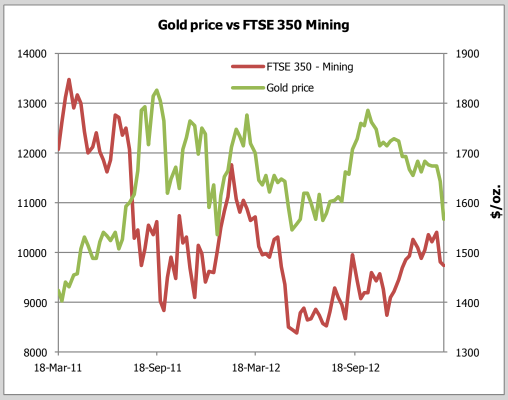
Gold Review

18th March 2013



Source: Fidessa

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Goldilocks Fantasy

Gold prices have inevitably suffered as the Great Rotation from fixed income to equities gathers momentum and investors begin to believe in the possibility of rising real interest rates. Pessimists claim that gold now offers little store of value as the global economy stabilises and the upsurge in inflation is tamed.

However, this fantasy is not going to last. There will be no stabilisation in the global economy or inflation until sound monetary policies are adopted, which does not seem likely at present and will almost certainly require another major financial crisis. Until then, we expect more instability and volatility and a rotation back into gold.

Gold equities continue to lose ground in part due to falling gold prices but largely due to earnings disappointment and political uncertainties in the major gold producing regions. We continue to recommend discretion and see attractive valuations among both gold producers as well as junior explorers.

- **Gold demand recovers strongly in Q4 2012...**
  Quarterly demand fell in 2012 on a year-on-year basis across all the main end-use sectors in the first three quarters, but bounced back by 4% in Q4 2012. The Q4 2012 gold demand was up 8% on the previous quarter. In value terms, gold demand was worth $66.2bn, 13% above Q3'12. This recovery was achieved despite flat Chinese demand and once Chinese demand picks up we expect demand to grow even stronger.

- **....while supply remains tight**
  Unlike fiat money, gold cannot be printed and supply has been relatively fixed. Lack of significant discoveries and subdued investment means that supply will probably get tighter. These fundamentals combined with the underlying economic conditions mean that gold prices will bounce back sharply.

- **Stock selection remains paramount**
  We continue to believe that investors need to be discrete when investing in gold equities. Rising costs, labour disputes and/or political uncertainties mean that despite the recent share price falls many stocks still do not offer a sensible risk/reward balance, e.g. African Barrack Gold.

  Once gold prices begin to rise, we expect the major gold producers with strong defensive earnings growth such as Polyus and Polymetal to recover first, followed by junior explorers such as Bullabulling and Conroy Gold which are not only the cheapest stocks in relation to their peers but also operate in politically stable regions. According to the 2012/13 Frazer Institute annual survey, Africa's policy attractiveness overall continues to decline, while Scandinavia and Ireland continue to climb the rankings of the most attractive jurisdictions for mining investment, which should favour a company like Conroy Gold & Natural Resources PLC.

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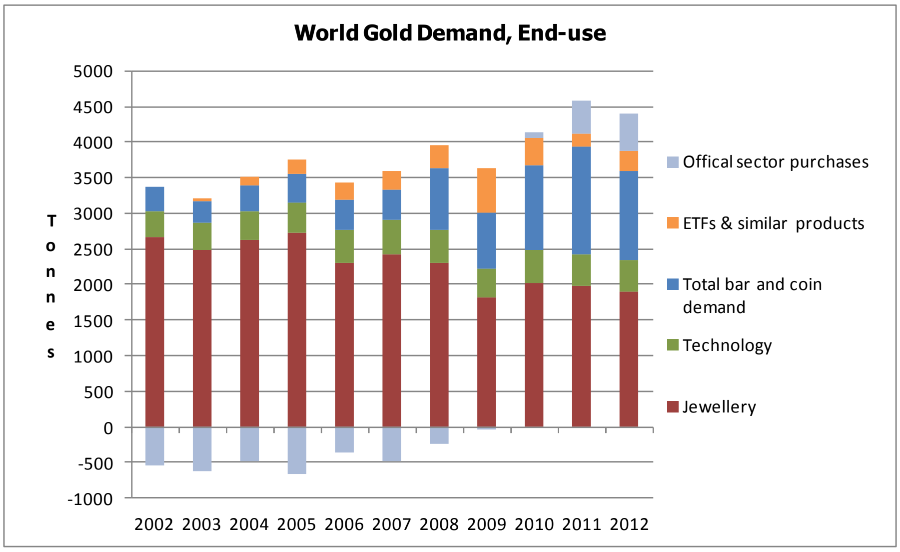
1. Gold Industry Trends

1.1 Are the long-term trends in demand for Gold sustainable?

In our Gold Review published in October 2012, we identified two distinct long-term trends in the structure of gold demand:

1. Total world demand for gold has been growing gradually since 2003 primarily with the help of investment demand.

Global gold demand grew steadily between 2003 and 2011, and while it fell back in 2012 on an annualised basis, demand in Q4 2012 recovered to post the second highest quarterly total behind the record Q3 2011. Investment demand (bar and coin, ETFs, etc) has been the main driver of this growth in recent years as shown by the graph below. Exchange-traded funds (ETFs), closed-end funds (CEFs) and exchange-traded notes (ETNs) aim to track the price of gold and are traded on the major stock exchanges. Not all these instruments hold physical gold, e.g. gold ETNs generally track the price of gold using derivatives. As a share of the total gold purchases, investment demand grew from 13% in 2003 to 37% in 2011. The reversal in full year 2012 was caused by the fall in investment demand. Demand from the jewellery and technology sectors has been resilient in recent years after falling sharply in 2008.



Source: World Gold Council

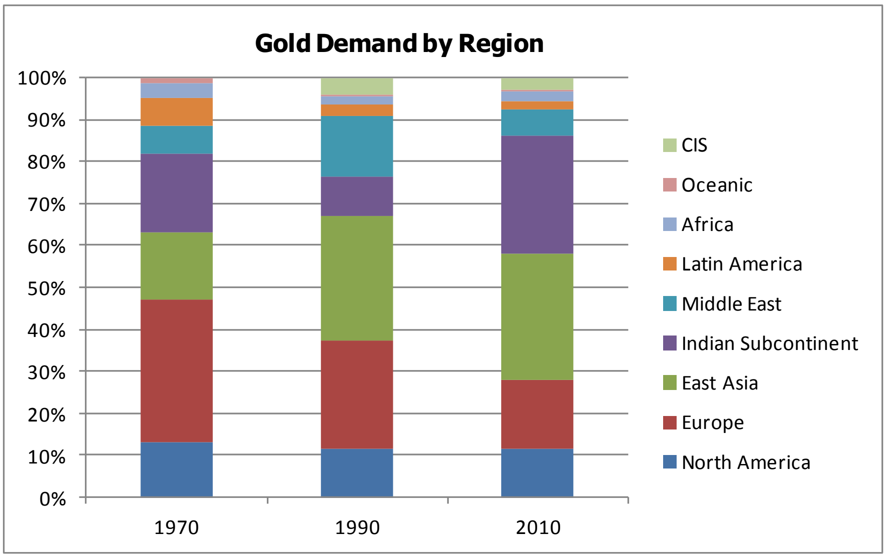
In recent times, official sector purchases have also driven demand as a host of central banks increase their holdings of gold. In the developed world, the percentage of gold in foreign exchange reserves stands at over 70% in the USA, Germany, France and Italy.

