

# Looking Favorably on Medusa Mining

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October 22, 2010 | about: [ANDPF.PK](#) / [DMMIF.PK](#) / [GBG](#) / [GG](#) / [KGILF.PK](#) / [MNEAF.OB](#) / [SGRCF.PK](#) / [XSRAF.PK](#)

With the recent purchase of Andean Resources ([ANDPF.PK](#)) by Goldcorp ([GG](#)) and the operational success of several underground gold and silver mines -- largely thanks to elevated metal prices -- the industry is starting to place some of its attention back on mining companies whose employees generally lack a good tan. Underground mines tend to be complicated in relation to their open pit cousins and nowhere is the complexity more pronounced than in the economics associated with an underground operation. With an open pit mine you typically need to define a large resource in order to support a construction decision but due to the bulk nature of the deposit the drilling may not have to be very complicated or extensive. By contrast, the majority of mineralization in an underground mine typically does not get defined to reserve level prior to a construction decision in part because the drilling required to "chase" a vein can be very extensive and expensive. Indeed, many underground mines never define more than 5-10 years worth of reserves at any time yet they continue to operate for many decades. They simply wait until mining takes them close to the edge of the current reserve blocks before conducting new discovery and definition drilling, though as we shall see below all long-lived mines have certain world class features in common.

The difference between mine types is significant enough that we are considering dividing our upcoming Mid-Tier Gold Producers Report between companies that have predominantly underground mines vs. open pit. In our recent [Silver Producers Report](#), we have already adjusted the underground mining statistics to take into account resource expansion that has been drill-tested but not yet officially entered into the mine plan. Our approach to mid-tier gold producers with underground mines will likely be similar.

In the meantime, we would like to take the opportunity to look closer (risking the possibility of turning to stone) at one underground gold miner that has an important feature in common with many open pit mines: a very low operating cost. That company is Medusa Mining ([MDSMF.PK](#)), the new mid-tier gold producer in the Philippines that is having a hard time knowing what to do with all the cash that its flagship Co-O Mine is throwing off -- so in a fashion entirely agreeable to us it has decided to pay a dividend. The market cap of Medusa may look rich for the current production profile and resource base but the distribution, size and extent of the classic epithermal gold veins at Co-O suggest that the deposit could be a long-lived, world-class asset. The mine is already producing gold at an extremely low cost thanks to consistently-high grades and relatively cheap Philippine labor (not to mention the 7 year tax holiday granted by the Philippine government). We wouldn't necessarily buy here but then again Medusa doesn't look to us all that different an opportunity than Andean, and Goldcorp did cough up US\$3.4 billion for that one.

The key to evaluating an underground mine like Co-O is not necessarily the current resource figures but rather the nature of the veins: do they show grade continuity and width consistency, do they extend along strike or dip for hundreds to thousands of meters, are there parallel veins or structurally-favorable zones nearby that are mineralized in a similar manner? The answer to one or more of these questions must be yes for the vein system to be considered highly prospective and two or more yes answers are usually required for a designation as potentially "world class". Of course ultimately the most important thing is the cost of pulling the gold out of the ground, yet not every world-class underground gold deposit will necessarily score well in that regard. Indeed, there are only a few consistently profitable underground gold mines out there: Goldcorp's (NYSE: [GG](#)) Red Lake operation comes to mind as do a couple of underground gold mines in Nevada and South America.

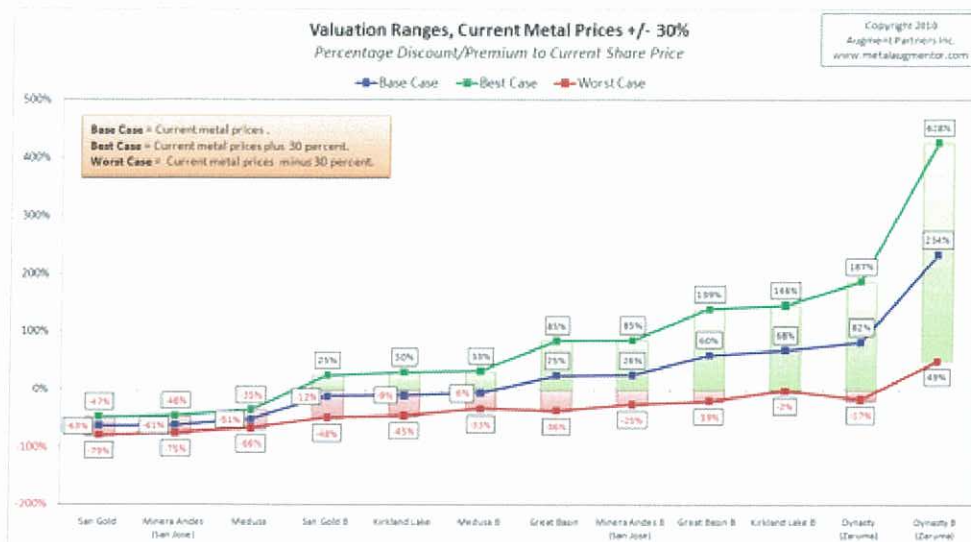
And then there is Medusa and its Co-O Mine, which turns out to be unique among the mid-tier gold producers in terms of profitability. Indeed, looking through our model we could find only a few other companies with similar potential for highly-profitable, world-class underground operations. So without further ado, let's take a look at some of them.

