

LETTER TO SHAREHOLDERS



Dr. Thomas Kaplan | chairman, board of directors

Both my education and professional experiences in natural resources over the past two decades have convinced me of at least two things: that Fortune sometimes can have a wicked sense of humor, and that, while history may not quite repeat itself, it unquestionably rhymes on occasion. As one whose career has revolved around a fascination with, and big bets on, the rhythmic nature of human behavior and market cycles, I have made understanding these elements a key ingredient in an investment strategy that accepts, and indeed embraces, the belief that some fundamental truths don't change, even if the variables that coalesce into an investment case can gestate slowly. A corollary to this approach is that one should never get too emotional about an asset class. This includes commodities, the arena in which I have pursued my vocation. Having no formal training in engineering or geology that would bias my thinking toward following a path in industry or natural resources, I am active in the sector for a strictly utilitarian reason: because I believe I know how to make money in it. I am the first to admit that I experienced beginner's luck on my inaugural attempt at exploration, with silver in the 90s. And outrageously good fortune persisted in platinum and hydrocarbons. I was simply in the right place at the right time with the right assets. I reckon the same is taking place in precious metals again. My *buona fortuna* – not only in identifying exceptional assets to express a thesis, but also in finding exceptional colleagues who are at the top of their game in sourcing and developing these assets – is without a doubt more pronounced now than at any time in my career. *I don't make such a claim lightly.*

Having worked together for as long as two decades, my team and I have devised a method that seeks to distill our track record into something of a technique. The aim is to mitigate risk, even if that means more than our fair share of errors of omission, in order to focus on finding the category-killer plays that can reward us for our discernment but also offer the maximum returns. This implies the following: identifying the sector that we believe, from a top-down

standpoint, will make us tens of times our money if we are right; sourcing the category-killer assets with which to leverage that thesis – and provide the attributes that will deliver excellent returns even if the macro thesis takes time to unfold; and working with the smartest people who can not only brutally vet those assets but also have the courage to challenge every assumption about our strategy. To such quantitative and qualitative discipline, we would add the critical intangibles that underlie success in this space: patience and upholding a sense of conviction that allows one to withstand adversity – as well as the occasional agony of waiting for the revaluation of these assets. This approach has worked particularly well for us in the sphere of natural resources. Because we have had experiences of multiplying invested capital a hundred-fold following this model, the fact that our patience has been rewarded on occasion in silver, platinum, and hydrocarbons provides a serenity that is, admittedly, a luxury.

This serene luxury is a haven in and of itself. The world today is in uncharted waters in so many arenas – economic, social, and political – that any thoughtful analyst has to contend with anticipating a myriad of scenarios as he or she deploys capital. I for one believe that an asset that cuts through the noise very succinctly is gold. I fundamentally believe it is an asset that should do well if the world does well. It also will do well if the world doesn't do well. I normally prefer to focus on the sunnier of the propositions and eschew what I call the fear factors. It's always been my conviction that, if one can't justify a proposition using only Economics 101 – supply and demand – then the investment thesis should be treated with an arched eyebrow. That having been said, as the next leg in gold's bull market is likely to find its *ex post facto* rationale to be one or other of these fear factors, then I am willing to play along. And maybe I will even make a grudging nod to the argument as well.

Indeed, this past October, there appeared an elegantly written piece by Cameron Crise for Bloomberg entitled "Is Gold Really a Good Hedge?" The subtitle was itself telling: "Bloomberg's Macro Man columnist set out to test whether gold really offers protection against market turmoil. What he found was a bit of a surprise."

Let me quote directly:

Gold bugs point to a myriad of reasons to own their favorite metal, from fiat currency debasement to gold's history as a monetary unit. Among the favorites, however, is gold's utility as protection against a market or political crisis. In August, for example, Bridgewater Associates LP's Ray Dalio suggested investors should hold 5 percent to 10 percent of their portfolios in gold to hedge against rising political risks. I'm a macro strategist who writes Bloomberg's Macro Man

column, and I found myself wondering: Is gold really an effective hedge in periods of risk?

