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Medusa keeps it simple at its gold mine in the Philippines

SITE VISIT

BY TRISH SAYWELL

MINDANAO, PHILIPPINES — It's not the Abu Sayyaf guerrillas, 500 km away on the other side of the island, or communist rebels, or even the Moro Islamic Liberation Front, that should worry you on a trip to see **Medusa Mining**'s (MML-L, MML-A) gold mine in southeastern Mindanao, the second largest island in the Philippines.

It's the white-knuckle drive from the airport that could kill you. The three-hour road trip from Davao to the mine site along a busy two-lane highway puts you perilously close to running over villagers and animals — primarily small children and dogs — or colliding with motorcycles loaded with six or more passengers, or rear-ending lorries whose brake lights don't work.

On a recent site visit for investors, brokers and the media, Geoffrey Davis, Medusa's managing director, regaled the group with a tale of how he had once seen an overloaded truck almost tip its load on a curving section of the highway that was unlevelled and under repair. "They stopped and tied the load to a coconut tree to stop it moving any further," he said.

But seeing Medusa's high-grade underground gold mine, Co-O (pronounced Koh-oh), and learning more about the company's exploration projects in this richly mineralized part of Southeast Asia, is well worth the trip.

The gold mine is situated along the Diwata Ranges, which form part of the East Mindanao Ridge, a mineralized region with a mining history dating to before the Second World War.

The Diwata Ranges are to the east of the region's main structural feature — the Philippine Rift Fault — which stretches about 1,200 km in a northwesterly direction from southern Mindanao to northern Luzon and provides the region's main source of volcanism and mineralization.

BY TRISH SAYWELL

A gold bar is submersed in hydrochloric acid at Medusa Mining's Co-O mine in the Philippines.

Medusa's tenements lie between the gold and copper districts of north Davao in the south and Surigao in the north.

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Geoffrey Davis, CEO of Medusa Mining; Bill Phillips, director of operations at Philsaga; and Manuel Barbas, mine manager, at Medusa Mining's Co-O gold mine in the Philippines.

"We've got over 800 square kilometres of the best structurally prepared and mineralized ground in Southeast Asia," Davis says.

Medusa's flagship asset — the Co-O mine — lies on the west bank of the Agsao River, about 20 km east of the Philippine Fault and 140 km north of Davao. The mine is believed to lie within a 15-km-diameter truncated caldera, identifiable from volcanic and geographical features. (Calderas are known to be favourable for gold and base metal mineralization.)

The high-grade, low-cost mine produced 47,869 oz. of gold at an average head grade of 13.3 grams gold per tonne and at a cash cost of US$213 per oz. in the fiscal year ended June 30, 2009. And it's on track to produce even more: 86,000 oz. gold in the year ending June 30, 2010, and 100,000 oz. the year after that.

"We're going to get to 100,000 ounces very soon and we're doing that primarily through development — we're not even more than 50 per cent stoping yet," says Jono Lawrence, Medusa's exploration manager.

With record-high gold prices moving into uncharted territory and already up about 30% so far this year — Medusa's news in August that it might have a second gold mine on its hands at Bananghilig, about 25 km north of the Co-O mine, along the Barobo Fault Corridor — came as music to the ears of its shareholders.

The company's share price on the Australian Stock Exchange has rocketed from under A50¢ per share in November 2008 to about A$4.19 today — about a 700% increase.

"Some of the bigger brokers are starting to take notice of us," Davis says. "We're number six or seven on the list of the biggest gold producers on the ASX and the lowest cash cost producer."

Soon, Medusa will attract even more attention, with its Nov. 27 debut on the Toronto Stock Exchange under the ticker symbol MT.

Substantial shareholders include Rex Harbour & Associates with 12.3%; Advanced Concept with 6.47%; and Sprott Asset Management with 5.37%.

"(Eric) Sprott is a very happy chap," Davis says. "He likes what we do."

