Lies, Damn Lies and Cash Costs

Mark Twain popularised the phrase (attributed to 19th century British Prime Minister Benjamin Disraeli) that there are “three kind of lies: lies, damned lies, and statistics”.

We’ve been spending some time looking at the mining industry due to recent price falls, and here the most prolific and unscrupulous statistic of choice is known as ‘cash costs’.

Cash costs are ostensibly presented to investors to strip out the impact of non-cash accounting charges, like depreciation, from a miner’s operating results. It’s not usually wise to remove depreciation, which tends to be a real economic expense, because it can grossly overstate profitability. Capital costs can be more than 50% of the total cost of a mine or more. This is particularly an issue as miners are pursuing ore bodies progressively further underground.

There are, however, some circumstances where it could be useful to bypass depreciation. For example:

- Where a mine has a high upfront cost that has already been spent, you might be more interested in its remaining cash flows over the finite mine life; or
- When a miner has pressing liquidity issues, you might be more interested in knowing how much cash can be generated to pay lenders or suppliers/employees

Even in these situations, cash costs can leave an investor significantly overstating the free cashflow that will be available to pay debt or equity. Not only do cash costs exclude historical expenditures over the mine's useful life, they also ignore *future* capital outlays required to continue to operate the mine. These costs are expenditures that are not growth related but required to maintain production, even if these outlays are non-discretionary and even if they can’t be deferred.

To give you an idea how significant ongoing capital outlays can be, **Newcrest** recently reported cash costs of $750 per oz of gold but all-in sustaining costs of $1,283/oz. That’s an increase of 70% and a decrease in the implied free cash flow margin from 52% to 17% (using a gold price of $A1,550/oz). The all-in sustaining cost is a measure being pushed by the World Gold Council to improve disclosure and includes stripping costs required to access the ore.

In other words, costs including costs. Once you do that, though, you won't find many that have made or are making a profit. It's a sector full of very average businesses and, despite the dramatic selloff, we aren't finding a lot to get excited about.