THE GLOBAL SPECULATOR

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AUSTRALIAN GOLD COMPANY COMPARISON

With gold shares broadly depressed at the present time, I thought it might be worth writing a quick piece on Australia's listed gold producers and an alternative approach to reviewing companies you may be interested investing in. We will look at 4 key characteristics when comparing gold producers and finish off by demonstrating this approach with an up to date look at what Australia presently has on offer.

- **Enterprise Value per Ounce:** An EV is simply the Market Capitalization of a company (number of outstanding shares multiplied by the current share price) adjusted to eliminate the effect of a company's **Financial Assets** and its **Financial Obligations (Liabilities)**. You **subtract** the **Financial Assets** which would include items such as (not exhaustive):

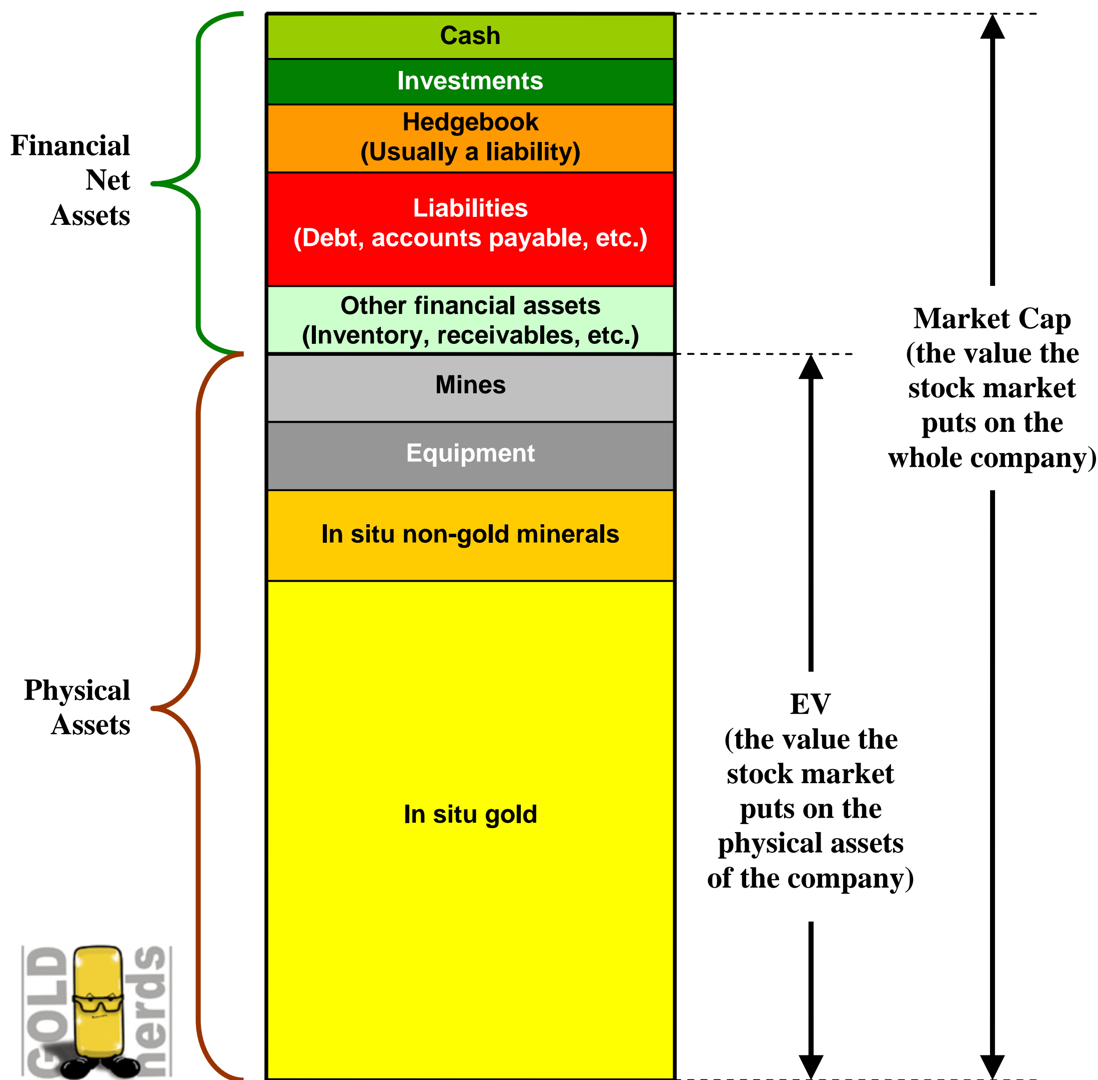
1. Cash and Cash Equivalents.
2. Accounts Receivables.
3. Inventories (If a producer)
4. Listed and Unlisted Investments where you can readily establish a fair value.
5. Derivatives (Purchased Options and favorable Forward Sales Agreements)
6. Future Income Tax Benefits

And then add the company's Financial Obligations including (not exhaustive):

1. Accounts Payable
2. Interest Bearing Liabilities
3. Deferred Tax Liabilities
4. Derivative Obligations (Unfavorable Forward Sales Agreements and written options contracts)
5. Retirement Obligations

What you are left with is essentially the value the market is attributing to the company's non-financial assets or its projects. This is demonstrated diagrammatically on the following page. To work out an **EV per Ounce** you simply divide the **Enterprise Value** by the total number of ounces the company has attributable to it via its projects**.** This provides a useful number in which to compare what you are paying for the gold assets of different companies.

