

Classical Insights

Global Investment Analysis Based on the Classical Economic Model

Classical Insights Morning Bullet Points September 29, 2009

Four attractive junior golds:

	Mcap (US\$ m)	EV (US\$ m)	Price (US\$/sh)	Shares (mln)	Target price	Upside to tgt	Volume (last 2 wk)	Main project
Maudore (MAO CN)	\$44	\$37	\$2.30	19	\$9.47	312%	\$114,869	Quebec
Orezone (ORE CN)	\$28	\$22	\$0.47	59.3	\$2.02	332%	\$31,869	Burkina Faso
Victoria Gold (VIT CN)	\$77	\$73	\$0.35	220	\$1.45	317%	\$157,140	Nevada & Yukon
Carpathian Gold (CPN CN)	\$67	\$62	\$0.23	290	\$1.24	440%	\$40,204	Brazil & Romania

Sources: Bloomberg, Churchill Research estimates

The valuation gap between major gold producers and gold explorers is now 30 to 1 based on ounces in the ground. That's a huge disconnect. Many Canadian- and Australian-listed explorers have fantastic assets trading at just \$10 an ounce. The average gold major, meanwhile, is being valued at \$300 an ounce. This 30-to-1 valuation gap makes no logical sense. A big gold company easily could pay \$100 an ounce for an explorer and have it be highly beneficial to its existing shareholders. As such, a wave of acquisitions is likely in coming quarters.

With gold at \$1,000/oz., almost any gold project makes sense – but the good ones make tremendous sense. The cost to mine 1 gold ounce at a typical mine is about \$400. Throw in another \$200/oz. for sustaining capex, SG&A and tax, and that still leaves you with \$400/oz. in after-tax profits. Therefore, if you have a blueprint for a 100,000 ounce/year mine that will cost you \$150 million to build (about average), *you can expect a payback period of less than four years (i.e. a 27% annualized return).* That's an unheard-of figure in the gold industry – especially when you consider that investors are satisfied with just 4% earnings yields (i.e. 25x P/E) from the majors. So, the majors have every incentive in the world to buy explorers.

But how does an investor know which gold explorers to buy? After all, they all sort of look the same at first glance. My solution for this problem has been to analyze a bunch of them at once. Over the past week, I downloaded about 100 mining-company presentations. I then picked out the 10 most interesting and emailed questions to the managements. On Friday and Monday I chatted with CEOs, CFOs and IR managers. In the end, I settled on four companies to add to the Classical Insights portfolio: Orezone, Victoria Gold, Maudore and Carpathian Gold. Each has more than 300% potential upside, so if just *one* of them works as planned and the other three do nothing you're still up 75%.

Here is a comparison of the four firms on an EV/oz. basis. The far-right column shows EV per *eventual* ounce. That figure is based on the number of ounces each firm should have when all its drilling results have been incorporated into NI 43-101 resource calculations.

Valuations are low on an EV/ounce basis:

	EV (\$ mn)	Resources (in million ozs.)			Current	Eventual ounces	Implied
		Indicated	Inferred	Total	EV per oz.	(my estimate)	EV per oz.
Maudore (MAO CN)	\$36	0.0	0.5	0.5	\$68	2.5	\$14
Orezone (ORE CN)	\$23	0.9	1.8	2.7	\$8	4.0	\$6
Victoria Gold (VIT CN)	\$69	2.7	1.7	4.4	\$16	8.0	\$9
Carpathian Gold (CPN CN)	\$62	4.1	4.2	8.3	\$8	10.5	\$6

Sources: Company data, Churchill Research estimates

Price targets are based on a takeout price per ounce multiplied by each firm's ultimate ounces. Exploration-company takeovers tend to be done for between \$50 and 200/oz. I assume Maudore gets acquired for \$60/oz., Victoria Gold for \$40/oz. and both Orezone and Carpathian for \$30/oz. Maudore gets the highest price because its grades are astronomical (20grams/tonne). In fact, the ore there is so valuable (\$600/tonne) that you wouldn't even need to build a mill. You could just ship truckloads of the stuff (at 10 tonnes each) down the road to one of the nearby Quebec mills. Orezone gets a discount (\$30/oz.) because its deposit is low grade and in Burkina Faso. Carpathian gets a discount because most of its ounces are low grade and in Romania. Victoria Gold gets an in-between valuation. It has two interesting properties in great jurisdictions, but it would be too much to assume both get acquired and/or built (though they certainly could be).

