CONTRARIAN RESEARCH REPORT

The Contrarian Series

February 1, 2019

Franco-Nevada Corp.

(BUY)

Price (intraday):	$76.69	**Ticker:**	FNV
52-Week Range:	$58.26 - $77.92	**Dividend:**	$0.96
Shares Outstanding:	186.4 million	**Yield:**	1.25%
Market Capitalization:	$14.3 billion		

Data as of February 1, 2019

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The Contrarian Report

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Investment Thesis

Franco-Nevada is a Canadian gold-focused royalty and streaming company, although it is involved, to a lesser degree, in other commodities, including silver, copper, oil and gas. In this capacity, the company does not operate mines itself, but rather collects royalties from mining companies or purchases future gold production at pre-arranged prices, in exchange for providing investment capital. Those prices represent, effectively, a discounted present value of future years' production, established by using an interest rate negotiated between the miner and Franco-Nevada. It is clear both from per-ounce prices for new gold and silver contracts announced by the company, as well as from the rate of book value expansion over time, that these are double-digit rates of interest. In that sense, Franco-Nevada is as much, perhaps more so, a factor or discount buyer as it is a precious metals company. It earns that discount over time and is a consistent generator of ROE, which can't be said for neither the metals themselves nor the mining companies.

Under this business model, the company is the beneficiary when its investees increase production, as well as when gold prices rise. However, it is not directly impacted by cost inflation, as the expenses are borne by the operators, not directly by Franco-Nevada. Similarly, the company is not encumbered with risks that are normally faced by mining companies, such as increased personnel costs, exploration and development expense, and mine reclamation or remediation. The latter is important, as these costs are difficult to predict and can be quite costly in severe cases.

In the past 10 years, the annual volume of gold-equivalent ounces the company has sold under royalty agreements has increased from 110.3 million ounces to 497.7 million ounces, or almost fivefold. Yet, of the 376 royalty properties that comprise its asset portfolio, only 107 are producing. Those properties, or perhaps contracts is more apt, may be thought of as a dormant asset. As such, there is an enormous amount of upside potential when these properties start production.

The Franco-Nevada business model is unusually attractive. Royalty companies are among the highest-margin businesses of scale that exist, in that there is very little operating expense. General and administrative expenses in the most recent quarter were only a few percent of revenue. The company produces copious amounts of free cash flow, which are reinvested in additional royalty contracts or paid out as dividends – the company has increased the dividend rate every year since its initial public offering in 2007. The business model also engenders a strong balance sheet, with the company incurring little in the way of debt, thereby minimizing the financial risk. This appears to be borne out by its share performance. Since its inception, the shares have produced a total compound return of approximately 16% per annum even as gold prices have languished and gold mining companies have declined. Moreover, it outperformed the S&P 500 by roughly a 4:1 margin. This occurred despite a weak pricing environment for gold and silver, if down 30% and 67% from their 2011 prices qualifies as weak.

At its core, the Franco-Nevada shares offer significant optionality: exposure to higher commodity prices and greater production volume care of the large portfolio of as-yet undeveloped properties. The current stock valuation is largely predicated on observable cash earnings. The shares trade at about 30x the run-rate cash flow for the nine months ended this past September. While expensive if viewed superficially, it is hardly so in context. First, the prices of the commodities that the company finances are near multi-year cyclical lows, and it is historically typical for cyclical companies to trade at high valuations of depressed earnings – albeit that Franco-Nevada's earnings have been rising for years; but they would be more robust otherwise.

Moreover, as a royalty company with virtually no operating expense risk and no balance sheet risk, and no capital expenditure requirements in the conventional sense, it has historically traded a multiple of about 15x to 50x EBITDA.

And perhaps most importantly, only about 30% of the mine projects associated with its royalty and streaming contracts are yet producing. It can't be known with any specificity if or when most of this non-productive portfolio will become active, but it certainly will not occur all at once, nor even begin with any significance within the normal institutional investor's time reference range of the next several quarters, nor should even be hoped for if the price of gold and silver remain at levels that are breakeven for a mining company. It can be calculated that even under a mildly positive scenario, returns of 40% could be achieved. Obviously, under more favorable conditions, they could be much higher. Thus, the inherent operating leverage and ongoing compounding of book value renders the Franco-Nevada equity as superior to an outright purchase of physical gold, and would be the preferred choice for one who believes that gold price will rise.

Ultimately, the risk/return profile offered by Franco-Nevada appears to be favorable, and therefore the shares are recommended for purchase.

Company Description

Franco-Nevada is a Toronto-based company that owns royalties and streams in gold mining and other natural resource investments.

Historical Considerations
Although Franco-Nevada, as it exists today, lists its initial public offering as December 2017, the company can trace its origins to the early eighties. The original Franco-Nevada was initially listed on the Toronto Stock Exchange in 1983. It began as a public gold exploration company founded by Seymour Schulich and Pierre Lassonde, who are credited with devising the first gold royalty contract, although such arrangements involving oil and gas royalties did exist at the time.