ENTERPRISE VALUE



- **Net Financial Assets (NFA):** This is simply the total financial assets of the company less the financial liabilities. This gives you the Net Financial Assets of the company or the available working capital. To put it another way, this is the number that gets subtracted from the Market Capitalization to arrive at the Enterprise Value of the company. In a capital intensive industry, such as the mining industry, it is critical to keep track of a company's financial position in order to assess its ability to continue to operate going forward.

- **Total Cost per Ounce (TCO):** This takes the company's EV per ounce and adds the company's average cash cost of producing an ounce of gold. It also adds any development costs associated with building new mines divided by the total number of ounces of the company. What results is an indicative number on how much you are paying per ounce of gold when investing in that company. If it comes to

more than the spot price, you know you might have a problem and a few prudent questions to the company may be worthwhile.

- **Reserves as a Percentage of the Resource:** When comparing different companies obviously not all the ounces the companies have on their books are going to be mineable. You need to ascertain what % of the companies total resource base could realistically be mined. Reserve is the name given to the classification of a resource which is considered economically feasible to mine (economic studies have conceptually demonstrated the viability). Therefore, the higher the percentage of reserves that make up the total resource, the more you would expect to pay per ounce of gold on an enterprise value per ounce basis.

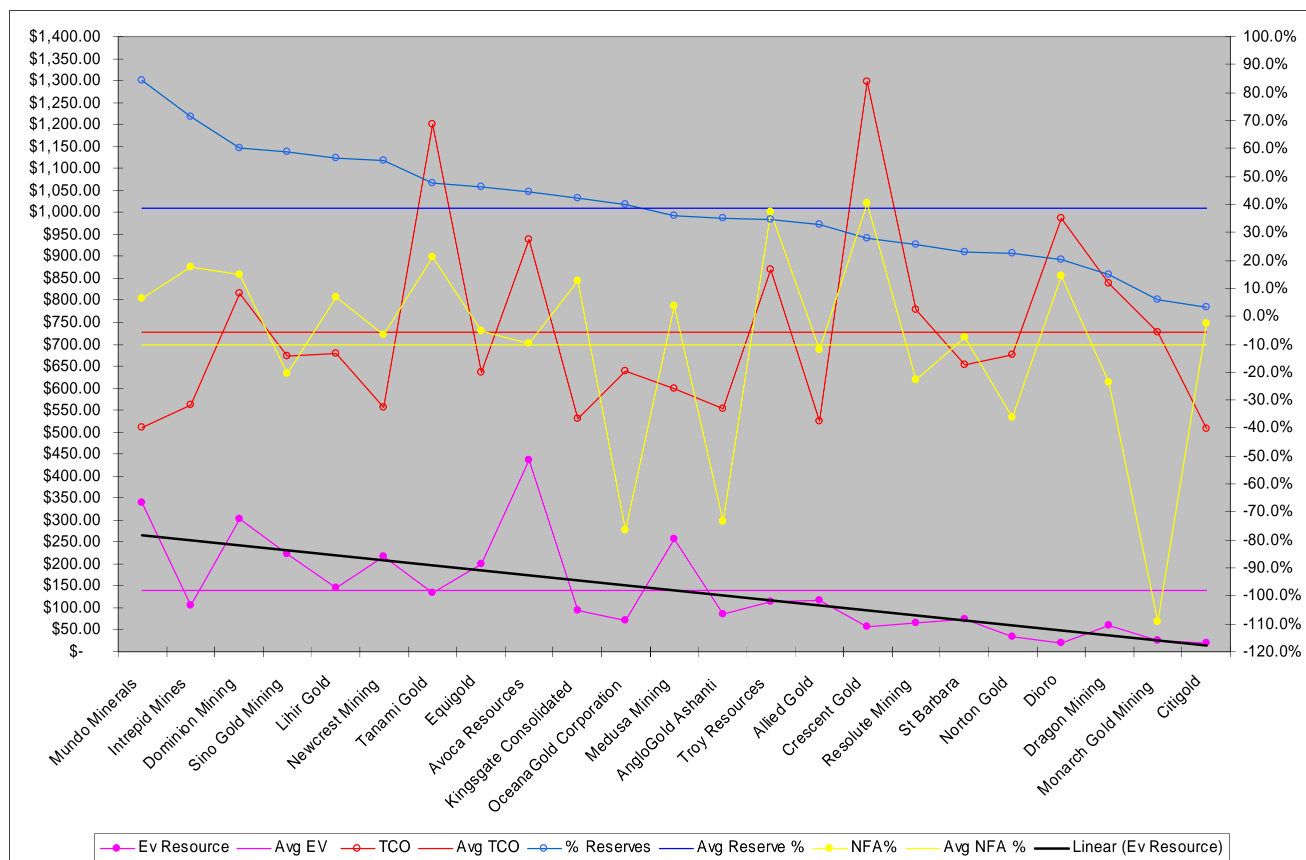
When you compare the above 4 factors on a line graph and you sort the Australian gold producing companies into the order of highest proportion of reserves to resource to the lowest, you start to get a very interesting overview of the sector. The graph below does exactly that for 23 of Australia's gold producing companies from the fledgling entities all the way up to the larger more established producers. If a company hasn't attained commercial production for a project, we use the forecast cash cost provided by the company to arrive at the relevant TCO.