### Peer Group Comparison

Before we get into the details, it should be noted that for the purposes of this analysis, Dynasty Metals ([DMMIF.PK](#)) and Minera Andes ([MNEAF.OB](#)) are only being evaluated based on their Zaruma and San Jose projects respectively. In other words, we are excluding Minera Andes' large Los Azules copper project in Argentina and Dynasty's developing Jerusalem and Dynasty projects in Ecuador. The reason for doing this is that we are analyzing only flagship operating assets in this particular comparative exercise and not potential development assets. Such exclusions aren't trivial. The Los Azules project boasts a \$5+ billion net present value at current copper prices and Dynasty's Jerusalem and Dynasty projects, if developed, would together more than double the company's gold production profile. But there are nevertheless substantial risks associated with these projects. For example, the capital cost of Los Azules is estimated at over \$3.5 billion. Such a sum at least partially explains why Xstrata ([XSRAF.PK](#)) walked away from its back-in option in late 2009 -- that and the fact that Xstrata has its plate full with other copper development projects. The point is that these exclusions actually improve the quality of the peer comparison, and since the excluded assets are not flagship projects to which the market currently ascribes significant value, our approach isn't really out of line with market perception.

The following comparative valuation chart illustrates Medusa's relative positioning among a chosen peer group of similar size (mid-tier production range of 100,000 to 1 million ounces gold per annum), high grade, potentially world-class underground gold producers. For purposes of this analysis, we evaluated all of the companies using two sets of assumptions. The first set assumes that the mine life is only long enough to deplete the current proven and probable reserves (in the case of one company that does not have reserves, we used measured and indicated resources), which is obviously a faulty assumption given that we are looking at supposedly world-class mines that should be capable of replacing current reserves with new discoveries for several decades into the future. The second set, marked "B", assumes a mine life of 25 years, which in our discounted analysis is essentially equal to "forever" since production beyond 25 years will only add very small amounts to the overall valuation. For the most part the mines being operated by these companies *do* appear to have the potential for long-lived operation of 25 years or more. We did not assume an increase in annual gold production within either set of assumptions unless that increase is in the process of being "baked in" due to board-approved expansion plans or ongoing feasibility studies.

Below is one of our most-useful charts -- target valuation ranges based on different metal prices. This is just a starting point and investors interested in greater analytical detail will want to construct charts that present peer valuations from several different perspectives or simply consult the work we've already done.



*[Note again that companies with an appended "B" represent a scenario in which all mine lives are 25 years regardless of current resource and reserve base.]*

To our surprise, the valuation range of Medusa and its peers in the baseline case reveals distinct groupings. Medusa, Minera Andes and San Gold ([SGRCF.PK](#)) carry the greatest premiums while Kirkland Lake Gold ([KGILF.PK](#)) and Great Basin ([GBG](#)) appear fairly valued and Dynasty appears somewhat undervalued. Note again that these groupings are based on the first set of assumptions under which mine life is limited to currently-defined proven and probable reserves (except Dynasty, where we used measured and indicated since it does not have reserves). The foregoing along with difficulty ramping up production and taxation/royalty uncertainties in Ecuador can adequately explain why Dynasty is trading well below its valuation target.

