Special Precious Metals Bumper Issue

DIGGERS AND DRILLERS

December 2008 Vol. 3, Issue 12 www.portphillippublishing.com.au

The Man Who Beat Recession

By Al Robinson

In the late 1970's one young broker in America made the gutsiest decision of his life.

An inflationary recession was driving down US stocks. He'd taken hits on a few of his recommendations. Some clients wanted out. But he was sure about the investments. It wasn't an emotional attachment; he knew them well and he'd done his homework.

So he backed himself. Instead of letting the clients sell out onto the market, he ***offered*** *them a market. He bought the stocks for his own account.*

It was the cleverest move he ever made.

The stocks he bought - from his own clients no less - were gold juniors. For the next two years the gold mining sector featured quadruple digit share price gains as gold roared into the stratosphere.

Why? Because gold became like money. As inflation took hold, investors rushed to the one thing that kept its value. Scarce, precious metals.

That broker stuck to his idea. Now he's a millionaire, and one of the most well-respected resource investors on the planet. You can read more about him later in the issue. But now - for gold investors willing to stick to their good idea - history is about to repeat itself.

The 2009 Gold Super-Bubble Has Already Begun

Gold became like money in the late '70s. It will happen again. In fact, in this month of December, one of the greatest precious metals bubbles of all time is already underway.

The gold price is still just US$830. That will seem cheap this time next year. Future investors will look back on the closing stages of 2008 as the beginning of something huge.

A gold super-bubble has been set in motion. And the interesting thing is that it hasn't affected prices yet. The gold and silver rocket won't actually blast-off until 2009.

That gives you this month to strap yourself in.

The Golden Dam Bursts Next Year

How can a precious metals bubble be underway? Gold prices are lingering in the same space they've been for months.

Well, a super-bubble occurs when a teeming crowd of investors pile into a sector without even thinking. It happened in technology stocks at the beginning of the decade. It happened

Inside D&D:

The Man Who Beat Recession *By Al Robinson* Page 5

Three Reasons Why the Australian Gold Junior Market is a Speculative Feast Right Now *By Al Robinson* Page 6

5 Quality Australian Gold Juniors On Sale *By Troy Schwensen* Page 7

Share Tip Updates Page 11

Your new password for this month is:
Username: osi Password: shiny
www.portphillippublishing.com.au/osi
Please e-mail us at cs@portphillippublishing.com.au to receive the weekly updates.

ISSN 1834-3260

in US housing too.

The one fact you should know is this: it's already happening in gold.

The idea isn't even up for debate. You can confirm it for yourself further along in this month's newsletter.

One little graph shows that super-bubble pressure is building up like mega litres of water straining against a flimsy dam. When the dam finally bursts, all hell will break loose. A deluge of terror-stricken investors will drive up precious metals prices like it's 1979.

"The credit crunch has already cost America more than the New Deal, World War Two, the moon landing and the savings and loan crisis combined."

Two Reasons to Buy Into the Precious Metals Super-Bubble Right Now

Here's the key.

There are two reasons prices haven't boomed yet. Two stubborn barriers to a super-bubble in precious metals remain.

They will both fall in 2009. Then the dam bursts.

Honestly, I don't even know how high precious metals prices could go. The cause – the most ambitious world-wide inflation of fiat money in history - has been unprecedented in size. In the U.S. alone the Federal Reserve's balance sheet has grown by one trillion dollars in the last month to over $2 trillion and counting. The Fed's creating new money to buy Wall Street's toxic assets. The effect of this growth in credit and money should be unprecedented too.

Well, perhaps not entirely unprecedented. Something like this has happened before. To be more specific, the gold price record in today's dollars is around US$2200. That happened in January of 1980, the last time investors became spooked by inflation.

That record could easily fall. This time, the increase in money supply and credit is global in scope. That means the rise in the gold price could be even higher - and happen just as quickly, if not more so.

So in this month's *Diggers and Drillers* special gold edition, you'll read about the gold super-bubble. You'll read why the real bubble is already in motion. And there's an investment that could provide even bigger gains than gold itself.

The 2009 Gold Mania Begins

Let's briefly recap the case for precious metals investment. Why do people buy gold?

In short, because it's sound money. It holds its value. There is no printing press for gold. It's scarce.

That's why in 1979 gold investment became a mania. In the late 1970's inflation was eroding the value of the average man's paper wealth at 10% per year. So he swapped his paper currency for precious metals.

Enough people agreed with him to send gold prices up over 200% in a year. It capped an incredible five-year run for gold prices.

If you glance out the window at today's economy, you'll find you're looking at a similar situation. The scourge of inflation is only beginning to rear its filthy head. According to US economist Jim Bianco, the credit crunch has already cost America more than the New Deal, World War Two, the moon landing and the savings and loan crisis combined.

Over $4.3 trillion spent on Wall Street and not a single victory battle, bridge, dam, railroad, or footprint on the moon to show for it.

That's a lot of new money Feds are pumping into the economy. And new money invariably leads to price inflation. Each new unit of currency makes each existing unit of currency worth incrementally less. When a man catches on to this, he begins to spend his money more quickly before it loses value.

Businesses raise prices to adjust to all the new money in the system. This causes consumers to spend money even faster, before prices rise again. Cash becomes like a giant national hot potato. It's a vicious cycle of rising prices where people are desperate to trade increasingly worthless paper for something that doesn't lose value day by day.

So the idea here is simple.

You're on the verge of another inflationary period like 1979. New money held by the average man will lose its value - fast. That's when he'll swap his paper money for a shiny, heavy metal that keeps its value. And then you'll experience a super-bubble in gold firsthand.

The graph on the following page is evidence that the crucial shift away from paper money is happening right now.

It shows quarterly worldwide gold investment. That means physical gold investment in the form of bars or coins. It also includes investment in gold held at Exchange Traded Funds (ETFs). In the last quarter, demand for gold skyrocketed.

Gold prices have risen over 300% since mid-2000. But the world's hunger for gold broke new ground last quarter. It soared higher than any other quarter in the last 4 years - by over 100 tonnes.