Holding the tiger by the tail

The rocks at Co-O are about 30 to 40 million years old, from the Tertiary age, and visitors are lowered underground in a skip to see them.

"In 2002, Philisaga Mining Corp. was mining it with hammers and chisels and extracting about 2,000 ounces of gold a month," Davis says. "The project has only had an explosives licence for the last three and a half years since Medusa acquired Philsaga."

"This is how they were mining sixty years ago," adds Bill Phillips, director of operations of Philsaga, Medusa's local partner. "You keep it simple. It's very effective."

Medusa — through Philsaga Mining — took possession of Co-O in December 2006. Medusa and its subsidiaries control Philsaga, a company set up by Phillips and his Filipino partner, Col. Samuel Afdal (Sammy), its president.

Phillips, a veteran narrow-vein gold miner from Kalgoorlie, is in charge of running the mine, while the retired army colonel looks after security and nurturing the political and community relationships needed to operate successfully in the Philippines — and Mindanao in particular.

But it's Phillips who knows the mine best and how to operate it. "When I first looked at this mine, I could see that all the ingredients were there," he says. "This is my thirteenth mine and it is the best one in terms of size, grade and workforce."

Of the 13 mines Phillips has owned, one was in Indonesia and the rest were in Australia. But he has looked at mines all over the world — including in China,

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New Guinea, and Russia. "This one had a good chance," he says of Co-O. "I figured if we did it together with Sammy, it would be okay. It would have been nearly impossible without him."

He adds: "It was also a good price."

That was partly due to the alignment of several factors, including low gold prices, the dot-com bubble, and spotty management — including a period when it was owned by Musselbrook Energy and Mines. Musselbrook was owned by the late Australian media tycoon Kerry Packer — who at the time of his death may have been the richest and one of the most influential men in Australia — but was not someone with a great deal of mining experience.

By the time Packer walked away from it in 1992 after producing 60,000 oz. of gold at a loss, debts had piled up. "I don't think Kerry really wanted to be in mining, really," Davis muses. "By the early 1990s, the whole operation was unviable."

For seven years, Co-O was put on care and maintenance before a company called Philippine Gold took it on. But by the time Davis started consulting for Philippine Gold in July 1999 — the company was nearly bankrupt and his mandate was to sell the mine as quickly as possible.

"I was told to try to sell anything I could to pay the bills — there was no international phone line, no fax line. It was a bloody nightmare," he recalls. "But at that point, you couldn't sell anything. It was the dot-com era and nobody wanted to hear about mining."

Not only that. Philippine Gold had US$4.5 million owed to creditors and about 37 court cases against it, Davis says. "There was a hold on some of the Co-O land titles."

Even so, when Phillips came in to take a look at it, he knew almost immediately that he wanted it.

"Bill and Sam bought the Co-O mine in 2000, when gold was at US$256 per oz. and formed Philsaga to own it," says Davis. "Everybody thought they were crazy."

Phillips has lived in the Philippines ever since. Davis formed Medusa in 2002 and floated it on the ASX. Its IPO in 2003 included a joint venture with Philsaga. Following Medusa's acquisition of Philsaga in December 2006, the group started redeveloping the mine and exploring the surrounding tenements.

The Co-O mine currently has a 1.4-km strike length and multiple orebodies. The Great Hamish vein, with an average grade of about 30 grams gold per tonne, contains more than 300,000 oz. gold, and is the largest vein, stretching about 800 metres in length.

The mine currently extends down to a vertical depth of 200 metres to the fifth level, but a sixth level 50 metres deeper will be completed early next year.

Currently, Co-O has an indicated resource of 1.25 million tonnes grading 15 grams gold per tonne for 603,000 oz. gold. In the inferred category, Co-O contains 2.73 million tonnes grading 8.9 grams gold per tonne for 777,000 oz. An updated resource estimate will be ready for release in the middle of January.

Based on its reserves, Co-O should provide at least five years of production at a rate of 100,000 oz. gold per year. Probable reserves stand at 1.04 million tonnes grading 14.9 grams gold for 500,000 oz. gold.

