

GOLD STOCK VALUATION USING EV PER OZ

When investing in anything it pays to have a sense of value. Let's say, for instance, you were looking to buy a house in a suburb you like. For starters, you could just charge in like a wounded bull and purchase the first house that takes your fancy. I think many of you would agree that this approach is fraught with danger. If you were somewhat smarter, you would probably do what most people do and look at as many houses that are for sale in that suburb first and try and establish a sense of value before making a purchase (giving you peace of mind). The savvy investor may even take this process one step further and establish a value on what all these properties have in common, the answer of course being land. They may work out a value that they are paying per square meter of land for each property inspected. Next, they would compare this with an average for the suburb compiled from recent historical sales data.

Now valuing a property by looking at the valuation of the land is of course only half the battle in establishing whether you are getting reasonable value for money. Why? Because every house built on that land obviously differs in various ways. The house could be bigger in size and better equipped. The land itself could be located in a more desirable part of the suburb, such as on a hill or by a lake or river where there may be a view and breezes. The list could obviously go on but I think you get the general idea. All these other factors are variables that you would take into account in order to establish what you think that particular property is worth. But your starting point would be the value of the land and you would build on your analysis from there, based on a comparison of these other variables.

When buying shares in a precious metals company, how many of you readers go through a similar process in order to determine whether the company you are buying shares in is reasonably priced. For most, the thought of going through this process is much too daunting. It is much easier to get your stock broker to perhaps recommend a company. You could find an "expert" and subscribe to their newsletter and trust that they will recommend some worthwhile companies. If you have sufficiently researched the newsletter writer, this is a totally legitimate option. The only problem with this is that it is the newsletter writer that has researched the company not you. If after buying the stock it plunges 30%, you may be left wondering whether this "so called" expert is all that he or she is cracked up to be. The experts, on the other hand, will probably frantically buy up more stock on the pull back and back their own judgment. Some of that stock may ironically end up being yours. The thought of losing your hard earned dollars just becomes too much to handle. Sound familiar? Let's be honest, we have all been there at least once!

In my experience there is no substitute for being able to personally assess value, even if it is at just a basic level. There is also nothing wrong with receiving stock recommendations from newsletter writers or stock brokers on the proviso you have the ability to check these companies out yourself. This is what will give you the conviction to buy and hold which brings me to a concept I want to introduce to you today. It is a relatively simple but practical method of comparing similar precious metals companies and establishing a sense of value.

Enterprise Value per Ounce

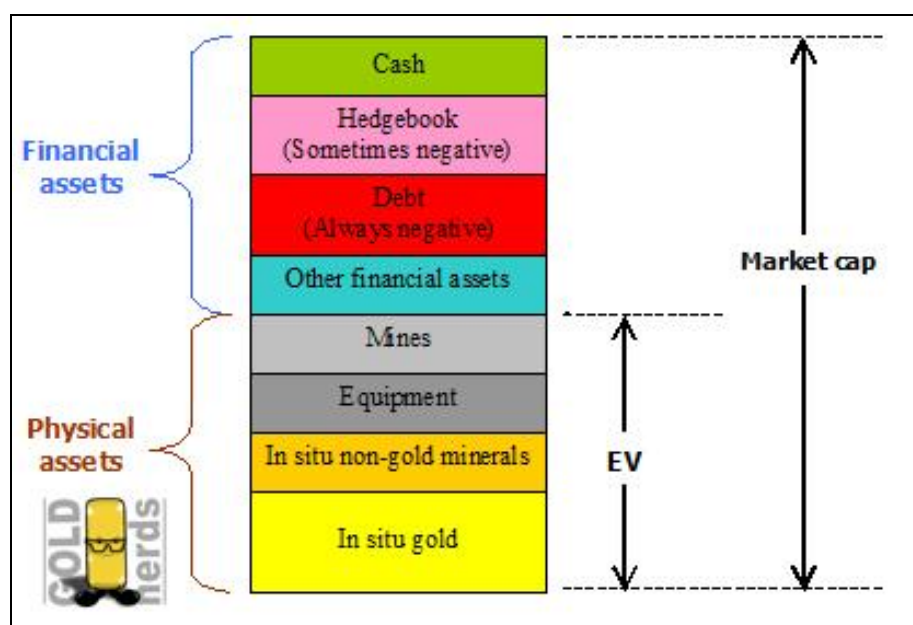
Let me start by defining what an Enterprise Value (EV) is. An EV is simply the Market Capitalization of a company (number of outstanding shares multiplied by the current share price) adjusted to eliminate the effect of a company's financial assets and its financial obligations (liabilities). You subtract the financial assets which would include items such as (not an exhaustive list):

- 1. Cash and Cash Equivalents.**
- 2. Accounts Receivable.**
- 3. Inventories (If a producer)**
- 4. Listed and Unlisted Investments where you can readily establish a fair value.**
- 5. Derivatives (Bought Options and favorable Forward Sales Agreements)**

And add the company's financial obligations including (not an exhaustive list):

1. **Accounts Payable**
2. **Interest Bearing Liabilities**
3. **Derivative Obligations (Unfavorable Forward Sales Agreements and written option contracts)**
4. **Retirement Obligations**

What remains is essentially the value the market is attributing to the company's non-financial assets or its projects. If you were to look at this diagrammatically it would appear as follows:



To calculate an EV per ounce, you simply add up the total number of ounces attributable to the company via its projects and divide this number into the Enterprise Value.

