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# Gold industry M&A: Riding the new wave buoyed by lessons from the past

While M&A trends may be poised to accelerate, gold industry players will need to keep past lessons in mind or else risk repeating previous mistakes.

*by Greg Callaway, Siddharth Periwal, and Oliver Ramsbottom*

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**Although the gold industry has struggled to create value for shareholders over the past decade,** its performance has started to improve in recent years. However, the advent of high gold prices in 2020 catapulted the industry to new heights, gaining significant attention from financial investors due, in part, to global uncertainty and low interest rates. Strong prices have delivered a well-rounded and solid performance by gold companies, which are expected to generate unprecedented cash flows.

With high balance-sheet flexibility, M&A, capital structure, and payouts are likely to remain key discussion topics. Moreover, low exploration budgets over recent years, declining reserves of large gold companies, and high industry fragmentation may also cause a growing wave of M&A activity to make business sense.[1] Nevertheless, management executives in gold companies need to be mindful of mistakes made during the previous gold price boom, when growth was chased unidirectionally by several companies. This resulted in underperformance by the industry for several years, and many companies urgently had to focus on operating-expenditure reduction, capital-expenditure rationalization, and balance-sheet cleanup. Acquisition premiums, uncertainty over commodity prices, and shareholder and activist–investor scrutiny will also warrant caution.

We believe that, while lessons from the past may sound a note of caution for management teams, M&A will likely be an accelerating trend for gold companies in the coming years. In the context of increasing M&A, we have identified five imperatives that all gold companies should consider embedding in their strategies to ensure that inorganic growth creates value in this cycle.

## The industry backdrop

In order to obtain a more complete picture of forthcoming trends, it is integral to gather a historical understanding of the industry.

### Underperformance in the past decade

Assessment of the gold industry's performance over the past decade suggests a disappointing track record. Although there were periods of strong performance—for example, 2010–12, when gold prices boomed; or post-2015, when companies started increasing performance—total return to shareholders (TRS) at an aggregate level was –2 percent CAGR until 2019. This was in-line with the overall mining sector but lagged significantly behind the global equity markets; the S&P Global 1200 generated 7 percent returns over the same period. This was explained by companies' performances. From a macro perspective, gold demand post-2011 has been relatively flat, ranging from 4,200 to 4,600 metric tons; and gold prices declined significantly post-2012, adding further pressure to industry economics. At the same time, driven by inflation, several operating-expenditure and capital-expenditure inefficiencies affected profitability; gold companies focused on reducing all-in sustaining costs and capital expenditures from 2012, which decreased approximately 25 percent from 2012 to 2016. The industry's financial performance has, indeed, improved—but by 2019 was not able to reach profitability in line with 2010–12 levels.

### Tides turned in 2020

This improving performance has accelerated given the significant increase in gold prices since early 2020. Along with increasing economic uncertainty, low interest rates and quantitative easing have resulted in significant interest from financial investors in "safe-haven" assets. Holdings by financial investors have reached an unmatched level with exchange-traded funds (ETFs), now the second-largest holders of gold behind US government reserves. This has offset the effect of declining demand from other users: for example, jewelry demand decreased significantly during 2020 due to lockdowns, with delays in celebratory events and uncertainties over future income.

[1] Greg Callaway and Oliver Ramsbottom, "Can the gold industry return to the golden age?," April 2019, McKinsey.com.

On the back of strengthened gold prices, the industry has performed well on most economic key performance indicators (KPIs) (Exhibit 1):

