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INVESTMENT TOOLS FOR COMPARING GOLD STOCKS (PART 3) – *MAKING MONEY VERSUS ACCOUNTING PROFITS*

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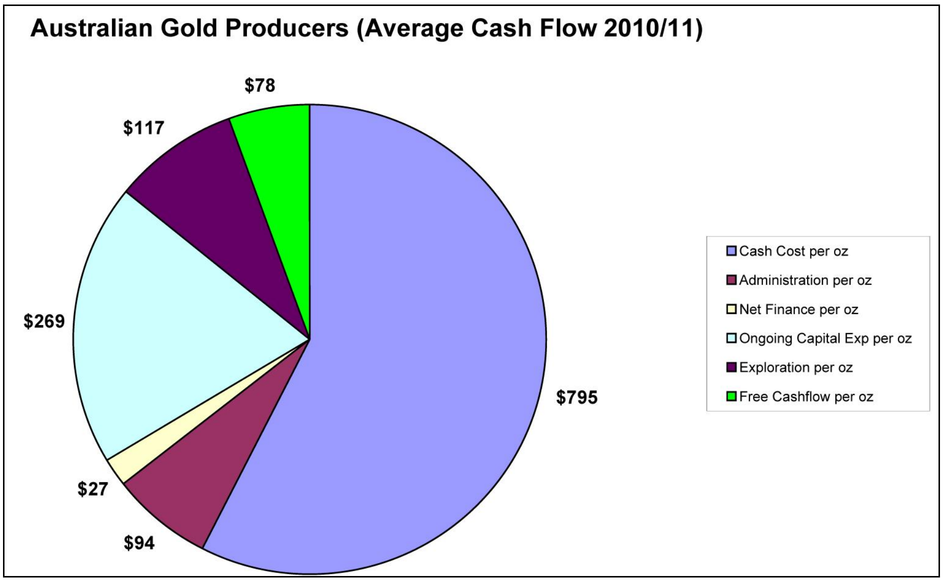
In this final part of our series, I want to discuss a cost often overlooked by investors before finishing off with a breakdown of the Australian gold sector to reveal the bigger picture.

Ongoing Capital Expenditure can often be the difference between a company generating positive cash flow and not. It is not recognized immediately in a company's income statement and therefore tends to be inconspicuous. It includes things like a pre-strip or cut back for an open pit mine, underground development work to access a new section of an ore body, or alternatively the replacement of plant and equipment. It is capitalized and depreciated over a period deemed appropriate by the company. Translation: The cash flow impact is immediate but the income statement effect is delayed. This makes it theoretically possible for a company to report an accounting profit but not actually make any money.

Companies for the most part are correct in their treatment of these costs. Much of this work will be of benefit to the company going forward. From an accounting perspective it therefore makes little sense to realize the entire cost upfront. So what's the problem you ask? Well the problem is the failure of many companies to clearly outline this expenditure in their quarterly results. Mining is a very capital intensive business and these outgoings, whilst variable in nature, often remain stubbornly high. This can result in significant levels of depreciation and write offs towards the end of a project's life. In other words, the healthy profitability reported in the earlier years can fail to reflect reality, creating the illusion of a viable operation (the truth is often revealed much later when it is too late for shareholders).

Ask a mining executive what the cash cost for their operation is and most can answer without blinking. It is usually the first piece of information an investor looks at when perusing a company's results. Cash costs on average represent approximately 60% of a typical mining company's cash outgoings (Source: www.globalspeculator.com.au). The next highest is ongoing capital expenditure which on average accounts for 20% (Source: www.globalspeculator.com.au). Ask a mining executive what they typically incur in ongoing capital expenditure and I bet the answer isn't nearly as fast! In fairness this number is more variable in nature. However, any mining executive worth his salt should be aware of all outgoings and at least provide an indication. Failure to answer this question satisfactorily should be a warning sign. Far too often we see investors (even analysts) focusing on the cash operating costs for a company. This leads to the natural assumption of "profitability" when significantly under the spot price of gold. In reality, more often than not, nothing could be further from the truth. I'll now demonstrate how "making money" and "profitability" can be two entirely different things, greatly influencing investment outcomes.