	Gold holdings Tones	% of Foreign Exchange Reserves
USA	8134	75.1
Germany	3396	71.9
Italy	2452	71.3
France	2435	71.6
Netherlands	613	60.2
Portugal	383	89.9
Austria	280	55.6
Greece	112	82.3

Source: World Gold Council, Hybridan LLP estimates

2. The geographical shift of gold demand since 1970

There has been a dramatic shift in demand from North America and Europe to the Indian subcontinent and East Asia in the past fifty years. North America and Europe had a combined share of 47% of the global market in 1970, but this fell to 38% and 27%, respectively, in 1990 and 2010. The drop in global share for North America and Europe was compensated for by the Indian Sub Continent and East Asia, rising from 35% in 1970 to 58% by 2010.



Source: World Gold Council

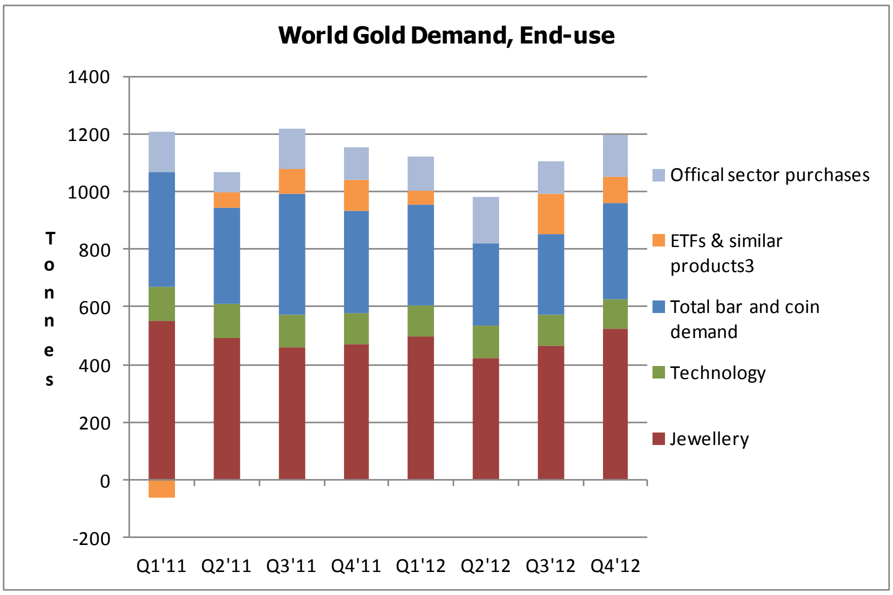
Delving into the various categories, one can see that jewellery demand has been a major driver of the shift from West to East. As North America and Europe's dominance of the sector has diminished from a 44% share in 1970 to just 14% in 2010, the Indian subcontinent and East Asia have grown to represent 66% of demand from 36% in 1970.

Investment demand is harder to estimate due to a lack of granular data. In addition, new financial products including ETFs have likely caused a marginal alteration of investment mix. Therefore, a number of assumptions have been made by the World Gold Council to be able to paint as fair a picture as possible of the distribution of investment.

Technology demand has maintained a remarkably consistent share of the total over the last four decades at just over 10%. This is despite a changing backdrop and at times, strong price increases. With electronics becoming the dominant force behind technology demand, as dental usage shrinks, the regional shift from high-cost producers to low cost producers has been a natural process. East Asia and the Indian subcontinent are at the helm of gold use in technology with a combined regional share having grown from 17% in 1970 to 67% in 2010. Furthermore, gold continues to develop new diverse functions within technology thanks to its unique properties and applications.

1.2 Is the near-term demand wobble temporary?

Data for full year 2012 shows a 4% decline in demand for gold compared with the very high levels experienced in 2011. It remains to be seen whether this was a blip or the start of downward trend. As the graph below shows, demand has recovered strongly since the low point of Q2 2012.



Source: World Gold Council

In the first half of 2012, gold demand fell by 5% year-on-year and would have been lot worse were it not for the continuing surge in buying by the official sector. However, in the second half of 2012 demand fell by just 3% as support from the jewellery sector and central banks recovered.

Quarterly demand in 2012 on a year-on-year basis fell across all the main end-use sectors in the first three quarters, but bounced back by 4% in Q4 2012. The Q4 2012 gold demand was up 8% on the previous quarter. In value terms, gold demand was worth $66.2bn, 13% above Q3'12.

In Q4 2012, double-digit year-on-year growth from the jewellery sector and central bank buying was partly offset by shrinkage in technology and investment demand. Demand in the jewellery sector was up 11% while official sector purchases rose 29% on the corresponding quarter in the previous year, making this the eighth consecutive quarter in which central banks have been net purchasers of gold.

Fourth quarter demand for gold in the technology sector was down on Q4 2011 by 3% which was expected following moves by manufacturers in Q4 2012 to substitute gold bonding wire. This was as much a reflection of the inventory cycle, as of weaker demand for electrical items. Investment demand (the sum of ETFs and total bar and coin demand) was down 8% compared to the same quarter last year, but was 19% above the five year quarterly average.

Whilst Indian full year demand was down 12% on the previous year, the market performed strongly in the final quarter, an increase of 41% on the same period last year. Both jewellery and investment demand reached their highest levels for six quarters.

Within the bar and coin segment, India was the notable outlier, generating 51% growth in Q4 2012. The strength in Indian investment can also be easily depicted by the strong counter-trend growth in the "medals and imitation" coin segment, the vast majority of which is accounted for by India.

Total bar & coins demand by Country (tonnes)

	Q4'11	Q4'12	% change	2011	2012	% change
India	72	109	51%	368	312	-15%
Greater China	66	68	3%	272	274	1%
Japan	-12	-4	-67%	-47	-10	-78%
Indonesia	7	4	-42%	25	22	-13%
South Korea	1	1	-38%	3	3	-10%
Thailand	23	15	-35%	104	78	-25%
Vietnam	26	17	-36%	88	66	-25%
Middle East	9	9	-6%	33	30	-11%
Turkey	17	7	-61%	73	48	-34%
USA	20	17	-18%	84	53	-36%
Europe	96	65	-32%	383	274	-29%
Other	33	30	-7%	129	1149	788%
Total	**359**	**337**	**-6%**	**1515**	**2297**	**52%**

Source: World Gold Council

Indian demand for jewellery was up 35% year-on-year as the prospect of duty increases, which came in to force in January 2013, may have added to strong buying in the final quarter to beat the anticipated price rises.

Total Jewellery demand by Country (tonnes)

	Q4'11	Q1'11-Q4'11	% change	Q4'12	Q1'12-Q4'12	% change
India	113.5	618.3	35%	153	552	-11%
Greater China	144.8	549.6	1%	145.8	544	-1%
Japan	4.1	16.6	2%	4.2	17.7	7%
Indonesia	6.1	30.2	7%	6.5	30.8	2%
South Korea	3.1	12.5	-55%	1.4	9.4	-25%
Thailand	0.6	3.6	-17%	0.5	2.9	-19%
Vietnam	2.5	13	-20%	2	11.4	-12%
Middle East	27.5	154.6	21%	33.4	148.3	-4%
Turkey	6.5	70.1	8%	7	70.4	0%
Russia	22.1	76.7	0%	22.1	81.9	7%
USA	42.2	115.5	-5%	40.1	108.4	-6%
Europe	25.4	50.2	-9%	23	44.6	-11%
Other	74.1	261.1	16%	86.3	286.4	10%
Total	**472.5**	**1972**	**11%**	**525.3**	**1908.2**	**-3%**

Source: World Gold Council

Chinese Q4 2012 demand was flat year-on–year, reflecting the impact of the economic slowdown. However, this is an improvement over Q3 2012, when demand in the jewellery sector was down 5% year-on-year while bar and coin investment demand was 12% lower. More important, consumer demand as a whole is running 20% above its 5-year quarterly average confirming the longer term strength of the market.