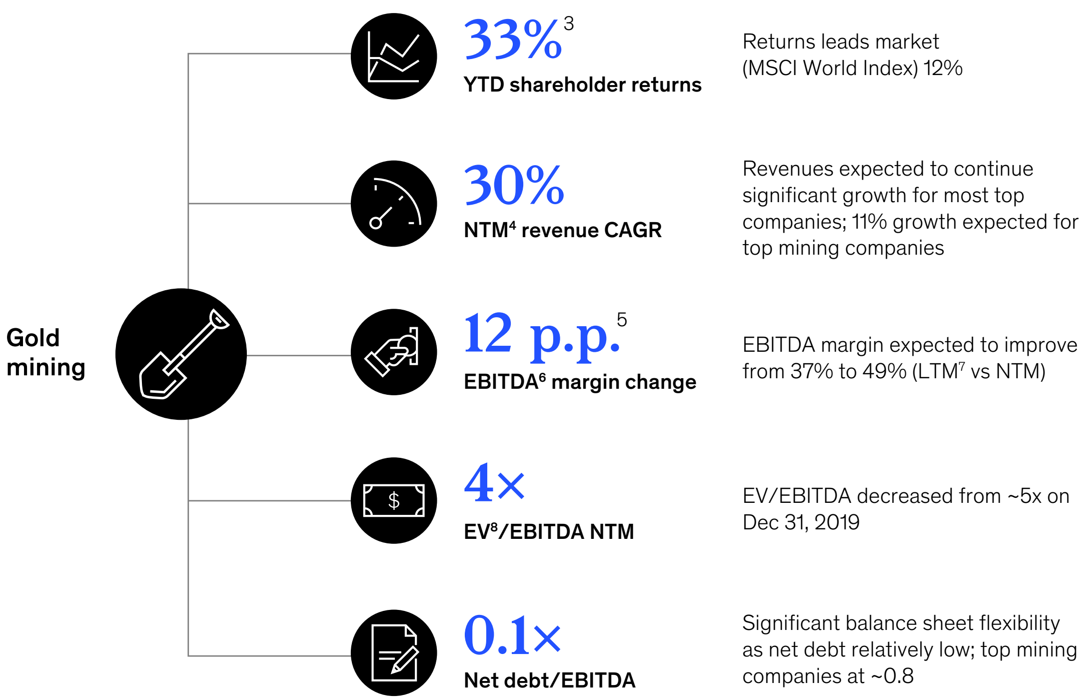
— *Returns to shareholders.* The industry generated a TRS of approximately 33 percent in 2020 as of December 15, delivering one of the leading returns. For reference, the MSCI world market delivered 12 percent returns over the same period.

— *Fundamental performance.* Both the top and bottom lines improved in 2020 for the majority of gold companies. Revenue for the next 12 months is expected to be even higher relative to that of the previous 12 months. Similarly, margin is also expected to improve significantly over the next year. This improvement outperforms both mining and other broader sectors.

Exhibit 1

**Gold companies and equities enjoyed significant tailwinds in 2020.**

**Median,** as per market cap[1] (n = 156)[2]




[1] As of December 15, 2020.
[2] Some data using analyst estimate based on smaller sample set.
[3] TRS in USD based on market weights as of December 2019.
[4] Next twelve months.
[5] Percentage points.
[6] Earnings before interest, taxes, depreciation, and amortization.
[7] Last twelve months.
[8] Enterprise value.
Source: S&P Global Market Intelligence

— *Balance-sheet health.* Gold companies improved on leverage ratios in 2020. With an expected increase in performance, leverage ratios are expected to further decrease significantly, providing a much healthier balance sheet in the near future. Leverage ratios for the gold industry are expected to be significantly better than most other mining industries.

## Why M&A is likely to become an accelerating trend

The gold industry has had, at best, a mixed history with M&A. Deals made during the last boom resulted in substantial overpayments, followed by significant impairments. Naturally, the deal volumes in the industry decreased after the gold boom as companies started to focus on operating expenditures and capital expenditures. However, deal activity has picked up recently, especially post-2018. Several companies that were involved in significant M&A in the past couple of years have also delivered high year-to-date TRS. Even in 2020, deal volumes went up significantly, although average deal value was much smaller. We believe M&A will remain a top-of-mind topic in the gold industry given the requirement to grow and consolidate, combined with the capacity for M&A. More specifically, three factors are likely to push M&A as a topic during strategic discussions:

### High disposable cash flow

Although mine capacity is expected to be reduced by approximately 3 to 7 percent as mines curtail or halt production due to COVID-19 measures, the jump in prices will more than offset the effect on

