18 months, China has captured the market's attention as its net gold imports surged to an average of 45t/month from being a small net exporter in 2009. In November 2012, net imports surged to 62t, twice the annual output of Zijin in just one month. We estimate China accounted for c. 25% of global gold consumption in 2012, with a lot of the gold going in reserve. Figure 2 illustrates the rate of net gold imports into China since 2009. China produces c.355t of gold from its own mines, meaning annual gold consumption in 2012 is likely to be about 800t, compared with just 450t in 2010.

Fig 2: China's net gold imports surged again in November 2012



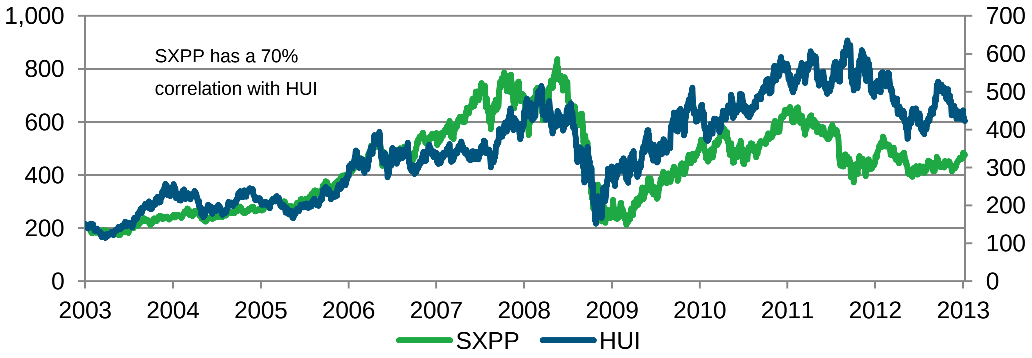
Source: Census and Statistics Department of Hong Kong, CEIC

During the Japanese boom 25 years ago, the country imported over 600t of gold – nearly 35% of global consumption in 1986. During the deflation years, imports plummeted, and between 2000 and 2011, Japan imported just 40t each year on average. Japan is a market that is no longer talked about in gold, but we think it could materially surprise in 2013 if the Yen continues to depreciate and inflation finds its way back into the mindset of the Japanese housewife. We believe it is possible that Japan could import as much as 300t in 2013, which would represent 7% of global consumption. To put that in perspective, we expect the growth in global mine supply this year to be only 100–150t. Our report, *In gold we trust* *(14 June 2011, Yan Chen)* illustrates how a lack of financing means only a few gold mines are under construction. Investors are no longer focusing on growth and are now urging gold company CEOs to pay dividends at the expense of new mines. In reality, demand for gold is growing much faster than for any other commodity. Prices are not moving much higher because scrap gold supplies have filled the gap, as highlighted in the report, *Gold – Strength in EM demand pillars* *(8 November 2012, Dan Smith)*. But the key question that remains is how much longer scrap supply will grow.

Gold shares are no different from other mining companies

The perception among many investors is that gold shares are different from other mining stocks. We disagree and Figure 3 shows that both the SXPP (UK Diversified Miners) and the HUI (gold shares) have a 70% correlation. In reality, digging for gold or copper is the same business. It's a business of moving dirt and selling your product in US dollars. Mines are the same, the technology is the same and workers are paid the same whether they work in a copper or gold mine. This is why it would be wrong to think that gold shares will miss out on a rally in the miners. Each has its day and gold seems to be next off the rank to move higher and push the shares higher.

Fig 3: SXPP vs HUI Gold Miners Index



Source: Bloomberg

In summary, we believe it is the right time to buy gold shares. We like the fact that most investors are positioned for a fall in gold prices. Key price drivers are likely to be continued central bank buying and constrained supply, as highlighted in the report on 8 November 2012. Bull markets in any asset class do not usually end in this way (a slow decline from their highs). We have yet to see a big spike in prices like other bubbles and that is partly the reason we are confident about another move up in gold shares. Our top picks are Zhaojin and Zijin.

