

Fundamental Analysis of Mining Stocks

This week look at Gold Resource Corp. (GORO).



NOBS bespoke report dated September 9th 2012

Gold Resource Corp (GORO)

Company Overview

Gold Resource Corp (NYSE: GORO) is junior gold mining company operating in Mexico. Its flagship property is the operating and producing 'El Aguila' silver/gold mine in Oaxaca, Mexico and it also has a asset book of exploration and development stage properties in the same region. Current share structure is as follows:

Shares out: **53.016m**
Options: **5.702mm**
Warrants: **Zero**
Fully diluted shares: **58.718m**
Current share price: **\$21.32**
Market Cap: **\$1130.3m**
Est Fwd Dividend yield: **~3.4%**
Approx cash per S/O: **\$0.87**

All prices are in US dollars unless stated. Forex US\$1=CAD\$1

Today's report

The object of the NOBS fundamentals report today is straightforward; we're laying out the case for a short position in Gold Resource Corp (GORO) and fully intend to act on this next week so if you don't feel like reading all the ins and outs of the argument, stop right here and go read something more interesting than this issue of The Weekly, or turn on the TV or go to the movies and watch a decent first releae film. The bottom line is that your author is going to short GORO and the rest is noise.

GORO was last featured on these pages in IKN168 dated July 22nd and in that more narrative article I said that GORO was overvalued on any metric you care to examine, but particularly when compared like-for-like with peer companies. On that day we chose to stack GORO up

against Fortuna Silver (FVI.to) and Rio Alto Mining (RIO.to) as the information about those other companies is always close to hand for your author, but comparatives against any number of other companies would work just as well. In IKN168 we made clear that we believe GORO is and will remain a profitable mining company over the medium term and unless it announces more bad news to the market in the style of its 2q12 production numbers, it will stay that way. However, our contention in July was that, aside the untrustworthy management and the fanatical shareholders who are their own red flag, GORO was simply overvalued.

On July 22nd, GORO stock was priced at \$17.39. Today the share price is \$21.32, i.e. up 22.6%. Back in IKN168 the advice was to avoid the stock as a long position but if you are short GORO stay that way (*and according to NASDAQ figures (3), GORO short interest currently stands at around 4.3m shares so you have company if you are*). Things change today and the reasons are three:

1) We changed the emphasis of *The IKN Weekly* as announced in IKN171 dated August 12th to cover more producers.

2) In that same edition IKN171, the door was opened to recommending short positions for the first time on these pages. Here's how we broached the subject at that time:

I will consider offering recommendations on shorts. I get a lot, and I mean A LOT of people telling me that I'd make a good shorter of mining stocks, probably because of the style of the IKN blog more than anything else. However, I've kept The IKN Weekly long-only up to now because the type of stock we cover (typically Canadian, junior, small) is often tough to short for the retail investor and you need to be either in a pro-shop or have a really smart broker (and a longer-term relationship with the brokerage) to be able to play the downside to these stocks. With the move to more producer stocks and the potential move up in market cap size, the chances of finding stock to borrow and and gets better for us retail grunts, so although I'm not wild about the idea, I'm not going to stop myself any longer if I find a shortable that's screaming at me.

The fact is that GORO ticks off all the boxes I'd want for a short in the junior mining world, as it's a) listed in the USA which makes the mechanics of shorting easier b) has a decent market cap c) has a higher dollar share price than your average junior producer, which makes things easier too d) now that the stock has moved back up, it doesn't seem merely overvalued (as in July) but really 'screaming at me'. On which subject...

3) The share price of GORO has moved back up to above \$21, a price I did not expect to see again in this stock in 2012. It's clear that the impetus of the move has been on the back of the improvement in gold price (*July 22nd gold stood at \$1,576/oz, today it's 10.3% higher at \$1,739/oz*), but all the same we've seen this rally in an already overvalued stock that's been basically uncontested and at 2X beta to the metal that defines its corporate title.

In other words, in IKN168 we called avoid but this time we're serious. We're going short GORO next week and the details as to why are found below.

The dividend

This company is all about its dividend. Not quite all, because it still has to mine its rock, process it and sell it at a profit and in fact on that score it does quite well. GORO did hit significant problems in the last quarter 2q12 and we'll go into some depth about those further down, but the reason why the dividend is all important is that it's the only visible means of support for an otherwise very over-extended share price. On August 28th GORO announced (4) the latest of its monthly dividends of 6c per share payable to shareholders of record on September 10th with the payment moving on September 24th. Let's first consider the cost to GORO of this dividend distribution policy. At present, there are just over 53m shares out of GORO. As 4.3m of those are held in short positions (*note: those shorting GORO are liable to any dividend paid*) this means GORO the company is scheduled to pay out 48.7m lots of 6c dividends in September; that's \$2.922m. If we then assume the company makes the dividend 6c per month over a year (*and the way things are going it looks like that's GORO's objective*) this would imply that a little over \$35m were paid to shareholders per year.

As for the yield, that currently stands at 3.4% per annum if we consider 6c/month per year and the current share price, a yield figure that GORO is proud to show off to the world. Here's a link to the latest corporate presentation (5) which gives a good idea of the image and limited aspects of the company it prefers to offer to the market (*and if investors are convinced by simply reading through a corp presentation without checking out the underlying numbers and quarterlies, then that's their decision*). By way of example, from that presentation we are given this table of "peers" to GORO. The Miriam Webster dictionary defines peer in this way:

Company	Annual Dividend Estimate	Yield %	Share Price Close 8/30/2012
Agnico Eagle	U.S.\$0.80	1.7%	U.S.\$46.00
Barrick	U.S.\$0.80	2.1%	U.S.\$37.08
Goldcorp	U.S.\$0.54	1.4%	U.S.\$39.49
Kinross	U.S.\$0.16	1.8%	U.S.\$ 8.51
Newmont	U.S.\$1.40	2.9%	U.S.\$48.55
Yamana	U.S.\$0.26	1.6%	U.S.\$16.32
Royal Gold	U.S.\$0.60	0.7%	U.S.\$84.18
PEER AVERAGE		1.5%	
Gold Resource	U.S.\$0.72	4.0%	U.S.\$18.00

Source: Based on each company's annual public filing and Bloomberg.