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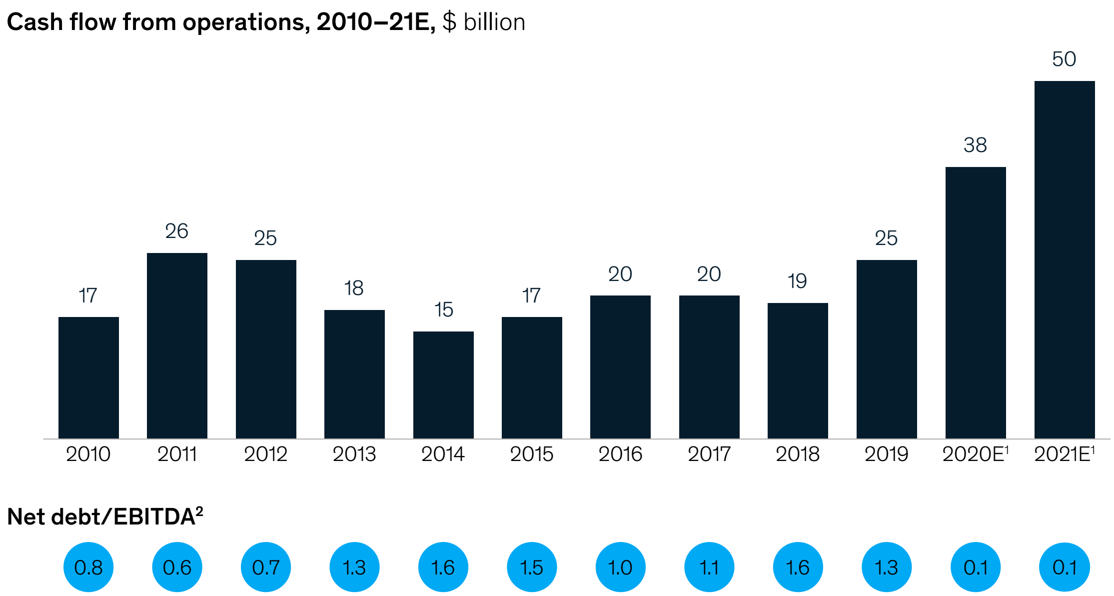
cash flows (Exhibit 2). Gold companies are expected to increase cash flows to an all-time-high level. We analyzed a sample of 85 gold companies that sell-side analysts are expecting to generate nearly $38 billion in 2020 and $50 billion in 2021. This is significantly higher than the $25 billion generated in 2019 and the $15 billion to $20 billion generated from 2013 to 2018. The increase will also be seen in most companies: approximately 80 percent of the sample set is expected to witness an increase in cash flows. Even though companies are expected to improve organic investments (both greenfield and brownfield), free cash flows will leave significant cash balances at their disposal. Additionally, the industry's debt capacity has climbed considerably as leverage ratios have greatly decreased with improving financials. This will provide additional room to invest, if required. We expect some part of this cash to be distributed back to shareholders. In fact, some companies have already increased

Exhibit 2

## Gold companies are entering 2021 with strengthening cash flows and balance sheets.




Note: Based on companies for which data are consistently available for entire time period (n = 85).
[1] Based on consensus analyst estimate.
[2] Earnings before interest, taxes, depreciation, and amortization.
Source: S&P Global Market Intelligence

dividend payouts for the year. However, given the high attractiveness of the gold industry, we expect companies to redeploy a significant part of capital to secure growth.

**High industry fragmentation**

The gold industry remains one of the most fragmented industries in the mining sector (Exhibit 3). The top five gold producers contribute less than 20 percent of the world's total gold. In contrast, for most other metals, the top five producers make up between one-third and two-thirds of global production. Traditionally, the gold sector has remained fragmented because there are lower barriers to entry for the industry. Even at a small scale, companies have been able to sustain themselves given the underlying economics. Also, properietary processing techniques in the gold industry are an exception in comparison with other metals, which, in turn, helps companies sustain themselves at a small scale. In the past, we have seen deals that provide easier access to funds, operational capabilities, and so on. For example, when Equinox Gold acquired Premier Gold Mines, Christian Milau, CEO of Equinox Gold, said: "Combining a 50 percent interest in the permitted, development-ready Hardrock Project with our strong balance sheet and operating cash flow provides a clear path to production for Hardrock that I believe will unlock substantial value for both Equinox Gold and Premier Gold shareholders." With the increase in cash availability and overall attractiveness, M&A is likely to gain traction.

