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YE Apr30 Δ: '96 116.9%; '97 28.1%; '98 36.4%; '99 39.4%; '00 180.9%; '01 -50.5%; '02 18.7%; '03 28.8%; '04 166.7%; '05 28.2%; '06 153.3%; '07 8.8%; '08 -25.2%; '09 -50.3%; '10 162.3%; '11 2.6%

## Junior Gold and Natural Resource Sector Report

September 8, 2011

### Consolidating Venezuela's Gold Belt RUSORO MINING (RML-TSX Venture)

#### UPDATE



**Weekly chart: High \$4.50, Low \$0.095, Last \$0.095**

#### **CONTROVERSY AND FEAR CREATES OPPORTUNITY**

After nationalizing the assets of three foreign companies, the only international company still extracting gold from Venezuela is Rusoro Mining. We continue to believe that the government backs the Russian-Canadian miner as a means to help develop the country's gold sector. The Vancouver-based company, backed by Russia's powerful Agapov family, has emerged as Venezuela's preferred and official partner for gold mining.

Despite sitting on one of the largest undeveloped gold deposits in the world in the south of the country, Venezuela has struggled for decades to develop its gold sector, which has been over-run by illegal miners and smugglers. Venezuela officially produces 11 metric tons of gold a year, but illegal miners extract an additional 10 to 11 tons annually according to its leftist president Hugo Chávez. By all accounts this is creating an environmental nightmare.

However, there are increasing signs that the country may be close to some kind of master plan to deal with it. Chávez is battling back after the removal of a baseball-sized tumour and undergoing a third round of chemotherapy, and faces an election next year. He's come face to face with his mortality, and he is making the gold sector a priority to strengthen the economy and the future well-being of his people.

### ***The world's largest known treasure trove of gold***

There are a potential 70Moz of gold in the Kilometer 88 district alone according to some analysts - a worthy prize for whoever ultimately gets to develop the area – and specifically the controversial Las Cristinas and Las Brisas gold projects. Last February Venezuela's state mining company told Crystallex International Corp that it had terminated their operating contract for the Las Cristinas project. Crystallex was awarded the contract to mine the 16.8Moz deposit in 2002, but the country's Ministry of Environment and Natural Resources refused to issue the final required permit.

In late 2008 Rusoro attempted to get its foot in the door in the Kilometer 88 district when it launched a hostile takeover bid for Gold Reserve, then developing the Las Brisas gold-copper project. That offer was withdrawn after the Ontario Superior Court of Justice intervened. The court ruled that Rusoro had improper access to Gold Reserve's confidential information because its advisor on the bid, Endeavour Financial, had worked with both companies.

The Russian connection to Venezuela runs deep. Last month Chávez announced the “nationalization” of Venezuela's gold industry in what was later explained to be a bid to stamp out illegal mining and boost international reserves. Tellingly, he chose an address to the army to make this announcement, as he was presenting them with newly purchased Russian military equipment. He was quoted “I'm counting on you because the area remains in anarchy, run by mafias ... we can't keep allowing them to take it (*Ed. - the gold*) away,” adding that he would sign a decree in the coming days approving the move. “Let's convert it into our international reserves because gold is increasing in its value.”

The move follows opposition accusations that the Venezuelan government plans to transfer billions of dollars in foreign exchange reserves held in countries such as the US to banks in “friendly” countries such as China, Russia and Brazil in order to avoid its assets being frozen.

Analysts estimate that of Venezuela's \$29bn international reserves, the government will only be able to move about \$5bn of its cash reserves. But with some two-thirds of its reserves held in gold, amounting to 364 tons worth \$18bn, the government is allegedly also planning to move the 211 tons of gold that it keeps abroad, worth \$11bn, to the vaults of the central bank in Caracas.

Members of Venezuela's government had indicated years ago that it would likely retake control of the Las Cristinas project, and publicly suggested that it would take Rusoro Mining Corp as a partner. Both these events have since taken place.

With the CBV's relaxation to the gold export limits last fall, we were hopeful Rusoro would finally be seeing better days, but the risk appetite has only declined as the US and European debt crisis has deepened, and Venezuela is increasingly viewed as a untrustworthy state aligned with Cuba and Russia. Should Chávez make clear his policies towards development and increasing cash flow into the country, or be ousted for a more liberal regime, a company like Rusoro is remarkably well-positioned to benefit.