The company made its first gold royalty investment in 1986, acquiring 4% of revenues from a mine located in Nevada owned by Western States Minerals. On an initial investment of $2 million, by 2002, the mine went on to generate $23 million annually for Franco-Nevada. In the 1980s and 1990s, Franco-Nevada completed several more royalty acquisitions, and eventually sold its only mining property, the Nevada Midas mine, in 2001.

In 2002, original Franco-Nevada was acquired by Newmont Mining, and the original Franco-Nevada team continued to operate the royalty business within Newmont. In the years following the acquisition, the company continued to build its portfolio of royalties, eventually numbering almost 300, of which two-thirds covered base and precious metals, with the remainder in oil and natural gas.

Over time, Newmont Mining decided to focus exclusively on its mining operations, thereby selling its royalty and certain other non-core investments. This was accomplished via the initial public offering for "new" Franco-Nevada in late-2007.

Prefatory Remarks

Before a description of the company commences, it is worth discussing the general merits of the royalty business. Notably, a precious metals royalty company is *not* a mining company. Franco-Nevada conducts no mining activities on its own. It also does not own any mines, land, or other capital assets. A royalty company is more akin to an investment bank – it provides funding to a mining operator so that mining operations can be initiated. In return, the royalty company is provided a royalty payment from the sale of the product (gold) or the right to purchase the product at a predetermined price. The latter structure is called a streaming agreement, and the agreed-upon purchase price is typically significantly lower than the prevailing price of the product.

Typically, the purchase price is based on a discount rate calculation, in which it is not unusual for the discount rate to approach 10% per annum, or more. Thus, the royalty company is accorded a low degree of risk as it pertains to commodity price fluctuations. Obviously, when the price of gold rises, Franco-Nevada would benefit, in the form of higher earnings, all else equal. However, even if prices remain unchanged, the company would still earn profits since its contracted purchase price would be substantially below the prevailing gold price. More importantly, even in a declining price environment, the company could be expected to remain profitable so long as the decline does not fall below the contracted purchase price. This is a powerful protection from financial duress that is not normally available to the typical gold mining company.

Why might a mining company accept funding from a royalty company rather than issue equity or debt? First, developing an ore body requires a very substantial amount of capital, and a number of years might be required before it can begin production and generate revenues. Generally, the company might not want to dilute its existing shareholder base, especially when gold prices are weak. Obviously, it is much more advantageous to issue equity when its valuation is high and it is in a strong position, rather than when the shares are undervalued. As to debt issuance, the disadvantages are many: high cost of funding; onerous or restrictive covenants and other requirements (e.g., restrictions on dividends, leverage ratios, etc.); and an ongoing interest burden, among others. For a company that is in the early stages of resource discovery or mine construction, the interest payments would be problematic in the face of no or negative cash flows. Therefore, the agreement to sell a portion of its gold at discounted rates in exchange for an upfront payment appears to be logical from a mining company's perspective. When its share valuation is low, it can avoid excessive and perhaps permanent dilution; it need not risk its solvency through leverage in a notoriously uncertain business.

In contradistinction, Franco-Nevada has no requirements for ongoing operational expenditures. Since it does not conduct mining activities itself, it has very little expenses, aside from general and administrative expenses. It does not hire mining personnel, purchase mining equipment, acquire land, or even apply for mining permits. These are all the responsibility of its investees. As such, the company has little in the way of financial risk (it has no debt).

Franco-Nevada is, however, dependent upon the viability of the mining company. Thus, a decline in the price of the underlying commodity can ultimately affect Franco-Nevada in the form of lower production or even the miner's bankruptcy if prices become sufficiently low. Nevertheless, it must be understood that the company's agreements typically specify that its agreement pertains to the resource itself, so that if another company were to take over production of the property in question, Franco-Nevada could enforce its agreement upon the latter firm. In this case, a defunct mine is never a full loss; since it has title to the land, there is always the possibility that at some future point in time, its investment could be recovered.

Current Operations

Franco-Nevada is the largest gold-focused royalty and stream company in the world, having the largest and most diversified portfolio by commodity, geography, revenue type and stage of project.

As of November 5th, 2018, the company has interests in 109 producing properties, 35 advanced properties, and 233 exploration assets. As a result, a little less than one third is currently producing cash flow. Phrased alternatively, there is much earnings growth potential embedded in its asset portfolio. Of the 107 producing mines, 43 are focused on precious metals and 57 are related to oil and gas. The oil and gas investments are the result of a recent expansion initiative to broaden its commodity exposure. The remainder (seven) are focused on other minerals, such as copper, nickel, zinc, and coal.

Exhibit 1: Franco-Nevada Asset Portfolio

Franco-Nevada Asset Count at November 5, 2018

	Precious Metals	Other Mining Assets	Oil & Gas	TOTAL
Producing	44	7	58	109
Advanced	28	7	–	35
Exploration	138	70	25	233
TOTAL	210	84	83	377

Source: Company reports

Notwithstanding the above figures, the company states that exposure to precious metals is its primary focus, targeting revenues from precious metals of at least 80% of total revenues in the foreseeable future. This is corroborated by the following: 210 of its total asset base of 377 (which includes producing, advanced, and exploration properties) are related to precious metals.