The man in the street is swapping his paper for metal. That's the key requirement for a gold mania. And the gold mania is the fastest, hardest, last leg in a precious metals boom. It's the period of a super-bubble. It can go higher and last longer than most people expect - which is why the biggest gains in gold are yet to come.

What's more, this demand surge is only likely to increase over the next year. Governments worldwide have established their plan. They will inflate money supplies as much as it takes to support the global economy during recession. That will add urgency to gold investment as paper money supplies increase and currencies become worthless.

But that graph below - and the man in the street swapping his paper for gold - lead us inevitably to one question. Why isn't the gold price in a bubble *already*?

The Falling Barriers to a Higher Gold Price

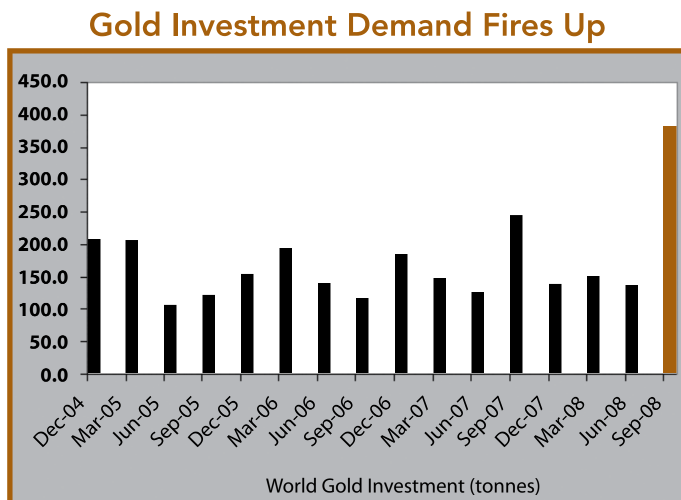
There's a ceiling on the gold price that keeps it from rising. The ceiling is made of new gold supply that can come on to the market at any time to swamp demand and bring down prices.

Two major sellers have added to the gold supply this year. They've satisfied the average man with his shrinking paper wealth so far. But that won't last.

Firstly, speculators have sold gold to cover margin calls. Hedge funds in particular want or need cash fast and sell whatever they own to get it. Even gold. Newer investors in gold who don't understand it's long-term anti-inflationary benefits have been especially stupid in this respect.

But even institutional gold holders sold this year. They had to. When a hedge fund receives a margin call on its debt, it has little choice but to sell something. Gold has been one of those things. It doesn't matter that gold has a reputation as a safe-haven. Leveraged investors did what they had to do. They liquidated.

Gold Investment Demand Fires Up



Source: World Gold Council

Research Capital Organisation noted this month that gold has come under a lot of selling pressure from margin calls in particular. That has kept the price of gold down during record investment demand. The margin calls won't last forever though. And the gold price has stabilised since the initial plunge. After bottoming just above US$700, gold is now US$830. It looks as though hedge funds have unwound.

Meanwhile, there are more sinister reasons why precious metals prices seem restrained.

Gold is not officially money. Governments and central banks do not recognise it as legal tender. But gold and precious metals act like money in times of great financial stress, because they tend to keep their value. And because they keep their value, they compete with the power central banks wield over the monetary system.

Don't believe it? Well according to the Commodity Futures Trading Commission, 98% of all net short positions in the silver market are held by two commercial banks – another institution that benefits directly from a paper money system.

The second factor keeping the gold mania from becoming a price bubble has been bank selling. Central banks hold huge reserves of gold that they sell into the market. It depresses gold bullion prices for a time.

In fact, above ground Central Bank gold supplies are arguably even more important than new gold supply from miners. Just 2% of the entire gold supply comes from gold producers. The other 98% is above ground. It sits there until a financial crisis drives up demand for gold as currency.

Central bank selling is the final barrier between the current gold investment mania and a real super-bubble in the gold price. But only as long as governments keep selling their gold. And next year that selling pressure will shrivel up.

JP Morgan analysts expect central bank gold sales to "fall quickly" in 2009. The reasoning is sound. European central banks have a five-year agreement with an annual quota of gold they can release onto the market. The current five-year agreement ends in September next year. According to JP Morgan, central banks could soon exhaust their 500-tonne-per-year selling quota. Buyers would dominate the gold market if that happened. Prices would rise.

There's a surprise though – one with even bigger implications.

Central Banks Aren't Acting Like Central Banks

JP Morgan may have the wrong end of the stick. European central banks don't even *want* to hit their gold-selling quotas. This year has seen them back-

flip on gold selling.

According to bullion analyst Julian Phillips, sales are slowing rapidly. Germany has publicly stated that it will sell no more gold before September 2009. So have the Swiss. In fact, Phillips has tallied up the current rate of gold trickling from European banks onto the market. It's less than half the amount the banks said they would sell. At this rate, they'll only sell 130 tonnes of the 500-tonne quota.

What's going on? Could central banks actually be hoarding gold? Are the sellers now hoarders?

It's almost unthinkable. That would be the ultimate signal of an impending gold mania. Central banks – the ultimate currency villains to precious metals supporters everywhere – may be embracing gold and silver as currencies. It's the kind of thing that could even lead to a new gold-standard currency system.

Only time will tell. But if this continues, there's little else to prevent 2009 from being the year of the gold super-bubble. The market is already infected with a precious metals mania. It's just a matter of time before the symptoms of that infection appear in precious gold prices.

Why there's a Better Choice than Gold

The real question now becomes one of selection. How can you ride the gold bubble to maximum profits? The answer lies at the very source of most resource investing woe this year: falling industrial demand for commodities.