Peer (n): one that is of equal standing with another; one belonging to the same societal group especially based on age, grade, or status

From this we are forced to conclude that GORO, with a tonnage throughput of less than 750tpd in the first six months of 2012, that is due to produce around 110k of gold equivalent in 2012 and with a market cap that fluctuates around \$1Bn, is on an equal standing to Barrick (mkt cap \$40.2Bn), Goldcorp (\$34.9Bn), Newmont (\$25.7Bn), Kinross (\$11Bn) Yamana (\$13Bn) Agnico Eagle (\$8.5Bn) or Royal Gold (\$5.4Bn). Now I'm not one to knock GORO's ambitions, but it does seem a little premature to consider this company a peer of the Tier 1 names listed in GORO's own corporate brainwash material.

The dividend policy at GORO is its key marketing and selling point, it's USP (*unique selling point, as the jargon goes*) and the company never misses an opportunity to tell its holders about how lucky they are to hold a stock that pays dividends amongst all the drudge and nonsense of the junior mining world. It looks to return cash to its shareholders in the form of a monthly payment and emulate larger precious metals mining companies, which is fair enough. But this is not a mature, large and diversified Tier 1 but a junior that has aggressive growth plans (*if you swallow whole what this management team says, at least*) and a limited treasury with which to fund their plans. The day the dividend is stopped is the day GORO loses trust and goodwill with the people it has managed to convince. Not only that, but there's clear evidence that the company has been paying dividends out of treasury and not its positive cash flow recently, as the company saw its cash treasury reduced in 2q12 even though operations expenditures were inside the range of the normal. The operational problems it faced in 2q12 cut production, but instead of cutting down on its faddish dividend it preferred to sell more metal than it produced and deplete treasury in order to cover 18c worth of dividends. It's the kind of stunt you can get away with for a limited period, but not for any length of time. More on that later.

The 43-101 resource count

One of our complaints back in IKN168 (July 22nd) was the lack of a 43-101 compliant resource held by GORO at its producing mine. The good news on that score is that the 43-101 that had apparently been held internally by GORO for over a year was published in late July (just hours after our IKN168 report in fact) and can be examined on this link (6) at the company website. It's a good thing that we've finally got a 43-101 from GORO as first and foremost, it gives us an idea of what the company has got at its main El Aguila underground resource. Here's the relevant table from the report:

TABLE 14-6
Gold Resource Corporation
El Aguila Project
Summary of Resource Estimate, as of December 31, 2011

Resource Class	Cutoff Grade (g Au/t)	Tonnes Above Cutoff	Gold Grade (g Au/t)	Silver Grade (g Ag/t)	Copper Grade (% Cu)	Lead Grade (% Pb)	Zinc Grade (% Zn)	Vein Width (m)	Equivalent Ounces Gold
Indicated	1	1,012,000	3.2	280	0.39	1.2	4.1	5	415,000
	7	587,000	5.2	440	0.52	1.8	5.2	4.8	350,000
	9	479,000	5.7	500	0.58	1.9	5.5	4.9	326,000
Inferred	1	3,468,000	1.8	190	0.3	1.2	4.1	4	1,048,000
	7	1,738,000	3.1	320	0.42	1.9	6.1	4.7	847,000
	9	1,259,000	4	400	0.48	2.3	6.3	4.1	731,000

Notes:
1 - Base case cutoff of \$32 for mineable resources.
2 - Equivalent gold based on \$1,000/oz gold, \$20/oz silver, \$2.50/lb copper, \$0.61/lb lead, and 0.99/lb zinc.

This table underscores just how little gold resource there is at the corporation named Gold Resource Corp. As the average gold grade of milled rock at GORO isn't much above that 3.2 g/t stuff noted in the indicated resource (e.g. 3.73 g/t 2q12, 4.27 g/t 1q12) it looks like GORO is making no bones about digging all the resource out as stands from the 5m width and milling it no matter what cut-off. Therefore that 1 g/t gold line is the place to consider its contained metal and although we're told that there are 415,000 oz of gold equivalent, do the math and you'll see that the indicated resource contains just 104,129 oz gold (*the rest of that Eq number coming from silver, copper, lead and zinc*). And as GORO mined out a minimum of 13.3k oz Au in the first two quarters of 2012, it means that the indicated resource for gold is almost certainly sitting under 90,000 oz today, unless any of that inferred material has got its upgrade. When considering that type of gold resource in the light of the company's \$1Bn+ market capitalization and I'm forced to the conclusion that it looks a little on the thin side. And yes, that was me being ironic.

By the way, the average grades for all metals in that indicated 1 g/t cut off line suggest that once processed at the typical reported recovery grades and sold at today's market prices (*and yes, I'm being generous enough to include the recent jumps in silver and gold*) each tonne is worth around \$530 in rock value. With costs likely to stay above \$300/tonne and perhaps approach \$400/t in 3q12 if GORO has the same sorts of problems it saw in 2q12 that's the margin disappearing in front of your eyes, folks. Meanwhile, the same revenue dynamics applied to the inferred material in that 43-101 resource chart (*again, the 1 g/t cut-off*) would suppose a rock worth of around \$350/t, which calls into doubt whether that part of the 43-101 resource at El Aguila is truly economic these days in the face of rising costs. At the moment it is, but we're definitely looking at a different scenario for operating margins if that grade is defined as stands.

Before we leave our quick look at the Aguila resource we need to consider one positive for GORO; the Pincock Allen Holt (PAH) 43-101 technical report noted that the company has so far enjoyed positive grade correlation to the resource numbers and plant head numbers. It depends on the metal, but the overall gold equivalent was calculated to be some 11.8% higher than expected which means that on the whole, the resource is performing very closely to its undiluted resource numbers and this effect has counteracted the assumed 20% mine dilution in the original company mine plan. In other words, it's a fair guesstimate to use the number in the 43-101 resource as the actual head grade.

The second quarter production report and guidance

On July 19th GORO came out with its 2q12 production report and offered an unpleasant surprise to its shareholders. Production had dropped to just 14,488 oz AuEq (gold production just 6,342 oz) and as a result, guidance for the year was cut to 100,000 oz to 120,000 oz AuEq from the previous 120,000 to 140,000 oz AuEq. This bucket of cold water resulted in a sharp sell-off of GORO stock, as seen in this price chart and yes, it's not difficult to spot the day on which the bad news came out, is it?