Within the aggregate investment number, a significant drop in demand for bars and official coins was partially offset by improvements in ETFs and medals/imitation coin segments. The divergence in the different segments of the investment market serves to highlight contrasting behaviour among different sets of investors. ETF investors responded positively to the prospect of additional monetary policy stimulus in a number of countries. Bar and coin investors instead showed a degree of hesitancy and an inclination to take profits at higher price levels.

1.3 Underlying drivers remain intact

While demand in the first nine months of 2012 was well below 2011 levels, we believe that after a strong recovery in Q4 2012 the overall trend is still on an upward trajectory. Q3 of 2011 was particularly an exceptional quarter for demand and therefore year-on-year comparisons are misleading. We have no reason to believe that demand and price of gold are fundamentally under pressure. In fact, many of the interlinked political and economic factors such as inflation, real interest rates and sovereign debt have intensified and made gold an even more attractive financial asset particularly compared with fiat money.

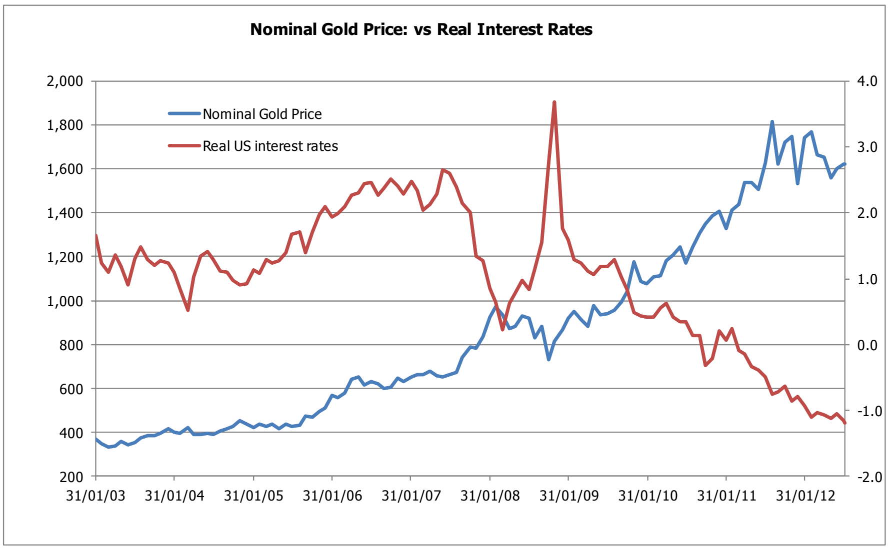
1.3.1 Why Gold is Superior to Fiat Currency?

Let's begin with the obvious. We know that central banks the world over have been printing money at exponentially growing rates in recent years. There is now so much paper and electronic money floating around the world that gold cannot possibly be expected to keep up. You can't print gold, after all, you need to find it, dig it out of the ground, refine it, etc., a hugely expensive and time-consuming process which practically ensures a stable rather than exponentially growing supply of the stuff.

Gold promotes real growth and this is why responsible governments in the past have always relied on gold-backed money. Whenever governments choose to ditch gold-backed money, devalue and create as much inflation as they desire, the end result is the destruction of the currency and the economy, be it France in the late 18th and early 19th centuries, Germany in the 20th century and Latin America in the second half of 20th century. Even the Romans, who built a huge empire on sound money, eventually succumbed to manipulating money through debasement.

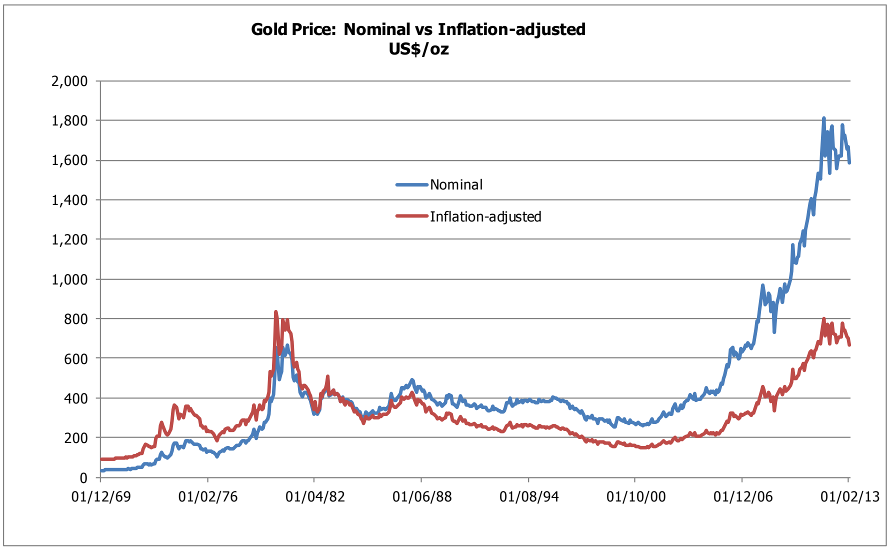
Of course, several myths about gold continue to be perpetuated. For example, gold-backed money favours the US versus the Rest of the World. It is true that the US has the largest gold reserves in the world. However, the fact is that at current gold prices, the US would not even be able to cover one year of its current-account deficit with its gold reserve. The other myth is that gold favours gold-mining countries over others such as China and India. This would be true if Africa and certain parts of Latin America were rich. Some argue that since most gold (and silver) are privately held in the hands of the wealthy, a gold-backed currency would make them even more so. The fact is that since the US abandoned gold in the 1970s, the exponential fiat money growth in recent decades has helped to create even greater wealth disparity.

Real wages grew quickly under the gold standard, which created the largest middle-class in history. However, the economists who now populate the central banks and economic policy-making are adamant that simply creating more paper creates real wealth. Currently, the central banks in all the major developed economies are pursuing very low real interest rates and loose monetary policy. The new Japanese government is so bereft of ideas that it has vowed to create inflation as its main policy.



Source: World Gold Council, US Dept. of the Treasury

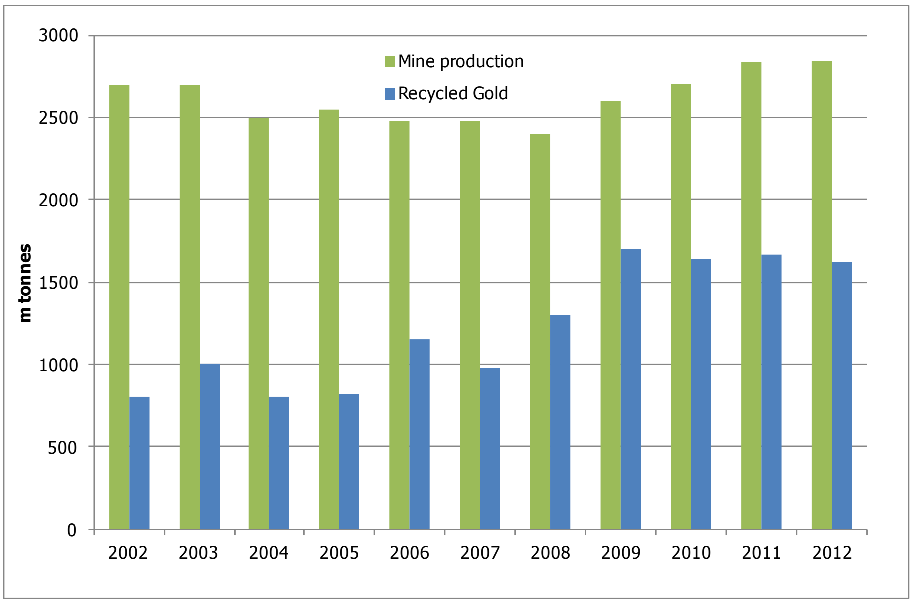
Records show that gold remains the best inflation hedge because in the very long-term the purchasing power of gold has been remarkably stable. In the 1830s, the price of gold in 2010 dollars was around US$450/oz with the real price much the same in 2005.