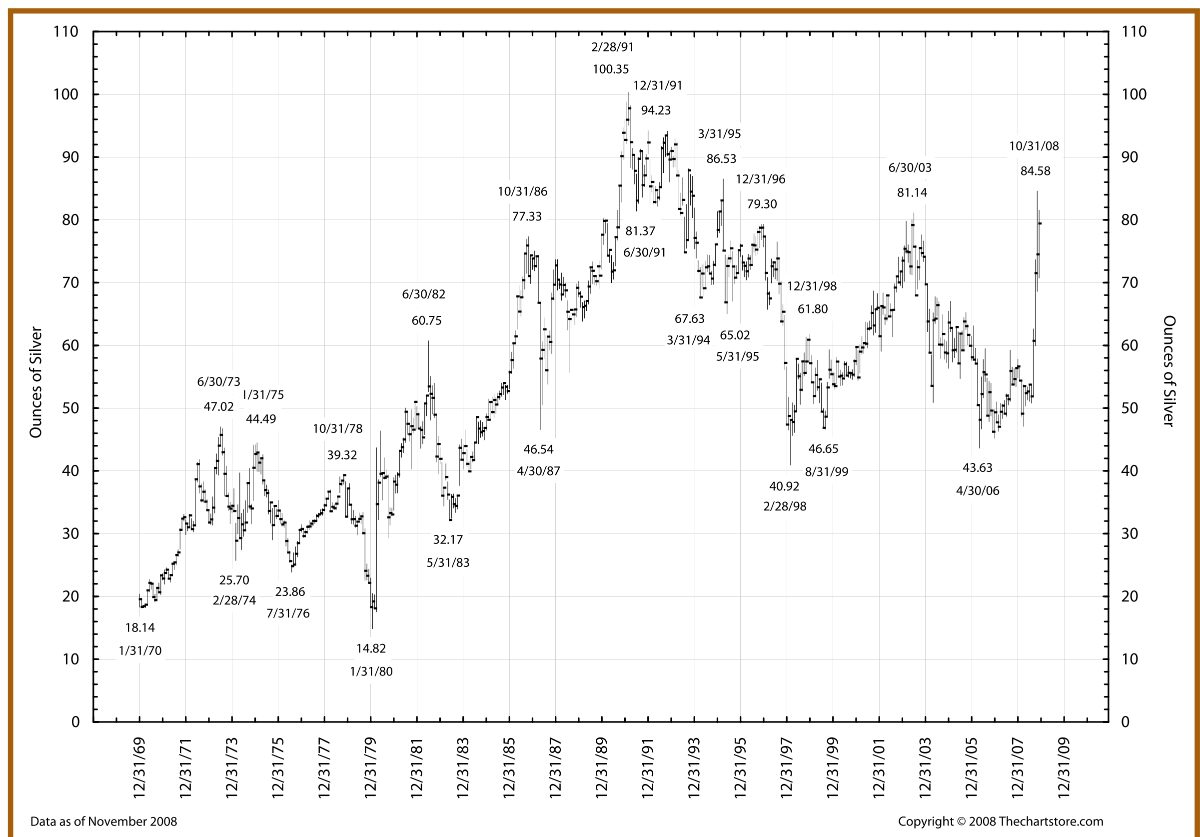
Gold isn't the only non-fiat currency. History has shown that silver can be an even more lucrative option during a financial crisis. Individuals and institutions hold silver for the same reason as gold. It retains value.

But silver is an odd metal. During average times silver prices respond mostly to demand from electronics manufacturers, jewellers, or photographers. Up until now, economic sources of demand have pushed silver prices lower and lower. It has sold off a lot further than gold. Silver is down over 50% from its high this year. That means it has greater upside for the precious metals boom in 2009.

How much more?

Well, when the gold price eventually takes off, silver will follow it up. It typically switches roles from industrial metal to safe-haven investment during a financial crisis. So the important question now is: how cheap is silver *compared* to gold?

Gold/Silver Ratio



The gold-silver ratio is a standard gauge for this. Simply put, it's the gold price divided by the silver price. Falling economic demand for silver – and a falling silver price - has pushed the ratio all the way up to 80.

A ratio of 80 is pretty high. It means that silver is over sold compared to gold and is due for a rally. It doesn't happen often, as you can see on that chart. The last time it hit 80 was 2002. This foreshadowed the bull market that took silver from US$4.50 to US$21. It was a 377% run.

Let's assume the gold price doesn't move from where it is, and silver rises until the gold-silver ratio readjusts to a more reasonable value of 50. That would mean a silver price around 62% higher than

today. That's with no gold price upside built in. It's a pretty good head-start.

But if silver were to test its all-time inflation-adjusted high – the high point it reached when it followed gold up in 1979 - it would peak at US$130. Right now it's a little over US$10.

In other words, if the gold price broke its all-time record it would return you $2,650 for every $1,000 you put down today. A record-breaking silver price would return $13,000.

Gold investment is booming, gold prices are yet to boom, and silver is historically oversold relative to gold. It's time to grab this opportunity before it disappears. This month I'm recommending you buy silver.

The Easiest Way to Own Silver in Australia

The easiest way for you to gain financially from the silver boom is through the new **Silver Exchange Traded Fund (ASX:ETPMAG)**. If you've never invested in an ETF before, there are a few things you should know first.

An ETF is a traded security like a share. You buy it on the ASX one day, hope that it rises in price, and then sell it another day on the ASX. The difference is the asset that it represents. Most shares represent ownership in a real company. The silver ETF represents a claim to ownership on one troy ounce of real silver stored in a London warehouse.

"To sell now would be to leave the big money on the table."

This is different from actually owning silver. You won't be able to buy a share of the silver ETF and demand the ounce of silver delivered to your house. If you want to own real physical silver, that's another story entirely.

But with the ETF, you will be able to sell your share for a nice gain if the precious metal mania takes off next year. Any investor in a silver ETF participates in the gains or losses the price of silver bullion experiences.

I suggest you read through the prospectus before investing. It covers all of this in detail. It's available online at http://www.etfsecurities.com/au/document/downloads/MSAL_prospectus_11_Dec_08.pdf.

The only substantial risk with this investment – apart from any potential losses made by silver – is that the ETF is in Australian dollars. You need to be aware of the currency risk involved. If the Australian dollar surges against the US next year, it could nullify the gains made by the US dollar silver price.

