FROM THE CAPITAL

Diversification or doubling up?

Assessing the benefits of a second mine not as straightforward as 1, 2...

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Addressing the Denver Gold Forum recently, Perseus Mining Ltd chief executive Jeff Quartermaine expressed "a strongly held view" that being a single mine company in West Africa "is a fairly perilous thing to do".

The idea that a second mine will offer some form of value enhancing diversity is frequently advanced as though two mines are always better than one. Any justifying rationale is far more subtle. A diversification argument depends on the additional asset having uncorrelated returns with the first. In the extreme, if the returns are no different and highly correlated, there is no diversification benefit. Most times, companies espousing the diversification thesis do so without any such analytical backing.

At one level, ASX- and TSX-listed Perseus is among the more successful international miners. It has made the transition from explorer to producer with a 3.1Moz reserve base and gold output at its Edikan mine in Ghana running at about 200,000oz/y.

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In common with others in the industry, a weakening gold price will be creating some anxieties. The company's guidance suggests that all-in costs will straddle US$1,200/oz in the current half year. Efforts are being made to get costs closer to US$1,000. A key step in that direction will involve the company extricating itself from obligations to its contract miners and possibly moving to an owner operated production model during 2015.

Perseus' primary contractor has apparently been able to pass on costs with little constraint. As a result, wages growth among the contractor's employees was not taking account of the company's ability to pay and Perseus faced a rising cost structure.

More broadly, Perseus' cost pressures were being fanned by the companies in the region

Perseus Mining's Edikan mine in Ghana is producing about 200,000oz/y

most able to pay. Having wages set at the margin by the most mobile workers and those able to pay the most is nothing unusual. In the gold mining industry, that means companies with the highest grades can call the tune for the rest.

Individual companies can take steps periodically to scale back such pressures, but they will tend to arise again simply because it will be in the best interests of someone to bid a higher price for the resources they need to get a job done. Unable to quarantine themselves from such pressures, companies must keep coming up with fresh ideas while recognising any gains will soon be eroded as competition for resources continues.

In this sense, gold miners like Perseus are at the mercy of market forces continually eating away at their profitability. Perseus is not alone, despite Quartermaine intimating during the Denver presentation that Perseus had been singled out by investors whose dissatisfaction resulted in what he described as an "inelegant" exit in mid-2013.

The period between October 2012 and June 2013 was not a happy one for many gold miners. Of those in the All Ordinaries gold index, for example, the median share price decline was 66%. Perseus was at the upper end of the range of losses but, in the lead up to commercial production in January 2012, the share price had risen by over 300% while the index had climbed just 23%.

The timing of the decline in the Perseus share price coincided exactly with the decline in the gold bullion price and the gold share price index. This suggests Perseus had more than average leverage to the macro conditions at the time but that the timing of company-specific events was not driving the investment outcome.

Perseus was poised for a fall as soon as market conditions became less forgiving. Even when the price was A$2.40/share (US$2.20/share), Goldman Sachs had a valuation of just A$1.48 reflecting the underlying economics of the business. In mid-2012, Perseus achieved an annualised production rate of more than 200,000oz and was forecasting production as high as 265,000oz in the following 12 months. Since then, for the financial year just completed, production was only 180,519oz and costs had risen to US$1294/oz, resulting in a A$31 million loss.

For its size, Perseus is cheap with a market value of A$175 million. A valuation several times higher would be consistent with other companies in the sector with similarly sized output. The fundamental problem faced by Perseus is a cost structure that is too high to sustain a better market value.

Its costs are likely to be lower in the year ahead, but it will not have the ability to radically transform a cost structure dictated by a combination of geology and market forces. Achievable reductions might barely compensate for a lower gold price. So, could Perseus investors have been better off with the same experience in two mines simultaneously, rather than just one?

One argument sometimes put for having more than one operating mine rests on the idea that operational failures at one would still permit production at the other to cushion any adverse market impact.

In April 2014, Perseus did report a production failure after a fire in the processing plant at the Edikan site. The share price fell 13%, but the index also fell by 6% and the share price had fully recovered by June despite the index being down another 8%. The market appeared happy to concede that this event should not have any lasting impact.

If a second mine is there to be developed with a suitable return on capital, it should proceed. On the other hand, if Perseus had just one mine with costs closer to US$800oz, say, and producing steadily at 200,000oz and perhaps paying a dividend, the search for a second mine might lose some intensity.

The 'two mines are better than one' hypothesis is based on flimsy ground if it ignores the underlying sources of value recognised by the market. Too often, the second-mine argument mirrors a loss of confidence about operational outcomes at the first mine, rather than a strong analytical case for a change of strategy. ▼

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