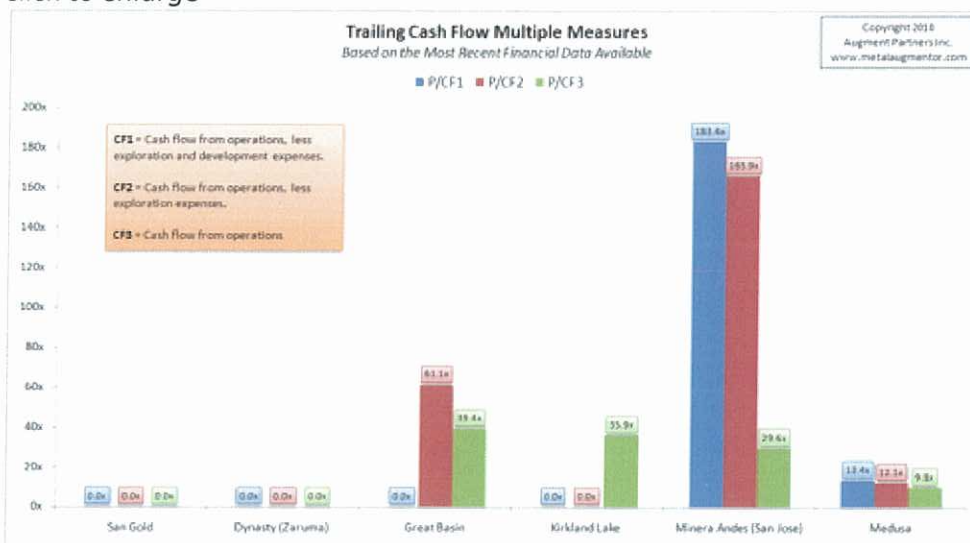
The grouping of Kirkland Lake and Great Basin requires a subtler explanation -- in essence, these two companies carry a chip on their shoulders in terms of proving to the world that their mines are world class. Not coincidentally, both Kirkland Lake and Great Basin have plans to ramp up production substantially during the next few years. If this cannot be done on schedule, or more likely if profitability is delayed while significant expansion costs are incurred, their share prices are unlikely to sport premiums. On the other hand, if these two companies can achieve the aggressive goals that management has set out, there is substantial upside to their share prices purely as a result of positive operating performance.

That is not the case with the three companies trading at a premium to baseline valuation, where merely positive operating performance is already baked into the share price. Indeed, it turns out that Minera Andes and San Gold have more in common with Medusa than just the same placement in our hypothetical valuation range: all three companies are producing roughly 100,000 ounces of gold from operations grading above 10 grams per tonne gold equivalent, all three have relatively short mine lives based on current proven and probable reserves, and none of them have "baked in" plans at this point for a major expansion in production beyond the 100,000 ounce per annum range (note that Minera Andes is entitled to 49% of production from San Jose). So it would seem to us a useful exercise to compare these three gold producers directly. The hypothetical "B" case presented in the above target valuation chart helps in this regard, indicating that San Gold gets the least boost from an expansion in mine life to 25 years followed by Medusa and then Minera Andes. This order pretty much follows the present size of the proven and probable reserves of each respective company and therefore it may be appropriate to consider San Gold as having the lowest "discovery risk" and Minera Andes the highest (though their recent discovery certainly helps in this regard).

Were we to include Minera Andes' Los Azules copper project in this analysis, the company would appear very undervalued. But considering most if not all copper developers look significantly undervalued despite the current copper price environment, this is nothing to cheer about. On the other hand, our detailed review of the Los Azules project parameters reveals the deposit to be ideal for exploitation by open pit and the project could represent very substantial value to a company willing to continue permitting and feasibility work in light of the massive capital commitment. Similarly, if Kirkland Lake can execute on its growth plan while bringing grade and operating costs in line with expectations, it could deserve the valuation range indicated in the above chart. Finally, Great Basin might see continued strength if Burnstone moves into production with few hitches.

In the extended peer comparison analysis provided for subscribers of the Metal Augmentor service, we delve much deeper into a variety of valuation measures and operating metrics, but there is only so much we can do in this public format without getting too bogged down. So we'll dispense with further details and cut to the chase, which is that Medusa's profitability trumps other factors that indicate Minera Andes and San Gold are equals -- they won't be until they also achieve stable, profitable operations at production capacity as illustrated by the chart below:

*click to enlarge*



In conclusion, Medusa Mining may appear richly valued based on its current production profile, but considering the potentially-world-class nature of the Co-O mine and the recent achievement of highly-profitable operations, a comparison to peers like San Gold and Minera Andes has us looking favorably in Medusa's direction. Kirkland Lake, Great Basin and Dynasty are in a different league and while each one has some things going for it, an investor looking purely for leverage to higher gold prices (and perhaps participation in the gold miner buyout frenzy) may want to look in the direction of Medusa as well.

**Disclosure:** Long DMMIF.PK, Long GBG

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