"We've got tens of kilometres of development to complete sequentially so we can start stoping veins as the development progresses," Lawrence explains. "Development dirt is running at between 7-12 grams gold per tonne. . . I think it's going to be a twenty-year mine without any trouble."

Adds Davis: "We don't know how big Co-O is going to get. We think it could go to 3 or 3.5 million ounces."

For now, however, production is ticking along smoothly at a time when gold has reached historic highs and Medusa's cash costs by industry standards are at record lows. And Medusa will have completed the expansion of its carbon-in-pulp plant, 12 km north of Co-O, to 1,000 tonnes per day (up from 550 tonnes per day) in December.

In the third quarter ended Sept. 30, production reached 18,054 oz. gold, up from 16,009 oz. in the previous quarter, at an average grade of 14.7 grams gold per tonne and at an average cash cost of US$193 per oz. (or US$150 per oz. before taxes, royalties, and local production taxes).

Longer term, the mine's cash costs are forecast to be in the range of US$200 per oz. That's partly due to low drilling and labour costs. At about US$140 per metre, drilling costs in the Philippines are very low compared to an industry average of about US$200 per metre, while miners, depending on their skill set, earn wages of between US$100 and US$500 per month.

Medusa also takes advantage of being a small company with low administrative costs. "With big companies, about 30 per cent of their budget is spent on drilling, but much of it goes to overhead," Lawrence explains. "Close to 90 per cent of our budget goes into drilling costs and field work. It's not wasted on overhead."

In addition, the Philippine government's Bureau of Investments has granted Medusa's processing company a four-year tax holiday (corporate taxes in the country run at 30%), which the company can apply to extend for one year, as many as three times.

In total, Medusa pays a 2% royalty to the government on gross gold sales and 1% to indigenous people. Thirty per cent of the royalty payment to the indigenous people goes directly to the community, 30% is managed by the local and regional Indigenous Peoples Department, and 40% goes to the indigenous people who own the land. Medusa is also required to provide about 1% of its costs of production to the local community, who choose how the money is to be spent.

With A$25.6 million (US$23.5 million) in cash and no debt, the unhedged gold

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producer says it plans to spend about A$14 million on exploration in the current fiscal year, although that number could go up as results dictate. Last year, Medusa spent about US$12 million on exploration.

Ten geologists and 12 drill rigs are actively exploring the rest of its tenements. Currently at the Co-O mine, Medusa has six rigs at surface and three underground. Two others are drilling vein systems around Co-O. By March or April next year, there will be four drills working underground.

"I'll still be exploring here for the next twenty years," says Lawrence. "Mark my words: There will be other Co-O's."

A second mining front

In August, Medusa released a JORC-compliant maiden resource at Bananghilig in the northern portion of the company's claims, along the Barobo Fault Corridor in the Tambis district.

At a cutoff grade of 0.6 gram gold per tonne, Bananghilig, which is open in all directions, has an inferred resource of 15 million tonnes at an average grade of 1.3 grams gold per tonne for 650,000 contained ounces gold.

The Bananghilig resource brings Medusa's total resources to more than 2 million oz. gold (Co-O's global resource is 1.38 million oz. at 10.8 grams gold per tonne) and the company believes the high-tonnage, low-grade deposit will propel it to the status of an upper mid-tier gold producer.

"Bananghilig's gold grade is low compared to that at Co-O (averages 10.8 grams gold) but, with the resource located close to the surface, a more economical open-pit operation is likely," writes Thomas Jones, a mining analyst at Growth Equities & Company Research in an Aug. 13 note to clients. "The 650,000-ounce resource has the potential to grow as the company continues exploring the 18-km corridor along the Barobo Fault."

Many of the significant intersections have gold mineralization starting from surface.

Drill-hole intersections have included 2.42 grams gold over 205.9 metres; 2.13 grams over 182 metres; 3.96 grams over 116.5 metres; 8.4 grams gold over 64 metres and 0.64 gram gold over 569.9 metres.