The reasons for this big miss, as offered up by GORO, were interesting too. In its July 19th NR the company President Jason Reid was quoted (7) as follows:

"Early development of the Arista mine, in which we drove straight to and developed directly on the veins, was a means to rapidly feed ore to the mill and generate cash on an accelerated basis. The rapid development on the veins, which enabled record first quarter production, pushed back overall mine development into the second quarter including preparations for stoping from levels 7 to 10. Doing so resulted in less second quarter production but has put the Company in a more sustainable production position for the second half of 2012."

In other words, GORO had stuffed its early quarters with unsustainable production and had to do something tantamount to stopping all stoping on the higher grading veins in order to pay for its previous haste. More explanations were forthcoming (*they came with the heavy doses of spin but there was information underneath*) in the 2q12 earnings report, the accompanying NR (8) and also the conference call from GORO the day after it reported its financials. You can read a transcript of that ConfCall on this link (9) and it's a most interesting read too, because it's solid evidence of the type of sophistry preferred by the officers of this overhyped company. For instance, it was proud of having returned a net profit and made particular mention of having "banked \$800,000" during 2q12, because they must think shareholders will be happy with an extra \$800k in cash despite the way current assets dropped by over \$17m. Idiots abound.

But back to the mining issues during 2q12, and the main blame was levelled at more water being encountered as the mine went deeper (wow, hoodathunkit?), more ventilation and power therefore needed at depth (ditto) and "safety issues" as well. We of course applaud that GORO puts safety first and prefers to cut back on production schedule to protect the wellbeing of its workforce, but all the same the type of issues reported are hardly unexpected in a vein mine as it opens up new and lower levels. It all smacks of a company that was desperate to please in its first quarters of production and mining at a rate that they knew they wouldn't be able to maintain; the question is therefore why they chose to do things that way.

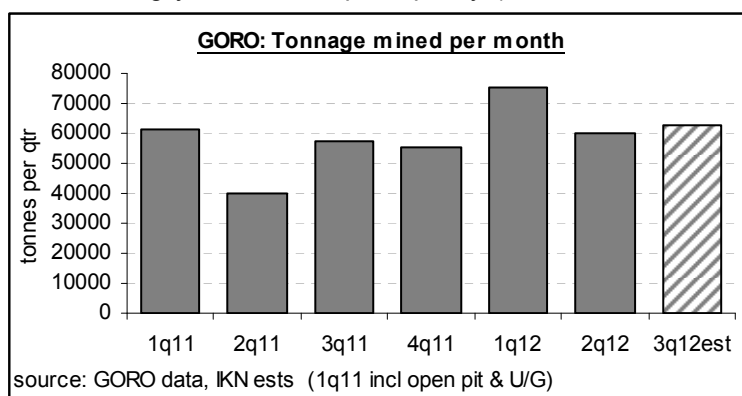
Guidance for 3q12 and beyond

Part of the 2q12 bad news was directed at guidance for the rest of the year and here we seem to be hearing two stories at once from GORO. On the one hand the company was super-keen to tell us that the problems were behind them, the stoping of the higher grade materials was back on track and that things would be more sustainable in the second half of the year and they'd "created the lead time needed" (*gotta love that mining-speak*). However, we were also guided to 100k minimum AuEq production for 2012 which means a minimum production of just 55k oz AuEq for the second half of the year, what with 1h12 coming in at 45k oz AuEq. Ok fine, they may have decided to go the UPOD (under-promise over-deliver) route for the rest of 2012, get all bad news out of the way in one shot, etc, but we also note that in the ConfCall, when pressed on the stopes then back in production the stoping is happening on two levels (7 & 8) and simply being prepared on others (9 & 10). As GORO had been running at least three faces at a time in its more profitable quarters (3q11 through 1q12) it suggests that things are still not back to normal. We're going to get better grades in 3q12 than we saw in 2q12, as long as we can take the company's words at face value, but we're still not going to get the type of numbers seen in the first part of 2012, that's a certainty.

So to our forecasts for 3q12 (*and in the conclusion section we make out case as to why 3q12 is a key period for both the company and our proposed short position*). Let's start with tonnages milled and although the mill isn't likely to be running yet at its 900tpd capacity (*CEO William Reid full explanation of that is the underperformance was "for various reasons"...very enlightening*) we can expect GORO to post better throughput numbers than in the poor 2q12. Our forecast 63,000 tonnes milled in 3q12 implies an average daily throughput of 685tpd.

As grade is likely to increase with the stoping material making up more of a percentage of the plant head material, we'd fully expect better silver and gold production figures for this quarter.

However, we're less interested in the amounts GORO produces and more interested in its sales figures, because after inflating its 2q12 with inventory ounces we'd be mildly surprised if the company can sell as much as it did without compromising itself further down the line. It's tough to make an accurate guess on GORO's 3q12 numbers because it's a small operation, so minor production variations in a single mine/mill make a much bigger difference to a small mining



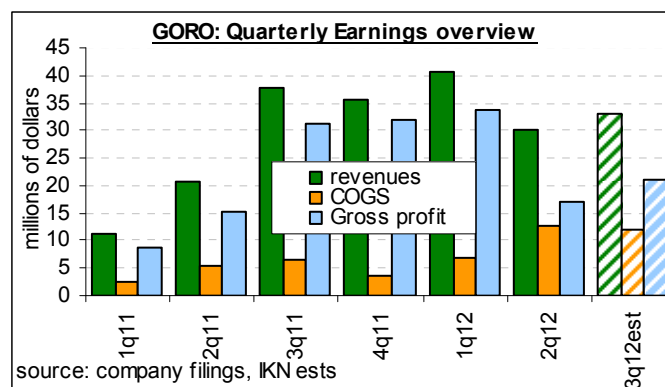
company such as GORO than a big one like ABX (*excuse me for not considering them 'peers'*). Just as one example, indicated/inferred resources aren't deeply understood (*much less than proven and probable by simple definition*) so fluctuations and variation to what is expected wouldn't surprise. Any change in grade, pinch/swell, faulting, host rock type makes a difference to a small mining operation such as this, or even something as prosaic as a machinery failure can matter. Then on another tack company may again sell down inventory to inflate 3q12, perhaps doable just one more time to paper over cracks. It's not so likely but I wouldn't put it past them because of the baseline lack of trust that can be put in these people...which is another another good reason why it's a tough set of numbers to call.