But the bubble in precious metals will probably be felt throughout all currencies. Silver and gold have both gained in Australian dollars over the past four years, following their US counterparts up. Now we're simply relying on Australians to embrace precious metals as a safe-haven as well as Americans. After all, that has been the difference between the inflation of 2008 and the inflation of the 1970s. This one has been a global effort. The effect on gold should be global too. **Action to Take: Buy the ETFS Physical Silver Exchange Traded Fund (ASX: EPTMAG) when it begins trading this month.**

The Man Who Beat Recession

But what about that young broker?

There's a decent chance you've heard of him. His name is Doug Casey. He's a millionaire with his own research firm. His book, *Crisis Investing*, is one of the highest selling financial books of all time. And these days he's even more vocal on precious metals investment than he was in the 1970s.

To keep backing a good investment idea when it isn't succeeding can be difficult. Casey did. And the virtue of sticking to an idea – when you know it's a good one – is evident in his success. In a March interview Casey, one of the greatest success stories to come out of the last gold mania, predicted the following (emphasis added is my own):

> *"Gold has been in a bull market since 2001. It's gone up, on average, about 25% per year compounded, and there's absolutely no reason the bull market should stop now. On the contrary, there's every reason to believe that the gold bull market, having gone through its Stealth stage and still being in its Wall of Worry stage, is going to hit the Mania stage.*
>
> ***To sell now would be to leave the big money on the table."*** ■

Are you up to date??

Your Diggers & Drillers newsletter and weekly updates are available online each month at www.portphillippublishing.com.au/osi

Use your current login and password to access all the latest news on the world of natural resources and hard assets (passwords are updated at the beginning of each month via email).

Your weekly D&D e-letter is sent direct to your inbox every week. If you do not receive these emails, or need to supply us with an email address, please contact Customer Services at cs@portphillippublishing.com.au

Three Reasons Why the Australian Gold Junior Market is a Speculative Feast Right Now

In 1980, at the dawn of the real gold junior explosion, investors pocketed gains as high as 13,000%. That's what a gold super-bubble could mean for gold miners today.

There's one big difference. In 1979, the gold miners had been riding the crest of a 4-year bull market before the last big push. It would have been a gutsy move to buy in then. Today, you have a much less daunting market to invest in.

Gold juniors have taken serious punishment this year.

It's time to speculate on them. Specifically, it's time to speculate on the most unpopular gold plays. That means looking at the stocks whose prices have been driven into the ground by market pessimism.

Unpopularity is the key. You should buy gold miners when the stocks are reviled. When investors are contemptful of them. When average people are disgusted and mortified at the idea of buying one of these shares.

"Gold stocks? They're going down! You're mad."

Then when the same people are finally buying, you sell. At a 13,000% gain if possible.

Gold miners today have lost more than a third of their market value this year. They're as unpopular as any other kind of resource stock in December. That, combined with the remarkable potential for the gold price this year, makes it buy-time. And if you look closely at these companies, you can see three omens that the gold junior market is pretty close to rock-bottom.

These three signs aren't just for gold miners though. They're three easy-to-spot characteristics that tell you when a sector is out of favour. Other resource sectors will bottom in 2009. Bet on it. They'll probably give off these three signs. And when they do, that's the time to think about going long. The gold junior sector ticks all three boxes this month.

Number One: Stocks That Forget About Their Commodity

Just two charts illustrate this idea pretty well. If gold miners tumble while gold prices are booming, that's an opportunity. At the bottom of the page you can compare the gold company index with the Aussie gold price over the last year.

Australian gold is up 32% this year. The entire Aussie gold mining sector, including the big names like **Newcrest (ASX:NCM)** and **Lihir (ASX:LGL)**, are down 37% - and they've both held up better than the juniors.

Domestic Aussie gold miners mostly sell their gold in Australian dollars to refiner AGR Matthey. Logically, their cash flow should fluctuate up and down with the Aussie gold price. So should their share prices.

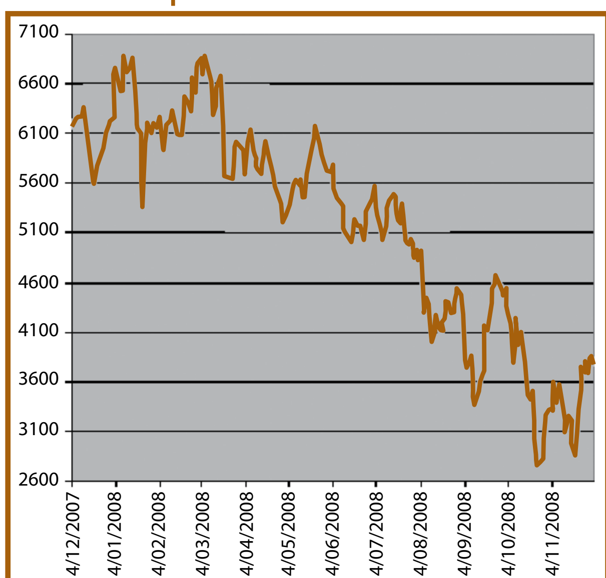
But gold shares have stopped bearing a resemblance to gold. In fact, the shares don't even look like the US-dollar gold price – which has performed worse than Aussie gold.

When Aussie gold prices no longer resemble the U.S. gold price it's a fair sign that the market is losing its head. And it's a sure sign gold miners aren't popular right now.

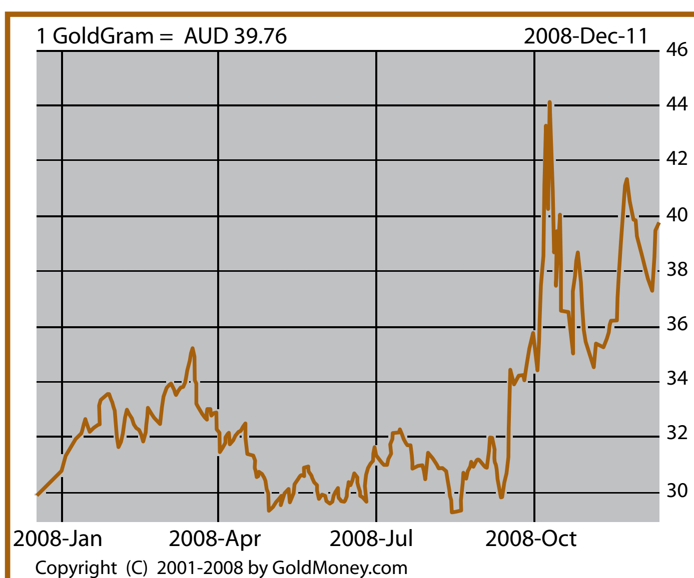
Number Two: Projects that Go Missing

This one's simple. For companies that have more

Gold Companies Slide with the Market



The Aussie Gold Price Booms Late in the Year



than one project, you can put a value on each project. You add them all up, and that total should come close to the market value of the company.