Franco-Nevada's revenue is generated from a variety of agreement types, including net smelter return royalties, streams, net profits interest, net royalty interests, and working interests. They are distinguished as follows:

- Net smelter return royalty: A royalty payment that is equivalent to a percentage of the revenue generated by a mine when its product is sold, including deductions as defined by the royalty contract.
- Streams: Streams are purchase agreements that provide the right to purchase all or a portion of one or more metals produced from a mine at a preset price, in exchange for an upfront deposit. Streams are not royalties because they are not an interest in land and there is an ongoing cash payment required to purchase the metal.
- Net profits interest: A royalty, in which payments only begin after the operator has recovered its capital costs.
- Net royalty interest: Similar to net profits interest royalty, but which is paid net of capital and operating costs.
- Working interest: An ownership position in the property and operation and therefore is liable for cash calls on their share of capital, operating and environmental costs, usually in proportion to the ownership percentage.

The company's preferred agreement is the net smelter return royalty, although it does also engage in other types of agreements, primarily streams.

Exhibit 2: Royalty Interests, by Geography[1] (as of 9/30/18)

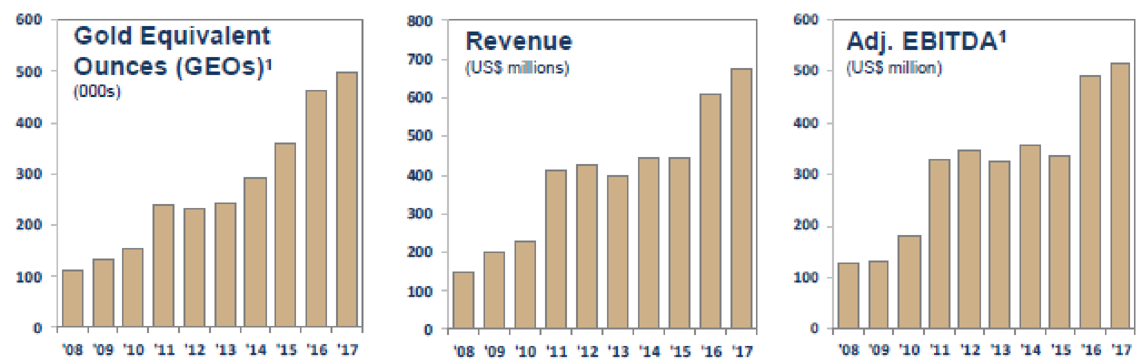
(expressed in millions) Property	Interest
PRECIOUS METALS	
Latin America	
Antapaccay	Stream (indexed)
Candelaria	Stream 68%
Antamina	Stream 22.5%
Guadalupe-Palmarejo	Stream 50%
Other	
United States	
Goldstrike	NSR 2-4%, NPI 2.4-6%
Stillwater	NSR 5%
Gold Quarry	NSR 7.29%
Marigold	NSR 1.75-5%, GR 0.5-4%
Fire Creek/Midas	Fixed to 2018 / NSR 2.5% (2)
Bald Mountain	NSR/GR 0.875-5%
South Arturo	GR 4-9%
Other	
Canada	
Sudbury	Stream 50%
Detour Lake	NSR 2%
Golden Highway	NSR 2-15%
Hemlo	NSR 3%, NPI 50%
Musselwhite	NPI 5%
Kirkland Lake	NSR 1.5-5.5%, NPI 20%
Timmins West	NSR 2.25%
Canadian Malartic	GR 1.5%
Rest of World	
MWS	Stream 25%
Sabodala	Stream 6%, Fixed to 2019
Karma	Stream 4.875%, Fixed to 80,625 oz
Subika	NSR 2%
Tasiast	NSR 2%
Duketon	NSR 2%
Edikan	NSR 1.5%
Other	
OTHER MINING ASSETS	
OIL & GAS	
Weyburn	NRI 11.71%, ORR 0.44%, WI 2.56%
Midale	ORR 1.14%, WI 1.59%
Edson	ORR 15%
SCOOP/STACK	Various Royalty Rates
Midland/Delaware	Various Royalty Rates
Orion	GORR 4%
Other	

Source: Company reports

[1] A more complete description of Franco-Nevada's assets can be found at: https://s21.q4cdn.com/700333554/files/doc_downloads/asset_handbook/v13FF_FN_AH'18_04.03.pdf

Since its initial public offering in 2007, the annual amount of gold-equivalent ounces Franco-Nevada has sold increased from 110.3 million ounces to 497.7 million ounces, representing a compound annual growth rate of 18.2% per annum. This has been achieved in part through a continual expansion in the royalty portfolio. As an example, within the past year alone, it has: entered in to a strategic relationship with Continental Resources to acquire mineral rights in the South Central Oklahoma Oil Province and Sooner Trend Anadarko Basin Canadian and Kingfisher Counties plays of Oklahoma; entered into an amended and restated stream agreement pertaining to the Cobre Panama project, which is in the construction phase (Cobre Panama is one of the world's largest copper/gold/silver deposits and is currently being constructed; production begins in 2019); and acquired royalties on the Orion Thermal Project (oil & gas), among others.

