Junior explorers may be underperforming the gold price this year, but Macquarie Capital Markets Equity Analyst Michael Gray is finding opportunities for mergers and acquisitions within the precious metals space. In this exclusive interview with The Gold Report, Gray and Research Associate Shawn Campbell talk about the technical aspects that are making a number of juniors attractive targets.

Source: Brian Sylvester of The Gold Report

The Gold Report: Michael, the companies you cover read like a who’s who of junior precious metals explorers. But with the junior explorers vastly underperforming the gold price this year, how are you pitching these equities to your institutional clients?

Michael Gray: Other than the strong mergers and acquisitions (M&A) thesis for the majority of our coverage list, we’ve also highlighted to clients what we would call game-changing exploration upside that a number of our stocks are exposed to. One example would be Extorre Gold Mines Ltd. (XG:TSX; XG:NYSE.A; E1R:Fkft), an explorer in Santa Cruz, Argentina, which we initiated coverage on in March 2011. At that point, it was trading at $5.09/share. We had a $9.50/share target. It ran to $14/share during the summertime based on its April 2011 Zoe vein discovery at Cerro Moro. Currently, it trades around $7.50/share.

We also believe there’s a strong investor appetite for high-grade, high-margin situations with relatively near-term production associated with low capital costs and short permitting timelines. That’s really reflected in Goldcorp Inc. (G:TSX; GG:NYSE) acquisition of Andean Resources Inc. last year.

Finally, there is significant optionality associated with a number of our stocks that have large gold resources in this gold price environment.

TGR: Your target prices for precious metals explorers are predicated on prevailing forward-curve prices. That is a less than an ideal method given that it doesn’t take into account tightness or weakness in the market, interest rates or inflation-adjusted values. What are your thoughts on that?

MG: It is difficult to accurately predict gold price over the next year, let alone the next five years. We use the forward curve for precious metals adjusted about every quarter on an as-needed basis for our valuations. For the past seven years, we have found it to be a very good predictor of realized future spot prices for gold.

TGR: You recently revised your long-term gold metal price assumptions for five years. In 2017, you’re projecting a gold price of $1,837/ounce (oz) up from $1,714/oz, while your long-term price for silver is $33.42/oz up from $28.97/oz. Do you believe your price projections are aggressive in comparison with other
MG: Our valuation philosophy is to use a flat 5% discount rate and the prevailing forward curve for long-term prices for gold, silver and foreign exchange. We then apply an operating multiple to the net asset value (NAV) that is less than one times NAV, whereas some banks may use a lower price deck and a different discount rate, but a multiple to NAV that is greater than one times. In the end, the entire valuation picture needs to be looked at to assess aggressiveness. We believe we're middle of the road.

TGR: What's your typical multiple to NAV?

MG: Among our explorers, we have a range of 0.35 to 0.85x NAV. Our high-end NAV multiples are associated with companies with high-quality assets that we see as potential takeover candidates like Extorre.

TGR: Extorre and ATAC Resources Ltd. (ATC:TSX.V) have solid potential to be involved in M&A activity in 2012, according to your reports.

MG: Extorre’s Cerro Moro project has Measured, Indicated and Inferred resources of 2.4 million ounces (Moz) gold equivalent (Au eq) that, according to its recent scoping study, are both mineable via open-pit and underground methods. We model Cerro Moro's high-grade silver resources to have -$1,045 cash operating costs on a silver byproduct basis. This is one of the best high-grade projects out there in our view.

TGR: The Argentinean government recently issued a decree requiring the repatriation of sales proceeds for mining companies in Argentina that could impact a project like Cerro Moro. Has the way that you valued the company changed as a result of those government measures?

Shawn Campbell: We looked at that decree when it came out and the stocks definitely had an initial reaction to it. The explorers and producers, such as Barrick Gold Corp. (ABX:TSX; ABX:NYSE), have all been consistent in saying that they believe the effect of this is an additional cost of 1–2% based on revenue. The mechanics are that companies will have to convert, or repatriate, sales into pesos, but the current system allows them to transfer it back into the U.S. and then send the money abroad. We did a sensitivity study on Extorre and it had minimal effect on our target price and net asset value.