Spoiler alert for those who would rather Google the article and wait for the author's conclusion. For the rest of you I will cut to the end result, to which the author arrived after engaging in an objective as well as compelling analysis:

When I set out to do the analysis, my bias and expectation were to find that the putative relationship between gold and risk aversion was simply a myth. Yet the statistics appear to show a relationship, and anecdotal evidence supports the notion. Given the solid performance of a portfolio including gold and the chance that the comfort of owning some might prevent investors from panicking at the height of a crisis, I have to conclude that the notion of gold as a hedge against serious risk aversion is true.

The implication is that Ray Dalio, who is not only successful but arguably the most rational man in the room (and by that I mean *any* room) might be right in his firm's analysis. I am sincerely indebted to Mr. Crise for being willing to confess the unexpected outcome of his enquiry. Gold is so underappreciated at this moment that to mention it with anything less than derision, even while acknowledging its attributes, can be a career-killer. I adore such dissonance, as it has so often presaged great things for the markets we have targeted for capital allocation. Nonetheless, with investors fixated on short-term performance, I can feel the pain of those who do not have the luxury of a long-term approach, and thus cannot afford to be as cavalier as I am about the timing of an investment when my end goal is to multiply the capital many times over. Put another way, I believe that I have been in this movie before.

In the early 1990s, when silver was trading at \$3.50 per ounce (down from the \$50 high recorded during the Bunker Hunt episode), the prevailing sentiment was that silver was going to be disemboweled by the demise of silver halide film. Conventional wisdom was that it would fall in value to \$2 per ounce. Being fresh off the boat as a macro analyst, in my spare time I investigated this market and found it to be based on what I termed a myth. My analysis indeed suggested that, far from being slain by the demise of silver film, silver was going to shrug off the advent of the digital camera. Rather than falling to \$2, its price would move back to double digits and maybe even challenge the all-time highs in due course. So, driven by a giddy conviction about an emerging opportunity in silver, and being unable to identify a worthy asset to capitalize on the anticipated move,

I started my own company. Condensing a decade into a sentence, the team we assembled was able to discover a fabulously high-quality project – which today remains one of the world's largest and lowest-cost silver and zinc producers. I've glibly made it sound a tad easier than it really was. But that about sums it up. I should add that silver did not go to \$2, but in fact returned to \$50 for a moment and, I suspect, will do so again. But that story is for another time.

I applied a similar strategy to an investment in the energy sector. In the early 2000s, when oil was trading below \$20 per barrel and the market's view was that the price would fall to a normative \$12-15 per barrel, my analytical stance was that oil could easily rise to \$100 a barrel. To play this out, I created a new exploration company, Leor Energy, which I named after my two kids. Once again, we were able to identify a highly prospective asset and take it up the value chain. That asset was ultimately sold for more than \$2.5 billion in 2007, when oil was trading well north of \$100 per barrel. When we followed this act by pivoting to gold, it was trading at \$650 an ounce or so. I should add that the dollar was trading at \$1.45 to the euro. That's worth noting. Oil was much higher than it is today. And the dollar is stronger. And yet gold has doubled. It makes one wonder about certain myths – such as gold being just a commodity and that it needs a weak dollar to do well. I would not belabor the point that inflation – which is often considered a prerequisite for strong gold prices – has not been in evidence this past decade. And yet gold has doubled.

I believe that our secret to realizing substantial returns from these two investments lies in the fact that we were able to identify a sector with fundamentals ripe for a major upside move, hitching our bets to the best vehicle of choice, partnering with the best management team in the business, and executing the strategy of taking the assets up the value chain to fully capitalize on the move in the sector. Our returns in silver and energy were more than 100 times our investment.

Now, we see gold through the same prism as we saw silver and energy: unloved by investors, yet with the potential to generate killer returns when a bullish sentiment returns to the sector. In gold, our vehicle of choice is NOVAGOLD, a company with two unique assets located in the best jurisdictions. It has a top-notch management team with an unparalleled track record of making things happen and doing them right. To us, NOVAGOLD is the right story at the right time. It represents a once-in-a-lifetime opportunity to make the very lowest-risk/highest-reward trade in gold. For as extraordinary as the assets were that we discovered or came to control over the last two decades, none was actually in our view *unique*. As a consequence, this vehicle has the potential to outperform them all.