Exhibit 3: Historical Precious Metals Sales (2008-2017)



The Cobre Panama investment is noteworthy in that the company has contracted for a fixed payment stream of $418 per ounce of gold and $6.27 per ounce of silver until 1,341,000 ounces of gold and 21,500,000 ounces of silver have been delivered, subject to a 1.5% annual inflation rate factor applied to the purchase price. Thereafter, the ongoing payment will be the greater of 50% of the fixed price and 50% of the spot price. Given a recent spot price of $1,318 per ounce of gold and $15.89 for silver, Franco-Nevada would be entitled to purchase approximately $2.1 billion of gold and silver at fixed prices, assuming no change in the prevailing prices of the metals. It would also suggest gross profits of $1.4 billion, based on the contracted royalty prices. This example also illustrates the large margins at which the company can negotiate into its agreements: an initial purchase price of $418 versus a spot price of $1,318 per ounce of gold, implying that this project would still be profitable even if gold prices declines by up to 68%. One must consider that the company's other projects, whether producing or in development, possess similar characteristics.

Financial Considerations

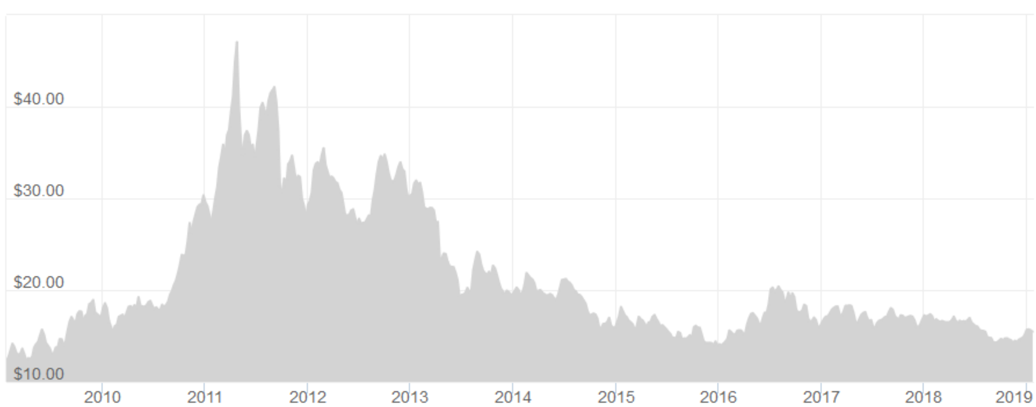
As illustrated in the preceding exhibit, Franco-Nevada has produced increased revenue since its initial public offering. Indeed, revenues have risen almost sevenfold since 2008, to $675.0 million in 2017 (full-year 2018 results have not been announced yet, as of this writing).

Generally, a primary factor in the company's revenue stream is the price of gold and silver, with a positive correlation between revenue and the commodity price. However, it must be stated that precious metals prices have experienced a multi-year bear market (since 2011), which negatively affects Franco-Nevada's financial results. Thus, its ability to maintain and/or increase revenues in the face of a declining price environment speaks to the strength in its business model.

Exhibit 4: Historical Gold Price (10 Years)

Source: Apmex

Exhibit 5: Historical Silver Price (10 Years)



Source: Apmex

Despite the exposure to precious metals price variability, Franco-Nevada still produces high margins, even during negative pricing environments. For example, in the five-year period of 2013 to 2017, the company's IFRS[2] gross margins ranged from 30.3% (2015) to 52.7% (2013). Net margins were as low as 2.9% (2013) to as high as 28.8% (2017). The low net margin produced in 2013 was primarily the result of a large ($112.9 million) impairment charge relating to a platinum streaming contract arising from the cancellation of a processing contract with the mine's operator. Absent this non-cash charge, its net margin would have been 31%. As a frame of reference, among the major U.S. companies with the highest acknowledged profit margins are Microsoft, with a 32% net margin this past fiscal year, and Facebook, at 39%.

Exhibit 6: Historical Income Statement (2013-2017)

	2017	2016	2015	2014	2013
Revenue	$ 675.0	$ 610.2	$ 443.6	$ 442.4	$ 400.9
Cost of sales	142.0	105.8	93.1	72.9	60.2
Depletion & depreciation	273.0	273.8	216.3	163.1	129.3
Gross profit	260.0	230.6	134.2	206.4	211.4
Corporate administration	21.3	20.7	15.1	16.4	15.2
Business development	3.6	3.4	2.7	2.2	3.0
Impairment charges	-	67.5	62.9	31.1	
(Gain) on sale of royalty interest	-	(14.1)	-	-	-
(Gain) on sale of gold bullion	(0.3)	(2.3)	2.2	-	-
Operating income	235.4	155.4	51.3	156.7	193.2
Foreign exchange gain/(loss)	1.1	0.2	(4.1)	(1.6)	(17.2)
Realized gain on investments	2.0	12.4	0.9	-	-
Impairment of investments	(4.5)	-	(2.0)	(0.4)	(30.7)
Income before infnance items and income taxes	234.0	168.0	46.1	154.7	145.3
Finance income	5.4	3.5	5.3	3.9	3.5
Finance expense	(3.4)	(3.6)	(2.9)	(1.6)	(1.9)
Pre-tax income	236.0	167.9	48.5	157.0	146.9
Income taxes	41.3	45.7	23.9	50.3	22.3
Net income	$ 194.7	$ 122.2	$ 24.6	$ 106.7	$ 124.6
Gross profit margin	38.5%	37.8%	30.3%	46.7%	52.7%
Net profit margin	28.8%	20.0%	5.5%	24.1%	31.1%
Corporate administration as % of revenues	3.2%	3.4%	3.4%	3.7%	3.8%
Gross margin excluding depletion & depreciation	79.0%	82.7%	79.0%	83.5%	85.0%