TGR: How big can Extorre’s Cerro Moro get in terms of total ounces in the ground?

MG: The analogy we draw is to AngloGold Ashanti Ltd. (AU:NYSE; ANG:JSE; AGG:ASX; AGD:LSE) vein field at its Cerro Vanguardia gold-silver mine, which has been operating since the late ’90s. Currently, it's 9 Moz gold in past-production current resources. We hosted a conference in Toronto recently where one of the representatives from Formicruz, who formerly worked with AngloGold Ashanti, suggested that he wouldn't be surprised if that district will ultimately see more than 12 Moz of gold produced. Extorre’s Cerro Moro project is basically an array of veins in the early stages of exploration that have a number of similarities with Cerro Vanguardia. It already has 2.4 Moz Au eq in resources. We feel comfortable that Cerro Moro could ultimately grow to a +5 Moz number in its life. We currently value Cerro Moro based on 2.7 Moz Au eq.

TGR: Who are the likely suitors?
MG: Companies that have expressed interest in that region certainly are potential suitors. If the production profile can reach the right critical mass, companies such as Eldorado Gold Corp. (ELD:TSX; EGO:NYSE) would be interested, given it had bid for Andean before. Yamana Gold Inc. (YRI:TSX; AUY:NYSE; YAU:LSE) and Goldcorp, companies with operations down in Argentina that are interested in a high-grade production of a certain size, could also be interested. We also think given that it has high silver content—roughly 50% of the value—some of the midtier silver producers could also be interested.

TGR: Why is ATAC amongst the top group of Macquarie’s list of M&A candidates given that you just cut the 12-month target price to $8.50/share from $11/share?

MG: ATAC is an early call. This is a sediment-hosted gold geological setting similar to Nevada’s Carlin trend. It has all the right signs and signals in terms of geological environment and early success in drill holes from September 2010 documented ore-grade gold mineralization over significant thicknesses. Although our Carlin thesis is intact as far as we’re concerned, it’s clear that the geological risk for defining large resources in the short term has increased due to the high degree of structural control versus lithological controls. We moved our target price down to reflect this geological risk.

We have a strong conviction that the geology associated with the Rackla gold belt is the type of hunting grounds that the seniors have been looking for, but generally haven’t found on a worldwide basis outside of Nevada, and that given the strong geological similarities the Rackla gold belt has good potential for hosting such Carlin-type gold deposit. There are very few tier-one (+20 Moz) opportunities in the world and, with the right amount of success and given its enormous 100%-owned land position, ATAC could be an attractive takeover target.

TGR: Is it any closer to proving the theory that this is a Carlin-style mineralization?

MG: With the empirical evidence of the geological setting, the mineralization style, the signature of elements—antimony, arsenic, mercury, thallium, gold, low silver—and numerous characteristic alteration features, there are not too many people out there who necessarily would disagree with that deposit-type analog. The deposit type is important as it suggests that the potential endowment could be very large given the northern part of the Carlin trend alone has 100 Moz of gold. We’re not necessarily saying that would be the endowment within the Rackla gold belt; however, we certainly see evidence of a big system in place between the Osiris targets, where there’s been a significant amount of drilling, and out 26 kilometers (km) to the west to the Pyramid gold prospect, which also has a number of the indicative geological features. Again, ATAC is an early takeover candidate in our view partly because of the rarity of this type of geology and potential.

TGR: Is there a first-mover advantage in terms of a major coming in early and locking up this belt once it has proven there are significant amounts of gold there?

MG: Some of the senior mining companies have been spending up to $50 million (M)/year on their greenfield worldwide budgets, looking for another Carlin trend or similar tier-one asset. It doesn’t take too many years of spending that amount of money to justify moving early on an asset like this at the right price.

There is no question: ATAC’s Rackla gold belt is still at a very early exploration stage and no resources have been documented. There is also a very short field season in the Yukon to contend with, especially in this particular area, so it certainly
would be early and aggressive for a senior to be doing anything right now. This said, it's a very special situation as there's just not very many of these Carlin-type environments, especially associated with a large land position, 100% ownership and no royalties, anywhere on a worldwide basis.