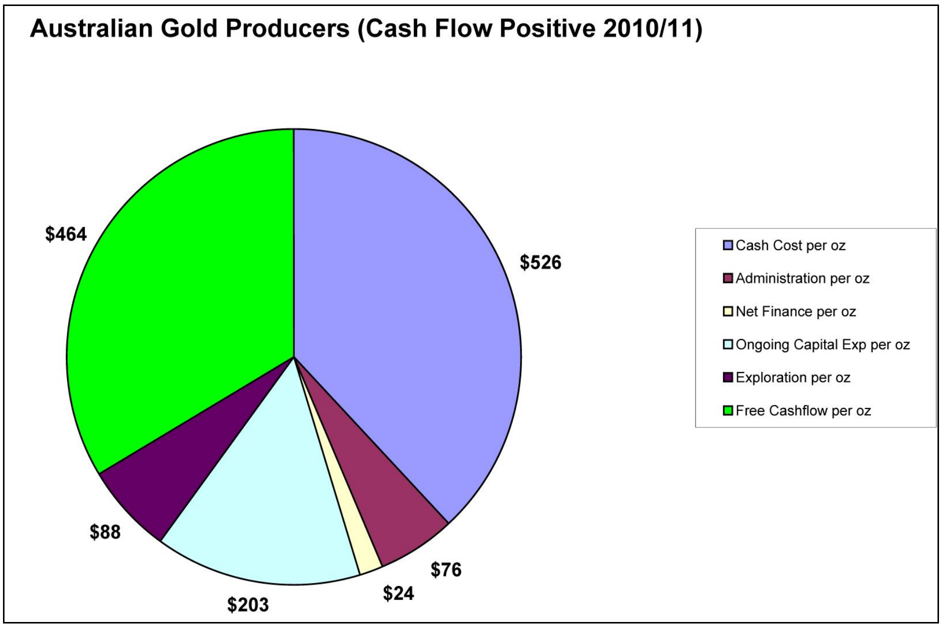
The following pie chart is a representation of 29 ASX listed Australian gold producers with a minimum annual production rate of 30,000 ounces (oz) for the last financial year. It is an approximation of all the big ticket cash related outgoings on a per oz basis as an average for the sector. We have used last financial year's average gold price in Australian dollars of $1,380/oz as an indicative guide to free cash flow (the green). In this case, the average Aussie gold miner generated just $78/oz in free cash flow for 2010/11 (assuming the average gold price of $1,380/oz was realized). Much of the Ongoing Capital Expenditure ($269/oz) and Exploration ($117/oz) represent an immediate cash outlay with a minimum effect on profitability as they are mostly capitalized. This is how it is theoretically possible for a mining company to make an accounting profit whilst hemorrhaging large quantities of cash. Take these items out of the equation and you may add close to $386/oz ($269/oz + $117/oz) to the $78/oz or $464/oz in "implied" profitability before non-cash related expenses. This often leaves unsuspecting shareholders bewildered as companies report profitability but repeatedly go to the market for money (capital raisings).



Source: www.globalspeculator.com.au

In addition, when you buy shares in a gold mining company you are also paying for your right to participate in the company's activities. At GoldNerds we call this cost the **Enterprise Value per mineable oz**. For the 29 companies in our focus group, the average price was recently $260/oz (Source: www.goldnerds.com). Paying $260/oz for $78/oz in free cash flow is a losing proposition. You would actually be better off investing in gold (which has no operational risk). Perhaps this is why Exchange Traded Funds (ETF's) are becoming so popular. Before we hastily dismiss investing in gold mining companies altogether, let's spilt our focus group in two.

The next two charts represent 13 cash flow positive companies with total outgoings less than $1,380/oz (Group 1) and 16 cash flow negative companies with outgoings more than $1,380/oz (Group 2). The first thing to note is the vast difference in free cash flow between these two groups ($464/oz versus -$235/oz).