But right now – as you'll see time and again in the next article – there are miners with projects that simply don't add up. Companies that own producing mines aren't getting credit for them in their share prices. In the case of gold miners, it's gold you can get for free as an investor. And when the market comes back to gold stocks, the shares will adjust back up to recognise this.

It's one thing to add a 'risk-premium' to a mine or a company if it might not see production. It's another altogether to act as though the project doesn't exist. That's basically as pessimistic as you can get. And it's making gold miners cheaper than they have a right to be.

Number Three: The Cash Factor

Then, of course, there's the ultimate insult. The third factor that makes gold shares so appealing—and shows you just how truly unattractive they've become to the rest of the market—is that you see share prices that value companies below their cash balances.

You read about this phenomenon in the October issue of *Diggers and Drillers*. It's when a share price falls so low it ignores all but the most liquid assets of the company. This year you and I have seen the market discount those liquid assets more than once.

When a company is selling below the value of its cash at the bank, you know that the sector is unpopular. There's at least one gold junior in the pages that follow that has suffered this fate.

This shouldn't logically happen. It only *does* happen in the worst of bear markets. But if the company is sound, it's as good a buying opportunity as you'll find. And right now some gold juniors are so unpopular the market is putting a discount on their bank accounts.

The Five Best Juniors on the Market

D&D reader Denis Dargan wrote in recently, hungry for more commentary on the gold junior story:

> *"Greatly impressed by your work. I was wondering if you can give us subscribers some more tips on any precious metal juniors with big prospects. I know we already have Citigold and St Barbara but do you think that gives us enough risk spread if anything happens to either or both of these? I am asking at this point because I think we are shortly looking at a big move in gold/silver unlike any we have seen in recent times" – Denis*

Thanks for your note Denis. I couldn't agree with you more about the potential move in gold.

So at this stage, I'd like to hand you over to an expert on gold juniors: Troy Schwensen. It's obvious that the gold sector as a whole is primed for a big move if gold mania kicks in this year. But Troy has studied the individual companies. He has talked with management about the issues involved with each investment. He crunches the hard numbers every day in the gold sector.

In the next article, he profiles the five most exciting gold junior opportunities on the ASX. Troy has clients that happily pay for similar analysis. But he was kind enough to present his thoughts exclusively to you this month.

I'm not officially recommending any of these firms. **St Barbara (ASX:SBM)** and **Citigold (ASX:CTO)** remain the two *Diggers and Drillers* gold plays. Should you buy any of the following five? That's up to you. As always, don't invest money you can't afford to lose. They're the kind of stocks you put 1% of your portfolio in, tops. But if you earn a 13,000% gain on 1%, it doesn't matter that the initial investment is small. You'd make $130,000 on a $1,000 investment that way. Not a bad punt for something so unpopular, is it? ■

5 Quality Australian Gold Juniors on Sale

By Troy Schwensen

[Editor's Note: Troy Schwensen is a professional investor and trader. He is the editor of The Global Speculator newsletter and a research analyst with www.goldnerds.com.au. Troy is a CPA and has held senior analyst positions with The Fosters Group as well as numerous accounting roles with ASX 200 companies including Goodman Fielder. He's an experienced gold analyst with an in-depth knowledge of the Aussie gold equities market. Below he'll talk you through what makes the share price of a gold stock tick, and the five juniors likely to tick the fastest.]

The Schwensen Method: Four Golden Traits

I've been investing in gold mining companies both here in Australia and North America on a full time basis for many years. I've learnt this: the key factors for investing in gold juniors remain the same, whether you are investing in good times or bad. There are four that I use. In the good times you can ignore them at your peril. But in the bad times they become critically important. These factors include (in order of importance):

1. **Does the company have quality management?** People with a demonstrable

track record of success in whatever it is they are endeavoring to achieve, be it exploration, project development or commercial production.

2. **Does the company have quality assets?** Assets that are going to deliver results for shareholders with minimal risk. Are the grades appropriate for the type of mining? Is there good infrastructure? Does the feasibility study demonstrate strong economics with sufficient contingency built in for inevitable mistakes? These are all important questions relating to assets, which I'll cover as appropriate to each company.

3. **Does management have a material, vested interest in the business?** Is management putting their own money where their mouths are and holding a material stake in the business. Is there willingness to return a portion of profits back to shareholders (demonstrating confidence)?

4. **Is there a low-risk entry point into the investment?** Is the market providing us with a low risk entry opportunity?

The first two factors are qualitative. They come down to experience in following people and the progress of countless mining projects - picking up on what works, what doesn't and why.

The last two factors are quantitative. I like to see management collectively hold at least a 5-10% position in the company. As far as low risk entry points, I like to roughly but conservatively calculate what the assets of a company are worth.

I have a rule of thumb for producers – which is what every gold junior aspires to be. A producer should trade roughly at a Free Cash Flow (FCF) multiple that reflects the mine life of its project(s). That is the expected annual cash flow from its project(s) - using present metal prices less any corporate and sustaining capital related costs - multiplied by the expected life of the project(s).

In other words, it's the net cash the company should make from the mine each year, multiplied by the number of years it should make it. Simple.

I then add the Net Financial Assets (NFA) of the company to arrive at a valuation – basically the financial assets on the company's balance sheet after subtracting liabilities. It's a simple though slightly subjective valuation method. And it provides what I consider to be a good price target.

Most importantly it gives me a low risk Entry Level: ***any price below this valuation is an entry point.*** The Entry Level is the most important factor of the Four Golden Traits. It's the one thing you have to establish when buying an Aussie gold share.