Source: World Gold Council, US Dept. of the Treasury, Hybridan LLP

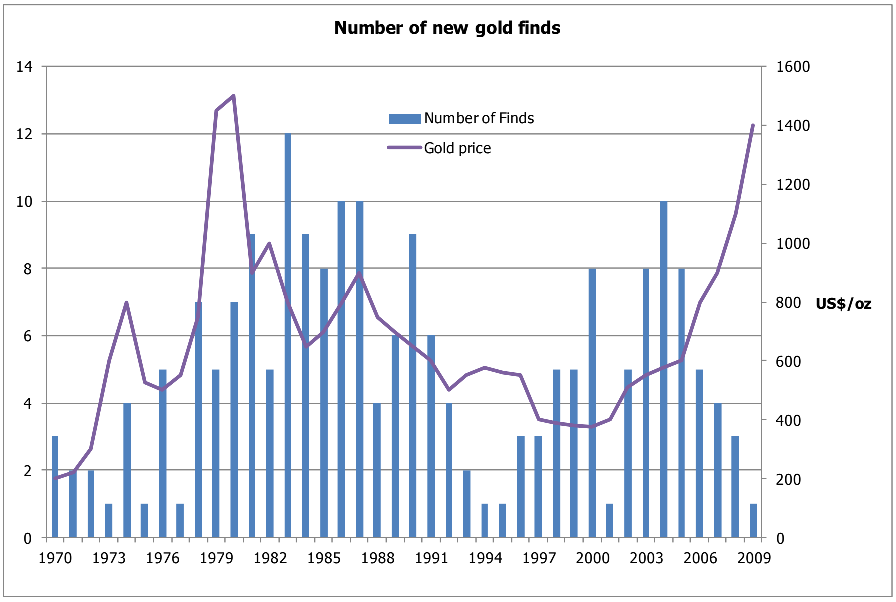
1.3.2 Gold is also superior to other commodities

The supply of gold has also been relatively fixed for the last century, with annual mine production a small portion of the total stock of gold outstanding and with a limited ability for annual production to rise in response to a change in the gold price. This distinguishes it from other commodities where substantial supply responses to price changes are possible, at least over the medium term.



Source: World Gold Council

Lower grades and disruptions caused by labour strife and other factors means that many gold producing companies are struggling to reach their target production targets. And as we pointed out in our last Gold Review, the number of new gold finds is also declining. This means the supply of new gold will remain stable or even decline and continue to underpin prices.



Source: World Gold Council

Another important attribute of gold is its relatively less prominent use for industrial purposes, compared with other commodities including precious metals such as silver and platinum. Only around 10% of gold demand in 2011 came from industrial uses with the balance coming from jewellery and investment demand. As a result, gold lacks the strong link to the economic cycle that other commodities have and gold thus has low or negative correlations with these and other financial assets.

1.3.3 Production cost

Another factor that is continuing to underpin the gold price is the structure of the marginal cost of production, which ironically has hit valuations of gold equities. We discuss this factor in Section 2.2.

1.3.4 Market regulations and reforms

In what might be the most underreported financial story of 2012, US banking regulators recently circulated a memorandum for comment, including proposed adjustments to current regulatory capital risk-weightings for various assets. For the first time, unencumbered gold bullion is to be classified as zero risk, in line with dollar cash, US Treasuries and other explicitly government-guaranteed assets. If implemented, this will be an important step in the re-monetisation of gold and, all other factors being equal, should be strongly supportive of the gold price, both outright and relative to that for government bonds, the primary beneficiaries of the most recent flight to safety.

A key reason why gold may not have been acting like a safe-haven asset in recent months is because banks are so capital impaired that they are scrambling to reduce their holdings of risky assets in favour of so-called 'zero-risk-weighted' assets, against which they needn't set aside any regulatory capital. As it stands, gold has a 50% risk-weighting. But some government bonds, including US Treasuries, German Bunds and British gilts, are zero-risk-weighted.

The change is not due to take effect until later in 2013 and when it does banks will not have their regulatory capital ratios penalised for holding gold instead of government bonds as a safe-haven, zero-risk asset.

Other factors driving demand for gold are the regulations and reforms in emerging markets following economic liberalisation. In our last report, we described how openness and greater participation in global trade and capital markets have increased consumer access to gold in newly industrialised nations. In addition, changes in regulation specific to the gold market such as the three consecutive Central Bank Gold Agreements (CBGAs) and the self-regulation by mining companies with regard to forward hedging, have also supported the stabilisation of the gold market. Finally, new products and ways to access gold such as ETFs and gold accumulation plans have released pent up demand and increased access and flexibility for individuals as well as institutions.

The shift from West to East has also broadened the motivation for holding gold. Whereas Western gold buying motives crudely involve profit, status wealth preservation or diversification, buying motives in other regions also include affinity, auspiciousness, savings, and gifting. The rebalancing of geographical demand has also widened motives for buying gold which, ceteris paribus, increases stability in the price.

Another driver, and ultimate beneficiary, of the changing dynamics of the gold market has been liquidity. Liquidity in the gold market is far greater than commonly perceived. Greater liquidity provides assurance for larger as well as smaller investors. It also provides better pricing transparency and enables gold to be bought and sold more easily; the latter being key during times when cash may be in short supply. Furthermore, recycling markets in the West are less developed and prone to higher margins than in India for example, where jewellery can be bought and sold with ease. Increased liquidity provides a more ductile market, buffering price swings.

Finally, the combination of the rise of Asian and Latin America economies and the global current account imbalances have generated increased demand for sizeable holders of foreign exchange reserves to diversify. This demand is a primary driver of the shift in central bank activity from net sellers to net buyers, and is expected to continue given low gold to total reserve ratios.

1.4 Risk of confiscation

There has been a persistent fear among both institutions and private owners of gold that, at some point in the near future, their gold will be confiscated by their governments, as was the case in the US in 1933. Via an executive order, the U.S. citizens lost the right to own gold from May 1933 until 1974. Only foreign central banks could continue to exchange the U.S. dollars that came into their possession – known as Eurodollars for decades—for gold and did so particularly when the U.S. dollar was devalued and then floated against the gold price in 1971. Why? After four years of depression, it was felt necessary to increase money supply to invigorate the U.S. economy and make assets preferable to cash. The monetary system was based on the Gold Standard, a system that set the gold price at a fixed level against the dollar and other currencies across the developed world. Had gold been left in the hands of individuals and private institutions, such an issue of money may well have led to it being sold for foreign-held gold. This would have defeated the government's purpose in devaluing the dollar. The U.S. government had to confiscate the gold of its citizens to ensure the focused success of the increase in the money supply.