Philsaga undertook underground exploration at Bananghilig from 2005 to 2007 through a 50-metre shaft, adits, and underground and surface drilling totalling 7,716 metres in 31 holes.

The majority of the resource is contained within a 0.2-gram-gold-per-tonne domain measuring 850 metres east to west, and 550 metres north to south, with the mineralization defined to variable depths of 100-150 metres due to drill-hole depth constraints. The mineralization is open in all directions.

A second and smaller domain to the northeast is about 375 metres long in a northeasterly direction, about 100 metres wide and open beyond 75 metres depth, with increasing grades to the northeast.

The deposit is on the northern edge of a large aeromagnetically defined alteration zone measuring about 9.5 by 7.3 km. The zone also contains Medusa's Kamarangan copper porphyry prospect, which has indications of molybdenum mineralization as well.

Davis says that subject to the completion of a successful feasibility study and with field work starting in July 2010, Medusa aims to outline sufficient resources to justify building a new milling facility at the northern end of its landholdings with a production capacity of about 200,000 oz. gold per year.

In addition to Banganghilig, Medusa has six porphyry copper-gold targets including a copper deposit called Lingig, east of the Co-O mine.

Lingig was first spotted in 1972 by a joint venture between Japan and the Philippine government.

Medusa started drilling Lingig in August 2008. Recent intersections have cut 0.25% copper over 209.1 metres and 0.4% copper over 159.7 metres.

"The big prize will be finding the source of the copper," Lawrence says. "Hopefully, we'll find clean copper."

Since it started drilling Lingig in June 2008, Medusa has drilled about 10,400 metres. There are three drill rigs on the project.

But what about security?

In 1980, the Philippines, a country made up of 7,107 islands between the Philippine Sea and the South China Sea — was the fourth-biggest gold-mining country in the world and a large exporter of copper concentrates, Davis says. (The Diwalwal gold mine, for instance, just 50 km south of Co-O, has been estimated to have a resource of 7 million oz. gold and the vein system is very similar to that of Co-O.)

But investors have been wary of the country, particularly the island of Mindanao, which has experienced four decades of on-again, off-again conflict between the government and Muslim rebels, who have been fighting for self-government.

"The violence has cost an estimated 120,000 lives, facilitated the growth of at least one al-Qaeda-linked terror group and has stopped and started through a number of still-born or half-begotten peace deals," Simon Roughneen, a Southeast-Asia based freelance journalist, wrote in an article in August published in the newspaper *Asia Times*.

The website of the Overseas Security Advisory Council, or OSAC, part of the U.S. government, warns visitors "should exercise extreme caution" when travelling in the central and western portions of the island of Mindanao — specifically the provinces of North Cotabato, Lanao del Sur, Lanao del Norte, as well as the Sulu Archipelago.

But Medusa, which operates in eastern Mindanao, isn't worried at all about the

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violence in other parts of the island.

"The areas of ethnic tension are 500 km away on the southwest side of the island," Davis says. "Security issues can be a problem in the southwestern corner of Mindanao, but on this side of the island we don't have those problems. . . About 99 per cent of the population here is Christian. . ."

Sammy, who resigned from the army to manage security for the mine when it was owned by Kerry Packer in the early 1990s, says the groups advocating violence in the country would not gain a foothold in eastern Mindanao — a region where less than 1% of the population is Muslim.

He also said the company takes corporate social responsibility very seriously.

"The people are our first line of defense," he explains. "Most of the problems disappear once the economy develops."

Apart from the mandated royalty payments, Medusa and Philsaga through a foundation, support 2,000 students in 16 schools and provide scholarships and educational assistance to local school children. It also builds, repairs and maintains community halls, daycare centres, and local infrastructure such as roads and bridges; provides interest-free loans to rice farms; and supports water and reforestation projects.

Says Davis: "We've got good relationships here. This is where we want to be."