

Analyzing Natural Resource Stocks

By MICHAEL MARKOWSKI

The rise in commodity prices over the last several years has boded well for investors who owned shares in the public companies and industries within the natural resources sector, which were poised to benefit from the resurgence in global inflation. Now that inflation appears to be cooling, I thought that it might be timely to examine the health of the copper, gold and silver ore, coal, and metal mining industries. My interest is also in identifying those companies among the sector's industries that are the winners and sinners.

Let's start with the metal mining industry. For the period beginning April 2005 through July 2006, revenue or sales for the Metal Mining Industry grew at a minimum clip of 29% for the five consecutive quarters. In October 2006, revenue plummeted to an increase of only 4.4% as compared to a growth rate of 36.1% for the twelve months ended July of 2006. The rapid deceleration continued into the quarter ended January 2007 with a decline of 8.4% compared to the previous period. It's not surprising that cash flow from operations (CFFO) tracked the deterioration in revenue. After maintaining a minimum growth rate of 30% from April 2005 through April 2006, its deceleration began when the annual increase fell to 19.6% in the quarter ended July 2006. The rate of growth for the industry's CFFO dropped to 8.8% for the quarter ended October 2006 and dropped to negative territory with an actual decline of 5.5% for the quarter ended January 2007. An even more disturbing sign for the industry is that its capital expenditures have recently been plummeting. From each of the periods January 2003 through July 2006, the industry's capital expenditures grew at a minimum growth rate of 13%. In October, the growth rate slid to a paltry

3.4% increase as compared to an increase of 48% for the quarter ended July 2006. Similar to its other metrics, the rapid deceleration continued for the quarter ended January 2007, when it posted an actual decline of 15.7% in capital spending. The last time the industry recorded any decline in capital spending was for the three consecutive quarters ended April 2002. This is such a disturbing sign for this industry because there is a high correlation between the growth in capital spending and revenue. The outright decline in capital spending indicates that executives of the companies within the industry are forecasting a slowdown. They are battenning down the hatches for a possible recession.

My favorite (or winner) in the Metal Mining Industry is USEC, Inc. (NYSE: USU). USEC's free cash flow and CFFO both increased by over 125% over its latest 12 months. Based on its latest price, it's also trading at only 6.3 times its free cash flow. The sinner of the industry is Polymet Mining Corp. (AMEX: PUvl). Polymet most recently had a market cap in excess of \$400 million. It generated no revenue over its latest 12 months, yet it burned over \$16 million of cash over the same period and most recently had net assets of only \$12 million.

Compared to metal mining, the copper industry is a picture of perfect health. For its most recent twelve months ended January of 2007: its revenue was up 39%; its CFFO was up 112%; and its capital expenditures grew at a rate of 47%. Other metrics that did well include copper's free cash growth rate of 147%, and its profit margins and free cash profit margins came in at ten-year highs. Among 216 Industry groups that StockDiagnostics.com follows, the copper industry ranked among the top 20 for revenue growth, CFFO growth and free cash flow over its latest 12

months. Its free cash margin (the percentage of cash generated from a sales dollar) also gave it a number three ranking among the 216 Industry groups.

The copper industry's winner is Southern Peru Copper Corp. (NYSE: PCU). For its most recent 12 months, its revenue increased by 32%, and its free cash flow also increased by 47%. It also pays a 5.7% dividend to its shareholders. I did not find any sinners in the copper industry.

It appears that the fortunes of the gold and silver ore industry have changed. In the seven-quarter period beginning November 2004 through July 2006, the industry recorded consecutive trailing 12-month revenue declines. That all changed for the twelve months ended October 2006, when the industry's revenue jumped by 121% compared to the previous comparable period. The industry established a new winning streak after its posted revenue growth of 46% for the period ended January 2007. The industry's CFFO is in pretty good shape since it increased by over 100% for its last two consecutive reporting periods. Capital expenditures for the gold and silver ore industry also recently reversed by establishing a positive growth for its last two consecutive quarters after recording four consecutive quarters of decline. The industry's profit margin of 17% is currently at a ten-year high, and its CFFO profit margin of 30% is its highest since January 2001.