To see why, let's look at gold first. In his Fourth Quarter 2017

Investor Letter, the dean of institutional gold investing, John Hathaway, Tocqueville's Senior Portfolio Manager, outlined a compelling case for investing in gold now by looking at the following nine fundamental factors which obviously don't include any of the bevy of black swans that might alight upon our current geo-political reality:

1. The Extreme Valuations of Financial Market Assets That gold should be viewed "as cheap insurance on a possible significant retreat from current valuation extremes."

2. The Worsening U.S. Fiscal Position With the implementation of the new tax bill, according to the Tax Foundation, "the average annual loss of revenue over 10 years would be \$147 billion on a static basis and \$45 billion on a dynamic basis," an environment highly conducive to Quantitative Easing.

3. Rising Inflation The addition of stimuli, such as tax cuts, when the economy is already running at full steam, creates an environment for rising labor costs and a consequent rise in inflation.

4. A Precarious Financial Market Structure In the current environment of passive investing and machine-driven trading, there is a strong possibility that even a small downside correction could cause a large-scale capital flight from equities, which would cause capital-seeking safe havens to go to gold.

5. A Bullish Supply and Demand Outlook for Physical Gold With very few discoveries of any consequence over the last decade, the gold industry can't sustain its current production levels to meet the growing global demand. Major producers are in the most precarious position, as they are dealing with projected natural declines in their mature mines.

[I shall elaborate more fully why this factor is particularly important – it is indeed my favorite one – when we consider NOVAGOLD as a vehicle of choice to deliver extraordinary returns to its stakeholders.]

6. An Expected Further Weakening of the U.S. Dollar The expected increased inflation and fiscal deficit should create an environment conducive to a weaker dollar, which investors see as traditionally producing higher gold prices.

7. Gold as an Ideal Portfolio Diversifier and Risk Dampener An allocation to gold has been known to be a prudent strategy to reduce downside exposure during periods of market stress. For example, it has been demonstrated that a 10% allocation to physical metal employed since 1987 would have resulted in substantial outperformance vs. a traditional 60%/40% equity/Treasury allocation.

8. A Boost from Bitcoin In a recent interview, legendary investor Warren Buffet called cryptocurrencies, of which Bitcoin is one, a mirage. "The idea that it has some huge intrinsic value is just a joke," he said.

[My only observation about Bitcoin is that the explosion of interest in cryptocurrencies, rather than undermining gold, is pointing to what will happen to the gold price when it starts to move. What changed to make Bitcoin go from the perception that it's a fraud to an asset class? The price went up. Trite as that sounds, it is a classic phenomenon: What is cheap must be cheap because it should be, and will remain so – and what is dear must be valuable, and will only get more so.]

9. A Brief Comment on Gold Mining Shares Quality gold mining shares have traditionally performed better than bullion. The question is, what is the meaning of "quality gold mining shares"?

Clearly, for the purposes of our Annual Report, this last point is where the rubber hits the road. In my opinion, "quality gold mining shares" signifies equity in a gold mining company that owns assets that can be characterized by the following: a very large gold endowment that cannot be ignored; a high-grade deposit; a move-the-needle production profile that anyone would want to own; strong exploration upside; stable geopolitical location(s); a long-lived production profile requiring no replacement for many years to come; and a highly professional, ethical, shareholder-friendly management team with a well-established track record of successfully building and operating major mines. Not surprisingly, I just described NOVAGOLD, whose 50%-owned flagship Donlin Gold project in fact enjoys all of these attributes. In today's asset-starved gold industry, Donlin Gold is a category killer asset with attributes that, if it weren't backed by 1,396 drill holes, multiple feasibility studies, extensive engagement with our partners and local stakeholders, and funding to execute on its strategy – all of which have substantially de-risked the project over the last two decades – one might consider it a fantasy. Let's tally up the boxes that Donlin checks in a way that, certainly in the aggregate, renders it unique in our eyes:

▶ An extraordinary 39 million ounces of gold in the measured and indicated resource categories alone (100% basis), not including the inferred in proximity to the pit.

▶ With the present endowment contained within only 3 km out of an 8-kilometer-long mineralized trend, there is ample opportunity to discover more substantial gold outside of the future mine's footprint. The industry needs discoveries, and I for one personally believe that the next Donlin will actually be found at Donlin Gold.