($ in millions)

Source: Company reports

[2] Since Franco-Nevada is based in Canada, it reports under IFRS accounting rules, not U.S. GAAP

More interestingly, due to the accounting rules, Franco-Nevada is required to recognize depletion and depreciation expenses, which is a material factor in its stated margins and net income, given that the amounts in question are large, relative to total revenues. For example, the $273 million of depletion and depreciation represented approximately 40.4% of revenues in 2017. The company is required to record this expense as a reduction to its book assets during the normal course of mining.

While this might be wholly appropriate for a company that actually conducts mining activity, it must be remembered that Franco-Nevada does no mining on its own; it is merely a financier to the operators. Thus, depletion and depreciation are not "true" expenses, as they are not incurred directly by the firm. Thus, absent this line item, the company's margins would be much higher. For example, in 2017, the adjusted gross margin would be closer to 79%. Net margins would be much higher than the stated 28.8% that year.

Ultimately, this enables Franco-Nevada to generate positive cash flow greatly in excess of its statutory earnings. While the company reported net income of $194.7 million in 2017, its operating cash flow before changes in non-cash working capital was $495.6, or more than double stated net income.

Exhibit 7: Historical Net Income vs. Operating Cash Flow (2008-2017)

	Net Income	Operating Cash Flow
2017	$ 194.7	$ 495.6
2016	122.2	464.7
2015	24.6	317.2
2014	106.7	332.0
2013	11.7	249.4
2012	102.6	306.3
2011	(6.8)	271.1
2010	62.7	147.1
2009	80.9	128.6
2008	40.3	132.0

($ in millions)

Source: Company reports

Since it has no capital expenditure requirements, in the traditional sense of the term, Franco-Nevada has the flexibility to allocate its free cash flow as it sees fit. Historically, much of the funds have been reinvested into new royalty agreements, thereby expanding its royalty portfolio and, in turn, its earnings potential. The ample cash flow also allows the company to downplay the role of debt. Indeed, since 2007, it has had no borrowings except for a short period in 2015 (via a credit facility), which was repaid a short while later. The company currently has a $1.0 billion credit facility that was undrawn as of September 30th, 2018; however, it has been announced that subsequently, Franco-Nevada drew $200 million to fund the Continental Resources Oklahoma royalty agreement. Given its history, it would not be surprising if the debt were to be repaid quickly.

Another use of Franco-Nevada's free cash flow has been to fund the payment of dividends. The amount of the payout has consistently increased since its IPO. At the current rate, the shares provide a dividend yield of 1.2%, which represents a payout ratio of only roughly 29% of operating cash flow.

Exhibit 8: Dividend History (2008-2018)

	Dividends Per Share	Total Paid
2018	$ 0.95	$ 149.2
2017	0.91	125.8
2016	0.87	118.1
2015	0.83	94.1
2014	0.78	90.7
2013	0.72	101.8
2012	0.48	77.9
2011	0.39	49.2
2010	0.30	33.3
2009	0.28	28.2
2008	0.24	21.8

($ in millions, except for per share data)

Source: Company reports, Bloomberg

Valuation

In regard to valuation, it should first be noted that Franco-Nevada is expensive under traditional valuation measures. At the current price, the company trades at a price/earnings multiple of 72x 2017 earnings per share. Based on analyst estimates, its 2018 p/e is a slighter lower, yet still eye-watering, 64x.

However, as discussed above, it can be argued that the GAAP earnings do not adequately represent the company's real earnings. If cash earnings (or operating cash flow) were referenced instead, the shares would carry a much tolerable valuation of 28x 2017 "cash" earnings. One could also argue that the valuation is based on depressed earnings, given that the price of gold and silver are have decline significantly since 2011.

At this point, it is important to acknowledge that Franco-Nevada has consistently traded at high multiples. Perhaps this is confirmation that the investment community recognizes the investment merits of the company's business model. For example, over the past 10 years, the p/e multiple has ranged from a low of 34.4x to a high of 130.7x, averaging 60.9x during the period. From this perspective, the company's present valuation does not appear to be anomalous; on the contrary, it is valued near its historical average. Moreover, this multiple level has not impeded the capital appreciation of the shares – since its inception, the equity has generated a compound annual total return of 16% per annum, as compared to 7% for the S&P 500 and 10% for the Nasdaq.

