Energold Drilling Corp. - How To Get Indirect Exposure To The Precious Metals Market
Oct. 12, 2015 2:15 PM ET | 17 comments | About: Energold Drilling Corp. (EGDFF), Includes: ISVLF

Summary

Energold is a small drilling company servicing the mining, energy, water and manufacturing sectors.

Because mineral drilling is the company's primary business, Energold offers indirect exposure to the precious metals market.

In my opinion, the company is currently **deeply undervalued**, which makes it a buying opportunity for long-term investors.

Energold, through a small stake in **IMPACT Silver Corp**., also has direct exposure to the precious metals market.

It is common knowledge that during the California Gold Rush (1848) more fortunes were made by merchants than by miners. Such big names as John Studebaker, Levi Strauss or William Fargo are just a few examples. These people were selling things and services the miners wanted.
Therefore, if somebody believes that we are close to the beginning of the next stage of the precious metals bull market, parking some money in stocks of the companies indirectly exposed to gold or silver seems to be quite an interesting strategy. In this article, I would like to present a company, **which sells its services to mining companies.** The company is called Energold Drilling Corp. (OTCPK:EGDFF) (EGD.V in Canada) and its main business is to provide mineral drilling services to mining companies.

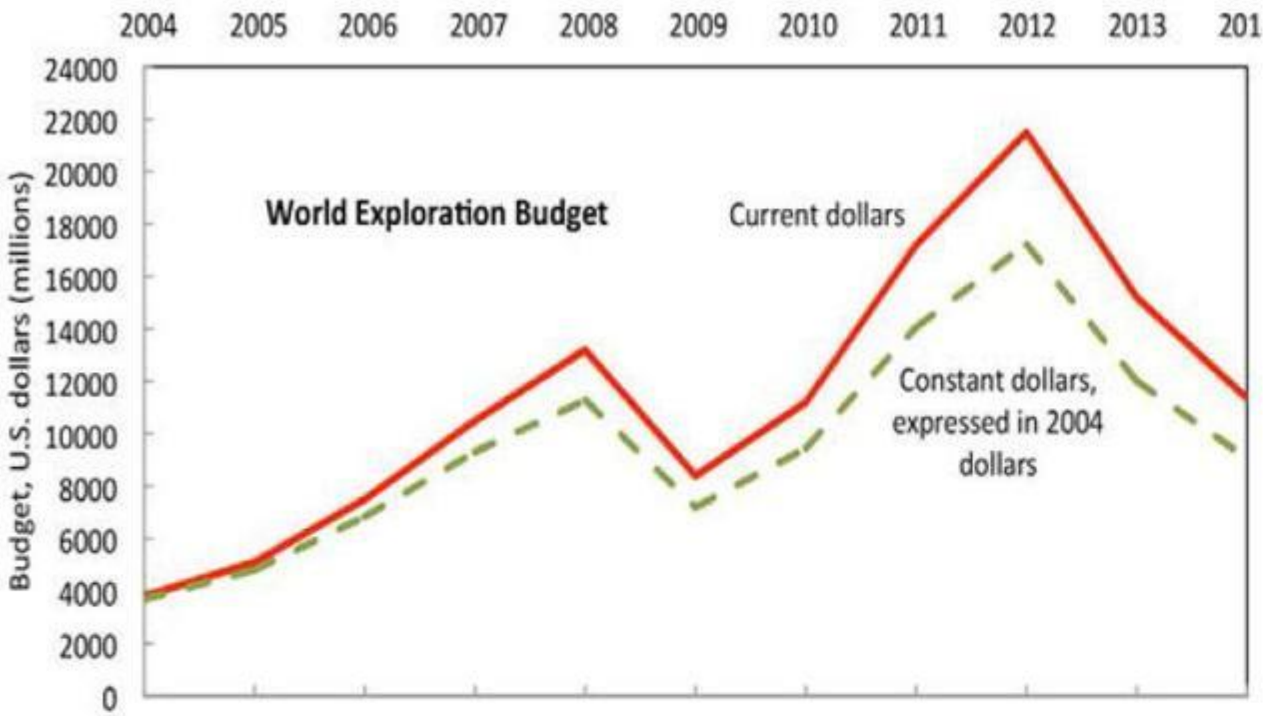
Introduction

Energold is a global specialty drilling company servicing the mining, energy, water and manufacturing sectors. The company is based in Canada. At its inception, Energold was an exploration company **but around 2001 it shifted its focus to contract drilling.** Currently, the company owns a fleet of 138 mineral drill rigs and 128 energy drill rigs, which positions it as a **mid-tier drilling solutions provider.**