I found three sinners among the gold and silver ore industry. The first is Birch Mountain Resources (AMEX: BMD), and it looks particularly worrisome. Its shares are up approximately 10 times from its five year low of \$.34 in May 2006. Birch recently sported a market cap in excess of \$250 million. The company generated almost \$60 million of negative free cash flow over its latest 12 months and only has \$6 million of working capital left. It looks like a clas-

sic boom and bust situation that has been caught up in the speculative fever. Other sinners, which also have greatly benefited from the recent speculation in gold shares include Yamana Gold (NYSE: DUY) and Novagold Resources (AMEX: NG). Yamana shares recently hit a five-year high of \$15.44 in february 2007 and are up from their five year low of \$1.65 in 2004. Of the sinners, it has the largest market cap by far (\$5 billion). Yamana had negative free cash flow of \$226 million over its latest 12 months, and according to its most recent financials, it had \$52 million in net assets. Novagold is another that has benefited from gold fever. Its shares woke up after hitting a five-year low of \$3.44 in May 2004 and are within range of their five-year high of \$18.20, which occurred in September 2006. It has a market cap of \$1.5 billion, has approximately \$50 million in net assets, and had

negative free cash flow of \$132 million over its most recent twelve months.

My two gold and silver ore winners are Northgate Minerals (AMEX: NXG) and Taseko Mines (AMEX: TGB). Both companies are firing on all cylinders. Northgate's free cash flow growth rate came in at 261% over its most recent 12 months, which exceeded its reported earnings growth of 224%. It's the same with Taseko. Its free cash flow increased by 691% over its latest 12 months as compared to earnings growth of 6.2% over the same period. Based on their most recent prices, both have market caps of less than \$1 billion and are trading at less than six times their most recent annualized CFFo.

Of the four industry groups comprising the natural resources sector, the coal industry came in at a solid third place. The Industry's growth in revenue for the period ended January 2007

slowed to 6.7% from the growth rate of 12.5% for the previous period ended October 2006. Not surprisingly, CFFO growth slowed as well. It increased at a rate of 10.6% as compared to 29% for its previous period. Coal has been consistent. It has generated double-digit profit margins for its last six consecutive quarters. To find even any other single quarter prior to the last six in which coal had double-digit profit margins, I had to go all the way back to its twelve months ended April 1997. I found no coal sinners and one winner. The one winner I found is Fording Canadian Coal Trust (NYSE: FOG). It is a coal trust that pays out quarterly dividends based on the coal it sells. It generates positive free cash flow and paid out \$2.60 per share in dividends for its 12-months ended December 31, 2006. Its shares appear to be undervalued as they traded as high as \$43 in early 2006. E

Symbol	Natural Resources companies with positive cash flow (CFFO)	MKT Cap	Recent Price	5yr high	5yr low	CFFO TTM%	Sales TTM%	Industry
FCX	FREEPORT-MCMORAN COPPER & GOLD	27.0B	70.94	72.2	9.95	20.22	38.56	Metal Mining
PCU	SOUTHERN PERU COPPER CORP	25.113	85.3	88	6.385	29.79	49.44	Copper
FAL	FALCONBRIDGE LTD NEW 2005	20.913	55.66	56.25	8	37.01	41.99	Metal Mining
FDG	FORDING CANADIAN COAL TRUST	4.213	28.66	22.47	13.7	9.09	-1.57	Coal
GG	GOLDCORP INC NEW	16.213	23.15	41.66	6.4	69.91	90.77	Gold & Silver
BVN	COMPANIA DE MINAS BUENAVENTU	17.98	32.63	34.86	9.95	103.44	81.37	Gold & Silver
AU	ANGLOGOLD ASHANTI LTD	11.6B	42.11	62.2	19.75	97.29	13.58	Gold & Silver
USU	USEC INC	1.911	22.61	21.15	5.2	47.22	18.55	Metal Mining
NXG	NORTHGATE MINERALS CORP	775.0M	3.05	4.82	0.92	198.97	89	Gold & Silver
KGC	KINROSS GOLD CORP	7.513	12.89	15.39	3.75	118.4	24.82	Gold & Silver
AEM	AGNICO EAGLE MINES LTD	4.6B	34.4	45.67	9.72	252.08	73.00	Gold & Silver
BWLR.F	BREAKWATER RES LTD	873.0M	2.09	2.2	0.05	619.95	56.27	Metal Mining
TGB	TASEKO MINES LTD	389.0M	3.03	4.25	0.19	636.5	37.34	Gold & Silver
IAG	IAMGOLD CORP	2.013	6.94	11.83	3.3	83.33	133.75	Gold & Silver
HL	HECLAMNGCO	993.0M	8.26	9.89	2.2	1,139.98	97.36	Gold & Silver
RGLD	ROYAL GOLD INC B	755.0M	26.41	41.659	8.55	75.15	29.74	Gold & Silver