We believe that the risk of another confiscation in the future is real and may be growing by the day because gold is rapidly returning to an active role in the global monetary system—as we have seen in the gold/currency swaps within the Bank for International Settlements and in the discussions on redefining gold as a Tier I asset right now—investors should be aware that this may happen.

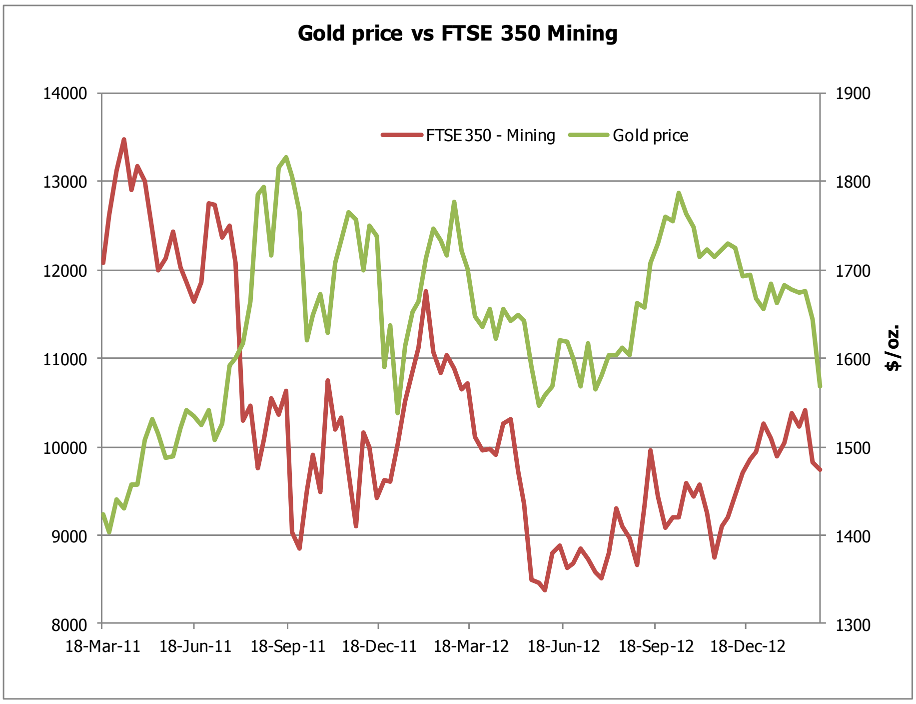
2 London Gold Equity Market

2.1 The Gold price vs Equities

At over 1% of the FTSE All Share, the London gold market is now too big to ignore. The major theme of the past eighteen months has been the de-rating of UK gold stocks across the board with serial production and profit disappointments driving gold equity discounts.

The disconnect between commodities and equities usually reflects a combination of commodity price, operational risk and geopolitical risks depending on where their assets are located. While gold prices have been largely stable for the past year, the primary reason for the de-rating of the gold sector has been the sharp increase in production and political costs and the impact on margins. Unless gold prices double and costs remain unchanged, the industry as a whole has to focus on increasing margins if it wants valuations to improve.

Valuations may recover over the next twelve months as investors realise the gold producing sector is still throwing off plenty of cash, with an average free cashflow yield of 6% among the major gold producers.



Source: Fidessa

Importantly, the mainstream mining sector dominated by multi-metal producers like BHP Billiton and Rio Tinto has already bounced back as the graph above shows. We believe the major gold producers with strong defensive earnings growth will be the first to recover, followed by intermediate producers and eventually the junior explorers.

As the table below shows, the downward share price trend among gold producing stocks appears to have gained momentum in the past month, with average share price falls of 13% compared with 11% in the past three months.

Performance of Gold producing companies

	Market	Share price performance			
	Cap (£m)	1m	3m	6m	1yr
Yamana Gold Company	7213	-7.4	-13.1	-11.5	-10.9
Polyus	6496	-6.5	2.6	-0.8	n/a
AngloGold	6424	-10.7	-14.1	n/a	n/a
Randgold Resources	5011	-6.8	-14.0	-21.7	-24.3
Polymetal	3623	-10.0	-15.4	-7.4	-6.2
Hochschild	1188	-20.5	-26.1	-22.5	-30.0
African Barrick Gold	959	-33.4	-43.9	-50.1	-45.3
Centamin	583	-11.5	-0.7	-36.8	-34.0
Medusa Mining	542	-15.1	-31.1	-22.9	-29.7
Petropavlovsk	472	-28.0	-24.4	-35.2	-61.3
Archipelago	344	7.1	-1.6	5.3	-7.7
Highland Gold	333	-7.4	21.2	-15.6	-33.5
Pan African	312	-11.5	-4.7	3.5	8.1
Kirkland Lake	267	-11.7	-24.9	-54.0	-62.5
Shanta Gold	83	-19.7	-7.7	-39.1	-53.3
Minera	72	-7.1	-17.9	-8.6	-42.6
Amara Mining	65	-22.2	-39.6	-49.5	-60.1
Charaat Gold	62	-2.0	23.3	-1.0	-23.4
Mwana	58	-22.1	3.9	26.6	-4.1
Avocet	44	-56.8	-66.9	-75.7	-90.3
Trans-Siberian Gold	43	-19.6	-2.5	-11.9	-49.4
Caledonian Mining	43	-2.9	26.9	32.0	10.0
Norseman	29	n/a	n/a	-2.5	-40.5
Orosur Mining	27	3.5	-9.6	-28.6	-32.0
Vatukoula	21	-22.5	-38.3	-60.8	-77.1
Goldplat	18	-6.5	-16.5	-27.7	-25.2
Peninsular Gold	16	-6.3	8.7	1.4	-20.2
Hambledon	16	-11.1	9.1	18.0	-42.9
Oxus Gold	13	10.0	28.2	34.4	44.0
Central Rand Gold	9	-11.6	-26.5	-25.0	-43.3
Angel Mining	6	n/a	12.6	-46.5	-68.1
Galantas	5	-19.0	-10.5	-32.0	-45.2
Kolar	5	-39.3	-39.3	-44.8	-70.9
Average		**-13.8**	**-11.0**	**-19.1**	**-34.6**

Source: Fidessa

On the junior end of the gold sector, the rate of decline also appears to be worsening with average share prices down around 9% in the past month compared with 6% in the past three months.

