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Recovery play?

By Ian Mclelland

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…this situation may present value to investors who like turnaround stories, and who believe in the ongoing fundamentals of gold, with an opportunity – especially as higher grades of ore are now available to effect production.

Norseman Gold, which is operating, refurbishing and redeveloping Australia's longest running gold mining operation, has hit a bump in the road. Gold production was below target for the three months to 31st January 2008. This was due to an unexpected run of lower grade ore on the Norseman Reef at the Bullen underground mine, and to slower than anticipated development of the Redfin reef at the Harlequin underground mine. Lower grade ore and lower throughput, plus increased re-equipping, redevelopment and staffing costs, put pressure on free cash flow; this hit the ability of the business to move into profitability. As Norseman Gold's story is "high cost gold producer with new turnaround management working to lower the cost of production and make profits", the market punished Norseman, pushing the shares to a new low of 28 pence before rebounding back to 32 pence. However, this situation may present value to investors who like turnaround stories, and who believe in the ongoing fundamentals of gold, with an opportunity – especially as higher grades of ore are now available to effect production.

Norseman Gold owns and operates the historical Norseman Goldfield, which first went into production in 1894, and has produced over 5.5 million ounces of gold in its time. Ore is currently sourced from two high-grade narrow-vein underground mines - the Bullen and the Harlequin. The Norseman mining centre currently has total resources of 1.9 million ounces at a grade of 4.1 grams per tonne of ore (g/t), with reserves of 329,000 ounces at a grade of 8.6 g/t. Because the mining centre was run down over a number of years the company needs to build up its ore resources and reserves, to support its drive towards producing 100,000 ounces of gold a year.

About a year ago, David Steinepreis - a serial dealmaker - took the plunge and reversed Davos Resources into Norseman, and completed equity financing which was substantial enough to turnaround a mine that was on life support. Since then, the task at hand has been multi-faceted. First, move the mine back into profitable production. Second, and running parallel to task one, invest in new equipment and staff to build up a steady, reliable production profile. Third, expand the resources beyond the revolving three-year model used previously. Fourth, move the mine back to maximum throughput. Not an easy task list by any stretch of the imagination, but having completed the takeover, Norseman should achieve a result on three of these four goals in 2008.

Despite the missed production target in the most recent quarter, Norseman Gold is still on track to be operationally cash flow positive this year. Production for the year ending June 2008, has been revised down to 75-80,000 ounces of

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gold, with a cash operating cost increased to A$730-760 per ounce against an average price received in the last quarter of A$935/ounce. About a year ago, when the Norseman turnaround story was just starting, gold was trading in a range below its May 2006 peak of US730.5 (A$944.8) per ounce. However, looking at the price of gold in US dollars when thinking about an Aussie gold producer can be deceptive because its value tends to increase much faster in US dollars than it does in Aussie dollars. So with gold near all time highs in US dollars, the goal remains the same for Norseman - produce gold at around A$730-760 per ounce. The converse also tends to be true; when the price of gold falls in US dollar terms, the US dollar tends to depreciate against the Aussie dollar, which will probably leave Norseman with the same goal - produce gold at around A$730-760 per ounce!

So, assuming that priced in Aussie dollars, the gold price remains static for the rest of this operating year, and Norseman comes in at the high end of its cash cost guidance, the company should post A$70 million in revenues and A$12 million free cash flow to the end of June 2008. Norseman is widely expected to post an overall loss for the year, as it has major capital expenditure and resource definition programmes still underway. But for most investors, the really important news will be the production levels in the final few months of the current year and guidance for the twelve months to June 2009.

Lower cash costs and higher production rates are anticipated as a result of improved mining equipment and higher grades at its two underground mines, plus plans to add a third, open pit, mine in early 2009. Resource definition drilling is expected to get underway in the next few weeks at the Lady Miller ore body, which already has 42,000 ounces of gold resource and the potential to add at least another 12 months mine life to the operation.

Norseman expects cash costs to fall towards A$550-A$600/ounce by the end of June as ore grades rise again, and this is already happening. The lower than expected grades at the Norseman reef were situated between the miners and a run of higher grade ore, and all you can do in an underground mine is chew though the stuff that is in the way. The problem at the Redfin reef was simply to do with having enough free cash flow to service all the company's priorities, including completing the access needed to get at higher grade ore …faster! So, the rising grades at the Norseman and Bullen reefs will help absorb fixed costs such as equipment and staff, improve free cash flow, support development, and help to move the company towards net profit.

Norseman, recently confirmed that, having hired two exploration geologists and a mine financial controller, it had finally reached full staff levels – Australia is now very short of experienced mining personnel. A full staff complement, reducing the need for external contractors, and an A$9.5 million fleet replacement programme are expected to cut Norseman's operating costs by A$3.1 million per annum. So it is credible that the company can settle down and move towards its goal of delivering 100,000 ounces of gold, or thereabouts, in 2008/2009, at around A$600/ounce. This would put Norseman closer to the middle of the cash operating cost league table in Australia, and firmly in the "mid-tier" range of AIM gold producers.

Norseman Gold's Broker, Blue Oar Securities, recently revised its forecasts for the company. In a recent research note, Blue Oar pencilled in a 'conservative' production target of 96,000 ounces for the year ended June 2009, with cash costs of between A$550-600/ounce. This gives earnings per share of 11 pence on profit before tax of £12.3 million, putting Norseman on a lowly profit to earnings ratio of 3.0 in 2009.
Looking ahead, Blue Oar values Norseman at between 50p and 108p per share; the higher valuation assumes that the company stays on track with production, extends the reserves of its currently operating mines and commissions its third mine early. In their recent research note, Ocean Equities, also brokers for Norseman, point out that compared to its peers, Norseman appears undervalued by various measures, including: ounces of gold actually produced, and forecast gold production.

Norseman still had A$14.5 million of cash as of January 31st, which combined with the mine investment plan, resource definition drilling, and continued building of the production profile, makes this gold producer a tempting proposition at these levels. Considering the medium to long term, the US dollar appears to heading one way, so the overall outlook for gold remains bullish – a declining US dollar attracts buyers to gold, as a safe haven, and this stimulates demand for gold which eventually pushes its price up in all other currencies. If Norseman can deliver better production in the near to medium term, investors willing to take the plunge could be rewarded handsomely for their faith.