Due to the fact that most recently the global mineral exploration expenditures had shrunk, the entire drilling sector was hit very hard. As a result, today the shares of many drillers are at their multi-year lows and some of them offer an excellent buying opportunity for value-seeking investors. In my opinion, Energold is such a company and its shares could be one of the best picks for those looking for an indirect exposure to the precious metals market.

The mineral exploration sector

According to many sources, since 2012, the nonfuel mineral commodities exploration spending has been in a rapid decline. For example, the U.S. Geological Survey in its "2014 Exploration Review" reported that the global exploration spending, expressed in current U.S. dollars, had peaked in 2012 when it reached around $22 billion. Since that time the spending was reduced by nearly 50% (to around $12 billion in 2014) - see the chart below:

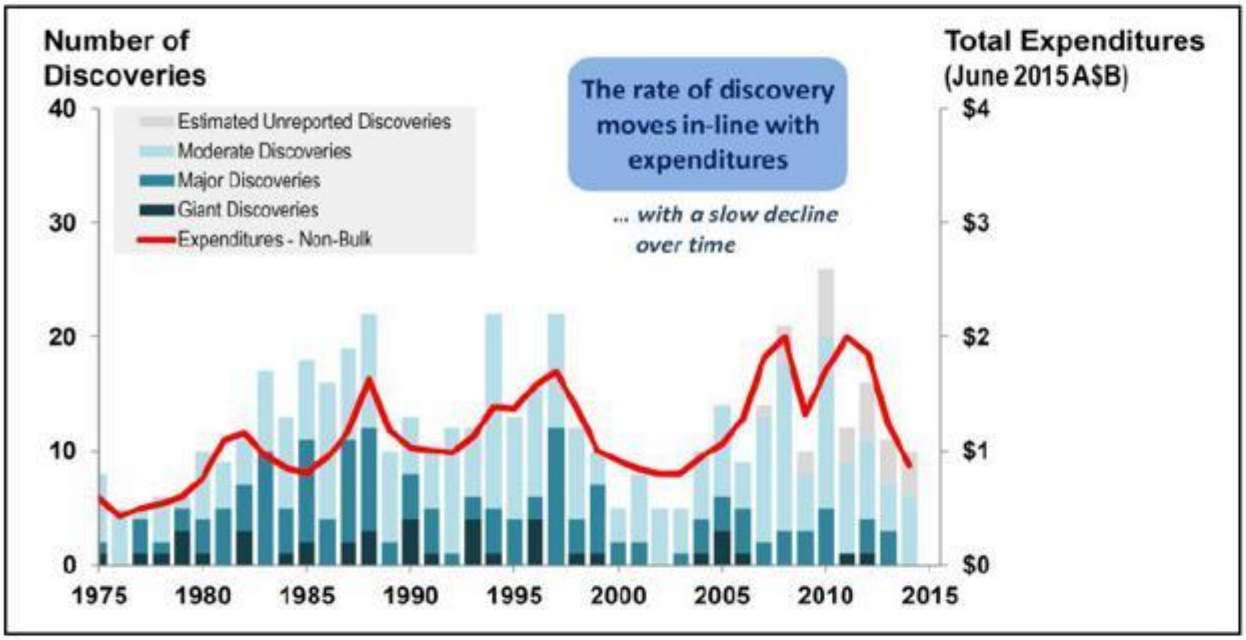
(click to enlarge)



source: U.S. Geological Survey

What is more, this negative trend seems likely to extend into this year as well. According to SNL Metals and Mining, in 2015, global exploration spending is estimated to stand at only $10 billion. Another problem - a slower rate of discovery of new mineral deposits puts additional pressure on the precious metals market. The chart below depicts this negative development:

(click to enlarge)



source: SNL Metals and Mining

As the chart shows, since 2010, the number of new discoveries has been rapidly going down and exploration spending has been closely following this trend. Simply put, mining companies have more and more problems to find new gold, silver and other metals deposits. Therefore, in 2014, mine site exploration expenditures (31% of total global exploration spending) surpassed for the first time grassroots exploration spending (30%). It means that the exploration effort is shifting from junior mining companies (grassroots exploration) to major miners (mine site exploration and late stage exploration). Putting it differently - cash is at majors not at juniors.