Performance of Gold exploration & development companies

	Market	Share price performance			
	Cap (£m)	1m	3m	6m	1yr
Patagonia Gold	126	-17.1	-30.1	-48.2	-63.1
Kryso	124	-5.1	14.0	0.4	9.7
Aureus Mining	80	-18.1	-25.8	-42.6	-50.0
Metals Exploration	62	5.3	-16.7	-26.8	-38.8
Condor Gold	55	-9.3	-10.4	-12.0	28.5
Serabi Gold	29	-14.5	35.4	32.7	-42.5
Papua Mining	28	-9.1	41.3	58.4	37.9
Kefi Minerals	16	-7.3	3.7	-4.8	18.8
Nyota Minerals	15	-31.6	-50.9	-62.3	-76.3
Bullabulling	14	-21.7	-26.5	-65.0	n/a
Touchstone	13	-20.9	-30.3	-45.9	-64.7
Ovoca Gold	12	-8.5	14.9	33.3	-40.3
Solgold	10	-13.6	-26.9	-40.6	-70.3
Kalimantan	10	64.3	48.4	-13.2	9.5
Ortac resources	9	-20.8	-7.0	-33.3	-52.7
Orogen Gold	9	-13.8	-24.3	-28.9	-39.6
Sovereign Mines	8	0.0	-17.6	-20.0	-59.4
Scotgold	7	-10.0	3.8	-18.2	-38.6
Goldstone	7	-28.3	-24.8	-46.5	-67.7
Conroy Gold & Nat. Rsrcs.	6	34.3	95.8	59.3	-18.3
Mariana Resources	6	-18.5	-43.6	-45.0	-69.4
Ariana	6	10.0	5.8	-7.4	-66.7
Noricum	4	-34.3	-34.3	-48.9	-74.4
Wishbone Gold	4	0.0	0.0	0.0	n/a
Aurum Mining	4	-7.7	0.0	20.0	4.3
ECR Minerals	2	-33.9	-41.8	-62.1	-80.3
Connemara	2	-3.2	-18.9	-14.3	-49.2
Greatland	2	-11.3	-23.3	-27.1	-61.5
Average		**-8.7**	**-6.8**	**-18.2**	**-39.0**

Source: Fidessa

2.2 Why many fail to achieve guidance?

Operating cost inflation continues to drive margin contraction. The same inflationary pressures which have driven gold prices higher in recent years are impacting consumables (fuel, steel, cyanide, cement etc.), availability and cost of labour, royalties and production taxes and CSR programmes. Combined with declining orebody quality (lower grade, deeper, harder to find, harder to extract) there is continuous upward pressure on the all-in cost of production and consequently profit margins.

Cost pressures may have started to abate over the past twelve months as risk-off markets forced a slowdown of new project development but with the central banks maintaining loose money policy it may not be long before cost inflation rears its head and equipment availability becomes tight again.

2.3 What is the actual cost of production?

Costs are also impacted by other factors. Bumper profits have fuelled labour unrest, driving unions to demand higher wages. An explosion of new taxes and royalties is pushing up regulatory compliance costs. The price of haul truck tyres alone has tripled in the past decade to $100,000. Energy and power prices are also on the rise. Capital expenditures, too, are reaching a new peak. In the rush to produce, mining companies continue to expand in more challenging provinces. This not only triggers expenditure on new equipment, but significant long-term infrastructure investments including railways, ports, housing and schools. To exacerbate the situation, political uncertainties and currency volatility are making it exceptionally difficult to contain costs in dollar terms. Centamin's production shortfalls relate to the political upheaval in Egypt, which now appears to be normalising, but for how long?

One of the main battles to maintain profitability is with government taxes; resource sector profits have long been tempting to governments. In recent years, mining royalties have increased in Australia, Chile, Peru, South Africa, Ghana, Tanzania and Burkina Faso, while new export duties have been introduced in India, Kazakhstan and Russia. In Indonesia, mines are now obliged to help the country meet its energy commitment before they can access export markets.

Notably, the bid to increase national revenues now extends beyond the introduction of new tax legislation. In addition to royalties, which tend to be charged against revenues, many governments have begun to impose super-profit taxes, discovery bonuses, resource rents, license fees, environmental levies and reconstruction tolls. Amid these rising levels of resource nationalism, some countries are even threatening to renegotiate existing tax stability agreements, throwing mining company financial projections into disarray and heightening political risk.

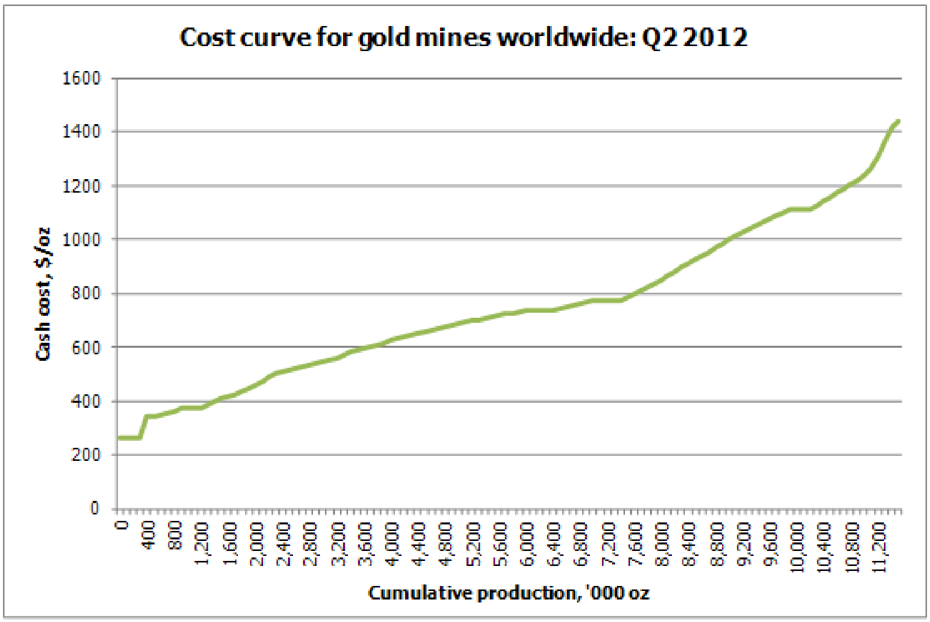
Mark Bristow, the CEO of Randgold Resources recently warned that mining code changes proposed by a number of African countries will deter further investment there. While Africa has the advantage of great mineral wealth, its competitors generally had better infrastructures, greater skills pools and more sophisticated economies. He pointed out that in the countries where Randgold has operations - Mali, the Côte d'Ivoire and the Democratic Republic of Congo - the present mining codes returned a substantial slice of the net revenue pie to its governments in spite of the fact that Randgold had funded the entire discovery and development cost and carried all the risks.

We believe the companies with the greatest flexibility to manage operating cost inflation are those with high grades, grid power availability and economies of scale. In this regards, in the gold producing segment, Randstand, Polymetal and Polyus are the obvious recipients of such benefits.

We calculate an average all-in cost of production at US$819/oz in Q2 2012. The all-in cost reflects the total cost of producing an ounce of gold including operating costs, royalties, D&A, net interest and sustaining capex (incl. maintenance, underground development & stripping). African Barrack is one of the most expensive UK gold producers due to the high cost Buzwagi operation which drags on group operating costs in addition to high annual development cost requirements at both Buzwagi (waste stripping) and Bulyanhulu (underground development). Petropavlovsk on the other hand has comparatively well contained unit costs within the hard rock business but the all-in costs are weighed down by high central admin D&A and interest charges.

Gold cash costs by year, $/oz

	2007	2008	2009	2010	2011	2012/Q1	2012/Q2
Average Cost	394	470	485	579	655	780	819
Average gold price	695	872	972	1225	1571	1650	1600
Difference	302	402	488	646	916	870	781



Source: Hybridan LLP estimates

Among the junior explorers, a number of companies including Conroy Gold, Bullabulling, Condor Gold and Ortac Resources continue to look undervalued. Given the issues in Africa, we see better opportunities in European and Latin American countries which are politically stable, have better infrastructure and reduced permitting risks.

In this context, The Fraser Institute's annual survey of mining and exploration companies provides an independent and comprehensive view of regional differences in attractiveness of mining investment. The study assesses how mineral endowments and public policy factors such as taxation and regulation affect exploration investment. A total of 742 responses were received for the 2012/13 survey, providing sufficient data to evaluate 96 jurisdictions. Responses to 15 policy factors are used to compile The Policy Potential Index (PPI), measuring the overall policy attractiveness of the 96 jurisdictions in the survey.