Quality companies, under "normal" trading conditions, tend to trade at significant premiums to this conservative valuation. As you'll see, there are some great firms trading below the Entry Level right now. The valuation part might sound dry, but it usually works for the best in the long run. The good news is that I've already crunched the numbers. You don't have to.

So here are best gold junior plays Australia has to offer.

"The Entry Level is the most important factor of the Four Golden Traits."

The Companies

The first two companies on my list have been in a 'transition stage' for 1-2 years. They're moving into new projects. Transition stages invariably result in short to medium term underperformance for a company. That usually means an investment opportunity. Each has an exceptional track record of project development and corporate governance.

1. Kingsgate Consolidated (KCN - $2.62)

Kingsgate (ASX:KCN) has been in transition for 2 years. This has been due to prolonged permitting issues with its Chatree North deposit, a situation worsened by ongoing political unrest in Thailand. But Kingsgate's CEO Gavin Thomas recently commented on this: "We have operated in Thailand for many years with many different governments and it has never impacted on our operations."

Kingsgate recently announced the completion of the permitting process, paving the way for production to ramp up as it sources ore from the newly developed C North pit. Target annual production for fiscal 2009 is 100,000 – 140,000 oz. A target cash cost of US$350/oz will place the company in the lowest quartile of cash costs for producing gold mining companies.

Kingsgate's success in Thailand is largely attributable to wonderful infrastructure including grid power costing just US$0.06 - $0.07 per KWH. By comparison, Australian companies pay $0.25 - $0.40. More importantly, KCN boasts an unrivaled social accountability record with a 99% Thai workforce. That'll go a long way to maintaining a good relationship with Thai officials.

Exploration potential is enormous too, with the recent discovery of Chokdee. It's located 20km north of Chatree in the central Thai gold belt. Gavin Thomas comments: "This discovery has the potential for a new Chatree-size gold system or even larger."

With **no debt and a strong balance sheet** Kingsgate is well positioned. And here's where the tried-and-true valuation method comes into play.

Using present metals prices and exchange rates, an annual production of 125,000 oz and a life of mine cash cost of US$425/oz, I estimate an average Free Cash Flow (FCF) from Chatree North of A$45m.

That equates to $0.50 a share. At the recent share price of $2.62 we get an FCF multiple of over 5. The expected mine life for Chatree North is conservatively 8 years, implying a valuation of $4.00 (8 x $0.50). Once we add the NFA of $0.17 a share, we get an Entry Level of $4.17.

"This means you are literally picking up the Andorinhas project for free."

This places no value on the 1.7 Moz resource (above reserves). A large proportion of that resource should be converted into reserves. The current share price also ignores enormous exploration potential. Directors are confident too: they own a healthy 7% of 93m ordinary shares outstanding.

2. Troy Resources (TRY - $0.74)

Troy Resources (ASX:TRY), like Kingsgate, is at the tail end of a transition stage. It ceased production on its highly successful Sertão mine in Brazil (July 2007). The next development asset is the Brazilian Andorinhas gold project. Troy bought this from Agincourt in November 2006 for just US$10m.

The project has a small open pit component called Lagoa Seca and a bigger underground ore body called Mamão. Lower grade ore is mined from Lagoa Seca and stockpiled. This will be supplemented with higher grade Mamão ore later on. That should see modest annual production of 50,000 oz, at a life of mine average cash cost of US$300/oz. The initial mine life is 5 years with the expectation of extending this, given Mamão remains open at depth.

I like strong balance sheets, and Troy Resources has one. It owns A$60m in cash and investments equating to an NFA of A$0.85 a share. This means you are literally picking up the Andorinhas project for free at the present share price.

That makes Troy's price a low-risk entry point, even before a proper valuation. I estimate Troy could potentially generate an annual FCF of A$13m (or $0.185 per share) from Andorinhas. At a share price of $0.74, this equates to a FCF multiple of 4. With a 5 year mine life, the implied valuation on a conservative basis is $0.92 (5 x $0.185). Add this to the NFA and you have an Entry Level of $1.78.

The current price is less than half that.

In addition, Troy has a commercially viable iron ore deposit at Andorinhas as well as a processing plant on care and maintenance, targeting a joint venture partner. There is also the Sandstone gold project in Australia. At current domestic gold prices, this could produce for another 12 months at higher cash costs. Troy has just 70m shares on issue with directors owning 14% and has impressively paid an annual dividend for 9 consecutive years. It has cash, quality gold assets, and the right price.

3. Dominion Mining (DOM:- $3.00)

Dominion Mining (ASX:DOM) has come a long way in a very short space of time.

DOM's Challenger project in South Australia started life in 2002. It was a small open pit operation with just 112,500 oz in reserves. As the project evolved into an underground mine, further exploration drilling built reserves to well over 700,000 oz and an annual production rate of over 100,000 oz. Challenger is now the benchmark for Australian underground mines.

The plan for 2008/09 is to increase reserves to 1 Moz, whilst maintaining annual production at 100,000 oz. With cash costs including royalties of A$457/oz (US$300), Dominion remains one of Australia's lowest cost producers.

Here's a tip though. Underground projects can be expensive from a capital cost perspective. So it's important to account for Challenger's annual capital expenditure when calculating the Entry Level. This is was A$265/oz in 07/08 .

At present metal prices, Challenger generates annual FCF of $46.5m. That's $0.45 a share, including ongoing capital expenditure and corporate costs. A share price of $3.00 equates to an FCF multiple of 6.5. A 7 year mine life implies a valuation of $3.15 (7 x $0.45). Add the NFA of $0.34 and Challenger has an Entry Level of $3.49.

This is a conservative estimate. It excludes the 300,000 oz outside the reserve base (high reserve conversion rate) plus the excellent exploration upside. Dominion has 102m shares outstanding with the directors owning 11%. And the best part is that Dominion pays you to own it. It gave out an annual dividend of $0.12 out of earnings per share (EPS) of $0.325 last year, representing a 37% distribution.