At this point, somebody could ask me - if there is so many bad news reported, why are you recommending this company? **My answer is simple - I am recommending this company because there is only bad news. This is a classic contrarian situation - no positives about a specific sector, poor financial results reported by companies, share prices at their multi-year lows.** All these factors usually mean tremendous, even surrealistic, undervaluation. Hence, if somebody shares my opinion, Energold could be a company of interest.

How it works

Energold's business model is quite unique. The company offers so-called **mobile drilling rigs,** most of which are manufactured at the company's subsidiary, Dano Drilling International. Such rigs are very easy to move from one location to another because they weigh no more than 2 tons. While most of its competitors have to move their equipment on trucks, tractors, etc., Energold's drill components may be transported using a small aircraft, pick-up trucks, dug-out canoes or, in some cases, even on people's back. As a result, the transportation does no harm to the environment and drilling rigs may be easily moved to remote areas (where no infrastructure is available) such as Amazonas or high altitude areas. Such a business model ideally positions the company as a drilling services provider to grassroots exploration companies - hence the company CEO's motto is "We will work where no one else will". The strategy proved to be right and Energold increased its mineral drill rig fleet from 24 pieces in 2005 to 138 at the end of the first half of 2015, offering its services to three mineral sectors: precious metals mining companies, base metal mining companies and junior exploration companies. Of these sectors, precious metals (both miners and juniors) represent the largest demand, therefore, it is a sector Energold is mainly positioned to. What is more, the number of new gold or silver discoveries has been shrinking for many years (see the section above) so the company believes that mining companies, to increase or sustain its mineral base, have to intensify exploration in remote areas (where Energold's drilling rigs are well suited).

As I mentioned above, since 2012, the mineral exploration sector has been in a big slump. Now margins are poor, the mining companies are cutting exploration budgets so, as a result, Energold is losing money. To prevent it, a few years ago, the company diversified itself into two other business lines: **energy drilling and manufacturing.** As of the end of 1H 2015, mineral drilling revenue accounted for 30.6% of the company's total revenue, while energy drilling and manufacturing accounted for 43.6% and 25.8%, respectively. It was quite an unusual situation because, in 2011, at its peak, mineral drilling was a primary business line, accounting for as much as 79.2% of the company's revenue **- the slump in mineral exploration has been truly astonishing. While I am quite confident that sooner or later we should see a radical improvement in global mineral exploration, Energold's decision to diversify itself seems to be right.** Currently, the margins reported by the energy division are much better than those delivered by the mineral division. In 1H 2015, the energy division delivered gross margin of 34% while the mineral division reported gross margin of just 0.2%. However, since the middle of 2014, the oil prices have been in their bear market so Energold warns that high margins reported by the energy division could go down as well (although not as much as margins reported by the mineral division). Fortunately, since its inception, as much as 51.7% of the drilling conducted at the energy division was attributable to geotechnical and geothermal drilling, which in some way, reduces the risk embedded in the energy sector.

Financial situation

The table below evidences the basic financial measures:

in thousands of C$	1H 2015	1H 2014	change (%)
Revenue	39,862	57,863	-31.1%
Gross margin	7,808	14,506	-46.2%
Operating income	-6,311	358	
Net income	-8,165	-2,701	
Debt	15,739	22,966	-31.5%
Cash	11,449	15,063	-24.0%
Cash flow from operations (excluding working capital issues)	-3,785	3,166	
Free cash flow	3,743	-3,314	
EBITDA	-1,541	5,307	
Market cap	32,763		
Price to book value	0.32		

