Industry Thoughts

ROYAL GOLD, INC. (RGLD) AND THE PRECIOUS METALS ROYALTY BUSINESS MODEL

Royal Gold, with a $7.99 billion market capitalization, is a precious metals royalty company that specializes in gold, although it has exposure to other metals as well. The royalty model of doing business is not well-understood, because it is relatively rare. Essentially, a royalty company invests money to obtain a revenue share from the output of a goldmine. The product need not be gold. It need not even be a metal; there exist oil royalty models. The royalty itself may take different forms. It can be expressed as a percentage of revenue or as a percentage of production. The important point is that not all royalties are the same.

One type of royalty is known as a metal stream. In this type, the investor receives, in exchange for an upfront payment, the right to purchase a portion of the mine's physical production at a fixed price over the life of the agreement. An agreement might last 30 years, and the purchase price might be $400 an ounce in the case of gold, versus a gold price now approaching $1,500 an ounce.

In a standard gold royalty, the investor receives, in exchange for an upfront payment, a percentage of the resource revenue produced, and this can be defined in different ways. For example, in a gross smelter return royalty, the operator reduces the payments to the investor by certain contractually defined costs. In a milling royalty, the payment is based upon ore throughput at a mill.

This type of structure requires very few employees, so the revenue per employee is extraordinarily high and this contributes substantially to the high return on equity of this business model. Royal Gold takes in about $18.4 million of revenue per employee. In contrast, Google's revenue per employee is about $1.4 million. Since Royal Gold does not actually mine or produce gold, it is similarly efficient in terms of employee count relative to conventional mining companies like Newmont Goldcorp or Barrick; Royal Gold has perhaps 25 employees, whereas the mining companies each have well over 10,000.

The other significant contributor to the generally high return on equity is the discount rate used to price the upfront payment for the future gold royalties. As described above, that payment might approximate one-third or less of the price of the metal at the time that the contract is struck. The royalty company's profits are, in a sense, simply about earning that discount, which is the same as the return realized when it receives those payments or gold in the future that it paid only one-third for.

Beyond that discount rate, though, Royal Gold also incorporates much optionality if gold prices were to increase. One form is additional profits is from the presumed expanding margins vis-à-vis the original royalty purchase agreement. The other is the possibility of increased production volumes. In Royal Gold's case, there is a dormant- or unproductive-asset component, since, *of 186 properties in which it has invested, only 41 are actually in production status*. This one reason why the earnings multiple of a royalty company such as this is not directly comparable to ordinary operating companies: its earnings can increase tremendously with very little if any additional investment.

The average remaining life of the mines currently operating is 14 years. Thus, Royal Gold does not need to reinvest much of its cash flow to continue operating.

However, at current precious metals prices, many miners are only marginally profitable. Thus, there are many opportunities to reinvest cash flow in additional contracts on favorable terms. Occasionally, Royal Gold will raise additional equity. The last such equity offering took place in October 2012.

Since 2001, the dividend has increased at an 18% compound annual rate. At current gold prices, the annual operating cash flow is about $250 million. The company has only a 27% dividend payout ratio.

Over long periods of time, and even during periods of declining gold prices such as the past five years, Royal Gold has actually outperformed the S&P 500.

The company has $119 million of balance sheet cash and owes $214 million of long-term debt. Shareholders' equity exceeds $2.17 billion. The stock offers long-term optionality on gold with a growing investment portfolio in royalties and a high return on shareholders' equity.

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