Here is the math on the upside:

Potential upside is 300% plus:

	Implied EV per oz.	Target EV per oz.	Target EV	Target Share price	Upside to target
Maudore (MAO CN)	\$12	\$60	\$180	\$9.47	312%
Orezone (ORE CN)	\$5	\$30	\$120	\$2.02	332%
Victoria Gold (VIT CN)	\$9	\$40	\$320	\$1.45	317%
Carpathian Gold (CPN CN)	\$5	\$30	\$360	\$1.24	440%

Source: Churchill Research estimates

Here are some observations I've had in the wake of plowing through all those Powerpoints:

- I **avoid** companies with a bunch of properties but no flagship. They're too hard to analyze. Vena Resources is like that. It seems they are buying up half of Peru but you can't tell what they're going to do with it. If a company has no flagship project its resources and energy will be diluted. So, it's best to buy a firm focused on one property, or two at most;
- I also **avoid** companies that are looking for several kinds of minerals simultaneously (i.e. gold, diamonds, chromium, iron ore and uranium). This suggests lack of focus and a sort of "flailing" mentality by management;
- I **avoid** companies with no Powerpoint presentations on their websites. Marketing is CRITICAL for exploration companies trying to attract funding. If a company can't take the time to put together a marketing presentation, it's probably not going anywhere. (And besides, it's too hard to figure out the story without a Powerpoint.);
- I **avoid** companies involved in rare earth minerals. I've never seen one of these work out. Also, it's a hassle to figure out the dynamics of the individual metals;
- I **avoid** companies seeking to build small mines on small deposits. They don't have critical mass. These sorts of projects frequently run into delays or funding problems because the managements aren't as experienced or connected. Some companies can make this business model work (Troy Resources, for instance) but if I am going to invest in one of these I would want to buy a going concern – i.e. a company with one or two small mines already in operation;
- I **look for** companies with just one or two projects and some cash in the bank, selling at a low valuation on a \$/oz. basis;
- I **look for** managements that have been through the entire process previously – i.e. they've built up *and sold* a development stage project at least once;

- I **look for** resource estimates that have obvious upside;
- I **look for** high ore grades. Alternatively, if ore grades are low, I'll want to see some mitigating factor (pre-existing development on site, low strip ratio, etc.);
- I **particularly like** brownfield projects that can be brought into production quickly. One area where I think gold stocks are priced very inefficiently involves *time value of money*. A gold deposit that can be brought into production in one year is probably worth 2x a deposit that needs four years to be developed – but stock prices often don't reflect that. I also like brownfield sites because you can have more confidence that they will actually *be* developed. The hurdle rate for permitting is lower and upfront capex is lower, so the all-in return is probably higher.

Moving on to the companies ...

Maudore Minerals (MAO CN) owns the Comtois gold project in Quebec. Grades are extremely high, reaching 171 g/tonne for one 1.0m section. The average gold grade is 20 g/tonne, which is still huge. The 43-101 resource is based on 66 holes but they've drilled 292, so the resource is likely to grow to at least 2.5m ounces. A new resource estimate is due toward the end of Q1 2010. Also important: the resource is shallow (less than 200m deep) and the veins are good width: 3.7m on average. In theory you could just truck the ore directly to a local mill. Each tonne of ore-bearing rock is worth \$600, and one truck can haul 10 tonnes. Even with a 500-1000 tpd mill (quite small) you could produce 250,000 ounces/year (quite large). Maudore might do a 4g/tonne open pit mine for a few years, then go underground.

Also of note: management believes it may find a Volcanogenic Massive Sulphide (VMS) deposit on its land package. More than half of the world's VMS deposits are in Quebec. If Maudore finds a VMS deposit, it could vault the ounce count much higher.

I spoke with CEO Ron Shorr last week. "I want to get things moving at faster and faster pace so by mid-next year we can show it to majors," he said. Shorr is a former mining analyst with Bear Stearns and Morgan Stanley. He did post-graduate work at Columbia's Henry Krumb School of Mines. He owns 7% of the outstanding shares.