**Declining growth options**

The heavy focus on cost-out initiatives post-2012 resulted in a dramatic decrease in exploration budgets across the industry, as well as juniors being starved of capital. Regarding operating-expenditure and capital-expenditure control, the gold industry witnessed exploration expenses being cut drastically by major producers as they primarily focused on brownfield expansion. McKinsey analysis suggests that, as a result, reserves of major gold companies have decreased by approximately 30 percent since 2012 (Exhibit 4). Reserve balances will see some adjustments as cut-off grade revisions help to convert resources into reserves; however, this will not be enough to ensure long-term production sustainability, especially for those companies that are looking to bring growth back onto the strategy agenda. As a result, M&A will be viewed as one part of the solution to rebuild and grow reserves (see sidebar, "Is this a good time for gold companies to engage in M&A?"). This trend has been accelerating since 2019.

## Is this a good time for gold companies to engage in M&A?

**M&As typically create the most value** when undertaken in a countercyclical manner. If M&A is done at a time when market sentiment and prices are low, there will be the highest likelihood of buying assets below fair value—although often the capacity to achieve M&As can be low, while board and stakeholder buy-in may be difficult to achieve.

Given the role of commodity prices in value creation, deriving value from industry transactions will also be dependent on future gold prices. The probability of buying assets below fair value at this point in the cycle is low, and thus there may be more risk in large-scale M&A today versus several years ago.

While there are several factors that support gold prices—such as economic uncertainty, low interest rates, and a weaker US dollar—forecasting prices is inherently challenging. Therefore, any initiative involving M&A not only needs to have a view on future gold prices under different scenarios but also should be founded on one of a number of assumptions: the buyer is able to extract more value than the seller due to strong synergistic value at asset level (for example, mines located next to each other or with strong geographical overlap); the buyer has a track record of operating assets better than the seller, potentially through technology or operating culture; or an acquisition is the most efficient and effective risk-adjusted way for the buyer to rebuild a depleted reserve base versus brownfield or greenfield exploration.

Exhibit 3

## High industry fragmentation suggests opportunities for increased M&A activity.

**Share of producers in industry,** 2019, %

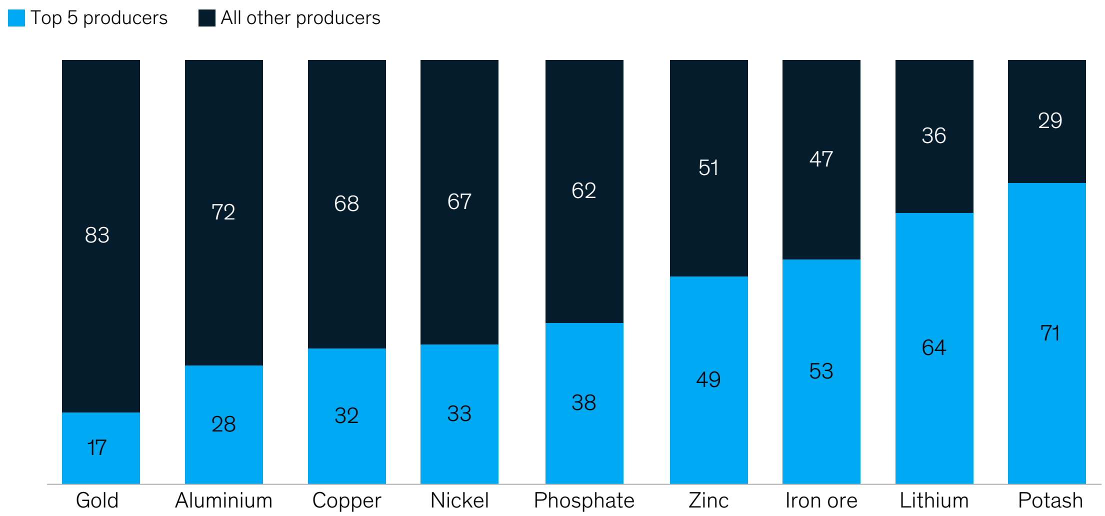
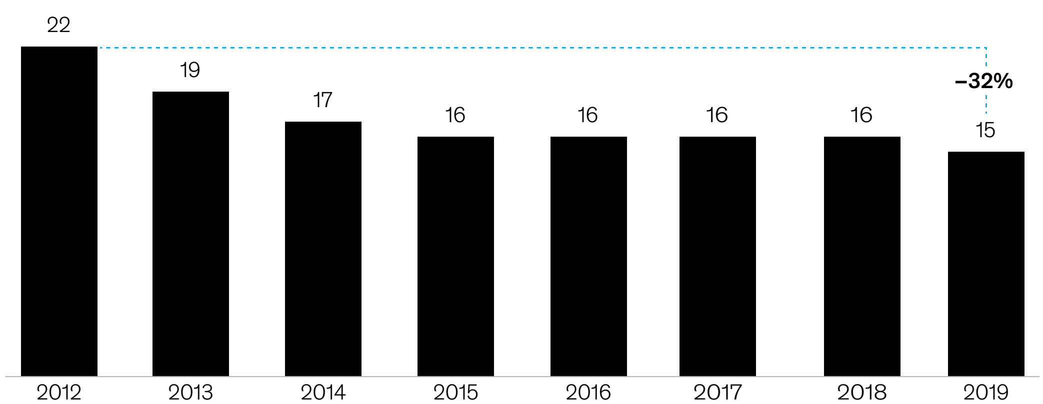



