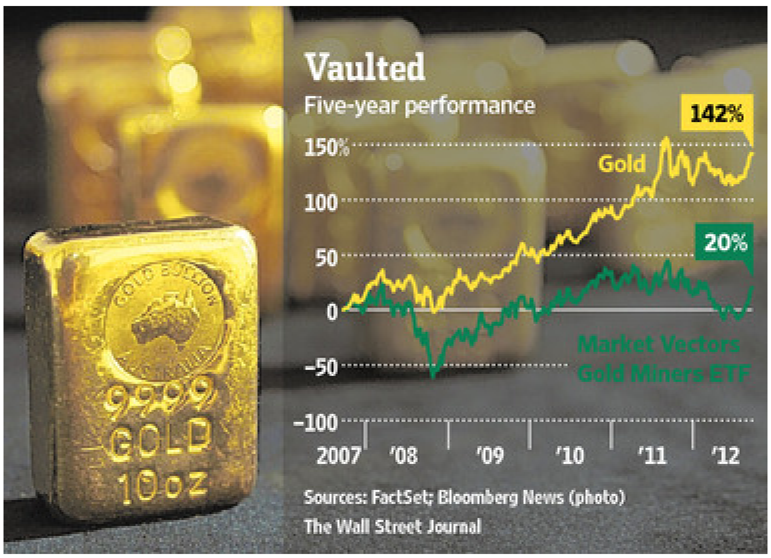
Gold Miners Are Over a Barrel

By LIAM DENNING

Describing last week's Denver Gold Forum, Mark Cutifani, chief executive of AngloGold Ashanti Ltd., AU +0.69% says: "It is clear that the industry is having its Jerry Maguire moment, which is not a moment too soon."

Mr. Cutifani is referring to the industry realizing that it needs to change its way of operating. As it dawns on miners that they have literally dug themselves into a hole, they may find inspiration in another sector that spends its time going underground: oil and gas.

Gold miners should provide leveraged returns on gold-price moves. But gold deposits have gotten harder to find and more difficult to develop. So even though average gold prices more than doubled between 2006 and 2011, so did costs. So much for leverage: In the past five years, gold has risen 142% while the Market Vectors Gold MinersGDX +0.52% exchange-traded fund is up just 20%.



The industry has compounded this with profligate spending. The top 10 miners by market value made an aggregate $68 billion in operating cash flow over the decade ended in 2011, according to data from S&P Capital IQ. But they spent almost $89 billion on capital expenditures and acquisitions. Dividends, meanwhile, amounted to less than $10 billion, even as shareholders were diluted to help fund expansion, with the share count jumping 151%.

Acquisitions, in particular, have irked investors and led to the ouster of chief executives at Barrick GoldABX.T +0.41% and Kinross GoldK.T +1.00% this summer. On Wednesday, Canadian gold miner B2Gold Corp. BTO.T +5.43% saw its stock drop 12% after announcing it would pay a 26% premium to acquire Australia's CGA MiningCGX -3.04% .

With investors increasingly able to get their gold exposure through metal ETFs rather than mining stocks, the message appears to be sinking in. Michael Dudas, metals and mining analyst at Sterne Agee & Leach, says that in Denver he heard four words repeatedly: "Discipline, focus, capital efficiency."

That is easier said than done. But one route the miners could consider is that taken by the oil majors back in the late 1990s, when they were also facing a moment of truth: mergers with no premium paid. These all-stock deals pooled the assets, and shareholder bases, of major oil companies and brought several benefits that could also help large gold miners.

First, synergies and spreading overhead across a bigger asset base mitigates cost inflation and boosts margins.

Combining assets also provides the opportunity to reallocate resources and sell off the weakest performers, improving return on capital. Indeed, ***Pawel Rajszel*** of ***Veritas Investment Research*** says Barrick reduced its cost per ounce in this way by spinning off African Barrick GoldABG.LN -2.67% PLC in 2010.

Merging also brings bigger balance sheets and diversity, helping to reduce the cost of capital and making it easier to take on big, risky projects. Political risk is rising and the scale of projects is getting bigger. For example, the price tag for Barrick's Pascua-Lama mine in South America could be $8 billion. That is more than the entire capital expenditures of No. 2 miner GoldcorpGG +1.06% over the last decade.

Bigger and with more options in their portfolios, gold majors would be better placed to manage costs and generate higher returns. The one pesky thing with no-premium mergers is that one chief executive has to find something else to do.

Given the mood in Denver, though, maybe some wouldn't be averse to taking a golden parachute.

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