4. Silver Lake (SLR:- $0.155)

Silver Lake (ASX:SLR) is a new comer to the Australian gold scene, listing on the ASX in late 2007. But the company team is experienced. It contains many former **Western Mining** nickel division employees. CEO Les Davis has 30 years industry experience involving a lot of underground nickel mining using narrow vein techniques.

Why is that relevant?

Well, Silver Lake bought the old Daisy-Milano underground mine and Mount Monger ground east of Kalgoorlie in Western Australia. Western Australia is Western Mining's old stomping ground. Right now the Mount Monger goldfield has had little exploration at depth. But it has excellent potential for new underground discoveries.

Shortly after floating, Silver Lake also acquired the 300,000 t/annum Lakewood Gold processing facility located 45 km from Daisy Milano. Ore production from the mine commenced soon after.

As at 30 September 2008, the total resource at Daisy Milano was 250,000 oz at an amazing grade of close to 1 oz/t. This formed the basis of a 5 year mine plan at an annual production rate of 35,000 – 40,000 oz. In the September 08 Quarter, Silver Lake produced 8,670 oz at a cash cost of $A687/oz. It's not the cheapest mine in Australia at the moment. Managing Director Les Davis said in an interview with HighGrade in May, "I think our biggest challenge at the moment is diesel, we budgeted A$1.20/litre for diesel and the bowser price is A$1.70, so we're $0.50 a litre over."

"If the current share price rises to my conservative Entry Level, it'd mean a 271% gain over your investment."

But Davis maintains that if Silver Lake can keep up production of 3,000 oz/month, cash costs will fall below $A500/oz. With the average price of diesel now under A$1.50/litre this cash cost seems achievable.

Assuming 40,000 oz a year at $A500/oz, we get an FCF of $A18m. That's $0.115 a share after ongoing development and corporate costs are factored in. At a share price of $0.155, this equates to an FCF multiple of 1.3. A conceptual mine life of 5 years implies a conservative Entry Level of $0.575 (5 x $0.115). The NFA per share is negligible.

Understand that Silver Lake is small, and like most of these companies, not the kind of play you bet your house on. It's a bigger risk that pays out like a lottery if it does comes off.

But it's very cheap today. The current share price attributes no value to the additional 1.1 Moz resource the company controls. It also ignores fantastic exploration potential. The directors own 13% of the 153m shares on issue. And if the current share price rises to my conservative Entry Level, it'd mean a 271% gain over your investment.

5. Independence Group (IGO:- $1.29)

Independence Group (ASX:IGO) is an established nickel producer. But it also has a 30% interest in one of Australia's most significant gold discoveries for many years.

Tropicana comprises 12,260 sq km of largely unexplored land over a strike length of 350km along the Yilgarn Craton in Western Australia. The JORC resource as it stands is over 4 Moz. Independence's share is 1.2 Moz: AngloGold holds the remaining 70% and is conducting a pre-feasibility study on the project.

That's good news. Independence is getting a free ride on the completion of this study. The conceptual plan is to build a mine producing 300,000 oz a year for a minimum of 10 years. The probability of growing the resource base is very high with little exploration undertaken at depth.

With the cost of steel, labor and fuel falling in recent months, the odds of a favorable development decision are firming.

Of course, you should know a little more about the company itself. Independence's primary project is Long Nickel, purchased from **Western Mining** for just A$15m. Since 2002, the company has generated a profit to date of over A$233m with production of 46,516t. The goal is to sustain production of 9,000 t/annum and remain in the bottom 3rd of world-wide nickel production cash costs.

The forecast for 2008/09 is 8,400 – 8,800t at a cost of A$4.50 - $4.65/lb. That's a very competitive cost figure. Yet the costs of many raw materials are declining making this cash cost conservative. The company fortunately has nickel hedging left of 1,800t at A$8.38/lb, which will be delivered into at a rate of 200 t/month. The present price of Nickel in Aussie dollar terms is a bit over A$6/lb. Independence has won out on that hedging contract.

Using present metal prices and ignoring the hedging (to be conservative), I estimate a FCF after capital and corporate costs of A$14m per annum or $0.125 a share. With reserves of 4.5 years we value the Long Nickel mine at $0.56 (4.5 x $0.125).

This doesn't account for 38,600t in additional resource. Plus there is Independence's proven track record of reserve conversion. Independence has NFA worth $0.96c a share. Combining Long Nickel and the NFA, you get a valuation of $1.52. At a share price of $1.29, you are essentially getting Tropicana for free. Independence has 112m shares outstanding of which the directors own 24%.

The company paid a dividend last year of $0.17 out of Earnings per share (EPS) of $0.44, representing a 38% distribution. It may be a nickel miner now, but Independence has a firm grip on one of the most promising gold projects in the country. And the market has priced that project at zero. ■

Share Tip Updates

Mineral Resources Wins Big Contracts, Announces Share Buyback

"Pick and shovel" play **Mineral Resources (ASX: MIN)** forged ahead this month with two good releases.

For a start, it announced a basket of new infrastructure and maintenance contracts with big mining and energy names. It did this through subsidiary PIHA Pty Ltd. PIHA operates primarily as a pipeline maintenance company. It specialises in dealing with the kind of corrosive, extreme conditions found in oil pipelines.

Pipelines are one of the more lucrative sectors of mining services. MIN's new revenue sources include new pipeline contracts with **Shell (NYSE:RDS)** and **BHP (ASX:BHP)**. Like a lot of services firms in Australia, MIN is maintaining a record order book.

How long it can last is difficult to tell. But MIN is aligning itself with the biggest players in the industry. One of the last areas to slow down in a recession will be future energy investment. Big oil has to keep investing in new production. Mineral Resources is well placed to keep profiting from that trend. Demand for energy may have receded temporarily. But energy scarcity will return to the headlines at some stage. MIN should continue to prosper from it in the future.

The second announcement relates to MIN's past prosperity. As a company with cash-flow, it has saved a lot of cash. At the end of last financial year it had AU$50 million. And now it plans to buy back shares on-market.

At the moment MIN has said it will buy back 12 million shares in the next year. That's almost 10% of the firm's on-market stock. This is one way good companies underpin their share prices when the market is acting up. They buy back shares. But only good companies with cash flow are capable of it.