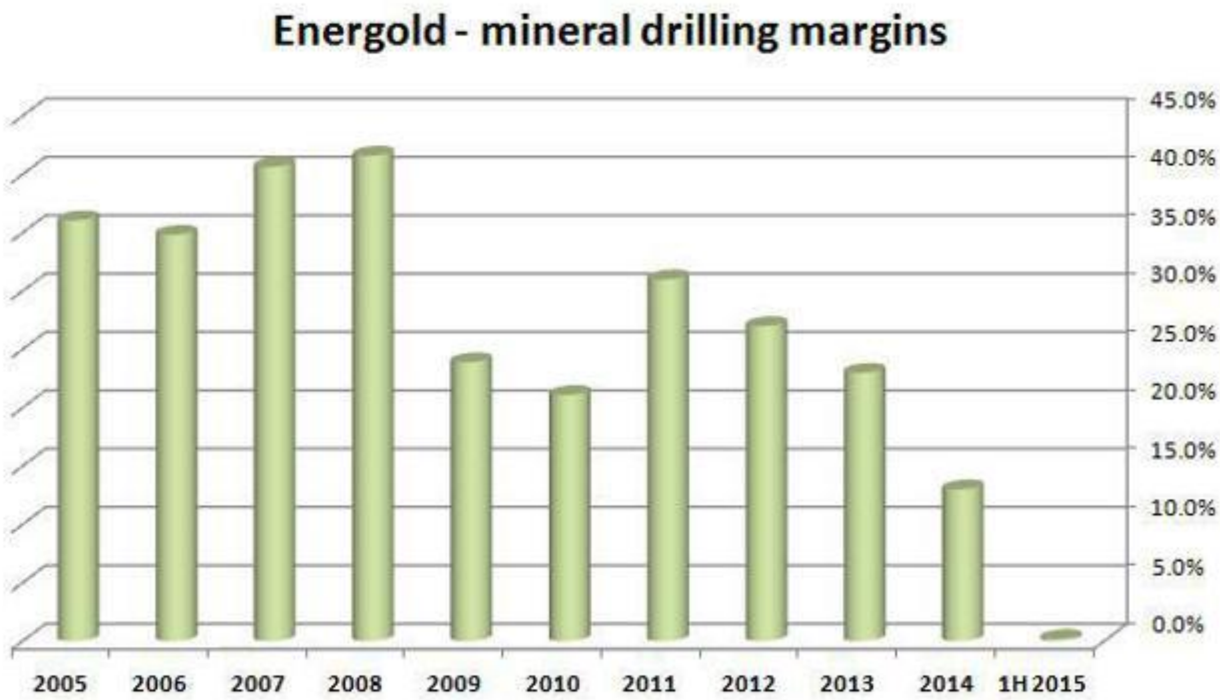
source: Simple Digressions and the company's reports

As the table shows, in 1H 2015, Energold reported much worse results than in 1H 2014, with **lower mineral division gross margins standing behind this negative development. In my opinion, these margins, calculated as revenue less direct costs, excluding amortization, are the most important metrics for drilling companies.** Simply put, they demonstrate whether a company, operating in a highly competitive market (and drilling is an intensely competitive business), has the pricing power or not. They also show whether a company controls its costs, especially its variable ones. **So let me dig a little bit deeper into gross margins delivered by three main Energold divisions (for better clarity I am using the percentage gross margin calculated as gross margin divided by revenue).**

Mineral division

The mineral division used to be the primary business throughout the company's history so it is quite interesting to track these margins since 2005 when the company was starting mineral drilling. The chart below shows these margins:

(click to enlarge)



source: Simple Digressions and the company's reports

It can be easily spotted that between 2005 and 2008 the mineral drilling business was flourishing. Then, in 2009, margins fell sharply. Energold explains:

"Gross margin decreased to 23.9% in 2009 as compared to 41.6% in 2008. Competitive pricing for drilling at mine sites reduced overall prices as the Company experienced a higher proportion of its activities at mine sites and ***less frontier exploration drilling than anticipated."***

As a matter of fact, this massive drop in margins affected other drillers as well. For example, Major Drilling Group International (OTCPK:MJDLF), a much bigger driller than Energold, also experienced a substantial drop in its margins, though a little bit later (from 33.6% in 2011 to 24.2% in 2010).