But call them we will and to put my head on the block, after fiddling for hours with a spreadsheet and finally deciding on a model that works to my general satisfaction here's how we forecast the 3q12 sales at GORO (note, not production but sales):

- **Gold: 6,200 oz** (was 7,119 oz in 2q12 and 6,668 oz in 1q12)
- **Silver: 650,000 oz** (was 603,426 oz in 2q12 and 828,376 oz in 1q12)
- **Copper: 200mt** (was 186mt in 2q12 and 210mt in 1q12)
- **Lead: 700mt** (was 651 mt in 2q12 and 706mt in 1q12)
- **Zinc: 2,000mt** (was 2018mt in 2q12 and 2144mt in 1q12)

Of the five the most important in the mix is silver that accounts for over 50% of revenues, but as they're all payable production we make a list of them all and consider each one in our calculations. So with our production guesses in place we apply suitable market prices (3q12 averages for gold \$1,700/oz avg, silver \$31/oz, both pretty optimistic to give the company a break to the upside, then other metals are minor stuff anyway) subtract the typical amounts that GORO leaves at the smelter gate (*according to its quarterlies we're considering between 10% and 12% of gross...we'll go for 10% to give the company a break again*)

We take a deeper look at the costs elements at GORO in a moment and we also reiterate some of the revenues expectations in the charts that follow, so it's all mixed in together between the two sections. However, here's how we anticipate 3q12 revenues to figure (*revenues of \$33m and COGS of \$12m*) with the resulting gross profit figure as well. The general outlook is one that's slightly better than 2q12 without knocking anyone's socks off, either.



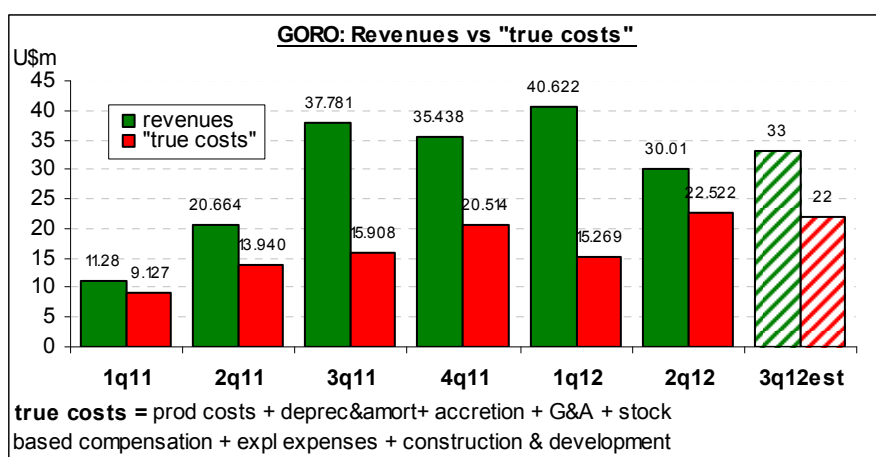
Costs profile at GORO

We now look more closely at the subject of costs at GORO and before we get into it, let's state nice and clearly that it's not easy to analyze this company's costs profile. What we have is a company that buries its costs parameters under ever-changing line items and makes it difficult to get a handle on how much it needs to spend in order to produce and pounce of gold (*well, really it's "gold equivalent", because as noted previously this company can have the word Gold in its corporate title but in fact receives a minority of its revenues from gold*). The company of course has the right to present financials in the way it sees fit as long as the methods comply with the US rules for listed companies, but the lack of transparency as seen in these company filings is one of your author's favourite red flags; the basic rule is that people who have things to hide will hide things, while people who are confident about their accountability will be fine about making them as transparent and understandable as possible.

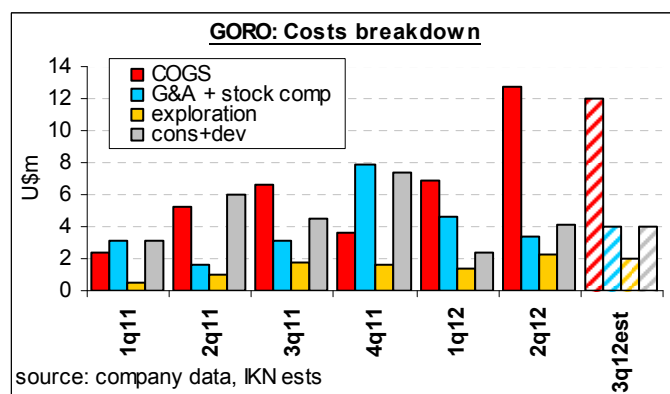
After due deliberation and chopping the numbers in several different ways, I've decided to present the GORO costs in what I'm, going to call "true costs" for our purposes. The phrase "true costs" (*not going to put it between tedious speech marks from now on*) tots up everything spent by the company and taken as a financial liability as it produces its metal and includes a whole list of things:

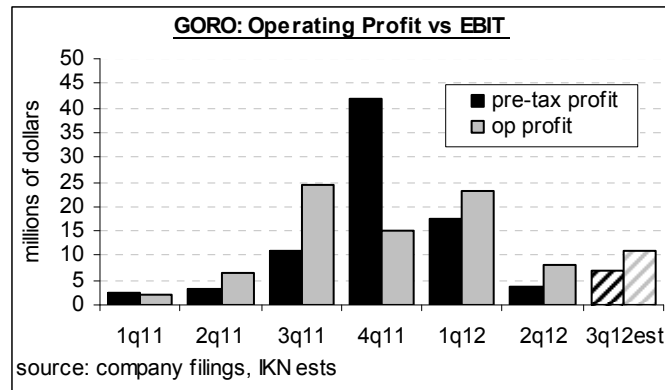
- **Production costs**, the money directly spent to mine and process its rock.
- **Depreciation and amortization**, pretty low because most exploration and development costs at the Aguila mine weren't capitalized by GORO, so there's less below ground "value" to subtract as the rock comes out.
- **Accretion**, normally a low number, a minor line item.
- **G&A**, which holds all the normal office-type items but it also includes the very generous stock-base compensation that GORO management hands to its key personnel (i.e. itself), because the company sometime includes these stock awards in its G&A and sometimes it doesn't, an example of the obfuscating behaviour that can be witnessed in its quarterlies. It's almost as if they don't want you to understand their financials... (cough, ahem).
- **Exploration expenses**, mainly on its undeveloped properties, baseline studies of the early stage projects etc.
- **Construction and development**, which seems to be a bit of a catch-all line item and where GORO registers monies spent on the upgrade of Arista (Aguila) veins, drilling to turn inferred into indicated, infrastructure expenditures etc but being a P+L line means it keeps balance sheet liabilities down.