OZ Minerals Faces Legal Action over Debt Disclosure, We Sell the Share

The misery continued for **OZ Minerals (ASX:OZL)**. It is now facing legal action for failing to disclose the debt details you read about here last week. Legal group IMF is currently raising funds so OZ shareholders can take a class action against the company.

OZ looked like the next big diversified Australian giant six months ago. It's a remarkable tale, and a frustrating one. The company is now very shaky. It isn't likely to get the debt refinancing it needs. That will probably mean it defaults on loans. And that means it will have to sell assets to pay off creditors.

OZ is still refuting the claims of dishonesty, however, despite the fact it listed half a million dollars worth of debt as maturing in 2012 rather than this month. The official line from the company is this:

Oz Minerals wishes to state categorically that it absolutely refutes any assertion or allegation that it has engaged in misleading or deceptive conduct or has in any other way acted other than in compliance with the Corporations Act, the ASX Listing Rules, or other than in the best interests of its shareholders.

It'd be a shock if it the company said anything else. It has its own legal interests to protect. But the OZ Minerals situation undoubtedly looks to be heading south instead of north. If, or when, the company begins trading again, I recommend you sell it. **OZ Minerals is a sell.**

Paladin Bids for Uranium Cash-Bag

Paladin Energy (ASX:PDN) raided the uranium 'pebbles' market this week. Some energy firms are still expanding their businesses despite the recession blues. Paladin is definitely one of them.

In addition to steadily growing its production in Africa, PDN bid for uranium minnow **Fusion (ASX: FSN)** this week. Paladin is offering AU$17.8 million. At a 59% premium to Fusion's current on-market price that might seem a rich price-tag. But you have to weigh up what Paladin is getting in return.

To begin with - for AU$17.8 million - Paladin gets *net* cash of AU$14 million. That's $14 million after subtracting liabilities. Fusion is a big bag of mining cash with no debt attached.

But the reason Paladin wants Fusion is uranium, and it has some. Fusion's major project is at Valhalla North. Paladin already dominates ownership at Valhalla. Fusion will be releasing a resource figure later this year for its share of the uranium there. The company reckons it has a total resource of over 37 million pounds of uranium.

It's basing that on two reverse-circulation drilling programs and a diamond drilling program. These turned up good uranium grades, but you and I will have to wait for the official JORC figure before we know for sure how good it is.

Regardless, Paladin's offer is conditional on the resource figure topping at least 6 million pounds. So that means - for AU$17.8 million - Paladin gets back AU$14 million in cash, plus a minimum US$330 million worth of uranium in the ground.

That's not a bad buy, if the uranium is mineable.

The 59% premium PDN is offering means Fusion's owners will probably take the deal. Fusion management have unanimously recommended the offer. That makes it even more likely. Paladin continues to stockpile quality future uranium projects at low prices. ■

D&D Recommendations
What to Buy, Sell and Hold

Please check with your broker for the latest prices.

Australia (AU$)	Entry /DATE	Entry PRICE	Current PRICE	Gain/ LOSS	STATUS	Open/ Closed
ENERGY						
AGL Energy (AGK: ASX)	21/12/2006	$16.10	$15.27	-5.16%	Buy	Open
Paladin Energy (PDN: ASX)	17/11/2008	$2.40	$2.63	9.58%	Buy	Open
Tap Oil (TAP: ASX)	22/02/2008	$1.76	$0.60	-65.91%	Buy	Open
Woodside Petroleum (WPL: ASX)	25/09/2006	$40.00	$34.48	-13.80%	Buy	Open
Worley Parsons (WOR: ASX)	23/10/2007	$44.84	$14.08	-68.60%	Buy	Open
PRECIOUS METALS						
Citigold (CTO: ASX)	06/06/2007	$0.41	$0.24	-41.46%	Buy	Open
St. Barbara Ltd. (SBM: ASX)	21/12/2007	$0.67	$0.27	-60.45%	Buy	Open
Australian Silver ETF (EPTMAG: ASX)	16/12/2008	Begins trading later this month	-	-	Buy	Open
BASE METALS, MINERS & MINING SERVICES						
AJ Lucas (AJL:ASX)	28/05/2008	$5.53	$3.91	-29.29%	Buy	Open
Incitec Pivot (IPL: ASX)	28/03/2008	$137.05	$2.42	-64.68%	Buy	Open
Jabiru Metals (JML: ASX)	15/09/2008	$0.29	$0.12	-58.62%	Buy	Open
Macarthur Coal (MCC: ASX)	11/07/2008	$17.25	$2.68	-84.46%	Buy	Open
Mineral Resources Ltd (MIN: ASX)	02/01/2006	$1.68	$1.75	4.17%	Buy	Open
Mirabela (MBN: ASX)	11/07/2008	$5.50	$0.86	-84.36%	Buy	Open
Nufarm (NUF: ASX)	01/02/2008	$15.02	$9.23	-38.55%	Buy	Open

Calculating Your Future Returns: It's important to remember that investing in shares can lose you some or all of your money. The potential gains in this letter are based on investing in Australian dollars on the Australian Stock Exchange unless otherwise indicated and do not include taxes, brokerage commissions, or associated fees. Please seek independent financial advice regarding your particular situation. Also, while useful for detecting patterns, the past is not a guide to future performance. The value of any investment, and the income derived from it, can go down as well as up. Investments in foreign companies involve risk and may not be suitable for all investors. Specifically, changes in the rates of exchange between currencies may cause a divergence between your nominal gain and your currency-converted gain, making it possible to lose money once your total return is adjusted for currency. For any investment, never invest more than you can afford to lose, and keep in mind the ultimate risk is that you can lose whatever you've invested. If in doubt of the suitability of an investment please seek independent financial advice.

Diggers and Drillers is published by Port Phillip Publishing Pty Ltd.
Registered Office: The Old Hat Factory 21/83-89 Brighton Road, Elwood, Melbourne, VIC 3184
Port Phillip Publishing Pty Ltd (ACN: 117 765 009) (AFS License: 323 988).
ISSN **1834-3260**