By the way, one bonus here is that Quebec *refunds* 45% of miners' exploration costs. So Maudore's \$4 million in cash on hand could go quite a long way.

I'm valuing Maudore based on 3 million ounces and \$60/oz. for a total valuation of \$180m. That implies 312% upside from the current market cap of \$44m. In reality, the ounce count can go higher than 3 million even if no VMS deposit is found. Maudore management still hasn't hit the boundaries of the existing main deposit.

Orezone Gold (ORE CN) owns the Bombore project in Burkina Faso. It is a 2.7m ounce resource, still open at depth and along strike. It is also *shallow*, running to a depth of 40m (so far). Management wants to get the resource up to 4m ounces and down to a depth of 150m. To date it has drilled to just 55m. Bombore is the biggest system in Burkina Faso, at 14km in length. So far 10km of that has been drilled. Conceptually, there could be a higher-grade area deeper down that is feeding the lower-grade surface area.

While the ore is low-grade at 0.6 grams/tonne it is also oxide, which makes it amenable to heap-leaching. Also, the location is great: It's on the highway and has easy access to both water and power. There are no people to move, and yet it's near the capital city. I spoke with CEO Ron Little on Friday. His near-term goal is to demonstrate the market that the oxides work – that this deposit really is amenable to heap-leaching. So, he is waiting on the results of the metallurgical study, due in Q4, before trying to market the story with any intensity. Little also wants to get the indicated ounces up to 2 million. "Very few projects have 2m ounces of oxide," he notes.

A challenge here is that the ore needs to be thickened up with cement before it can be processed, and cement is very expensive in Burkina Faso. Cement alone could add \$50-150/oz. to the operating cost of the mill. Management is looking into cheaper ways of getting it (importing it or even building a cement plant).

A big part of the story here is that Little was part of the team that built up and sold the Essakane gold deposit, which is now the #1 contributor to GDP in Burkina Faso. Essakane was sold last year for \$350 million (5m ounces at \$70/oz.). "We've been through the permitting process," Little says. Orezone has access to the whole list of investors and bankers that participated in the Essakane project. "All summer we've been turning money down," he says. Orezone owns two other interesting Burkina Faso assets, the Bondi and Saga properties. "We stopped drilling at 500,000 ozs. but both could be 1 million. Bondi is a huge structure. It's 4km long now and we think it goes more than 8km."

I'm assuming Bombore gets up to 4.0m ounces. Orezone is close to that figure now if you include Bondi and Saga, but I'm just counting Bombore. I am valuing the Bombore ounces at \$30 each. The low \$/oz. figure reflects the uncertainties surrounding the cement and metallurgy issues, plus the low grade and location in Burkina Faso. Overall, though, I don't see why this project can't get done. Orezone is currently trading at an EV of just \$5 per expected ounce, so even if the company is taken out for just \$30/oz. that still represents 332% upside on the current market cap.

Carpathian Gold (CPN CN) has two interesting projects. The first is a year away from production, and the second has an enormous resource.

- Riacho dos Machados is a permitted, brownfield, 1.3m-ounce resource in Brazil. The site already has roads, mine buildings and a power line, plus 40,000m of drill core. Management is aiming to start a 100,000 oz./year operation in 12 months. CPN needs \$125m to complete the task and has several offers from banks. The financing package would be 100% debt, according to management. There is an existing open pit on site with a resource of 19.7m tonnes @ 1.63 g/tonne, or 1.03M ounces. The underground resource is an additional 29m tonnes @ 2.87g/tonne, or 271,000 ozs. There is additional underground potential for 1.12m ounces @ 2.91 g/tonne and plenty of potential for additional discoveries elsewhere on the property.

The plan is to buy an existing mill and transport it to the site (which helps explain how the capex can be kept to \$125m). Cash costs are projected to be \$350/oz. On paper, this mine should generate at least \$30 million a year in cash flow. That alone would support a \$200m market cap for Carpathian.

- The Rovina Valley project in Romania has a huge resource: 7m ounces + 1.4bn copper lbs. And it's still growing. Management expects Rovina ultimately to be a 10m-ounce resource. The property is located in an active mining area of Romania. (Gabriel Resources, GBU CN, is developing a 14m-ounce project just 16 miles away. That mine will be the largest in Europe when completed.) Gabriel is two years ahead of Rovina in terms of metallurgy and drilling, says CPN management. On the other hand, Gabriel has a \$550m market cap, compared to Carpathian's \$67m.