So when we add all that lot up, we have the amount of money GORO spends on its ongoing business before tax. We can then compare the amount of money it brings in via revenues to the true costs amount, which looks like this in chart form:

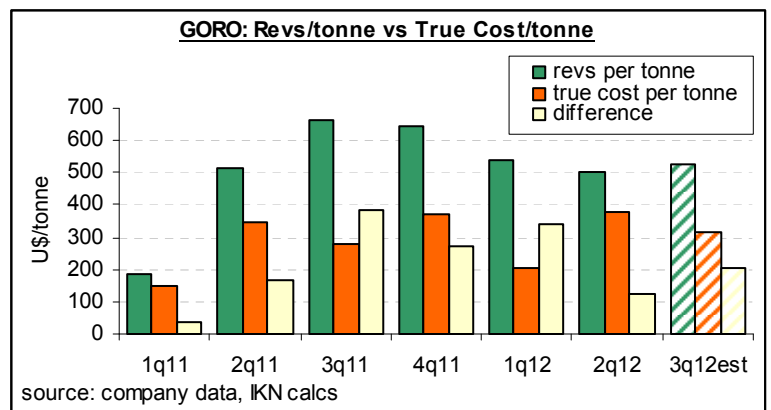


Here right is another way in which I've broken down the costs profile of GORO into components and it may help see how the above true costs is figured. The lion's share of the deal is the classic mining costs (COGS) but the other three all count, too. What we see is a company that had very low costs compared to its revenues in the period 3q11 to 1q12 when operating profit aggregated to over \$62m, over a buck per share and very good money for just three quarters for a company this size and of early age. However, the last quarter saw both costs rising sharply and revenues drop with the resulting squeeze on profits, as we can see in the chart below (note in 4q11 GORO benefitted from a one-off tax rebate that swelled its quarter bottom line).





Another reason to cut and dice GORO costs into the so-called true costs is that it gives a better straight line comparative on how much the company needs to spend in order to process one tonne of its rock, which we can see here right. It's notable that despite some pretty variable revenues numbers in its quarters so far, GORO's rock worth per tonne has been fairly steady and only fluctuated with the underlying prices of silver (*its main revenue generator*). We see that 1q12, for example, was a sweet spot for the company because although metals prices had dropped away from highs by then, the true costs per tonne was at a low \$203.38. As revenues from metals were at \$541.06/t, this mean that GORO was running a very strong \$337.69/t margin on its operations, so the more tonnes it got through its mill the better the bottom line. However, we note again how the wheels came off the machine in 2q12. The mining problems faced by GORO in the last reported quarter, coupled with the amount of money it needed to spend in the remedial process, saw margins sink to way below true costs and left the company just \$124.95/t to play with.



Let's consider that 2q12 in a little more detail, as the propping up of results through excess sales isn't something that GORO will be able to get away with again. Here's a little table that shows how much of the GORO top line revenue in 2q12 came from sales of gold and silver above and beyond the amount of metal actually produced by the company in the period:

GORO 2q12 revenues from inventory	
Au produced (oz)	6,342
Au sold (oz)	7,119
realized price	\$1631
\$ difference (m)	\$1.27m
Ag produced (oz)	487,053
Ag sold (oz)	603,426
realized price	\$27
\$ difference (m)	\$3.14m
grand total extra	\$4.41m
\$/t	\$73.58

source: GORO data, IKN calcs

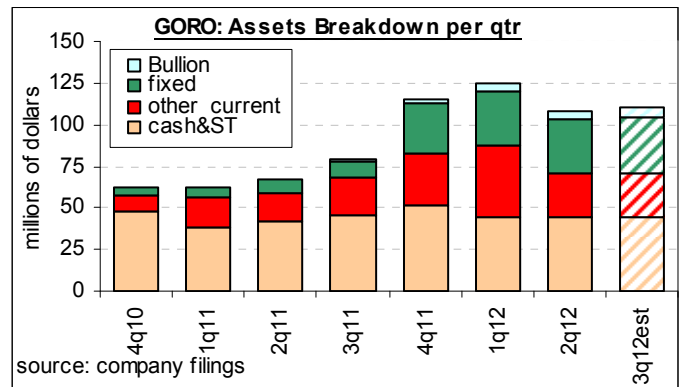
By way of explanation:

- In 2q12 GORO produced 6,342 oz gold but sold 7,119 oz. As its average realized price for gold in the period was \$1,631/oz, this implies that GORO managed to add \$1.27m to its revenues from sales of gold inventory rather than sales of gold produced.

- In 2q12 GORO produced 487,053 oz silver but sold 603,426 oz. As its average realized price for silver in the period was \$27/oz, this implies that GORO managed to add \$3.14m to its revenues from sales of silver inventory rather than sales of silver produced.
- Therefore, GORO added \$4.41m to its top-line revenues straight from inventory and when you consider the amount of rock milled in the period, that adds up to \$73.58 of cash for every tonne milled. In other words 60% of its profit margin in 2q12 came from inventory sales.

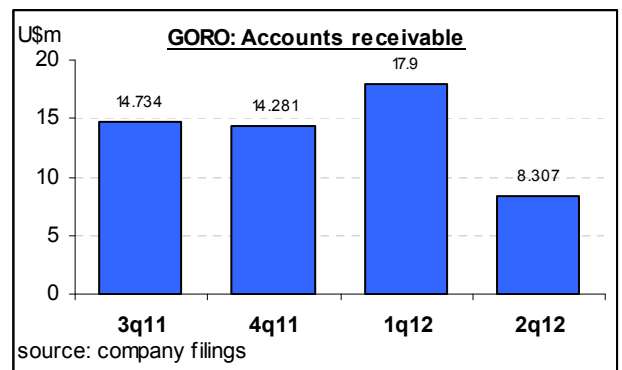
Indeed, when we check the balance sheet we see that in the lapse 1q12 to 2q12 filed inventories dropped from \$7.453m to \$5.287m, a difference of \$2.166m. As inventories are usually carried at cost and our true costs per tonne have been averaging at or around half of revenues per tonne, this makes sense. It's also the kind of thing a mining company can do once, perhaps twice max (*with \$5.3m left in the inventory tank there may be another bite at the cherry left*) but it's no way to run a business, especially one that needs constant positive cash flow from operations to fund its dividend policy of around \$9.5m per quarter.