Exhibit 4

## The looming reserve crisis across major gold companies has increased the need to look for growth inorganically.

**Reserves by major gold companies,[1] 2012–19**
Metric tons of gold, thousands




[1] Based on top 18 gold companies.

Source: S&P Global Market Intelligence

At a recent mining conference, Barrick Gold's CEO, Mark Bristow, said that the African gold industry should consolidate further due to a "serious reserve crisis" looming for the sector, which is not exploring enough and has seen average mine life fall.

## What can the industry learn and do different this time?

Despite all the factors supporting an acceleration in M&A, we believe the industry should proceed with caution. Some top management executives have already said that M&A has become very expensive. Additionally, uncertainty around gold prices will affect decision making on growth, especially through inorganic routes. One of the most conspicuous reasons for management, boards, and shareholders to take caution will be to ensure that the mistakes of the last gold boom are not repeated. In the last gold price upcycle (from 2010 to 2012), both capital expenditures and M&A spending increased significantly. Reserves were added at a significantly higher price. However, as gold prices fell post-2012, companies had to scale back capital spending significantly. An estimate suggests that the gold industry recorded impairments beyond $100 billion over the past decade. The industry struggled for years to improve ROIC and was able to do so only with a combination of operating-expenditure control, capital-expenditure rationalization, and improved gold prices post-2015. If an investor ignores the effect of impairments, as it understates the historical investment made by shareholders, we notice that returns on an aggregate level are still below the cost of capital. This is also reflected in the low TRS in the past decade.

Given the context of increasing M&A in a climate in which there are potential concerns about such activity, we have identified five key lessons for gold companies to consider incorporating into their M&A strategies:

1. *Exercise rigorous validation of premiums (if at all) paid.* The value-creation potential derived from M&A activity is, to a large extent, driven by how much was paid for the target. Premiums paid in M&A often go up along with the M&A activity in the industry. We have witnessed the same in the gold industry, where the price paid to acquire gold reserves was more than 70 percent higher in the high-gold-price scenario (2010–12 versus 2014–18). The premium paid as a percentage of the share price before the deal announcement was also on the higher side and peaked in 2012. For deals greater than $10 million, we saw that premiums in M&A started increasing again in 2020.

   As premiums indicate value above that of the company in markets, this implies additional value the acquiring company needs to extract from a deal. Thus, the higher the premium, the higher the risk that the deal will not create value for the shareholders of the acquiring company. If we look at recent large deals, we can make some interesting observations. The gold industry has seen three deals greater than $1 billion in which no premium was paid for the transaction. This scenario helps companies curb the downsides of M&A. Similarly, we noticed that most large deals (excluding deals led by Chinese companies) were stock deals. Again, this approach helps reduce potential downside from M&A activity, because both companies share the upside and downside of the deal.

   If we continue to see an uptrend in M&A activity, it will be important to ensure that M&A premiums are carefully evaluated. Also, companies should employ industry-acceptable structuring and payment methods that can reduce risks from M&A.

2. *Focus on robust ROIC while chasing aggressive growth.* The fundamental principle of value creation says that both ROIC (profitability) and growth create value. However, this is often ignored, especially during peaks in cyclical industries as companies decide to chase growth, losing sight of long-term through-cycle profitability. The gold industry also went through a similar phase. With the benefit of hindsight, we know that the capital market rewards companies that focus on growth as well as ROIC.

