Draft

How to Choose a Hot Stock
Example: Focus Minerals Ltd (ASX – FML) **26th August 2009**

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General comment:
Astute investors value gold stocks via several benchmarks including resources, assets, production and profitability, life of mine, quality of management and ground position.

These factors point to sustained future growth in share price = investor profits.

The balance sheet indicates financial health and potential yield – how much return am I going to get if I park my capital into this investment over time?

As such we also find debt, hedge book obligations, convertible notes and royalties influence share price too.

Introduction

This article looks primarily at Focus Minerals Ltd (ASX code - FML). I will be using this stock as an illustration of the investment principles above. I was not solicited nor paid by FML for this report. It is written in plain English as it is intended as an educational piece for general reading. Therefore comparisons are also used between market valuations of other companies in addition to a brief overview of the points covered above.

Educationally speaking - this story is mechanical in nature. The theory applies to all companies and their various stages of development. There are many phases along the path to profitable mining some of which are defining moments in terms of future potential and others which relate more to attractive present time investment criteria. Distortions in share prices based on general market sentiment also create opportunity, eventually undervaluation leads to overvaluation. This will be the time we seek to sell and take profits.

Make no mistake though – the single most important factor that drives any share price is money – purchasing pressure. I am talking about two buyers for every seller (or better), liquidity pouring into a stock in a sustained flow forcing the share price higher.

This can only result from broad investor / broker interest and media attention. In other words share price is driven by positive promotion in its various forms. To achieve this, a stock needs a good story initially followed by a positive information flow and over time it needs a high level of profitability over a sustained period.

This article investigates an undervalued gold miner, defines value by market capitalization, assets, resources and relative value by comparison. It does not recommend one stock over another there are several undervalued stocks trading on the ASX within the gold sub-sector at this time – and some that are overvalued.

Let's take a look at FML then and later on some comparisons to benchmark current valuation, potential future valuation and share price performance.

Investment Factors – Example FML

Part 1 Tangible Valuation

First of all consider that Focus Minerals Ltd holds a quality ground position and operation which is generally misunderstood by the investment community. This statement is true on balance considering the current sentiment and share price of this stock.

The current FML valuation (market capitalization) is $71.4 M @ 2.7c as of August 26th 2009. A basic list of their tangible assets, liquid assets, liabilities and ground position is useful at this point. The writer has researched company reports, the FML web site, and broker coverage and spoken to various personnel at FML in the preparation of this report and I thank them for their time.

Tangible and liquid assets (basic view)

Cash position (end June 09)	$21M
1.2 Mt PA Three Mile Hill Mill (Pattersons valuation)	$113M
Access to 480kt PA capacity at Greenfields Mill priority toll treatment	$strategic value
Mine declines, tailings dam	$20M (nominal)
Ore stock piles – low grade 1Mt @ 1gpt – 20% nominal value	$7M
+ mill ready Greenfields (Sept campaign prod est) 96kt @ 6gpt	
= 17,655 oz @ 96% recovery	
9,378 closes hedge book @ $984 – total cost $735/oz = net $249/oz	$2.335M
Balance: 8,277 oz @ spot = net circa $400 / oz	$3.3M
Ore stockpile at Three Mile Hill (FML Mill) 80kt @ 3gpt	
(Commissioning ore for initial production ramp up)	$2M
Resources	
JORC gold:	
The Mount – 2Mt @ 5.5gpt for 370k oz	$7.4M
Coolgardie – 20.6Mt @ 2.48gpt for 1.65M oz @ $20 / oz	$33M
JORC nickel – 591.3kt @ 2.2% Ni for 13,250t Ni	
– nominal value (Pattersons valuation)	$20M
TOTAL RESOURCES & ASSETS	**$229.035M**

Liabilities	
Bank Debt	$7.25
Convertible notes	$1.25M
Remaining mill refurbishment costs	$10.4M
Hedge Book – 9,378 oz @ A$984 (hedge loss mark to market factored above)	
TOTAL LIABILITIES	**$18.9M**

Notes on Production and Assets

08/09 production - $41k oz @ cash cost $603 / oz & total cost $735 / oz

09/10 production forecast:

- Sept qtr 17,500oz based on 96kt @ 6gpt and 96% recovery rate.
- Dec qtr 20k oz - based on 17,500 at Greenfields Mill and 2,500 oz from commissioning.
- H2 42,500oz – balance of their conservative (ramp up) 80k+ oz 09/10 production estimate for Three Mile Hill Mill.