In the 2012/13 study, the top 10 ranked jurisdictions were Finland, Sweden, Alberta, New Brunswick, Wyoming, Ireland, Nevada, Yukon, Utah, and Norway. Ireland has climbed three places to be ranked 6th in the PPI index.

The Frazer Insitute: Policy Potential Index, 2012/13

	Score (out of 100)	Change in ranking
Top Ten		
Finland	95.5	+1
Sweden	93.6	+5
Alberta	92.6	-
New Brunswick	90.8	-3
Wyoming	90.1	-1
Ireland	89.7	+3
Nevada	85.3	+1
Yukon	83.8	+2
Utah	83.8	+12
Norway	82.4	+14
Bottom Ten		
Indonesia	9.4	-11
Vietnam	11.6	-11
Venezuela	11.8	-4
Democratic Republic of Congo	12.3	-17
Kyrgyzstan	13.4	-5
Zimbabwe	13.4	-17
Bolivia	13.8	+1
Guatemala	13.8	+3
Philippines	14.0	-
Greece	15.6	-

Source: The Frazer Institute

2.4. Gold Producers

The London gold market has evolved into an established go-to market for gold producers across the market cap spectrum. The addition of premium listed stocks Polyus Gold and Polymetal to the main board of the LSE has changed the landscape of the market whereby senior gold producers now comprise around 75% of the combined market cap of UK gold producers.

With over 20 gold producers of various size and quality now listed on the LSE we have decided to focus our attention on a selection of stocks with contrasting abilities to manage production costs and earnings growth. Polymetal, Polyus Gold and Randgold Resources offer high margin production growth and shareholder returns. Centamin, African Barrick Gold and Shanta Gold offer higher risk/ reward profiles.

2.4.1 Polymetal International

Polymetal (POLY) is a quality gold producer with an impressive management team and is ready to reap the rewards of expansion, having already peaked with regards to both capex and net debt. Gold output increased by 31% to 1m oz in 2011 and exceeded original guidance by 6%. We expect a swing into positive free cashflow in 2013 and an increase in the current 20% dividend payout ratio as the Amursk POX facility starts to deliver consistently, generating significant operating cashflow. The Company expects a 5 year production CAGR of 15% with 1.4m oz pa by 2014.

POLY's growth strategy is to create centralised ore processing facilities to treat high grade ore (group reserve grade 2.67g/t vs. POG at 1.1g/t) and concentrate across various mine sources, as highlighted by the creation of the Dukat, Amursk POX and Omolon hubs. The strategy should see the company grow production to 1.4Moz in 2014 with growth to come predominantly from the Amursk POX hub. Further growth is expected to come from accretive synergistic bolt-on acquisitions leveraging existing hub infrastructure.

Capex and net debt have peaked and with a 2013 free cash flow (FCF) forecast yield of 12%, POLY is transitioning from a major construction and capex spend phase to ramp-up and operational optimisation phase. Notwithstanding, the inevitable delays at the Amursk POX plant (ramp up to full capacity now expected in Q4 2013), we view POLY as largely de-risked from both a balance sheet and operational point of view. A PER 8x 2013 EPS looks attractive and on an earnings basis POLY is considerably cheaper than peers Randgold (13x) and Polyus (11x).

2.4.2 Polyus Gold International

Like POLY, Polyus Gold (PGIL) also exceeded production guidance for 2012, by 5%, to reach a record output of 1.7m oz. It is arguably the cheapest UK gold major on a resource basis, trading at a discount to peers on nearly all metrics except EPS despite targeting an impressive 75% increase in production by 2015. Although unlikely to trade at a sector premium in the near term as it lacks the FCF yields and geo-diversification of its premium rated peers, trading on 0.7x P/NAV it is undeniably cheap. We expect impressive production growth driving 25% p.a. 5 year EPS growth.

PGIL is by far the largest UK-listed gold producer and one of the top ten producers globally by production, market cap and mineral inventory, with an eye-watering 90m oz reserve base delivering 1.7m oz of gold production in 2012. PGIL is targeting a near doubling of production to 2.8m oz pa by 2015 through expansion of existing operations and development of the giant Natalka project. Commissioning at Natalka is planned for December 2013. Given the scale of the project and the relatively late start of construction, if PGIL can achieve first gold on time and on budget it will be a good achievement by management.

PGIL is a relatively low cash cost producer. The centralised processing mentality provides economies of scale within individual business units with unit cost control driven by Olimpiada recovery improvements, the ramp-up of Verninskoye and the suite of expansion programmes underway.

2.4.3 Randgold Resources

Randgold (RRS) is also a high-quality producer, increasing output by 14% in 2012. However, on 13x PER 2013 and an EV/book value of 3x, RRS trades at a substantial premium to peers on most metrics. We are not certain this is warranted. Besides the risk of political instability of operating in Africa, there are looming project execution risk, the potential for further capex overruns ahead of the Kibali commissioning in late 2013 and DRC tax discussion disappointments.

Randgold is targeting 1.2m oz pa production by 2015 driven by the Kibali development project in the DRC, a growth of 15% on today's production levels resulting in best-in-class marked-to-market. RRS does, however, have a sector leading EBITDA margin at 62% reflecting high margin gold production and lean central admin costs. RRS should swing back into positive FCF territory in 2013 and we do see scope for significant positive revisions to the current dividend policy in 2014 on successful execution of Kibali.

2.4.4 African Barrick Gold

Despite the recent sharp falls in share price, African Barrick Gold (ABG) doesn’t look particularly cheap on 10x PER 2013. The Company faces several problems in its operations and with no bids forthcoming from China National Gold, there is little scope for M&A upside. Production peaked in 2012 and is expected to fall by around 10% in 2013. Thereafter, it is hard to forecast any growth until 2016 when the Nyanzaga development project comes online. Average cash costs are likely to rise further from US$949/oz achieved in 2012, particularly at Buzgawi which will be 100% powered by diesel in 2013. Output at Bulyanhulu continues to be impacted by paste fill and equipment availability issues together with the loss of skilled employees due to proposed government pension law changes. At North Mara, much work still needs to be done to resolve land access issues to ensure the Company has the appropriate footprint for its operations and it is relying on the Tanzanian government's support in achieving this. A strategic review announced in January this year is expected to be completed in six months.

2.4.5 Centamin

Centamin (CCY) continues to deliver as an operating company, output rose 30% in 2012 to 263,000 ounces, well above guidance. The economic turmoil in Egypt over the last two years may have provided an attractive entry point for a company with a world-class gold asset, de-risked high margin production growth model, internally funded by a robust balance sheet, a solid operational management team and P/E of 3x for 2013. With Stage 4 expansion on budget and schedule and CEY generating an estimated 30% of its market cap in FCF over the next 3 years we see solid potential for management to start returning meaningful cash to shareholders. However, given the political risks in Egypt this may be for the bravest investors.

2.4.6 Shanta Gold

Shanta (SHG) has completed the transition from explorer to producer. Its two Tanzanian projects are high grade (3g/t-5.5g/t) and the consensus in the next three years is for a total output of 250k oz of gold. Amongst its UK peers, SHG has probably the most superior production growth (4 year production CAGR of 110%) and cash costs forecasts, driving sector leading FCF yields of 32% in 2013. Trading on 2x PER 2013 with an exciting exploration portfolio and multi project growth, Shanta is one of the leading emerging gold producers.