Rather than assessing Franco-Nevada using traditional valuation measures, perhaps a better approach would be to view the company as a profit-generating enterprise that possesses a significant amount of dormant assets. These refer to the properties in its royalty portfolio that are in the development (aka "advanced") or exploration phase. Viewed from this perspective, the Franco-Nevada equity provides the investor with two sources of optionality.

The first pertains to appreciation in the price of precious metals. Given that the company's business model is leveraged to rising commodity prices (i.e., no commensurate increase in expenses when the price of gold or silver rises), substantially all of the additional revenue essentially becomes net profits, thus boosting earnings growth disproportionately, all else equal. Consequently, an increase in gold/silver prices of, say 10%, could increase earnings by more than 10%.

The second source of optionality is rooted in the probability that at least a portion of the properties that are not currently active will start producing gold/silver/oil/etc. at some point in the future. The most obvious property included in this category is Cobre Panama, which is expected to become active sometime this year. Considering that the number of dormant properties exceed currently active locations by a 2.5-to-1 ratio, the assumption that this optionality manifests into higher production appears reasonable.

To quantify this, let us assume that Franco-Nevada merely increases the amount of gold sold by its historical average of 18%. Additionally, let us assume that the price of gold advances by 10%. Observers will note that such a move would still place the price at roughly $1,450 per ounce, which is still approximately 20% below its 2011 high.

The result would be revenues of approximately $864 million. Assuming the company were to achieve its historical EBITDA margin of 77.7%, it could be expected to produce $671.4 million of EBITDA.

According to Bloomberg, Franco-Nevada has traded at a price/EBITDA multiple of between 15.4x and 50.2x, with an average of 27.4x in the last 10 years. Applying the average multiple would suggest a fair value of $18.3 billion in market capitalization terms. This would imply capital appreciation of almost 28% in this scenario.

2017 Revenues	$ 675.0
10% increase in gold price	67.5
18% increase in production	121.5
Adjusted revenues	864.0
Historical average EBITDA margin	77.71%
EBITDA	671.4
Mkt cap. @ avg. Price/EBITDA multiple	$ 18,329.7
Current mkt cap	14,321.0
% change	*27.99%*

($ in millions)

Source: Company reports, Horizon Kinetics Research

Of course, in success mode, meaning the company achieves results above the historical average, much higher returns could be envisaged. For example, if the company were to generate EBITDA margins at the higher end of the historical range (i.e., 84%), holding everything else constant, the fair value might instead be $19.8 billion, leading to capital appreciation of approximately 38%. This optionality provides a superior return to a straight investment in gold, and thus would be the preferred method if one were inclined to express a positive outlook for the commodity.

Summary and Recommendation

As a pure royalty company, Franco-Nevada exhibits characteristics that are desirable for an investor: high free cash flow; low-to-no debt; and shareholder friendly management, among others. Although the company sports a high price/earnings multiple (64x 2018E earnings), it is somewhat misleading since traditional accounting rules require the company to count depreciation and depletion as an expense, even though it is not an actual cash expense for the company. As a consequence, its cash earnings are significantly higher than stated earnings. However, the primary attraction in Franco-Nevada pertains to the inherent optionality that its business offers, leveraged to a combination of higher gold prices and increased mining activity care of the dormant assets embedded in its royalty portfolio. One could easily envisage returns of 30% to 40% absent heroic assumptions, with perhaps much higher returns in a favorable environment. These attributes are quite alluring, and therefore purchase of the Franco-Nevada shares is recommended.

Franco-Nevada Corporation

Condensed Consolidated Statement of Financial Position

(unaudited, in millions of U.S. dollars)

	At September 30, 2018	At December 31, 2017
Assets		
Cash and cash equivalents *(Note 4)*	$ 76.9	$ 511.1
Receivables	60.7	65.9
Prepaid expenses and other *(Note 6)*	34.9	39.4
Current assets	172.5	616.4
Royalty, stream and working interests, net *(Note 3)*	4,436.0	3,939.2
Investments *(Note 5)*	197.7	203.1
Deferred income tax assets	14.9	14.5
Other assets *(Note 7)*	13.4	15.2
Total assets	$ 4,834.5	$ 4,788.4
Liabilities		
Accounts payable and accrued liabilities	$ 21.2	$ 21.5
Current income tax liabilities	1.4	1.1
Current liabilities	22.6	22.6
Deferred income tax liabilities	67.0	60.3
Total liabilities	89.6	82.9
Shareholders' Equity *(Note 14)*		
Common shares	5,136.3	5,107.8
Contributed surplus	18.7	14.2
Deficit	(245.5)	(310.0)
Accumulated other comprehensive loss	(164.6)	(106.5)
Total shareholders' equity	4,744.9	4,705.5
Total liabilities and shareholders' equity	$ 4,834.5	$ 4,788.4

Franco-Nevada Corporation

Condensed Consolidated Statements of Income and Comprehensive Income

(unaudited, in millions of U.S. dollars, except per share amounts)

