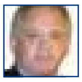
Insight: From the capital

Bulking up is never easy

Northern Star needs exploration gains to succeed on the world stage



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Northern Star Resources Ltd is openly setting itself up to attract global investors. To access these investment heavy-hitters it must get bigger, but not at any cost, says the company. Meanwhile, the fortunes of everyday investors will be hanging on whether those US institutions promising support for a bigger entity deliver their side of the bargain and re-price the shares.

Northern Star is one of the success stories on the Australian mining landscape. It bought the Paulsens gold mine from Intrepid Mines in July 2010. Despite an imminent slump in sector values, its share price bucked the trend over the next 28 months for a thirty-fold rise.

Some of the gains were subsequently lost, but, since the cycle peak at the beginning of 2011, Northern Star investment returns have been among the top 2% in the sector. No wonder the hearts of shareholders and investors have generally skipped a beat.

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Northern Star was in the right place at the right time. Growth opportunities for a mine that had already been producing for five years seemed limited. The gold price was still battling to break above US$1,000/oz. Intrepid Mines Ltd thought it was going after something far better in Indonesia.

Northern Star, merely a shell headed by an experienced operator of a contract mining business, was on the lookout for production. Intrepid gladly took A$40 million (US$37.5 million) not suspecting the asset would generate a A$73 million operating profit in its first year under Northern Star control.

Here was real value being added. Now, Northern Star managing director Bill Beament is laying out his experience as an astute buyer of assets and capable mine operator in soliciting support to replicate the Paulsens model.

For all the operating acumen brought to Paulsens by the new team, good fortune also

Star on the rise? Northern Star has, so far, enjoyed its time in the spotlight

came in the form of higher gold prices. In the last year of full production under Intrepid, the Paulsens mine produced 75,089oz for a US$31 million gross operating profit. In the year ended June 2012, the second year in which Paulsens was in the hands of Northern Star, the average gold price was a full US$797/oz higher.

Despite the surging gold price – worth the equivalent of an extra A$60 million on Intrepid's earlier production – the Paulsens profit only amounted to A$57 million. Rising costs and lower production had taken their toll.

On the more positive side, the Northern Star team has still done better than many. Production this year is running at around 100,000oz, but the industry bugbear – costs – have inflated further. All-in costs well under A$1,000 are a distant memory.

So, the question now is whether Northern Star can reproduce the investment success that came with the acquisition of Paulsens. The numbers say its chances are as slim or as likely as another doubling in the gold price.

That leaves the company relying on the potential gains from a bulked up business being re-priced in international markets. Beament is understandably eying covetously the production and reserve valuation multiples for some of the larger international gold miners.

Recent acquisitions from Barrick Gold Corp of its interests in the Plutonic, Kanowna Belle and East Kundana gold operations in Western Australia will take production from Paulsens' 100,000oz to 350,000oz for the company as a whole. Beament has also foreshadowed a push beyond this to around 600,000oz of annual production.

That would leave the company edging toward the likes of Eldorado Gold Corp, Buenaventura, African Barrick Gold and Iamgold Corp, whose 2014 production rates are expected to run between 650,000oz and 850,000oz.

These four internationals had an average market value of US$3,300/oz of anticipated 2014 production at the end of April. If the same metric was applied to Northern Star's current production, its market capitalisation would rocket from A$600 million to A$1.1 billion.

Here is cause for another skip in the heartbeat of investors. Bulking up most certainly makes sense if these are the rewards. The company could pay full market prices for an additional 300,000oz of production and still add value.

If only it were that simple. Bulking up is not just about the amount being produced. The size of the resource base also affects the value proposition. The average mine life of the four internationals (measured as the ratio of resource size to 2014 production) is around 37 years. For Northern Star, the equivalent measure is just 13 years on today's production rate. Northern Star's reserves are only three times larger than the current production rate.

Market value per ounce per year (equivalent to market value per ounce of resource) was A$87 for the four internationals but A$133 for Northern Star. Adjusting for the size of its resource base, Northern Star is already overpriced.

The size of the resource base has a dual effect on valuation. The longer the life of a profitable mine, the greater the underlying asset value. A 20-year mine life, for example, should be worth up to 45% more than a 10-year mine life, everything else being the same.

There is option value on top of this. The longer a mine's life, the greater the chance it will encounter multiple price cycles. The likelihood of a current investment loss being turned into a profit is simply higher for a long-life mine. This chance has value.

Northern Star's game plan needs it to get all the production efficiencies it can. More acquisitions are highly likely. That may not be enough. Beyond a ramp up in production, Northern Star needs large-scale exploration success, well beyond marginal increments around existing mines to compensate for current production, if it is to capture the market values being given to the larger international producers.

Northern Star needs a dramatic gain in mine life to be a competitive investment in international markets. Without that, it looks expensive and the promised re-pricing through enhanced global investor participation may not materialise.

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