Which brings us neatly to our examination of GORO's balance sheet and this is where the rubber hits the road on this stock. As we've seen, the company's mine is a profitable operation under normal circumstances and the type of margins between true costs and total revenues that it's capable of achieving in a good quarter (see 3q11, 4q11, 1q12) mean that there's plenty of cash flowing to the current assets. However, it also has its financial obligations such as that dividend policy so when a rough quarter happens, such as the one we saw in 2q12, it shows up quickly in the balance sheet items.



The other noticeable thing about GORO's books is the low asset costs assigned to its fixed assets, eg the mine, mill and exploration projects. When it comes to registering quarterly revenues this helps the P+L, because GORO doesn't have to subtract so much for its amortization & depreciation (*and also because the mine is relatively young; for a good contrast check the numbers OceanaGold (OGC) reports on these items for its New Zealand operations*). The downside comes on the balance, because it's a company that doesn't offer up much in the way of asset backbone to justify its share price. GORO really is all about its cash flow and profit potential and is designed to be that way; the reward for the shareholder or potential shareholder is holding a profitable company that pays a dividend, rather than a company with strong asset value.

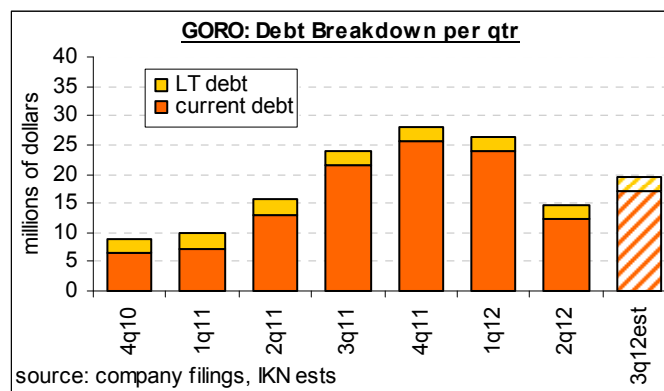
So to the chart and between 1q12 and 2q12, the GORO asset balance sheet (above) showed some pretty big changes. Its bullion purchases were put on hold (*that are held for those shareholders who prefer to take their dividends in metal than in cash...another faddy thing of theirs which doesn't mean much because there's nothing to stop you taking your dividends in cash and buying physical metal on the open market afterwards*) while its the cash position stayed more or less the same, thanks to the trade-off between the profit generated and the cash distributed via dividends. Fixed assets dropped as little as the modest depreciation/amortization took its slice, but the big drop came in the "other current" section which was down by a cool \$17.8m and that's where we turn our attention.



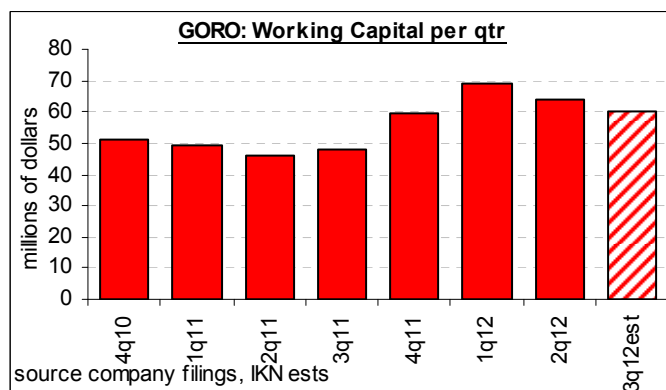
We've already noted that inventories dropped by \$2.166m between 1q12 and 2q12 (from \$7.453m to \$5.287m) because GORO tapped into its store room and sold silver and gold in order to inflate its revenues

top line. That's part of the story here, but the other, bigger part is that of accounts receivable and that looks like this (above) in tracking chart form. From accounts receivable in the \$14m ranges last year and a line item that went to \$17.9m in 1q12, this suddenly dropped to just \$8.307m in 2q12, a difference of nearly \$9.6m. This looks for all the world like a company that rings round the people that owes it money in order to get the cash owed so that it can pay the promised dividend. Again, it's a strategy that will work once for a company in a tight spot and it's good for alleviating a sudden liquidity crunch brought on by an unpleasant surprise in its operations, but it's not the way you can run a company over an extended period of time without changing attitudes towards its dividend policy.

Let's shift to the liabilities held by GORO as seen in this next chart. GORO builds up its corporate tax liability through the financial year and then sees that burden lifted, which was the case in 2012 as well (though the obvious change between 1q12 and 2q12 is obscured by a VAT (sales tax) liability carried in 1q12 and then paid). That aside, what we can expect from the company is a higher tax set-aside in 3q12 that will bring the total back up to around the \$20m that approaches the levels seen this time last year. It's an eminently manageable level of liabilities so let's not sound alarm bells where none are due but it does mean that working capital, which was already under pressure in 2q12, is going to feel the pinch again in 3q12.



Here's the working capital chart and this one is important folks, because GORO is a liquidity machine that relies on a strongly profitable mining operation to fund its business model. GORO does not have the luxury of some other companies that can throw in a weakly profitable quarter every now and again and cut cash away from its bottom line profits in order to fund an expensive round of development or exploration work (for example, see how Fortuna Silver (FVI.to) goes about its growth and business model). GORO isn't allowed to have a weakly profitable quarter; it must have good, profitable quarters every quarter and no excuses, because it doesn't have a whole heap of fixed assets to back itself up and it has bills to pay such as that \$9.5m/quarter dividend policy that it trumpets sans cesse. Look again at that working capital chart and consider that GORO declared a net profit for the 2q12 quarter of \$3.6m but saw its working capital drop by \$5.5m to \$63.7m. Then consider that we expect GORO to file a profitable 3q12 as well (we're giving its operations the benefit of the doubt) but even so, still expect the company to see a trimming of its working capital position to \$60m.