While the graph below may look a little intimidating at first glance, it is actually quite easy to follow once you understand how to use it. We simply start at the bottom of the chart and look at the pink line which is the **EV per Ounce (EV Resource)** you are paying for each of the above producers. The first thing you will notice is that the companies to the left of the chart have ounces that are valued significantly higher than the companies to the right. If we look to the blue line at the top of the chart we start to get an appreciation as to why that is. The blue line looks at the **percentage of the total resource ounces sitting in the reserve classification (Reserves %)**. As we touched on earlier, the higher this percentage the higher the value that is attributed to the companies overall ounces. This is the primary reason why one company's ounces may trade at a substantial discount or a premium to another's. We have drawn a black line of best fit that passes through the scattering of companies which demonstrates this clear relationship. Now you will notice that some companies have an EV per ounce significantly above the black line and some have an EV per ounce significantly below prompting the question: What are some of the other key factors that might heavily influence a company's EV per ounce?

This brings us to the two other components of the chart. The red line is the **Total Cost per Ounce (TCO)**. As was previously explained, this is the EV per ounce plus the Cash Cost per ounce plus any development costs that remain in order to bring any feasibility study stage projects into production divided by the total number of resource ounces. Obviously the cash cost is the largest component of this calculation and the higher this is the higher the overall TCO. It stands to reason that if a company's cash costs are higher than average this will negatively impact on the EV per ounce you pay for the company's ounces. Generally speaking, the higher the cash costs the lower the EV per ounce and vice versa. All in all, the lower the TCO the more attractive the company is to invest in, everything else being equal.

The last component that can have a significant impact on a company's valuation is its financial position. The yellow line in the graph is simply the company's **Net Financial Assets divided by its Market Capitalization (NFA%)** giving you a percentage. Generally speaking, the higher this % the more financially secure the company is. A negative % results when a company has more liabilities and financial obligations than it has financial assets. Whilst your average industrial company can get away with a highly geared balance sheet provided they have reliable cash flow, this generally spells trouble in the unpredictable and capital intensive world of gold mining. I have seen evidence of this in the negative share price performance of companies that become stretched financially. What results is countless capital raisings which dilutes shareholder value and depresses a share price. Alternatively, borrowing excessively from financial institutions leads to unwanted gold price hedging requirements and strict debt covenants which can at any time spell the end of a company that struggles to meet its commitments.

AUSTRALIAN GOLD PRODUCERS COMPARISON



DATA SOURCE: GOLDNERDS FORTNIGHLY UPDATE (6TH MAY 2008)

In summary, the above indicators become very useful when scanning across potential investment opportunities. In the above graph there are horizontal averages for each of the categories we have discussed to give you an indicative benchmark as to what is normal. When scanning for companies that may be potential investment opportunities, you start with the EV per ounce and look for companies that sit significantly below the black line. That is, the company is trading at an EV per ounce that appears to be below what it should be, given the compilation of its reserves and resources. The next step is to scan up and look at the TCO and NFA for the relevant companies to ensure they are within or better than the averages (horizontal lines). If they appear to be at satisfactory levels, you may have found an appropriate investment candidate worthy of further research. If, on the other hand, they fail miserably in any of the other components, you may have your explanation as to why the ounces are comparatively cheap.

Some Other things to Consider

- Note that companies towards the right of the graph with low reserve to resource ratios provide the investor with plenty of upside potential, assuming they can cheaply convert their resources to reserves with further exploration and feasibility study work. That being said, it is important these companies are financially secure (strong NFA) and have plenty of cash to fund this ongoing development.

- If a company has a high TCO, which generally implies a high cash cost, it may be worth investigating to see if this has been an ongoing problem or whether the higher costs are caused by a temporary event or phase that the company is working through. In the event of the latter, it may be worth investing in the company so you can take advantage of the re-rating of the share price once the issues have been overcome.

- Once you invest in a gold producer the above work doesn't simply end there. Monitoring the information needs to be done on an ongoing basis to ensure the company doesn't become overvalued or the financial status of the company doesn't start deteriorating. Remember, many mining companies have a fantastic ability to paint their company in the best possible light when it comes to quarterly reporting or asking shareholders for more money. This is yet another reason why it is important to do independent due diligence and not be blind sided.

It is outside the scope of this article for me to analyze each of the individual companies above, but I encourage you the reader to do so and become more familiar with these interrelating factors.

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