- ▶ While the quality of the gold grade has reduced by half in the last decade – and is continuing to fall – the average grade at Donlin Gold is 2.2 grams per tonne, and could commence production even higher than that.
- ▶ At a time when the gold industry can't sustain current production levels – let alone replace its depleting reserves or meet the growing global demand – when in production according to the feasibility study, it would be the largest, and one of the lowest-cost, pure-gold-producing mines *in the world*.
- ▶ Donlin Gold is located in the *right* part of the world. The State of Alaska, already the country's second largest gold producer, is a state that welcomes responsible resource development within the rare mining jurisdiction that scrupulously adheres to the rule of law – a decisive investment criterion when seen against the backdrop of jurisdictional risk which has so altered how the market views investment opportunities on the frontier.
- ▶ Company-making mines have a long life. Once built, the mine is expected to operate for 27 years, and, considering its superb exploration potential, likely for many years beyond that.
- ▶ The project's stakeholders – from Native Corporations to project partners Barrick Gold and NOVAGOLD to state and federal agencies – are perfectly aligned to ensure that Donlin Gold is built to the highest standard of safety and environmental stewardship.
- ▶ At a time when it takes, on average, more than 20 years to go from discovery to production, our project is in the advanced stages of the permitting process, which will allow the partners to be in the ready mode for development once macro-economic conditions are optimal for its stakeholders.
- ▶ Project optimization efforts are well underway to ensure that all stakeholders' resources are efficiently and effectively utilized when the project is constructed.
- ▶ The project is managed by a highly experienced team of professionals led by Greg Lang, one of the best mine builders and operators in the world.

While the above attributes aptly describe Donlin Gold, our flagship asset, a very similar case can be made for Galore Creek, our major copper-gold-silver project, which NOVAGOLD owns 50/50 with Teck Resources, one of the most respected diversified mining companies in the world. Once this valuable asset becomes a mine, it is expected to constitute the largest and most modern copper mine in Canada. And, just like Donlin Gold, this project has been

steadily advancing up the value chain and stands in an exceptional position to benefit from the recent escalation in the price of copper, as battery technology gains more and more ground in electric car applications worldwide. While we would very much welcome staying involved with this incredible venture, a company-maker in its own right, we recognize that an entity of the size of NOVAGOLD has to allocate its resources sparingly to make sure that shareholder value is not compromised. Hence, we will continue to work on prudently monetizing our interest in Galore Creek and apply the proceeds toward advancement of Donlin Gold. This represents the most shareholder-friendly strategy we believe we can pursue.

2018 should be a momentous year for NOVAGOLD. We are well within a year of securing necessary permits for Donlin Gold, one of the most significant gold projects of our time. In addition, our joint optimization efforts with Barrick are likely to yield enhanced value possibilities that should streamline project parameters and potentially improve its economics. That means that any positive development in the macro-economic environment for gold could produce what we call a perfect storm for all of our stakeholders. I happen to be more bullish about that occurring than ever before.

As chairman and largest shareholder of NOVAGOLD, I am extremely proud of this company's accomplishments. For me, it's been a remarkable 10-year journey of value-building. As we approach our important milestones, it is exciting to realize that we have the opportunity to unlock tremendous value for all of our stakeholders. On a personal level, I look forward to that because I am convinced that the rewards I received from my past investments in silver, energy, and platinum were in many ways a rehearsal for the main event: Donlin Gold.

In conclusion, on behalf of the board of directors, I would like to extend our sincere thanks to all of our stakeholders, including the many fine financial institutions that have become shareholders of this great company. In addition, I wish to convey our profound appreciation to our partners, Barrick and Teck, as well as the Native Corporations and First Nations of the jurisdictions where we have been operating for many years. I would also like to give a well-deserved tribute to the representatives of all various levels of government for their efforts to ensure that we do things right. Finally, I wish to express my heartfelt gratitude to the extended family of NOVAGOLD employees, as well as Donlin Gold and Galore Creek employees, for their hard work and commitment to excellence in everything we do. I feel truly blessed to be in their midst.



Dr. Thomas Kaplan
 chairman, board of directors
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