Mining Strategist Ecclestone on his “Buy” Recommendation on Chesapeake Gold Corp.

It is said that “small is beautiful” but also “smaller can be beautiful”. One would think it would be hard to “get smaller” when one has 18 million ounces of gold at one’s disposal but Chesapeake Gold Corp. (TSXV:CKG | OTCQX:CHPGF) has achieved the feat in shrinking its capex in a quantum leap, while maintaining its ounces and expanding its minelife.

In these times of tough financing conditions companies should be moving to “right-size” their projects. This frequently means that companies need to commission a recalculation and rewrite of previous Feasibility Studies based upon a new set of premises. That said many are not, through sheer lethargy or lack of funds to do so.

Chesapeake Gold, a stock we have followed for several years now, has bitten the bullet of rightsizing its project and come up with a drastically altered PFS that slashes capex from an eye-watering $4.3bn down to a more bite-sized $1.9bn. Well, bite-sized for the T-Rex of the mining species. The task of right-sizing is made even more daunting by the fact that the Metates project has truly massive *Proven and Probable* mineral reserves of 18.3 million ounces gold, 502 million ounces silver and four billion pounds of zinc.

The capex for the Metates project was certainly large in its original version and begged the question of where economies could be made and where the timeline could be adjusted, with modified volumes, to produce a project that would appeal to gold majors wishing to plug upcoming gaps in their pipeline.

Now that the totally overhauled PFS for Metates has come out we can see some major improvements in the strategy while achieving a significant drop in the capex.

The Main Changes

Our reading of the new PFS throws up the main changes being:

- Introduction of phasing with smaller production in the first years to generate cashflow
- Moving of the process complex from Ranchito to El Paso (thus nearer to existing infrastructure)
- Desalination plant to be built by an independent operator
- Only one autoclave for early years of production
- Leased mining fleet to lower capex
- Outsourcing of water, electricity production

The updated PFS is based on a lower initial ore throughput rate of 30,000 tpd (Phase 1) with a staged expansion up to 90,000 tpd (Phase 2) to be funded primarily from internal cash flow. This scalable approach addresses the market’s concerns on the upfront financing required under the previous plan.

Phase 1 production will operate for the first four years of the mine life with Phase 2 production starting in year five. Active pit mining is planned for a total of 27 years followed by 10 years of processing the stockpiled low grade ore.

The revised mine plan and analysis has optimized the mining of high-value ore with a low sulfur content which will now require only one autoclave (versus the previous three) and related ancillary equipment to process the majority of Phase 1 ore production. The single autoclave has resulted in a further reduction in the initial capital cost versus the two autoclaves required with the earlier mine schedule.

The initial Phase 1 capital costs are $1.91 billion, while the combined Phase 1 and Phase 2 initial capital, both including a 18% contingency allowance, is $3.49 billion or approximately US$211 per recovered ounce of gold production (not including the silver and zinc component).

Price Assumptions

The price of the underlying metals at Metates has been a wild ride over recent years but curiously enough the gold price used in calculations has moved only in a range of $1,200 to $1,350 per oz. In the case of the latest PFS the price used was $1,250 per oz, which is within our comfort range. The silver price in the latest iteration is fairly generous at $20 and we feel it's over-optimistic. We are more silver bulls than gold bulls but we would have gone with $16. Meanwhile we think the $1 per lb Zinc price used is way too conservative. You can't win 'em all in target prices, it seems.

Some Basic Economics

The Life of Mine average operating cost per tonne of ore mined including mining, processing and G&A are estimated at $9.37 per tonne or $628 per ounce net of by-product revenue from the sale of silver and zinc. Close proximity to a high quality limestone resource and low cost electric power contribute

significantly to the project’s operating financial performance.

At the base case, the Updated PFS demonstrates that Metates will generate a pre-tax NPV of $1.78 billion at a 5% discount rate with an IRR of 10.9%. The LOM cash operating cost is $628 per ounce. The project is expected to generate an impressive $11.15 billion in pre-tax cumulative net operating income at base case metal prices.

Novagold

While comparisons might be odious it is relevant to draw attention to the size of Metates compared to projects such as KSM, Donlin and Galore Creek in out of the way, hostile environments, or even less fortunately to Tasiast or Pascua Lama. The Metates project is almost classified as “easy” compared to these conceivable alternatives.

Firstly a confession. I have not liked Novagold since I was first introduced to the stock last decade. I was boggled as to a series of properties so inaccessible and with such geographical challenges could be deemed to be attractive. Then when the company becomes a favored stock of Paulson and George Soros (and this was deemed to be the smart money) we thought the inmates had really taken over the asylum. Paulson was of course still dining out on his perspicacity regarding sub-prime mortgages and could do no wrong. I was less impressed. This was just a new version of the fat dumb money that some parts of the mining industry are in permanent pursuit. Indeed it is usually harder to find such fat dumb money than it is to encounter a 10 million oz gold deposit.

Anyway Paulson had waded into Novagold around the turn of the decade and had, in 2012, some 36 million shares on which it has lost (according to Bloomberg) around $48mn when Barrick cast doubts on the jointly owned Donlin project. It was probably a pity that Barrick didn’t also cast doubts upon its

own Pascua Lama project and would have similarly saved itself a lot of grief. In any case, Novagold (and its similarly challenged *doppelganger*, Seabridge) have long remained darlings of a certain type of hedge fund that knows little about gold or mining. Fortunately for both the "new chums" have lined up to replace those investors that have preceded them in losing their shirts.

