

WEEKDAY  
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# Thar's Green in Them Thar Gold Stocks

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*Small-cap gold stocks can be a risky investment, but their takeover potential offers significant upside.*

**GOLD HAS SHINED IN** recent months, but the rally has left many gold-mining stocks in the dust.

Since January 2008, a popular exchange-traded [fund](#) (ticker: GLD) that tracks the price of gold bullion is up 9% -- versus a 32% loss for an ETF that tracks [gold miner](#)s (GDX). The breakdown comes thanks to the credit crisis and a surge in input costs that have sapped profits of companies that mine gold.

Gold miners have begun to recover in recent months, but a stark valuation gap remains between the major gold producers and the smallest gold explorers and developers. The so-called junior gold stocks trade at enterprise valuations between \$20 and \$40 per ounce of gold they hold in the ground, versus a historical norm of \$50 to \$75, according to Raymond James analyst Brad Humphrey.

The juniors are the small and micro-cap companies that represent the first line of gold exploration, development and production. The nascent businesses traditionally rely on external sources of capital to fund their business, so the credit crisis hit the stocks particularly hard in 2008.

The companies, largely traded on the Toronto Stock Exchange, include names like Osisko Mining, Detour Gold, [Minefinders](#) (MFN) and [Exeter Resource](#) (XRA). Minefinders and Exeter have shares listed on the American Stock Exchange, as well.

Consolidation is a routine ingredient in the gold sector, as large producers, or "majors," seek to bolster their gold production and replenish naturally depleting assets.

"What makes it different today is the discrepancies in valuation," says Joe Foster, the portfolio manager for Van Eck's gold fund. "Junior stocks, relative to larger peers, have never been this undervalued."

Moreover, a potential wave of consolidation could now create significant opportunity for their investors. (While other avenues of growth exist for the stocks, acquisitions often mark the quickest exit strategy for an investor.)

Robert Cohen, a portfolio manager at Goldman & Company, says the average junior gold takeout comes at a premium 30% to 50% above the preannouncement price.

A few important caveats: Even gold bulls recommend that investors limit gold-exploration exposure to 5% or 10% of their portfolios. Also, the M&A theme requires the continuation of a bull market for gold. Amid historically low-interest rates and an easing money supply worldwide, that's not a hard case to make.

At Monday's close of \$918 per ounce, gold is up 7% since *Barron's* touted the asset class last October. (See *Barron's*, "[Golden Opportunity](#)," Oct. 13, 2008)

Gold majors like [Barrick Gold](#) (ABX), [Newmont Mining](#) (NEM) and [Goldcorp](#) (GG), have raised about \$4.5 billion in fresh equity over the last three months, according to David Houghton who covers the intermediate and major category of gold producers for BMO Capital Markets. After raising

capital last fall to repair balance sheets, Houghton says the producers are now "building war chests for potential acquisitions."

Falling energy costs and the gold rally have also left major producers in a stronger position to take out the small, poorly-capitalized developers.

"The gold price is more robust and margins will be much improved, so that will put [producers] in a good mood to go out and buy some of these things," says John Hathaway, portfolio manager at Tocqueville Asset Management's gold fund.

So how should an investor play the takeout theme? Experts advise caution in picking junior gold stocks, paying particular attention to reserve levels and geopolitical stability, factors of great importance to a potential acquirer.

North American locations offer the greatest stability for gold companies. Foster and Hathaway both recommend shares of Osisko, a junior developer.

"They have a 7 or 8 million-ounce mine in Quebec which is mining nirvana," Hathaway says.

Louis James, senior editor and analyst for the metals division of Casey Research, suggests Amex-listed [International Tower Hill Mines](#) (THM), which has a new large discovery in Alaska.

**Ron Coby, an investor and commodity trader at Coby Lamson Capital Management, likes Exeter Resources, Minefinders and [Nevsun Resources \(NSU\)](#).**

Another Canada-listed stock in favor with analysts is [Detour Gold](#) (DGC on the Toronto Stock Exchange).

BMO Capital Markets analyst John Hayes cautions that the junior companies can't just market themselves into an acquisition. They have to "demonstrate a feasible project," Hayes says.

On the pricing front, though, independent junior stocks remain priced for potential acquisition. "Most exploration and development companies are still trading in line to where they've been acquired historically," Hayes adds.

Last month, [Iamgold](#) (IAG) acquired a junior explorer called Orezone Resources in a stock deal valued at about \$275 million. Shareholders of Orezone, a Canadian company with operations in West Africa, ultimately received a 300% premium for their stock.

The junior gold space is a definite gamble. With blue chips recently showing their own enhanced level of risk, though, investors might want to find stocks that at least also offer the chance at big rewards.