Note: further toll treatment remains a strategic option in the event of delayed mill completion or mishap on commissioning.

H2 cash cost estimate $600 and total cost allowance circa $735 / oz. Cash costs could fall to as low as $550 / oz, the initial estimate in the pre-feasibility study was $473 per oz. Production forecast of 80,000 oz is conservative given the 09 June quarter result from a 6 week toll treatment campaign of over 19,000 oz.

Upon completion of their treatment plant the milling costs will drop from $35/t toll treatment down to around $22/t. Therefore total costs should not increase in 09/10 as this provides a buffer against cost inflation of consumables for example.

Operating profits should be in the order of $400 per ounce @ A$1200 spot gold price resulting in overall gross operating profits of approximately $30M for 09/10. Note the hedge book and debt will be extinguished by the end of the December quarter.

Mill refurbishment costs will reduce the current cash balance in the order of $10M down to circa $10M – all complete by the end of the December quarter 09. Debt and hedge retirement will come from the next two milling campaigns along with additional cash flow. I would expect some retained capital resulting from this production to add upside to the cash balance.

The FML mine declines and tailing dam capacity are nominated above as they would normally be expressed as pre-strip ratios and waste disposal costs - translated into direct cash costs. These assets are in place and have value however the true cost of development of a tailings dam and declines into underground workings would be much higher to replace.

Comparison case in point Citigold (ASX – CTO) and their access portal – it was required to open ore pods over the past 12 months resulting in higher indirect cost (on their balance sheet) and operational focus diverted from gold production which remained low. Current CTO market capitalization is $134M and their June quarter production was less than 1,900 oz.

In ground valuation of the gold resources for FML is calculated at a very conservative $20 per ounce which is well under many other producer valuation comparisons - based on resources / market capitalization. The proven low cash cost per ounce and the fact that this resource is currently in production suggests that this valuation could be much higher. Therefore the valuation model above is considered to be potentially conservative.

General comment: The JORC contained assets are not yet mined and production costs in future years are not yet known – however these assets do point to projected profits and LOM (life of mine) which indicates mine sustainability. Commodities fluctuate in value which increases risk in future years if sale prices drop along side an increase in costs. Therefore high margin ore-bodies that can be mined over extended mine life after capital expenditure is returned are more attractive.

Summary Part 1 Tangible Valuation

Assets of approx $230M and short term liabilities of $20M gives a balance of $210M by this valuation model. Forward earnings however suggest a $30M gross profit which gives us a current market capitalization of 2.5 x gross profit. These earnings are current however they are not certain due to the mill refurbishment / start up risk.

The balance sheet is currently affected by mill refurbishment costs, hedge book finalization and pay out of the bank debt over the coming weeks.

Pattersons also indicated that FML enjoys exposure to any rise in the gold price at a rate of 30% increase in their valuation for every 10% rise in the gold price.

Cash costs will fall once the ramp up at Three Mile Hill is complete. Toll treatment next door at Greenfields will offset this with continued high grade production in the September and December quarters. Therefore the December quarter is likely to see commissioning production on top of toll treatment and perhaps a record quarterly production.

The market is clearly considering other negative factors here and weighing the above risks in the current valuation. The Matsa (MAT) agreement and "game changing exploration campaign" currently underway are positives not factored in the current valuation either.

Part 2 Additional Considerations

FML Management

The Board and Senior Management of FML have distinguished senior careers that cover senior roles for heavy weight mining corporations (WMC) and successful mid-tier mining companies. They have diverse industry specific skills that also apply to the geographical location of FML operations.