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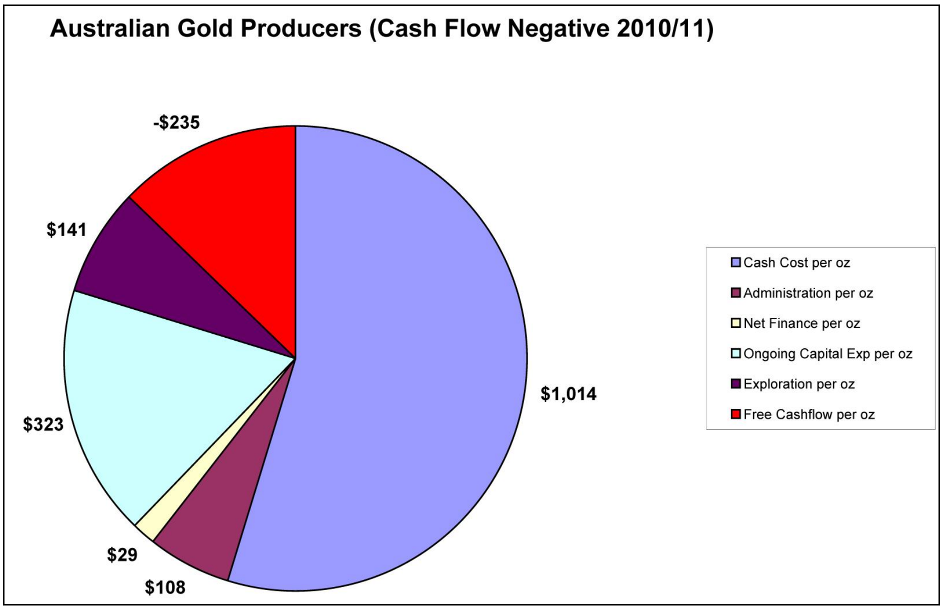

Source: www.globalspeculator.com.au

I have studied both lists of companies closely and have come up with 5 interesting observations:

1. The average cash cost for Group 1 ($526/oz) is almost half that of Group 2 ($1,014/oz). The average EV per mineable oz you pay for investing in Group 1 companies is $379/oz versus Group 2 which is $188/oz (Source: www.goldnerds.com). Paying $379/oz for $464/oz in free cash flow makes much more sense than $188/oz for a $235/oz net cash outflow.

2. Not surprisingly, all Group 1 companies reported an accounting profit. It may surprise you to read that 70% of the Group 2 companies also reported a profit for last financial year.

3. The Group 2 companies had on average 5 times the number of shares outstanding than the Group 1 companies after taking share consolidations into consideration (2 billion shares versus just 400 million).

4. 14 of the 16 Group 2 companies operated primarily in Australia where as 9 of the 13 Group 1 companies operated outside of Australia (implying greater viability). Perhaps Greens Senator Bob Brown should rethink his recent proposal of a super profits tax on our domestic gold miners!

5. The most telling statistic is the average share price performance of the two groups. Group 1 returned on average 112% for the 12 months to 30 June 2011. Group 2 lost on average 19% (despite 70% of these companies reporting profitability).

One of the most powerful tools an investor has in successfully identifying the right company is **numbers**. By studying the successful companies and learning what their quantitative attributes are, you naturally find it easier to isolate the better opportunities. As retail investors, it is important to appreciate the sobering fact that we reside at the bottom of the food chain. While mining executives, employees, State and Federal Governments, suppliers, contractors, fund managers and bankers all get paid first, we are very often an afterthought. That's why it is critical to take a proactive approach to your investing. Make the effort to learn how to isolate companies whose interests are aligned with yours. I'll give you a clue: They are the companies which make money as well as report accounting profits.

If you are interested in investing in the gold mining sector and want to equip yourself with the best and most affordable fundamental information, I encourage you to visit www.goldnerds.com

Troy Schwensen

DISCLAIMER

Troy Schwensen has invested in the precious metals sector for a living since 2002. He is one of the founding members of www.goldnerds.com.au and also writes a free financial newsletter at www.globalspeculator.com.au