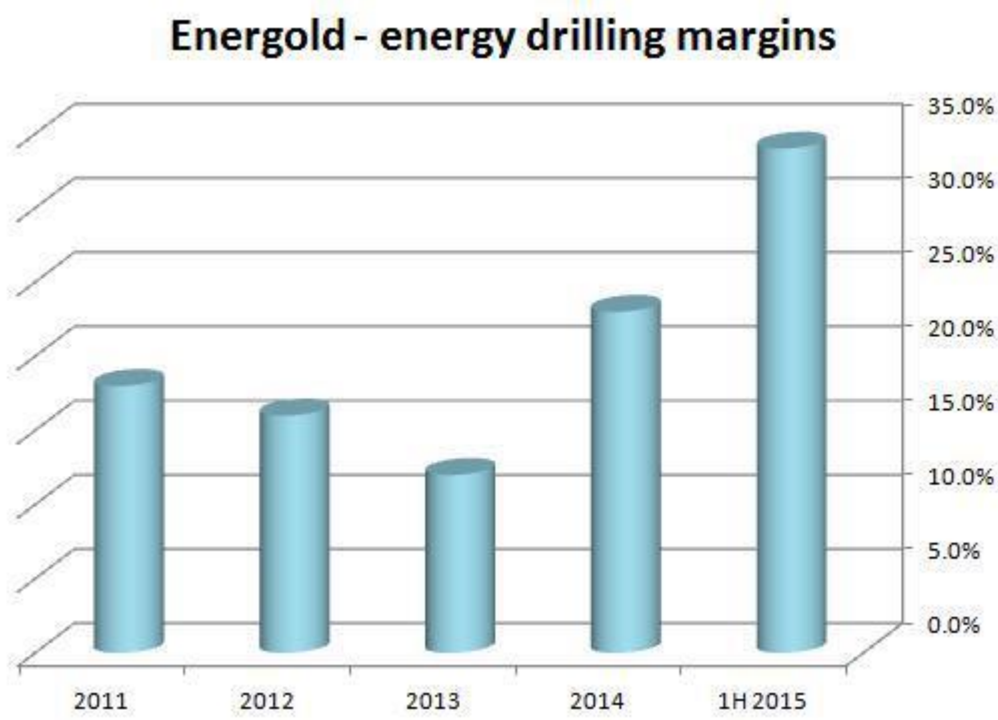
In 2011, margins improved quite substantially but since then they have been in a steady decline. In 1H 2015, **they hit a record low of just 0.2%.** Let me cite the company's explanation:

"Gross margin percentage remains heavily impacted by the type of drilling the Company performs, the region and country in which it works, and the type of client. ***Junior miners typically explore more frontier style environments that allow for higher margin frontier drilling, and there is now increased presence of senior miners exploring the frontier regions.*** *As smaller drilling programs are typical at this point in the cycle, economies of scale are reduced and contribute to margin compression."*

Well, Energold does not put it straight away but it seems that currently the company is drilling for senior miners, which have much stronger negotiating power than junior miners (which currently have practically no money to finance their drilling programs). What is more, there are less drilling contracts on the market. Hence, gross margins are severely reduced.