A balanced broad mix of finance and operative skills combined with historic success (track record – tick) makes this team a winner. This analyst has observed the consistent delivery of sound risk management policies and strategies over time.

What is more important to this analyst is that they under promise and over deliver. Time lines have remained constant with key outcomes delivered on time and on budget. If you have questions the company team is happy to communicate quickly and to the point. Given the quality of recent presentations and the FML web site we can also see that Management value promotion – this is a positive.

FML - History and Ground Position

Perhaps (?) Coolgardie is considered to be a tired old field because it has already given up over 2.6M ounces during its long mining history. Gold was first reported to have been discovered in Western Australia at Fly Flat near Coolgardie on the 17th September 1892 by Arthur Bailey and William Ford. Bailey reported that he had mined 554 oz of gold on that day and received a "reward claim" of 20 acres of mining lease. This was worked until 1963 yielding 500,000 oz of gold.

The Kalgoorlie gold rush began however in June 1893 with the discovery of rich alluvial gold deposits near Mount Charlotte. This distracted prospectors away from Coolgardie in a similar fashion to other discoveries in the Eastern States a few decades earlier. Prospectors tended to swarm to new discoveries just like investors swarm to the latest hot stocks today – little has changed in human nature over time.

The Coolgardie Goldfield remained the property of several small operators over time. This prevented the systematic broad approach needed to fully understand the geology or potential at Coolgardie. The dispersed ownership also meant mining and drilling below 100m depth was limited.

FML consolidated the field from 2003 to 2006 when it purchased the northern tenements taking the total ground holding to $210km^2$. This process still continues with the recent (28^{th} April 09) acquisition of the Garden Gully lease from Golden Deeps Ltd.

Resources had grown from 1.2M oz to 1.5M oz by 2006. FML took 100% control of the field in mid 2008 with a major funding package and share issue to former partners Committee Bay.

On the 28^{th} July this year FML announced an increase of 125k oz to 23.4Mt @ 2.6g/t for 1.92m ounces in total. They also stated that “Ongoing detailed collation and validation of historical data lays the foundation for similar future resource upgrades”.

Resource Upside Likely to Generate Ongoing Excitement

Over the last two years FML have come to understand the mineralization at the Coolgardie Goldfields to a much greater degree. Now the Company is reaching the stage that the debt and hedge book are almost cleared. Income is significant and set to increase so FML has decided to increase the exploration budget.

Speculation: Resource upside here is in the 4 – 5 M oz range over the next 3 – 5 years as the secrets of this impressive field are unlocked. How do I arrive at this speculation?

Given that Coolgardie has relinquished 2.6M oz over its history, with only sparse drilling due to the fragmented ownership, we are likely to see the currently defined reserves of 1.92M oz at least double from here under modern exploration techniques.

When you add historic gold production to the current un-mined resource this field has already established an endowment of 4.52M oz in total. I am saying that a total of 7.5 M oz is quite possible with sufficient drilling and use of the right technologies.

Resources have already increased 320k oz in the last 12 months during a time when the focus on additional resources has not been the main priority. The combination of deeper drilling, modern technology, higher gold prices and persistent exploration are highly likely to locate another 2 - 3M oz.

High gold prices will allow known lower grade resources to be added to the resource base and profitably fed through the mill. This further increases the likelihood of the successful definition of the resource upside targets suggested above.

FML are now using the new Leapfrog Software which has been designed specifically for the mining industry. It dramatically cuts modeling time, improves accuracy, and is an alternative to traditional CAD-based software.

Leapfrog makes it easy to incorporate new data and update existing models – a time-consuming process with traditional software. Creating multiple geological scenarios for near-mine exploration has not been a realistic proposition until now. As a result, mines have depended on a single 'locked-in' geological model that exposes the operation to an unacceptable risk associated with geological interpretation. Because you can use Leapfrog to create, test, and eliminate several alternative models as new drilling data is incorporated, you can lower and manage this interpretation risk.

A game changing exploration program and phase at FML is underway now and a further exploration budget of $6M for 2010. This will be increased as profits and production levels rise over the next 2 - 3 years. This would allow for an expanding resource base that more than offsets production ounces extracted and extend LOM to well over 15 years.