	For the three months ended September 30, 2018	For the three months ended September 30, 2017	For the nine months ended September 30, 2018	For the nine months ended September 30, 2017
Revenue *(Note 10)*	$ 170.6	$ 171.5	$ 505.0	$ 507.8
Cost of sales				
Costs of sales *(Note 11)*	33.4	33.0	93.4	106.8
Depletion and depreciation	66.0	70.5	186.2	209.2
Total cost of sales	99.4	103.5	279.6	316.0
Gross profit	71.2	68.0	225.4	191.8
Other operating expenses (income)				
General and administrative expenses	5.2	5.2	17.4	17.9
Loss (gain) on sale of gold bullion	0.2	(0.2)	(0.1)	(0.3)
Total other operating expenses (income)	5.4	5.0	17.3	17.6
Operating income	65.8	63.0	208.1	174.2
Foreign exchange gain (loss) and other income (expenses)	0.1	(0.9)	0.6	0.2
Income before finance items and income taxes	65.9	62.1	208.7	174.4
Finance items				
Finance income	0.7	1.6	2.4	3.6
Finance expenses	(0.7)	(0.8)	(2.4)	(2.4)
Net income before income taxes	65.9	62.9	208.7	175.6
Income tax expense *(Note 13)*	13.8	2.9	38.4	24.4
Net income	$ 52.1	$ 60.0	$ 170.3	$ 151.2
Other comprehensive income (loss):				
Items that may be reclassified subsequently to profit and loss:				
Changes in the fair value of available-for-sale investments, net of income tax *(Note 5)*	–	17.7	–	7.4
Currency translation adjustment	11.2	41.4	(29.3)	81.9
Items that will not be reclassified subsequently to profit and loss:				
Changes in the fair value of equity investments at fair value through other comprehensive income, net of income tax *(Note 5)*	13.6	–	(1.7)	–
Other comprehensive income (loss)	24.8	59.1	(31.0)	89.3
Comprehensive income	$ 76.9	$ 119.1	$ 139.3	$ 240.5
Basic earnings per share *(Note 15)*	$ 0.28	$ 0.32	$ 0.92	$ 0.83
Diluted earnings per share *(Note 15)*	$ 0.28	$ 0.32	$ 0.91	$ 0.83

Franco-Nevada Corporation

Condensed Consolidated Statements of Cash Flows

(unaudited, in millions of U.S. dollars)

	For the nine months ended September 30, 2018	2017
Cash flows from operating activities		
Net income	$ **170.3**	$ 151.2
Adjustments to reconcile net income to net cash provided by operating activities:		
Depletion and depreciation	**186.2**	209.2
Non-cash costs of sales	**5.7**	4.7
Share-based payments	**4.1**	4.0
Unrealized foreign exchange gain	**(0.1)**	(0.6)
Deferred income tax expense	**7.5**	10.2
Other non-cash items	**(0.9)**	(2.0)
Acquisition of gold bullion	**(19.4)**	(17.8)
Proceeds from sale of gold bullion	**8.1**	13.3
Operating cash flows before changes in non-cash working capital	**361.5**	372.2
Changes in non-cash working capital:		
Decrease in receivables	**5.2**	6.2
Increase (decrease) in prepaid expenses and other	**10.3**	(9.9)
Decrease in current liabilities	**–**	(6.2)
Net cash provided by operating activities	**377.0**	362.3
Cash flows from investing activities		
Acquisition of royalty, stream and working interests	**(702.3)**	(371.1)
Acquisition of oil & gas well equipment	**(1.1)**	(1.3)
Acquisition of investments	**–**	(12.3)
Net cash used in investing activities	**(703.4)**	(384.7)
Cash flows from financing activities		
Credit facility amendment costs	**(0.5)**	(1.0)
Payment of dividends	**(104.5)**	(94.0)
Proceeds from exercise of warrants	**–**	356.4
Proceeds from exercise of stock options	**0.1**	10.3
Net cash (used in) provided by financing activities	**(104.9)**	271.7
Effect of exchange rate changes on cash and cash equivalents	**(2.9)**	31.0
Net change in cash and cash equivalents	**(434.2)**	280.3
Cash and cash equivalents at beginning of period	**511.1**	253.0
Cash and cash equivalents at end of period	$ **76.9**	$ 533.3
Supplemental cash flow information:		
Cash paid for interest expense and loan standby fees	$ **1.7**	$ 1.8
Income taxes paid	$ **20.9**	$ 36.6

Franco-Nevada Corporation

Consolidated Statements of Financial Position

(in millions of U.S. dollars)

	At December 31, 2017	At December 31, 2016
Assets		
Cash and cash equivalents *(Note 5)*	$ 511.1	$ 253.0
Receivables	65.9	71.1
Prepaid expenses and other *(Note 7)*	39.4	37.1
Current assets	616.4	361.2
Royalty, stream and working interests, net *(Note 8)*	3,939.2	3,668.3
Investments *(Note 6)*	203.1	147.4
Deferred income tax assets *(Note 17)*	14.5	21.3
Other assets *(Note 9)*	15.2	23.4
Total assets	$ 4,788.4	$ 4,221.6
Liabilities		
Accounts payable and accrued liabilities *(Note 10)*	$ 21.5	$ 21.0
Current income tax liabilities	1.1	16.6
Current liabilities	22.6	37.6
Deferred income tax liabilities *(Note 17)*	60.3	37.5
Total liabilities	82.9	75.1
Shareholders' Equity *(Note 18)*		
Common shares	5,107.8	4,666.2
Contributed surplus	14.2	41.6
Deficit	(310.0)	(336.8)
Accumulated other comprehensive loss	(106.5)	(224.5)
Total shareholders' equity	4,705.5	4,146.5
Total liabilities and shareholders' equity	$ 4,788.4	$ 4,221.6