Disclosures appendix

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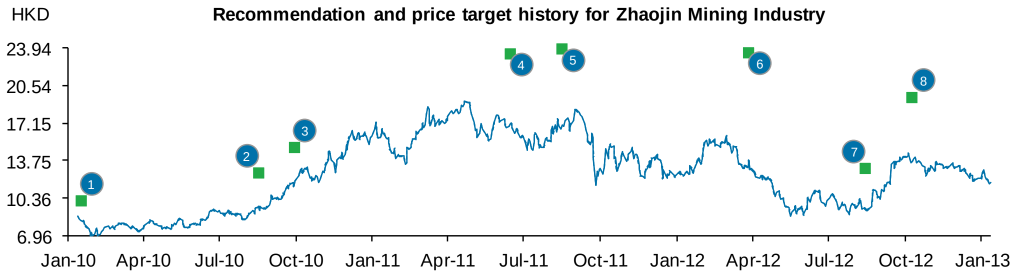
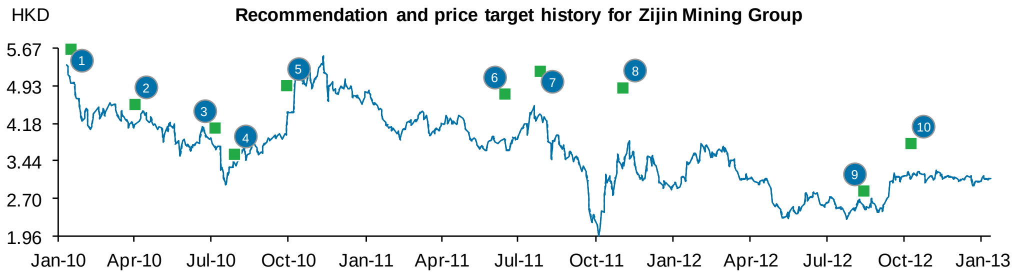
SCB makes a market in securities issued by the following companies: Zhaojin Mining Industry Co. Ltd. and Zijin Mining Group Co. Ltd.



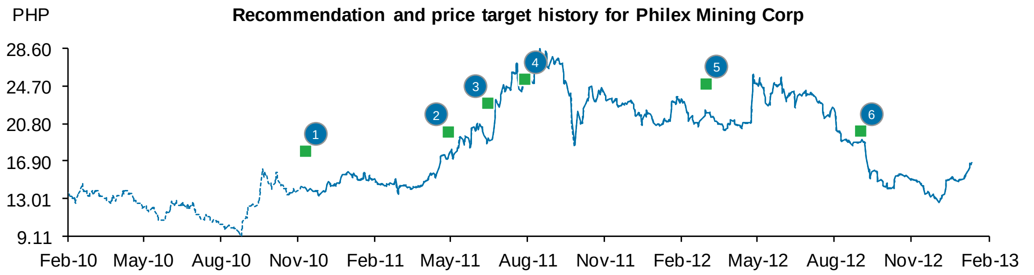
	Date	Recommendation	Price target		Date	Recommendation	Price target		Date	Recommendation	Price target
1	15 Jan 10	OUTPERFORM	10.16	4	14 Jun 11	OUTPERFORM	23.49	7	11 Aug 12	OUTPERFORM	13.10
2	15 Aug 10	OUTPERFORM	12.69	5	15 Aug 11	OUTPERFORM	23.94	8	6 Oct 12	OUTPERFORM	19.53
3	28 Sep 10	OUTPERFORM	15.00	6	26 Mar 12	OUTPERFORM	23.59				

Source: FactSet prices, SCB recommendations and price targets



	Date	Recommendation	Price target		Date	Recommendation	Price target		Date	Recommendation	Price target
1	15 Jan 10	IN-LINE	5.67	5	28 Sep 10	OUTPERFORM	4.95	8	1 Nov 11	OUTPERFORM	4.90
2	1 Apr 10	IN-LINE	4.57	6	14 Jun 11	OUTPERFORM	4.78	9	13 Aug 12	IN-LINE	2.86
3	5 Jul 10	IN-LINE	4.11	7	26 Jul 11	OUTPERFORM	5.23	10	6 Oct 12	OUTPERFORM	3.80
4	28 Jul 10	IN-LINE	3.59								

Source: FactSet prices, SCB recommendations and price targets



	Date	Recommendation	Price target		Date	Recommendation	Price target		Date	Recommendation	Price target
1	9 Nov 10	OUTPERFORM	18.00	3	14 Jun 11	OUTPERFORM	23.00	5	29 Feb 12	IN-LINE	25.00
2	28 Apr 11	OUTPERFORM	20.00	4	28 Jul 11	IN-LINE	25.50	6	31 Aug 12	IN-LINE	20.10

Source: FactSet prices, SCB recommendations and price targets

Recommendation Distribution and Investment Banking Relationships

	% of covered companies currently assigned this rating	% of companies assigned this rating with which SCB has provided investment banking services over the past 12 months
OUTPERFORM	55.1%	11.5%
IN-LINE	35.2%	15.6%
UNDERPERFORM	9.7%	3.4%

As of 30 September 2012

Research Recommendation

Terminology	Definitions
OUTPERFORM (OP)	The total return on the security is expected to outperform the relevant market index by 5% or more over the next 12 months
IN-LINE (IL)	The total return on the security is not expected to outperform or underperform the relevant market index by 5% or more over the next 12 months
UNDERPERFORM (UP)	The total return on the security is expected to underperform the relevant market index by 5% or more over the next 12 months

SCB uses an investment horizon of 12 months for its price targets.

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