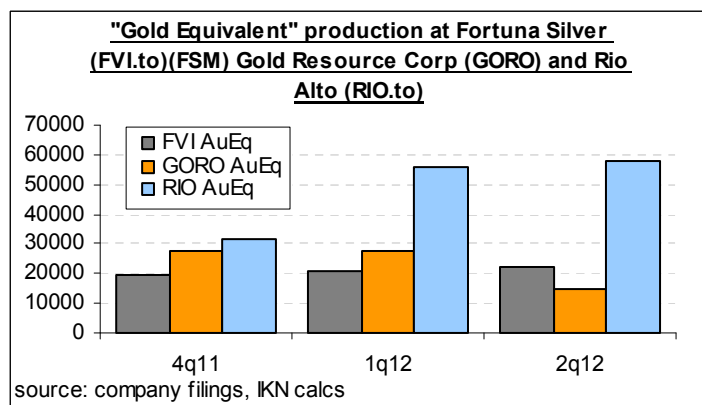
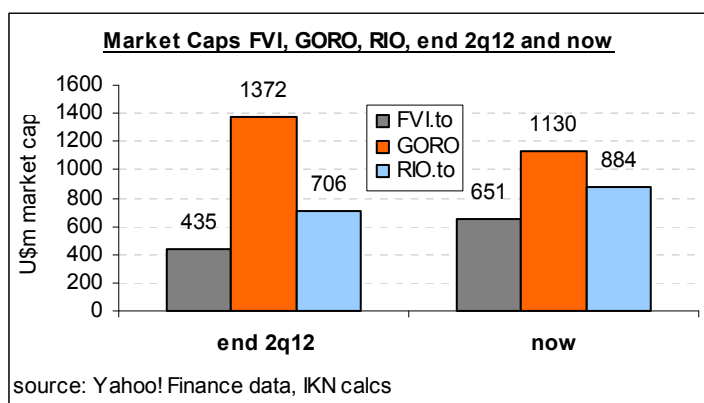


Valuing GORO

We know that due to the corporate plan at GORO, which is to grow the company into a cash flow machine that feeds dividends to shareholders rather than underlying asset value, the company has a low book value and thanks to its profitability is able to demand a 12X multiple to book. This is not and never will be a company that's measured by what it owns, it's a company that has to be measured by what it does. That means making a bottom line profit and being able to distribute that profit to its shareholders.

As we recognized in IKN168, GORO is overvalued compared to peers on a like-for-like basis. At that time we used the two charts you see below (though now updated to reflect September 9th valuations) and the inference is pretty clear; despite having a roughly equal production profile to a true peer company such as Fortuna Silver (FVI.to) (FSM) which is mostly silver, works in Oaxaca, produces gold as a minor product and base metals and a by-product credit, GORO

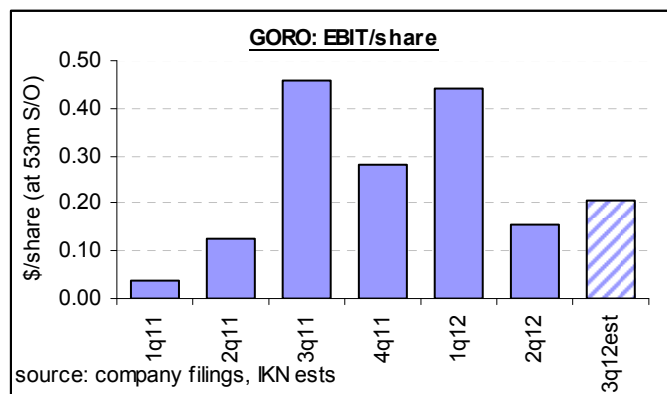
gets a much, higher market cap valuation. It's even called as worth more than Rio Alto, despite that company's far stronger track record of production, profit and delivery on promises.



Therefore, when we ask what the difference is with GORO, the answer must be in the way it goes about its promotion and shareholder attitude which all points to one thing, the different thing it does, the dividend. People like the fact that they're due to pick up 72c this year via a 6c payment every month (*even though the dividends are now taxable in the United States*)

Its monthly dividend has risen incrementally to the current 6c/month and the problem GORO now faces is that the dividend is a rod for its own back; it only takes a cursory look at the way in which it raided the sweet jar in 2q12, pulling in those accounts receivable and selling into its inventories, to see that it knows just how much depends on the company's unique selling point, the junior that gives the dividend. The logical conclusion is that if GORO has to cut or suspend the dividend it will be in share price problems.

How much of a problem is it, though? This chart shows the EBIT per share levels filed by GORO in the last few quarters, plus our forecast EBIT/share for 3q12. When it was putting in 46c/share and 44c/share performances on the back of solid production, low costs and strong market prices all was fine with the world, but with the bad production results of 2q12 and the new guidance, we're only now expecting 21c/share even with our reasonably generous silver and gold average prices assumed for the current quarter in our model. That would be an annualized 84c or a Price/EBIT ratio of over 25X, perhaps triple the multiple usually allowed to this size of company (or any size for that matter). We are reasonably confident that GORO can keep itself running profitably for the rest of 2012 but it now all depends on the amount of profit it can generate.



- The first thing it needs to do, first and foremost, is cover its dividend obligations with cash flow and by our model that's not going to happen in 3q12.
- Even then, if it manages to get to \$9.5m it's only running to stand still, to pay that dividend and with nothing left for its internal, corporate plans. This begs the question of just how GORO expects to open up its next mine, run a more aggressive exploration campaign and add value to the company as an asset. Working capital needs to rise in order to justify its plans, not drop as we're expecting.

The bottom line question is just how long GORO can keep paying its dividend. With \$45m cash at bank and \$9.5m cash to pay each quarter, the answer is that in theory (*and if it went on long enough the theories expounded and made popular by certain Charles Ponzi would begin to be considered*) at least it can carry on for a three or even four quarters even if its operations hit

glitches and the mine merely breaks even, but reality states that GORO will at some point have to protect its core business by keeping its own cash position intact and not running down its working capital, especially as it holds no particular value to its fixed assets (mine, mill etc). And even if the company fails to recognize a little bit of reality at the end of this quarter, the market will surely be less forgiving and anticipate the end of the dividend bonanza. We've considered the recent weak points at GORO and the revised forecast that aims for a production improvement from the weak 2q12. But we've also taken in the revenue and costs breakdowns as well as examining the balance sheet details of the company in order to see just where the weaknesses manifest themselves. What we see is a company that's going to make a profit as long as it performs to company expectations, but even then in 3q12 we expect it to register a net profit of \$7m, below the \$9.5m "running to stand still" level. It can of course sell a few more jewels to cover the difference, but we'll again see that in a deteriorating asset and working capital position. Meanwhile, its *smaller than you'd expect* El Aguila resource is further depleted and the remaining inferred gold at lower grade brings a new level of uncertainty into the picture.