Similarities between Tindals and the Avoca Resources Higginsville Line of Load are easy to draw. Higginsville started at 580k oz and now stands at over 1.4M oz as a result of deeper drilling. Grades increased as the depth potential of the mine was opened up. This allowed for higher production rates. Coolgardie has been only lightly drilled between 100 – 300m with little or no deeper drilling.

The Lines of Load at Coolgardie are also located along several kilometers of known strike and contain multiple deposits similar to Higginsville. When viewing the entire Coolgardie gold system it is even possible that the Lines of Load are one very large gold system but it too early to assume this.

The EM survey FML completed in the March quarter 2008 identified 17 targets, of which three coincide with known deposits (Perseverance, Empress and Big Blow). Of the remaining 14 targets that have never been drilled, the seven highest priority targets are yet to be extensively tested.

Further EM survey work is planned and a structural consultant is currently working with FML as they advance towards further resource definition.

FML considers that there is outstanding potential to increase Resources at Tindals in the short term with step-out and deeper drilling. We are currently seeing extension drilling at Perseverance where the ore body is open at depth (see above comments) in addition to likely deposit repetitions located using EM technology last year.

A decline is proposed at the Mount where there is already 370k oz defined. The Mount system is open to the north and south as well as at depth.

As a final note investors may not realize that although the grades are not generally spectacular at Coolgardie the ore bodies are consistently wide and large enough to enable economic bulk stoping methods.

This is the key which allows FML to achieve low cash costs, the occasional high grade pods that may become more common at depth could allow for 150k oz PA production levels similar to the Avoca resource – both mills rate at 1.2Mt PA throughput.

Notes:

Valuation Comparisons

ASX Code	Au Prod Last qtr	$ cost per oz	Sold $ / oz	A$ Res.	Gold Res'ce	Mkt Cap	Comments
FML	19,226 oz	$695	$1068	22 M	1.9Moz Also 13kt Ni	71.4 M	Refurbishing mill 1.2 Mt PA to be complete by December 09 Resource upside on Au and Ni is obvious.
ALD	16,739 oz	$771	$929	21 M	4.7Moz	208 M	LOM 10 years, looking at plant / production upgrade. Debt free. 54.5k oz Au hedged.
TRY	14,800 oz	$614	spot	35 M	742koz 15M oz Ag	140 M	Two operations Sandstone (to end 2010 + possible) and Andorinhas. Developing Caposo (early). Zero debt, pays dividends.
MUN	6,870 oz	$698	$1,205	2.2 M	n/a	51.4 M	Torrecillas late 2010 to add 40k oz PA. Major production increase planned in 2012. Budgeted cash cost $500 this year. Costs falling. Aiming high on production.
DOM	21,331 oz	$497	$1,118	45 M	1.5Moz	395 M	120 k PA production expansion / complete early 2010. Net cash margin $384 / oz over 12 months. Excellent exploration ground in WA. 26k oz hedged @ $944
DRA	19,535 oz	$727	$1,094 approx	18.9 M inc 4.2 bond	1.2Moz	44.2 M	Developing pit at Jokisivu for third mine – ample production capacity. Zara 20% Eritrea. Hedge 1750 oz at US$404 / oz remains. $16.8M liability 2011 Con Notes.
SLR	15,111 oz	$760	$1,210	20 M	1.5 M oz	72.6 M	No debt, no hedging, low capex mill upgrades towards 600kt PA. High grade assets. Au resource upside obvious.

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Notes on Table (previous page)
I have included some interesting value comparisons above which point to potential valuations:
Note: positive and negative comments are compared to FML.

ALD Allied Gold Ltd Market capitalization $208M

Chosen as it is has a similar production level to FML with resources in the range I expect FML to have in a few years. Also debt free, but FML will have no hedge shortly so more profitable than ALD.