What is clear is that the government has a serious environmental mess around Las Cristinas, and it badly needs a capable mining company to go in and clean it up, while finally extracting the gold. Venezuela is not exactly on good terms with any of the majors, and anybody perceived as US-based or oriented is persona non grata.

To add another layer to the story, one of our other significant portfolio holdings, Endeavour Mining (EDV-TSX), is an advisor to Rusoro through its now-wholly-own subsidiary Endeavour Financial, and is itself a rapidly growing gold miner with access to lots of cash, and with a strong affinity for growth by aggressive acquisition (*see our latest Update Report issued Aug 21, 2011*). Endeavour is currently in a \$300M merger transaction with Adamus

Resources (ADU-ASX). Endeavour's management team has a history of smart deal making and is growing Endeavour into an estimated 250,000oz/yr mid-tier producer by 2013.

### ***Venezuela's socialist evolution***

Last year Chávez devalued Venezuela's currency, announcing a dual system for the fixed rate bolivar. It devalued the currency to 4.30Bs and 2.60Bs against the dollar, from a rate of 2.15Bs per dollar in place since 2005, giving the better rate for basic goods in an attempt to limit the impact of the measure on consumer prices.

This was excellent news for Rusoro given the alternative they were facing before this development, selling gold to the Central Bank at about 50% of spot. Rusoro was warehousing its gold production following a Central Bank edict stipulating the percentage of gold that must be sold to the central treasury at 2.15Bs to the \$US, a massive discount to world spot prices. Rusoro now sells 60% of their gold to the BCV at 80% of spot gold price (no VAT), 30% is exported at spot (no VAT) and 10% domestic sale at 11.75% (plus VAT). Net-net this works out to about 80-85% of the spot gold prices, a significant improvement.

The new tiered mechanism also established an exchange rate of 2.60 Bolivars per US Dollar to import capital goods, increasing the efficiency of capital expenditures. Rusoro is allowed to use up to 30% of its liquid proceeds from exports to cover foreign costs, up from 10% which was the previous rule under the law.

Overall, these changes significantly increase net proceeds from gold sales, reducing the costs associated with the importation of capital items and key consumables related to Rusoro's on-going mining operations at Choco 10 and the VenRus government joint venture mining operation at Isidora.

Holders of Venezuela's foreign debt were pleased with the devaluation, since it improves government finances and lessens the need to issue more bonds. "The announcement is enormously positive for Venezuelan assets," Alejandro Grisanti, an analyst at Barclays Capital in New York, wrote in a research note. "It provides a further signal from President Chávez of his willingness to pay, while improving considerably the capacity to pay," leading Barclays to maintain its "overweight" position on the nation's debt.

Chávez said the 4.30 Bolivars-per-dollar exchange rate will curb imports and reduce the economy's dependence on oil, which had fallen about 40 percent from the 2008 record. Venezuela is South America's biggest oil producer.

### ***Strategic Focus Unchanged***

Part of Rusoro's successful strategy in Venezuela has been to use its in-country operating experience and political connections to resolve the various hurdles encountered by other parties attempting to operate in Venezuela. A good example is Gold Fields, one of the world's largest unhedged gold producers, while they owned the Choco 10 project. Operations were aggravated by local labour relations and poorly managed governmental ties. Rusoro's acquisition of the project and subsequent focus and results at Choco 10 saw optimized operating efficiency, lowered costs and improved production ramp-up alternatives.

Another well-engineered transaction was Rusoro's completion of the acquisition of Hecla Mining's Venezuelan assets, for which Rusoro paid \$25 million in cash and shares. Hecla was also having some operational issues in Venezuela and after a three month shutdown they decided a partnership would be the best scenario going forward. Rusoro moved quickly to optimize operating efficiencies and resolve the local issues.

These acquisitions were followed by an official confirmation by the Venezuelan Government that Rusoro is the State's "Partner of Choice", giving Rusoro a big leg up, well ahead of other potential operators, as THE go-to regional consolidator. Potential takeovers and mergers may yet catapult Rusoro to join the world's gold production big leagues.

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