We looked at a company that was able to grow its top line between 2009 and 2019 by approximately 9 percent, but its ROIC, on average, was only 1 percent and declined by about 400 basis points (bps) in the same time frame. The company delivered a TRS of –8 percent during this period, underperforming the industry average. In contrast, we looked at another company that, along with top-line growth of 9 percent over the same period, was also able to maintain an average ROIC of 9 percent, which increased by about 200 bps. This company was able to deliver a TRS of 13 percent, which significantly outperformed the overall industry.

We also observed that companies' TRS correlated strongly to growth during the price boom. However, the correlation disappears during periods of flat or declining prices, when TRS correlates more to returns on invested capital.

Keeping this in mind, while assessing M&A, companies should carefully evaluate how the deal will affect long-term growth and profitability to ensure that overall economic profits will increase. Companies need to assess impact on profitability using a through-cycle, long-term commodity price view.

3. *Adopt a clear M&A theme with defined synergies and optionalities.* As with any M&A, synergies (above premium paid) indicate the value-creation potential. In the resource industry, it is important to align the M&A theme with the broader strategy: for example, region-focused M&A to drive cost synergies or international expansion. Sources of synergy may vary widely depending on the type of M&A being undertaken. Thus, to ensure careful estimation of synergy, it is important first to understand how M&A can create value for the company, what the company is better at than the other company, and thus what will drive synergy and value creation.

   Companies' abilities to extract synergies go far beyond effective estimation. Companies also need to focus on:

   - *Setting internal stretch targets.* M&A practitioners highlight that internal synergy targets are often 50 to 100 percent higher than communicated to the market. Companies need to clearly define sources of hard and soft synergies derived from M&A. Deal teams should look at all potential sources of synergy by thinking through base-business protection, capturing combinational synergies, and seeking select transformational opportunities.

   - *Ensuring that synergies are achieved quickly.* McKinsey's M&A research shows that companies that achieve more than 80 percent of synergies in the first year post-acquisition have a significantly higher chance of achieving full synergies. More than 40 percent of companies that do not achieve synergy targets in year one never achieve their actual synergy targets. Further, we observed that excess returns (TRS) generated by the former set of companies significantly outperform the latter group.

   - *Considering integration challenges and containing implementation costs.* We can find numerous examples of situations in which actual integration was much less effective than planned. Some practitioners claim that it is the single largest driver of why deals fail to create value. Thus, the deal team needs to carefully assess potential challenges. In addition, it is important to ensure that implementation costs are effectively estimated. These costs vary widely but can significantly affect deal economics and thus require thorough estimation.

4. *Structure beyond pure M&A.* M&A comes across as one of the most prominent methods to chase growth. It bypasses several up-front hurdles—

especially in the resource industry—such as time required to make a mine operational, delays, or overruns. Nevertheless, while M&A plays an important role, companies should not lose sight of other potential growth options: for example, greenfield or brownfield expansion, joint ventures, private placements, and royalty deals. Some of these methods may work out to be significantly cheaper than pure M&A and should thus be evaluated as part of a growth strategy.

5. *Communicate (and deliver) to capital markets*. As we know, good deals can fail to create value simply because they were not well communicated to the market. It is important to have high levels of transparency with investors on all aspects of a deal. McKinsey's M&A research suggests that companies that clearly announce synergies tend to outperform those that do not. Especially given the history of M&A, companies need to ensure they have transparent, robust, and thorough communication with the market so they can reduce investor apprehensiveness and encourage strong buy-in from all stakeholders.

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We believe the gold industry is embarking on an accelerating wave of M&A driven by strengthening cash flows, restored balance sheets, and—in the context of growth—a need to rebuild reserves. However, because the previous gold price boom saw a similar wave of industry M&A that was followed by write-downs and impairments, careful deliberation and caution on the part of management teams initiating M&A are needed to guarantee that the mistakes of the past are not repeated. This will be critical to ensure that the industry emerges brighter and is positioned to create shareholder value in the years to come.

**Greg Callaway** is an expert in McKinsey's Johannesburg office, **Siddharth Periwal** is an expert in the Delhi office, and **Oliver Ramsbottom** is a partner in the Hong Kong office.