**TGR:** Strategic Metals Ltd. *(SMD:TSX.V)* is developing the Midas Touch project in the Yukon, south of ATAC Resources' Osiris discovery. Why is ATAC a takeover target and not Strategic?

**MG:** Strategic is a potential takeover target. However, its Midas Touch project has not yet documented a discovery drill hole with significant gold grades over a significant length, so ATAC is more likely given that it has confirmed significant gold mineralization. That said, Strategic has documented a fairly extensive +400-meter (m) long zone of arsenic mineralization on its Crag property, which seems to be in the right type of trap rocks (as ATAC's Osiris targets). Strategic also owns about 9% of ATAC, and its Midas Touch land position is very large and could be a compelling way to gain exposure to the Rackla gold belt in the Yukon.

**TGR:** International Tower Hill Mines Ltd.'s *(ITH:TSX; THM:NYSE.A)* Livengood project in Alaska, based on $1,400/oz gold and a cutout grade of 0.22 grams/ton (g/t), has 16.5 Moz of Measured and Indicated resources and 4.1 Moz of Inferred resources. Are we ever going to see a project of that scale developed in Alaska? There are certainly a couple there now that don't seem to be much closer to development.

**MG:** Livengood is a tier-one, +20 Moz gold asset, owned 100% by a junior, which is relatively rare. We currently model Livengood using a 0.35 g/t cutoff, a little bit of a higher grade, with life-of-mine grades of 0.65 g/t gold and include a starter pit in the first four years of 0.82 g/t gold. In September 2011, International Tower Hill released a large mill preliminary economic assessment (PEA), which contemplates a 91,000 ton/day (tpd) milling operation with life-of-mine average gold production of 607,000 oz per year. It is a large, low-grade mine proposition in Alaska. Livengood's key attractive feature compared to some of the other larger development projects is its good infrastructure as it is located on a highway 100km north of Fairbanks along with access to power and water.

**TGR:** Donlin Creek has 50 Moz and it's not anywhere close to being developed. Northern Dynasty Minerals Ltd.'s *(NDM:TSX; NAK:NYSE.A)* Pebble project is about 100 Moz and that's not very close to being developed either. It does seem that even though the ounces are there and the geology is prospective, they're not being developed. What is the impediment?

**MG:** For some of the other projects, there are significant infrastructure challenges. There aren't necessarily roads or any power infrastructure to these sites. Northern Dynasty also has some stakeholder groups not embracing the project.

Livengood is a brownfield site from former placer mining and it's next to the Alaska pipeline. It doesn't have a significant stakeholder group that would be opposing the project. There aren't obvious challenges in our view when it comes to community relations, First Nations issues or competing interests.

**TGR:** Rainy River Resources Ltd. *(RR:TSX.V)* just made a nickel-copper-cobalt discovery at its Rainy River gold project in northwestern Ontario. What do you know about that project?
MG: The Rainy River gold project is part of a new Canadian gold belt. It has more than 6 Moz gold in its global Measured, Indicated and Inferred resources. It's 100% owned and associated with a large land position—all attributes we like. A recent scoping study documented a combined open-pit/underground mine scenario that would produce 325,000 oz/year over about a 13-year mine life. The economic study estimated initial capital costs and sustaining capital of about $1.5 billion. It resulted in a pretax internal rate of return (IRR) of just less than 20% and a net present value (NPV) of $786,000 using a 5% discount rate. This project has come into greater visibility with this study.

It's extremely well located near the U.S. border in northwestern Ontario. The capital expenditure estimated in the PEA at $1.4B for initial and sustaining capital is higher than we expected. It is modeled as a 30 t/d operation. It will have a higher than average strip ratio to deal with and have overburden and water management issues to deal with, but certainly is a project that can be permitted. As far as the nickel-copper-cobalt discovery, it's not important to our valuation of Rainy River at this time as we interpret it to be relatively small with limited size potential.

TGR: It would just be a bonus at best. That IRR is fairly low and a lot can go wrong when bringing a project into production. What does Rainy River have to do to get that IRR up around the 30% range?

