Private Wealth Advisory

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We're On Our Own Pt 3

This is the third and final portion of this week's newsletter. I'm focusing on two companies we currently own.

Centamin Mining (CEE.TO)

Centamin is based in Egypt. Many investors view this as a major concern given the political strife occurring there today.

I would like to spend some time addressing this situation.

For starters, Centamin is the first ever large-scale mining company to be granted permission to mine in Egypt. It received permission via a concession agreement with the Egyptian Mineral Resource Authority, or EMRA, and the Arab Republic of Egypt, or ARE. The concession was made effective June 13 1995, granting a subsidiary of Centamin (Pharoah Gold Mines or PGM) rights to explore, develop, mine and sell gold and associated minerals found in specific in Egypt's Eastern Desert.

Centamin began exploring soon after. Six years later, in 2001, the company presented its findings to the EMRA and ARE proposing that enough minerals existed to label the area a "commercial discovery." Subsequently, Centamin was granted an "exploitation" license for an area 160 KM2 around the Sukari mine in Eastern Egypt.

The agreement was as follows:

- Centamin would pay a 3% royalty fee on all sales from the Sukari mine to the Egyptian Government.
- Centamin would foot the bill for all operating and capital costs related to the business.
- After Centamin deducted its operating expenses, the remaining profit would be split 50/50 between the Egyptian Government and Centamin.
- However, Centamin would take 60% of the profits the first two years the company is profitable. After this it would take 55% for the next two years. And finally the 50% proposed by the operating company on year five.

This deal reveals several key things. The most obvious is that the Egyptian Government lacks the expertise to get Sukari's Gold out of the ground. Gold mining was a common practice in ancient Egypt, but the country barely engaged in production in modern times: according to Goldworld Egypt's production of eight tons in 2008 was more than the country produced in the previous 100 years combined.

So why did Egypt suddenly permit commercial production in the 21st century?

Two reasons: a decline in oil production and the price of Gold.

Egypt had allowed foreign companies to engage in oil production for decades. However, Egyptian oil production peaked in 1993. And Egypt needed to find a new source of income (oil accounts for ~7% of GDP).

Meanwhile, the price of Gold kept going higher. The Egyptian Government figured it could generate $10 billion per year by allowing foreign companies to engage in production. With an economy of $188 billion this represents more than 5% of GDP.

Again, Egypt lacks the expertise required to explore and produce Gold in a commercial fashion. But it wants the money generated by Gold production. This is why the Government takes a large portion of profits (50%) but is willing to give Centamin a larger portion during the first four years of profits.

Fast forward to today.

Egypt is undergoing a period of intense political upheaval as the Mubarak government which has been in power for 40 years falls. Centamin has not been totally immune to the situation: workers staged a brief sit-in.

However, the company resumed production quickly. It has also confirmed that the rumors of the Egyptian Government forcing the company to halt Gold exports for four months (to stop corrupt officials from moving Gold out of the country) were totally false.

The market is certainly not seeing additional trouble for the company. Centamin shares bounced hard off of support and resumed their uptrend in early February:

However, we're not totally out of the woods yet. Centamin needs to take out its descending trendline before the market gives the "all clear" on the company:

As you can see, Centamin shares are currently testing this line. If we break above it, then we're likely going to $2.50 in short order.

What is the worst case scenario here? The worst case scenario is that the Egyptian government throws Centamin and all other foreign companies out of the country. This *could* happen: there is historical precedent for this in countries during times of social revolution.

However, we need to remember that Egypt has little if any expertise in Gold mining. The Sukari mine only *just* began producing this time last year. Throw Centamin out and Egypt will lose hundreds of millions of Dollars as well as the development of a mine that has already seen its resources increase from 1.3 million ounces to 14.5 million ounces in the last ten years.

Of course, political decisions are rarely made rationally. But Centamin's management has proven that it will make Egypt a heck of a lot of money… and with 50% of profits going to the Government, this is not your usual situation in which foreign companies take all the profits.

On a final note, I want to note that the reason we're investing in Centamin is because we expect a buy-out, NOT for its earnings potential. Having seen resources jump every single year over the last 10 years. Today Centamin is sitting on 14 million ounces in resources. This is a HUGE incentive for larger companies to buy the company.

So we're holding on for now. If the technical picture worsens dramatically, we'll reconsider.

TimberWest (TWF.UN)

The primary issue with TimberWest are its "stapled units." To understand what these are, you need to understand the levels of priority for shareholders in a corporation: what's called "absolute priority."

If a corporation declares bankruptcy, the first investors to get paid are creditors (those owning the company's debt). After that the equity shareholders (those who own common stock in the company) are paid.

Senior note holders, preferred shareholders and others are grouped in the "creditors" category.

In 2010, Timberwest chose to pay off some of its $150 million debt load by issuing "stapled" units: shares that are party equity and part subordinate note (a kind of debt instrument). The breakdown is as follows:

1) One share of common stock
2) $8.98 worth of a Series A Subordinated Note

The benefit of this arrangement was that stapled unit holders would receive interest payments between 2-12% per year on the Note portion of the unit, while also getting the benefit of share appreciation from the stock share. And if TimberWest were to go bankrupt, stapled unit holders would be paid *before* common stock owners.

We chose to invest in the common shares rather than the stapled units because they're simpler to invest in and the benefit of the stapled units (the interest payments) is not a sure thing. Indeed, Timberwest deferred payment on notes for 27 months in early 2009. And the company has also announced that it will pay deferred payments in *either* cash or *more* stapled units depending on its financial situation.

To me, unless the interest payments were guaranteed, there is little if any benefit to owning the stapled units. This is why I chose to have us invest in Timberwest's common shares instead.

This concludes this final portion of this week's ***Private Wealth Advisory***. Barring any major developments in the markets, you'll next hear from me in next issue to be published Wednesday April 6, 2011 after the market closes (4PM Eastern Time).

Until then…

Good Investing!

Graham Summers