New Luika is ramping up to full capacity and once a steady state of production is bedded down, SHG’s next gold mine - Singida - should be ready to start construction. Singida has 858k oz of resources with decent upside and capex is forecast at an ultra low US$40m. Additional growth will come from the massive near mine exploration upside at New Luika (JV with Great Basin Gold) where recent high grade drill intercepts including 4m at 35g/t highlight the very tangible potential for truckable satellite feed. Preliminary suggestions of gold mineralisation across a 3.6km strike length could prove to be transformational for the company.

2.5 Junior Explorers

The junior mining stocks (explorers/developers) have been hit particularly hard. The junior mining companies tend to underperform senior miners when the sector derates. In the current downturn, investors are clearly worried about future costs and the ability of junior companies to raise sufficient funds to complete projects. In this sub-sector, our preference is for companies with attractive valuations and low geopolitical risks such as Conroy Gold and Bullabulling or companies with strong funding such as Condor Gold.

As the table below shows Bullabulling and Conroy Gold are significantly undervalued compared with comparable gold exploration companies, many of which are located in countries where production and costs are subject to political and economic uncertainties. Ortac Resources is a good example where valuations look attractive but political uncertainty renders it higher risk. There are also a number of gold explorers with no compliant resource which have significantly higher valuations than Conroy and Bullabulling. Condor Gold looks relatively more expensive on an EV per ounce of resource; however, it has made good progress on delineating resources and raising capital.

Company	**EV (£'m)**	**Operating Region**	**Gold Resource** m oz	**Cut off grade** g/t Au	**EV/oz. of gold**
Bullabulling	13.6	Western Australia	3.50	0.5	3.9
Conroy Gold & Nat. Rsrcs.	6.4	Ireland & Finland	1.03	0.6	6.2
Ortac resources	9.1	Slovakia	1.3	0.4	6.9
Nyota Minerals	15.5	Ethiopia	1.9	2.3	8.3
Goldstone	6.6	Africa	0.6	0.5	11.0
Serabi Gold	29.4	Brazil	2.5	0.5	11.7
Mariana Resources	6.3	Argentina, Chile & Peru	0.5	1.0	12.2
Ariana	4.5	Turkey	0.5	0.5	10.1
Condor Gold	55.5	Nicaragua, El Salvador	3.5	1.0	16.0
Kryso	123.9	Tajikstan	5.0	0.5	24.7
Scotgold	7.1	Scotland	0.2	3.5	42.2
Metals Exploration	61.9	The Philippines	1.4	1.7	44.5
Aureus Mining	70.2	Cameroon	1.7	0.5	40.5
Patagonia Gold	125.9	Argentina	1.9	0.3	67.1
Aurum Mining	4.2	Spain	0	-	-
Connemara	1.9	Ireland	0	-	-
ECR Minerals	2.2	Argentina	0	-	-
Greatland	1.8	Australia	0	-	-
Kalimantan	9.9	Indonesia	0	-	-
Kefi Minerals	16.3	Saudi Arabia	0	-	-
Noricum	4.3	Austria	0	-	-
Orogen Gold	8.8	Serbia	0	-	-
Ovoca Gold	11.8	Russia	0	-	-
Papua Mining	28.0	Papua New Guinea	0	-	-
Solgold	10.1	Australia, Ecuador	0	-	-
Sovereign Mines	8.3	West Africa	0	-	-
Touchstone	13.3	Columbia	0	-	-
Wishbone Gold	4.3	N/A	0	-	-

Source: Company reports, Fidessa

2.5.1 Bullabulling

Based on our calculations, on an EV/resource basis, shares in Bullabulling at the current level provide the most value among the junior gold exploration companies. The Bullabulling Gold Project is located near the town of Coolgardie, approximately 60 km east of Kalgoorlie in Western Australia, and has a JORC compliant resource of 3.5m ounces of gold. Results of a recently concluded prefeasibility study have determined that the project is technically and financially viable with an open pit mine forecast to produce 1.95m ounces of gold over mine life of 10.5 years, at an average cost of $891 per ounce in the first three years of operation. Capital payback is expected within 36 months and NPV calculations imply a value of 38p per share, compared with the current share price of 4.6p.

2.5.2 Condor Gold

Condor Gold is focused on highly prospective precious metal concessions in the mining-friendly Nicaragua and dormant assets in El Salvador. Condor's concession holdings in La India, Nicaragua currently contain an attributable CIM/JORC compliant resource base of 2.5m ounces of gold equivalent at 4.6 g/t in Nicaragua and an attributable 1m oz gold equivalent at 2.6g/t JORC compliant resource base in El Salvador. A Preliminary Economic Assessment (PEA) prepared by SRK Consulting (UK) Ltd. on La India is encouraging. The results highlight an open pit and underground gold mine with an initial Life of Mine (LOM) of 13 years at an average gold grade of 3.8g/t of gold for a total production of 1.46m oz recovered gold and LOM average operating cash cost of US$575 per oz of gold. The project would create a NPV after tax of US$325m, based on a US$1,400 gold price and 5% discount rate, producing an IRR of 33%.

Recently, the Company has also been successful in raising funds to implement a feasibility drill programme and exploration drill programme and cover certain cash installment payments due in connection with the acquisition of the Espinito Mendoza and La Mojarra concessions in 2011 and 2012, respectively. In February, it announced a £7m placing, before expenses, predominately with Regent Pacific Group Ltd. Regent Pacific has also agreed, subject to the results of further due diligence on or before 21 March 2013, to invest a further £3m before expenses.

2.5.3 Conroy Gold & Natural Resources

Since our last update on 12th December, Conroy has made considerable progress on its plans to develop a mine at Clontibret. In January, it announced that the first results of the metallurgical test work being undertaken by Goldfields have been positive. The flotation test work has been particularly encouraging, with gold flotation recovery, at 90%, being higher than assumed in the Scoping Study. The results also indicate an 8% sulphur grade in concentrate whereas in the Scoping Study a grade of 12% had been assumed. The lower sulphur grade in the concentrate is highly advantageous as it will reduce process operating costs.

The Company estimates that the effect of these results would increase the IRR from 49% (in the Scoping Study) to over 55% and would increase the NPV from $72m to over $90m using the base case gold price of $1,372 per ounce as used by Tetra Tech in their Scoping Study and thus substantially increase the overall financial attractiveness of the project. This is equivalent to 22p per share compared with the current share price of 2.35p. According to the 2012/13 Frazer Institute annual survey, Scandinavia and Ireland continue to climb the rankings of the most attractive jurisdictions for mining investment, which should favour a company like Conroy Gold & Natural Resources PLC**.**

2.5.4 Ortac Resources

Ortac is a gold developer focused on developing its flagship Šturec Project near the town of Kremnica in Slovakia. Findings from the Scoping Study conducted on the Company's turec deposit were published in 2012 and re-affirmed the value and economic viability of this asset. From an economic perspective, the deposit has a current JORC compliant gold resource of 1.32m oz. located in a historically producing and proven gold-bearing mineral district. However, despite relatively high unemployment in the region, Ortac faces opposition from some locals and recently received a letter from the Mayor of Kremica. The concerns expressed relate to potential damage to historic buildings through blasting at the mine; memories of unpleasant experiences with mining during the Soviet era still linger. The Company has been engaged with the local community but there is a risk of prolonged delays before the Company can release a preliminary environmental report.

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