MG: It does have a pending resource announcement in January, which would include the majority of the drilling it conducted this year. Analysts are looking at that for visibility on conversion ratios to Measured and Indicated categories and if there is an improvement in the average grades. On a conference call in November when it released the study, it indicated a 10% change in grade had a +30% impact on project NPV. This is a grade-sensitive project and this is the first so-called economic snapshot of the deposit. That pretax IRR of 19%, given the capital costs, needs to be improved for this to become robust.

TGR: Brett Resources Inc. (BBR:TSX.V), which had about 5 Moz in the same area of northwestern Ontario, was bought by Osisko Mining a couple of years ago. Is that the thesis here, too?

MG: Rainy River is on a path where it has to derisk the project vis-à-vis permitting and economic studies to make it a compelling takeover target. It probably is in the gun sights given its size, but at this time, the economic visibility is really going to depend on that resource estimation that's coming up and the ability to optimize a number of the parameters.

TGR: Heading further south still, Midas Gold Corp. (MAX:TSX) has a 100% interest in the Yellow Pine mining district in Valley County, Idaho, and already has outlined about 6 Moz there. Why haven't more people heard of this story?

MG: The company just completed its initial public offering (IPO) in July, so it is still a new story. However, its Golden Meadows project, at 5.8 Moz Indicated and Inferred, is probably the largest gold resource in an IPO that we're aware of.

TGR: What's ahead for Midas?

MG: There are three resources on the property that have come in through the consolidation of this district. The relatively straightforward increase in resources will involve near-pit expansion, so sketching in the resources lateral and to depth of the
existing three deposits, as well as the infill drilling to increase the confidence in the resource categories. Subsequent to that, there is very high potential to expand mineralization along strike of the three deposits. Following that, there are a number of new targets that have never been assessed to depth. A number of the targets on the property were assessed only for oxide gold mineralization. There’s great sulfide-associated gold potential to depth on a number of the targets throughout the property.

TGR: What's the permitting regime like in Idaho?

MG: Idaho permitting has a bit of a reputation for taking a long time, but it's a very clear and harmonized process between the state and the federal government. Given that there are a number of examples of successful mines having been permitted in Idaho over the last 15 years, including a number of expansions, if you propose the project effectively and it does not have fatal flaws, our understanding is that eventually the projects get permitted.

TGR: In Guatemala, Tahoe Resources Inc. (THO:TSX) is developing the massive Escobal silver project with roughly a 20-year mine life. But Tahoe needs to convert its exploration license into a mining exploitation license. Will that prove difficult?

MG: In October, Tahoe received its environmental impact statement approval and is able to proceed with construction of a mine. That is a major derisking milestone. It signals that it's likely we'll see conversion of its current exploration license to a mining exploitation license. The timing is really going to depend on when the new mining laws are passed by Congress. Guatemala has a new president who will be inaugurated in January. We're likely looking at the new mining laws being passed after May 2012.

We model Tahoe’s +300 Moz Escobal silver-lead-zinc-gold project at 13 Moz silver/year over a 20-year mine life, including 19 Moz over the first five years, with cash operating costs of about $5.05/oz silver net of byproduct credits.

TGR: How do you account in your valuation for the risks associated with the new mining law coming into effect, and that this is a one-asset company developing a mine in a developing country over the long term?

MG: We try to reflect that as a balance between the world-class nature of Tahoe’s Escobal asset being rare, really part of an emerging silver vein district, and with the political risk. In this type of situation, we incorporate that political risk in our multiple to NAV until we see events unfold otherwise. Goldcorp has been operating the Marlin gold mine in northeast Guatemala for a number of years, which essentially gives us confidence that Escobal will become a mine. If the political situation doesn't deteriorate, then we're comfortable with our risk multiple. That said, we appreciate that Guatemala is a country that is moderate to high risk.

TGR: Would you say the management at Tahoe is the kind of management you would want in this situation?

MG: Chief Executive Officer Kevin McArthur and a number of the executives at Tahoe have extensive experience in Guatemala. It makes a difference having a team that's operated in a country and has that type of development experience. Our understanding is that McArthur is focused on building Escobal, getting it into commercial production, and then may look to build a multi-asset silver company from there.
In Brazil, Colossus Minerals Inc. (CSI:TSX) plans to bring the high-grade Serra Pelada gold-platinum-palladium (Au-Pt-Pd) project into production and appears to have enough cash to do so. But there could be some problems with Serra Pelada's metallurgy and some of the ground conditions in the past-producing pit there. Could you tell us about those issues?

