

## CAPITAL EXPENDITURE CLOUDS GOLD MINING PROFITABILITY

Just recently I read an interesting article which appeared on Mineweb called [The Illusion of Gold Mining Profits](#) written by Barry Sergeant. Sergeant highlights capital expenditure and its negative impact on the cash profitability of gold miners. He makes the important point that major gold mining companies, like Barrick, are facing dwindling production at existing mines and remain under constant pressure to find, buy or develop un-mined gold ounces. This in turn, is putting pressure on free cash flow. The issue I want to address today is the impact of capital expenditure on profitability and what it means for investors in gold mining companies. Sergeant in his article makes the following comment:

**Almost uniformly low "cash costs" as reported by individual companies in the gold industry are increasingly losing venter. The definition of "cash costs" for gold miners is anything but uniform, but uniformly ignores cash capital expenditure and cash spent on acquisitions. Even so, cash costs are rising for most gold miners.**

There are two types of capital expenditure. One type relates to the construction or acquisition of new projects. As a company requires capital to build or expand on existing operations, this is not so much of an issue provided the company is replacing or adding value via incremental and profitable production ounces. The other type of capital expenditure refers to ongoing costs associated with existing projects (sustaining capital). In my opinion, it is this second type of capital expenditure which requires further scrutiny. Some companies churn out seemingly positive operating cash flow and accounting profits only to repeatedly return to bemused shareholders asking for more money. It is important to note that costs associated with sustaining capital do not immediately enter the profit and loss statement nor cash cost numbers even though the expenditure has been incurred. From a profit perspective, this often makes sense in that it is not reasonable to recognize all the expenditure immediately. An example of this would be pre-stripping costs associated with an open pit mine. Pre-stripping is the removal of overburden in order to mine a section of ore in a deposit. Some companies do not recognize these costs up front because it distorts the cash costs for the period in question. Not all the gold associated with the pre-stripping cost is mined during this reporting period. Many companies legitimately capitalize and then amortize these costs on a production ounce basis.

There are other companies which, in my humble opinion, abuse the privilege of capitalizing expenditure and thereby conceal the true profitability of their respective projects. In the company Cash Flow Statement, investors need to pay close attention to the investment component and determine how much is actually being capitalized. Of the capitalized investment, how much is associated with existing projects and how much is spent on the construction or acquisition of new projects? Based on data provided by GoldNerds in the rolling 4 quarters to 30 June 09, the average cost per oz spent on sustaining capital costs for 42 prominent North American listed gold producers averaged US\$165/oz. The average cash cost for all these companies was US\$465/oz. The addition of these two numbers equates to US\$630/oz (considerably below the spot price) thereby implying profitability. Construction costs for projects can generally add anywhere from US\$75 - US\$200/oz which still implies an overall level of profitability (Total Cost US\$705 - US\$830/oz).

From an investor's perspective, you may want to consider the enterprise value (EV) per reserve oz representing the purchase price for acquiring those reserve ounces. For this same list of companies, the EV

per reserve oz presently averages US\$350/oz. Once you add this to the US\$630/oz in cash and sustaining capital costs, you are looking at US\$980/oz which exceeds the current spot price. I want to stress that this is obviously a crude number with limitations. It excludes the resource ounces over and above the reserves which could be inexpensively converted into reserves and are not given a value for the purpose of this assessment (resource ounces have no proven economic viability but are worth something). On the other hand, some of the reserves are associated with feasibility study stage projects, where construction costs are required to bring the projects into production. As we saw previously, this adds to the total cost you are paying to extract each oz of gold. Administration costs associated with running these companies have also been excluded.

This leads to the obvious question. If it is costing you more than the spot price to invest in the recoverable gold associated with these companies, why bother? The simple answer is the leverage these companies offer to higher gold prices. Mining companies generally provide a leverage of 3-1 to rising gold prices because you are buying a share in the company's profitability. Increasing gold prices also mean a higher proportion of resource conversion to reserves. Many of us are bullish on the outlook for the yellow metal and a number of these companies are well run and will give our portfolios more bang for our buck.

Given capital expenditure is generally ongoing and variable in nature, it needs to be monitored in the context of overall profitability. Some companies report cash costs below the spot price. Once sustaining capital costs enter the equation, these projects and companies are no longer cash flow positive. Let's consider an example. I know of a prominent company here in Australia which was building a new project whilst at the same time producing from existing projects. Excessive ongoing capital expenditure associated with the producing projects was getting masked by the construction related capital for the new project. When the company went to the market for additional capital, shareholders understandably assumed the money raised was entirely for the new project. What escaped detection was the underperformance of the existing mines. From an "operating" cash flow perspective the projects appeared to be profitable. Once sustaining capital costs were considered, the projects were actually hemorrhaging cash flow. Some companies often anticipate excessive capital expenditure will eventually ease. It is amazing how other unforeseen issues and events can continue to occur depending on the quality of the project and the management involved.

Analyzing a gold mining company's profitability in the context of operating cash flow performance alone can potentially be dangerous and misleading. I see many analysts refer to a company as having "cash costs in the bottom quartile of industry standards" only to ignore the fact that the project(s) in question are underground operations and ongoing development costs are conveniently excluded. As a rule, underground operations are more capital intensive in nature than open pit mines. Does this mean, from an investment perspective, that open pit operations are superior to underground operations? Not at all. I have seen many open cut operations suffer from higher capital expenditure associated with excessive pre-stripping ratios. All I am saying is, as investors, we need to take all these factors into account when comparing projects and companies. To ignore capital expenditure can be fraught with danger.

In our ongoing effort to develop a comprehensive information package for gold investors, the recently released North American version of the GoldNerds product includes a rolling 4 quarter summary of actual ongoing capital expenditure. It also provides a forward looking forecast of ongoing capital incorporating up and coming projects (this feature will soon be added to the Australian version of the product). These numbers are then integrated into a formula which adds an estimate of the future average cash cost (assuming all projects are developed), the enterprise value per mineable oz (customized indicator) and future construction

capital (associated with undeveloped projects) to provide users with a useful Total Cost per oz estimate. This enables investors to effectively compare gold mining companies from a very unique and useful perspective. If you are serious about researching gold mining companies I encourage you to pay us a visit. The North American version covers most of the established producers and many of the up and coming development companies listed on the North American exchanges.

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