GORO will be fine and will confound its critics (count me in) if it can move back up to 120k oz AuEq for 2012 and cut its costs profile back down to the place where it was during last year's sweet spot. It will be even better if it can deliver on its forecast of reaching 200k AuEq by 2013 or 2014 (*it used to be 2013, nowadays they seem far more reluctant to commit*) but this brings me to my final point about GORO, that it's management are unreliable, promise more than they deliver and have a long-standing tendency to fudge, revise and lower expectations after-the-fact. Not only have the pie-in-the-sky zero cash cost predictions for GORO never materialized, but they're also pretty self-serving, as witnessed by the events of May 10th 2012, forty days into the 90 days of 2q12 when the company reaffirmed its 2012 production guidance of 120k to 140k oz AuEq and on that very same day, Chair/CEO William W. Reid sold (9) 366,054 of his shares on the open market (*the price that day was between \$25 and \$25.72*). We later learned that the 2q12 had been a production disaster and when that information was made public the share price dropped by over 30% on very high relative volume. In the 2q12 confcall Reid defended his sales by saying they were for "State planning purposes" and a disposition by gift but whatever that might really mean you can't help but applaud the timing of his selling considering what he must have known about 2q12 by that time. That's just one example and for another, consider the near \$19m expended by GORO in G&A+stock in the last four quarters. That's a lot of G&A, so a closer breakdown of that number would be interesting but all we get from the filings is that the increases are, "...*due to an increase in stockbased compensation expense, salaries and benefits and professional consulting fees.*". Much on entertainment, guys?

GORO is the junior mining version of Christian Andersen story, The Emperor's New Clothes. In that story, the truth was masked by flattery and the refusal to look stupid by stating the obvious. In this one, the truth is hidden by a flimsy and apparently unsustainable dividend policy that will either have to be dismantled, will drain treasury away from the company or in the best of cases will inhibit the company by taking away the type of cash treasury it needs to run with its expansion plans. The current resource is seeing the best of its rock mined away and it's uncertain whether what's left will be able to offering the same type of margins. If I were GORO management I'd be itching to run a secondary offering at this point to try and lock in some of the overinflated equity value into treasury, sell some expensive shares to the greater fool and guarantee liquidity, but that will also come at the cost of dilution and lowered dividends for its current holders as well as going against the whole ostensible company ethos of being the shareholder-friendliest thing out there.

Its 2q12 results were a bad surprise for its shareholders, but the underlying problems that caused the sudden stop aren't going away soon. Costs are bound to rise from the 2012 levels and with indications that the best of the indicated resource is now being mined out, the case for the GORO business model now lies in the hands of the spot prices for silver and gold. If they go up GORO gets safe as all boats rise (*aside: your author will be floating in other boats*) but what we've already seen this year is the flimsiness of the business model being used; if the whole plan depends on depleting current assets in order to pay dividends, you're on a road to nowhere as a company and the multiples to earnings you're affording will be quickly crushed.

As for a formal valuation and target on GORO I will not try to pull the wool over your eyes on this and cook up some chart with a nominal target reached in some scientifically pleasing

mathematical manner. What I do know is that the GORO of today is significantly overvalued and that by way of a reasonable estimate, taking into consideration that things may go better or worse for the company than I expect or that it might reduce its dividend in the face of a mediocre 3q12 instead of suspending it completely (*to name just two variants among a thousand*), I'd estimate a downside price target at between \$12 and \$14 today, representing a market cap of up to \$742m at today's 53m share count and a downside to the first target of 34%. I'm not calling death and complete to-zero destruction on GORO because as long as it performs at a reasonably close level to its officers' guidances it will to be a profitable company in the medium-term, just not enough to justify its current valuation or its growth and reward plans for the future. Reasonably profitable won't be able to pay the bills, pay its dividends, its expansion and justify the current share price, but even then we're trusting (for want of a better word) a management team that talks a better game than it plays so the chances of a bonus to any short position, that of a black swan event, are always in the mix too.

Trade envisaged

After the action of last week that saw a whole lot of other junior miners lift on the back of Fed chair Bernanke's comments, the price levels at GORO went to what I consider a very overvalued level, not just overvalued. I'm expecting a little follow-on in the goodwill next week and as GORO is at the knee-jerk end of the junior gold market, it's likely to benefit a little further from the action. There's also the small matter of the stock going ex-dividend at the end of trading tomorrow, September 10th, when anyone short will have to pay 6c to their long counterparty. Big deal. So overall and taking it all into consideration, the plan is:

- 1) To go short GORO (*as it's a US listed stock and a short pool is usually available, that should be fairly straightforward*) at some point between now and Wednesday. The ex-divi date is of little consequence to my trade plans, frankly.
- 2) I plan to hold the GORO short until at least mid-October when the 3q12 production results are announced by GORO.
- 3) From there and depending on the market reaction, I will hold for the 3q12 earnings report that should turn up in mid-November.
- 4) At that point, I will likely close the position be it a win or a loss. But it will be a win.

In other words, my short in GORO is planned as a near-term trade. It's also something of a hedge against the current strong positive sentiment towards gold and its ilk that's suddenly sprung, but the bottom line is that my short position in GORO as of next week is more company-specific than anything else. The financials show that the company has painted itself into a corner with its dividend policy and in 2q12 obviously felt obliged to keep paying out, else face the wrath of its holders. However, to use another old saying you can't have your cake and eat it, so if the plan is to distribute earnings through dividends, what does a small and eager to grow mining company do for investment cash? In a best-case situation GORO will chop its divi while my short is uncovered and the resulting price dive fulfills the plan, but even if that isn't so, I expect the market will eventually cotton on to the financial weak GORO business plan and position itself for the eventual dividend demise. The drop if so will be gentle rather than violent, but it will do just fine too.

End of Report