Rovina has a 0.82 g/tonne gold grade (if you factor in the value of the copper) and a higher-grade core.

Permitting has gone smoothly. "We have never, ever had a problem," explains IR director Mike O'Brien. Carpathian's in-country manager for Romania is Alexandru Niolici, a Romanian geologist who previously had been CEO of a regional state-owned mining company there. He knows the people and the system.

The Romanian locals have been welcoming, says O'Brien. The project is in a historic mining district where unemployment is high. O'Brien says the local priests and the mayor support the company's plans.

The one drawback with Rovina is that it's still fairly early stage. CPN needs another two years to finish the drilling and metallurgy. Plus, it's definitely a greenfield site. There's no infrastructure. Capex to build the mine could be \$1 billion.

Valuation: I'm valuing Carpathian at US\$30/oz. on an assumed resource base of 12m ounces. That would imply a US\$1.24/share stock price, or 440% upside from current levels.

Victoria Gold (VIT CN) has two main projects: Cove in Nevada and Eagle in Yukon. It took me longer than usual to get comfortable with these assets, but the more I learned, the more I liked them.

- The Eagle project has indicated resources of 2.7m ounces -- and VIT thinks that figure may ultimately double. "We've got a pit outline, and the highest grades are at the deepest point, where they just stopped drilling," explains IR director Norman Chang. "There could be a million ounces in a larger pit design, and there are two other zones stepping out from Eagle that are higher grade." Three drills are on site right now.

The deposit is 90% oxide, and it could probably be developed as a heap leach project for \$200m, says Chang. "There's a big difference between 3m ounces in the Yukon that you have to mill and 6m ounces that you can heap leach." The latter method is far cheaper, and it's do-able in the Yukon because the climate is extremely dry. The deposit also is very *shallow*. The strip ratio should be better than 1-to-1, and may approach 1-to-2.

The politics of the region are fairly conducive to getting the project permitted, says Chang. All native claims have been settled in the Yukon, and the province has a new, pro-mining administration that wants to cut mine permitting time in half, to 1-1.5 years.

Geologically, the asset is similar to Kinross' Fort Knox mine, near Fairbanks. That mine produces more than 300,000 ounces/year – at a grade that is lower than Eagle's (0.49 g/tonne at Fort Knox vs. 0.85 g/tonne at Eagle). Kinross has constructed a heap-leach operation at Fort Knox, which shows it can be done at this latitude.

- Victoria has several Nevada assets of which Cove is the most interesting. It could be a very big project. Cove is a legacy open-pit operation, from which 2.3m ounces have been mined. A pre-feasibility study is in progress now (due 10/31) which will provide an updated resource estimate. The study may recommend underground mining from the old Cove Pit.

"If we go underground, it's essentially production right from the start," says Chang. "You just truck the ore to a nearby mill (of which there are plenty)." Chang says it would probably take about 9 months to permit the tunnel, so production could begin in a year from the publication of the pre-feasibility study.

The drill results from Cove have been excellent, including 13.9 meters at 37 g/tonne, and 10.4 meters at 22 g/tonne. "The Cove drill results were published when the market was crashing so nobody cared," says Chang.

While Victoria owns 100% of the Cove project, Newmont has rights to back in for 51% depending on how the resource estimate pans out.

Victoria also owns the nearby Big Springs resource, which is 1.2 million ozs. at a grade of 2.67 g/tonne.

Valuation: I'm assuming Victoria ends up with 8 million gold ounces, divided very roughly as follows: 5 million at Eagle, 2 million at Cove and 1 million at Big Springs. I then value those ounces at \$40/each, for a target EV of \$320 million. That represents 317% upside from the current market cap of \$77 million.

Part of the appeal here is Victoria's connection with Kinross. It was originally Kinross management that asked Victoria CEO Chad Williams to take the job. Victoria's Eagle project is exactly the sort of asset Kinross would be interested in, given its similarity to Fort Knox.

I'll be adding all four of these names to the Classical Insights portfolio.

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