Colossus' 75%-owned Serra Pelada Au-Pt-Pd project, in Para State, Brazil, is one of the highest-grade precious metal deposits on the planet. We conducted a site visit to Serra Pelada in mid-October. On metallurgy, the flow sheet for a conventional gravity recovery plant appears to be in place and would recover about 95% of the gold. Construction for that gravity plant is scheduled to start this quarter. For platinum and palladium metallurgy, the company has been working on the optimal flow sheet, which may involve calcining to burn off the carbon. This metallurgical work is still in progress and will rely on the evaluation of the bulk sample to be collected in the second half of 2012. We're currently modeling 65% recovery of the platinum and palladium.

As for ground conditions, the decline development for exploration and ultimate extraction of the Central Mineralized zone at Serra Pelada is lateral to the historic pit and initially used road headers, but the poor ground conditions eventually dictated that conventional drill and blast would be required and be more effective. As of early November, the decline was at about 600m and it involved shotcreting the walls followed by rock bolting and screening, then shotcreting again and locally strapping with steel. If advance rates of 4m/day can be achieved, then bulk sample extraction location should be reached toward the middle of 2012. We also expect the ultra-high-grade Au-Pt-Pd mineralization to have challenging ground conditions given the carbonaceous host rocks.

There have been some changes in management there. Tell us about that.

There have been a number of changes starting with, most recently, Ari Sussman becoming chairman of the board. He was the chief executive of two companies and now he's focused just on Continental Gold Ltd. (CNL:TSX). Claudio Mancuso was the chief financial officer and now is the chief executive. He will be able to focus all his energies on leading the company. There were certainly a lot of other management changes between Q211 and Q311 when the chief operating officer left. Colossus has hired Paulo de Tarso Serpa Fagundes as its new COO, who previously worked with Yamana as the general manager for its Mercedes Mine in Mexico.

Doesn't that make you raise an eyebrow or two at the same time?

Having been on the ground in mid-October, it was a chance for us to meet the entire team and gain an appreciation for its skill set and ability to work together. We were satisfied that the current team is prepared for the challenges that lie ahead associated with the project. This said, the technical risks associated with the project are still not quantified at this time.

Do you have any parting thoughts on investing in the precious metals explorer space or words of wisdom?

I like the expression *Good people do good things with a good capital structure* as it certainly applies to the precious metal exploration business where projects come and go. My main comment is that to be successful at picking the winners among the precious metal explorers, especially the early-stage ones, it's really...
important to reduce geological risk by looking at the right geology and focusing on high-quality assets. More often than not, they tend to be associated with technically superior management teams that are extremely persistent.

TGR: Thanks for your time.

Michael Gray is a mining equity analyst with Macquarie Capital Markets and covers a range of precious metal explorers and producers with an emphasis on North and South America. He is an exploration geologist and holds a Bachelor of Science in geology from the University of British Columbia and a Master of Science in economic geology from Laurentian University. His career of over 25 years in the mineral exploration business started with senior mining companies including Falconbridge, Lac Minerals, Cominco and Minnova where he worked throughout Canada and the USA. He co-founded Rubicon Minerals in 1996 and helped navigate the company through a series of joint ventures and an asset portfolio build that was eventually centered on the Red Lake gold district, Canada. During this period, Gray was president of the 5,000 member B.C. & Yukon Chamber of Mines for one year and on the executive committee for six years. Gray then joined the mining analyst world in 2005 where he brought to bear his technical skills to identify new precious metal opportunities at an early stage with outstanding exploration potential; he has covered a number of these opportunities that were subsequently taken over by gold producers.

Shawn Campbell is a mining equity associate with Macquarie Capital Markets and supports the analyst covering a range of precious metal explorers and producers with an emphasis on North and South America. Prior to being an associate, Campbell was an auditor with Deloitte for six years where he held key roles in auditing large public mining companies. He has a Bachelor of Commerce degree from the University of Victoria and is a CFA charterholder.

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