Franco-Nevada Corporation

Consolidated Statements of Income and Comprehensive Income

(in millions of U.S. dollars, except per share amounts)

	For the year ended December 31, 2017	2016
Revenue *(Note 14)*	$ 675.0	$ 610.2
Cost of sales		
Costs of sales *(Note 15)*	142.0	105.8
Depletion and depreciation *(Note 8(a))*	273.0	273.8
Total cost of sales	415.0	379.6
Gross profit	260.0	230.6
Other operating expenses (income)		
Corporate administration	21.3	20.7
Business development	3.6	3.4
Impairment charges *(Note 8(b))*	–	67.5
(Gain) on sale of royalty interest *(Note 8(c))*	–	(14.1)
(Gain) on sale of gold bullion	(0.3)	(2.3)
Total other operating expenses (income)	24.6	75.2
Operating income	235.4	155.4
Foreign exchange gain (loss) and other income (expenses)	1.1	0.2
Realized gain on investments	2.0	12.4
Impairment of investments	(4.5)	–
Income before finance items and income taxes	234.0	168.0
Finance items		
Finance income	5.4	3.5
Finance expenses *(Note 13)*	(3.4)	(3.6)
Net income before income taxes	236.0	167.9
Income tax expense *(Note 17)*	41.3	45.7
Net income	$ 194.7	$ 122.2
Other comprehensive income:		
Items that may be reclassified subsequently to profit and loss:		
Unrealized gain in the fair value of available-for-sale investments, net of income tax expense of $6.1 (2016 - $5.3) *(Note 6)*	38.4	52.9
Reclassification of realized loss (gain) in fair value of available-for-sale investments, net of income tax recovery of $0.2 (2016 - income tax expense of $1.6) *(Note 6)*	2.4	(10.6)
Currency translation adjustment	77.2	21.3
Other comprehensive income	118.0	63.6
Total comprehensive income	$ 312.7	$ 185.8
Basic earnings per share *(Note 19)*	$ 1.06	$ 0.70
Diluted earnings per share *(Note 19)*	$ 1.06	$ 0.69

Franco-Nevada Corporation

Consolidated Statements of Cash Flows

(in millions of U.S. dollars)

	For the year ended December 31, 2017	2016
Cash flows from operating activities		
Net income	$ 194.7	$ 122.2
Adjustments to reconcile net income to net cash provided by operating activities:		
Depletion and depreciation	273.0	273.8
Non-cash costs of sales	7.7	6.5
Share-based payments	4.6	5.0
Impairment charges *(Note 8(b))*	–	67.5
Gain on sale of royalty interest	–	(14.1)
Unrealized foreign exchange (gain) loss	(1.7)	0.5
Mark-to-market on warrants	0.2	(0.4)
Gain on investments	(2.0)	(12.4)
Impairment of investments	4.5	–
Deferred income tax expense	21.8	3.5
Other non-cash items	(2.1)	(1.2)
Acquisition of gold bullion	(24.1)	(53.5)
Proceeds from sale of gold bullion	19.0	67.3
Operating cash flows before changes in non-cash working capital	495.6	464.7
Changes in non-cash working capital:		
Decrease (increase) in receivables	5.2	(6.0)
Decrease (increase) in prepaid expenses and other	3.3	(4.5)
(Decrease) increase in current liabilities	(15.5)	16.8
Net cash provided by operating activities	488.6	471.0
Cash flows from investing activities		
Proceeds from sale of investments	12.6	28.6
Proceeds from sale of royalty interest	–	30.3
Acquisition of investments	(12.3)	(1.6)
Acquisition of royalty, stream and working interests	(499.5)	(744.8)
Acquisition of oil & gas well equipment	(1.7)	(2.1)
Acquisition of property and equipment	–	(0.2)
Net cash used in investing activities	(500.9)	(689.8)
Cash flows from financing activities		
Net proceeds from issuance of common shares	–	883.5
Repayment of Credit Facility	–	(460.0)
Credit facility amendment costs	(1.0)	–
Payment of dividends	(125.8)	(118.1)
Proceeds from exercise of warrants	356.4	–
Proceeds from exercise of stock options	10.1	16.3
Net cash provided by financing activities	239.7	321.7
Effect of exchange rate changes on cash and cash equivalents	30.7	0.9
Net change in cash and cash equivalents	258.1	103.8
Cash and cash equivalents at beginning of year	253.0	149.2
Cash and cash equivalents at end of year	$ 511.1	$ 253.0
Supplemental cash flow information:		
Cash paid for interest expense and loan standby fees	$ 2.4	$ 3.0
Income taxes paid	$ 38.2	$ 30.7