- Positive - has greater resources at 4.5M oz and therefore have established LOM whereas FML is still building theirs.
- Positive – debt free status.
- Negative - they also have a higher cash cost and that hedge which reduces their margin well below FML.
- Negative - they also have a lower production level. Note: however FML is not proven to have stable production as yet due to their current toll treatment status.

TRY Troy Resources NL Market capitalization $140M

Chosen as it is has a smaller production level and cost than FML will shortly. TRY is winding down a key asset however and has a risk building another – cash will be used.

- Positive - Lower cash cost, no hedge, no debt
- Positive - More cash – pay a dividend, solid balance sheet
- Positive & Negative risk - Building a new production centre to soak up cash
- Negative - Lower production, sovereign risk issues, Sandstone winding down operations

MUN Mundo Minerals Ltd Market capitalization $51.4M

Chosen as it is has a similar valuation and cash cost to FML.

- Negative – smaller production pipeline
- Negative – low cash reserves
- Negative – much lower production levels

DOM Dominion Mining Ltd Market capitalization $395M

Chosen as it is has a similar production profile to FML and similar Resources. Note DOM Reserves are at a much higher proven status. DOM is where FML is going in the not too distant future if FML plans work out – but they will have to get those cash costs down and pay a dividend to earn that yield status that DOM enjoys.

- Positive – higher cash reserve and strong balance sheet.
- Positive – lower cash costs, slightly higher production levels.
- Positive – pays a dividend.
- Recognized industry performer.

DRA Dragon Mining Ltd Market capitalization $42.8M

Chosen as it is has similarities; production level, minimal remaining hedge, cash level.

- Negative – higher cash cost.
- Negative – higher debt obligation (convertible notes).
- Negative – lower resources, stripping waste for new pit, harsh climate.

SLR Silver Lake Resources Ltd Market capitalization $72.2M

Chosen as it is has similarities in resource, production, market capitalization and cash. SLR share price has come off the market capitalization was very recently $90M.

- Positive – No debt, no hedge
- Negative – Lower production, higher cash cost
- Negative – cash spend on mill upgrade

Technical Analysis

Warning – technical analysis (T/A) is an art not a science. T/A is not reliable on small stocks because there is generally insufficient volume to produce reliable data. It can be useful however for timing purposes, as an indicator and remember – there are enough traders out there with stock filters and systems to make T/A indicators a self fulfilling prophesy.

Technical comments:

RSI is a useful comparison to price because it measures the internal strength of a stock. It can indicate a turning point as above at the end of July when we saw a sweet little buy signal. The price tracked first outside (below) the Bollinger Band (BB) and then made an equal low inside the BB while the RSI correlation to these lows showed upward bias.

Confirmation has been given (essential) with this latest price surge and once again RSI has also confirmed internal strength with a stronger peak almost equaling the early January 09 peak.

The bottom indicator is the Slow Stochastic which is also showing recent divergence (positive) and now looks like it could cross over to an upward bias. This requires confirmation but the red and blue lines have "pinched" down near the 40 level so we wait to see if we get confirmation or not.

This indicator should be viewed in two time frames so scroll down and take a look at the weekly picture where I view the long term RSI pattern, volume and weekly Slow Stochastic T/A indicators.

Taking the longer term view we can clearly see a long base formation is in place along with a massive accumulation as shown clearly by the volume indicator in the bottom window. Large rises are usually preceded by a strong base formation and this type of volume pattern.

There is also upward bias in the RSI indicator in red (3rd indicator up from bottom) and the Bollinger Bands are beginning to pinch together which can signal that a breakout is due in either direction. Next indicator is the Slow Stochastic, red and blue lines (fast and slow moving averages) and we see this is in an upward bias giving us a medium term uptrend.

Longer term indicators are generally used to help predict overall trends and short term indicators on previous page in the daily 12 month chart can be used to find suitable entry points.

Fundamental analysis gives us the big picture and future direction provided nothing goes horribly wrong with a company. Neither T/A or fundamental analysis can pre-warn us about these types of events and therefore one must keep an eye on support and resistance points on the chart and also the news flow on stocks. This is also why traders should never put all their eggs in one basket.

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