The reason we mention this, is because the two closest comparison in the "available" mega-sized deposit category are the main projects of Novagold and Seabridge. If a picture tells a thousand words, then this table is rather more telling:

	Chesapeake	Novagold	Seabridge
Market Capitalisation	$84mn	$2,001	$700.47
Cash Position	$25mn	$175mn	$15mn
Environment	Temperate	Arctic	Arctic
Project	Metates	Donlin	KSM
Gold Reserves	18mn	17mn	38.2mn
Gold Equivalent Reserves	25mn	17mn	64.1mn
Gold Equivalent Grade	0.90 g/t	2.09 g/t	.92 g/t
Initial Capital Costs	$1.9bn	$6.7bn	$5.3bn
Annual LOM Gold Production	660,000	550,000	508,000
Mine Life (years)	19	27	55
First 5 Years Cash Cost	$410	$411	
LOM Operating cost/t	$13.49	$37.79	
LOM Cash Cost	$490	$635	$607
LOM All-In Sustaining Costs	$650	$735	
Stripping Ratio	1:1	5.5:1	
After-tax NPV (5%)	$4.2bn	$1.5bn	$4.5bn
After-tax IRR (%)	16%	6%	11.50%
After-tax Capital Payback (yrs)	5 yrs	9 yrs	6.2 yrs

Predators to Ponder

In the size category where Goldcorp (and their ilk) shops, there is not much on offer.

Chesapeake Gold looks like a key chess piece in the international gold asset game which, if bid for even at a

multiple of its current market cap, would represent a significant and synergistic move by a major looking to plug a hole in future production goals.

With the project financing landscape so drastically altered in recent years there are less than a handful of gold projects of Metates' size that are not already in the hands of majors. Here we shall do a brief review looking at which companies might be predators:

Goldcorp – undoubtedly the most obvious suspect due to the project's size, location in Mexico (Goldcorp's comfort zone), the company holding a 9% stake in CKG and CKG's CEO Randy Reifel sitting on the Goldcorp board.

Barrick – this company is still in wound-licking mode after its Pascua Lama debacle. The problem the company has is that PL was destined to fill a gap in Barrick's future production and now cannot fulfill that task, therefore a replacement is needed. Barrick is at least in familiar territory as its Pueblo Viejo mine in the Dominican Republic is the closest comparative, geologically, to the Metates project.

Newmont – This company is much touted as a merger partner for Barrick, but in light of the troubled status of this mooted partner, such a merger would be negatively seen by the marketplace as a value-destroying. Newmont has, in recent times, sold out of its Mexican position to its partner there, Fresnillo. This company certainly has the resources, and the need to bring Metates to production. There are serious questions about the strength of its future production pipeline.

Freeport McMoran – this company is the most prominent gold/base-metal crossover stock. The company needs to balance further away from its Indonesian exposure and Mexico is a former playing field for Phelps Dodge, which was subsumed into Freeport during the last decade. The demands of being US-

listed though mean investors have little tolerance for long development projects preferring plug-n-play.

Agnico Eagle-Yamana – this pair are more likely to merge with each other than with anyone else at this point in time. Certainly if they did all merge together (consolidating the ownership of Osisko) then they would be a good cashflow machine and have the balance sheet to undertake a transaction like the undertaking of Metates.

Fresnillo PLC– this London-listed miner with a Mexican control group is the world's largest producer of silver from ore (primary silver) and Mexico's second-largest gold miner. The company is very cashed up and acquisitive. Metates is in the size category that Fresnillo is used to. As a "local group" it would also potentially be able to, tactfully put, arrange things more to its advantage than a foreign-controlled group might. The company has negligible financial debt on its books and had cash on hand of $154mn at the end of its last reported FY (as at Dec 2014).

Minera Frisco – a company that flies below the radar but has made waves in the past is Carlos Slim's mining venture. It paid US750mn to acquire some AuRico assets in 2012 and money is clearly not an object to one of the wealthiest men in the world.

Conclusion

When the original PFS came out, naysayers zeroed in on the capex issue which is always a criticism that gains traction, rightly or wrongly, these days. In the company's days of "build it and they will come" thinking, the project was sized to attract elephant hunters with a $4.3bn capital spend and a 25-year mine life. As elephant hunting is out of fashion, literally and metaphorically, the company has rightly focused on "right-sizing" the project to suit the tenor of the times. The updated PFS is the result of that process and definitely

more bite-sized, however still only for those in the top-tier of players.

While we can conjure with a variety of potential acquirers it is still apparent to us that Goldcorp remains in the pole position to move on Chesapeake. However the pace of takeovers should pick up now that gold has awoken from its slumbers. Big institutional shareholders will be pressuring majors on their pipelines and few of them have anything concrete they can offer over the next few years in way of added capacity. Chesapeake's Metates deposit with its new slim-line PFS is better positioned to "fit" in one of the pipelines that are lacking production of this size for later this decade.

To access the Hallgarten & Company independent research report titled "Chesapeake Gold: Updated PFS Brings Quantum Capex Reduction" – click here

To access the initial coverage by Hallgarten & Company – click here