The concept of EV per ounce is by no means a new valuation methodology and it certainly has its critics. Like land is the common denominator in our real estate investment example, gold in the ground is obviously the commonality when looking to compare gold related companies. Now critics of the EV method will tell you that when using this method you are incorrectly assuming that all metal in the ground is created equally. This is of course a valid criticism if and only if your analysis was to simply stop there. It would be like saying property A is better value than property B because I can pick up the land for a cheaper rate per square meter without taking anything else into account. Obviously this technique would be completely flawed. For instance, you can't conceivably take a producing gold mining company and compare its EV per ounce with an exploration company and come to the conclusion that the exploration company offers better value. You would be excluding the costs associated with the development of the mine, not to mention the premium a company receives in the market for successfully developing the project. My question to the critics of EV per ounce would be why on earth would you stop at just this first step? This limitation can be quite simply overcome by having a large enough number of companies to compare, so that you can isolate the ones that have the most in common (similar development stages) and generate the additional information required to consider the applicable variables. These might include:

1. **The size of the deposit. Bigger deposits tend to attract a premium due to the higher probability of being developed based on better economies of scale.**

2. **Different resource classifications dependent on drill spacing and economic viability. Reserves both Proven and Probable (supported by economic studies) versus just a resource (no supporting feasibility study work).**
3. **The depth of the deposit. Is it shallow enough for cheaper open cut mining methods? (Generally 150m-200m or ideally shallower) Are there large amounts of overburden that need to be stripped away adding to the cost of mining (stripping ratios).**
4. **The average grade of the deposit. Generally speaking, higher grades are cheaper to produce and attract a premium. If you are mining underground, higher grades become essential due to the additional capital cost associated with underground mining.**
5. **Different economics (cash costs, construction costs, ongoing capital expenditure etc) Useful by-product credits can in turn lower the net cash costs of production. The availability of infrastructure lowers construction costs. For example, access to grid power versus the requirement for diesel generators in remote regions (more expensive). Access to ready built roads and ports versus having to build this infrastructure. Underground mines have higher ongoing capital costs associated with the continuation of underground development.**
6. **The metallurgy (recoverability of the metals). Sulfide deposits generally have lower recovery rates than oxide and require a more complicated extraction process.**
7. **The political risks. A deposit in Zimbabwe would obviously trade at a substantial discount to say the same type of deposit in Australia or Canada.**
8. **The exploration potential on the properties and the probability of future expansion of the deposits.**

The precious metals sector is emotionally charged. When you study EV per ounce information on a large scale it becomes very apparent just how much influence market sentiment can have on a company's valuation. Earlier, I briefly touched on one of the risks involved in using newsletter writers for stock recommendations. Another risk associated with just blindly accepting a newsletter writer's (or a stock broker's) recommendations is the price you may end up paying for the shares in the company. Many newsletter writers go to the same trade shows and recommend the same companies. There is usually nothing wrong with the companies recommended but the risk lies in the price that you the subscriber may have to pay to acquire shares in the company. Your success or failure may be determined by simply how early or late you get in on the action. A simple way to avoid this risk is to have a basic sense of value. Perform a quick EV per ounce calculation and see what you are paying. Compare this to some of the company's peers and establish whether what you are paying is reasonable. Don't be the chump that is buying shares off the people that were fortunate enough to get in at the ground level and are cashing out.

One of the single largest limitations with the EV per ounce method is having enough comparable companies and all the associated information you need available to make the process of comparison easy and effective. For the average investor, you may be able to undertake this process for a handful of companies but it is not realistic to compile all the necessary information yourself. If something like EV per ounce sounds like it appeals to you, my advice would be to find a reliable information service that does the grunt work for you at a reasonable price. Most importantly, you need to find a group that actually use their own information and can properly articulate the optimal way of utilizing it. When a group sells you information but you are left confused as to how you are meant to use it, chances are they don't know themselves.

It is with great pleasure today that I introduce to you a precious metals research team called GoldNerds (GN). For those of you unfamiliar with the company, GN is made up of a group of researchers from primarily Australia. The group is comprised of people with a diverse range of backgrounds including accountants, ex banking and finance professionals, business analysts as well as ex-stockbrokers. The group has the added advantage of having close contacts in the mining industry, including reputable geologists and mining engineers (many of whom are subscribers).

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This is critical to ensuring the information offered to our clients is both relevant and useful. Most of the researchers are full time investors in the gold sector themselves and have a genuine appreciation of what information is pertinent. I am proud to say that I have been a member of the research team for more than 18 months. I use the product on a daily basis and am involved in its ongoing development. We have just released a North American version of the product to compliment the already extremely successful Australian version which is well into its second year. I encourage you to visit the GoldNerds website, or if you would like to download a free sample version (either Australian or North American), simply email me and I'll arrange one for you.

For anyone interested, I write a free monthly newsletter on the precious metals markets. This includes technical analysis as well as company updates on many of the prominent precious metals companies from around the world. Past articles and newsletters can be accessed in the archive section. Charts are updated on a weekly basis. Pay us a visit at the website below.

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