Energy and Manufacturing Divisions

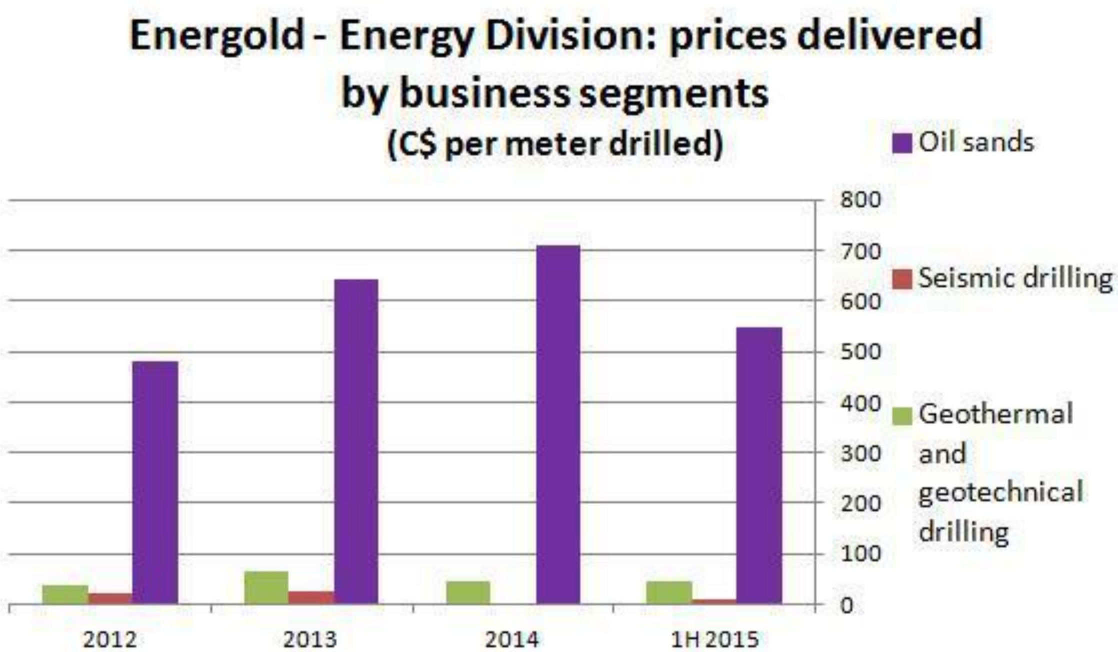
Now, let me show gross margins delivered by the energy division. The chart below shows these margins:



source: Simple Digressions and the company's reports

In this division, since 2013, margins have been in a steady increase. In 1H 2015, the gross margin delivered by the energy division was standing at 34.1%. Therefore, I am not exaggerating when I write that it was the energy and manufacturing divisions (with gross margin of 17.1%) that kept Energold afloat in 1H 2015. However, the company warns that, due to lower oil prices, the results of the energy division could worsen. Let me dig a little bit deeper into this problem.

Revenue of the energy division is delivered from three sources: oil sands drilling, seismic drilling and geotechnical/geothermal drilling. The most profitable is the oil sands drilling, which is conducted on behalf of major operators in Alberta, Canada. For many years, these operators have been paying very decently for Energold's services. The prices delivered by oil sands drilling have been much higher than those delivered by seismic or geotechnical/geothermal drilling - please look at the chart below:



source: Simple Digressions and the company's reports

As the chart shows, the profitability (for example, gross margins) of the energy division depends mainly on oil sands drilling and that was the primary reason Energold acquired Bertram Drilling Corp. in 2011. Up until now, this acquisition has proved to be a success. But most recently, Energold and other market commentators have been warning that the oil sands sector is in trouble and revenues and margins earned on oil sands drilling may go down. Let me cite the company: "*Revenue has decreased due to major operators cutting down on drilling programs as evidenced by the decrease in meters drilled in the oil sands. In the first quarter of 2015, activity dropped substantially in late February and early March as opposed to previous years, when activity continued through the end of March permitted by weather*"

Summarizing - mineral drilling is dead at the moment. Junior miners practically do not drill and senior miners drill less than in the past. These negative developments are responsible for totally depressed gross margins delivered by the mineral division. Fortunately, in 2011, Energold was able to diversify its business by adding the energy and manufacturing divisions. These divisions are doing quite well (in 1H 2015, they delivered gross margins of 34.1% and 17.0%, respectively) but the future of oil sands drilling does not look bright (this segment provides the highest drilling prices for the energy division).

In my opinion, the current medium-term bear market in gold and silver is going to its end. If precious metals prices start going up, the exploration budgets should follow them - then Energold, with its modern and quite large drilling fleet, should quickly benefit, even in the case when the energy division starts delivering worse results.

Valuation

Energold is a cyclical company. It means that it is very difficult, or even impossible, to prepare reasonable financial forecasts for such a company. Simply put, any analyst trying to do that would have to start his/her work from predicting the prices of commodity/commodities, which are crucial for a company's business. I guess every Seeking Alpha reader knows how hopeless such a work is. So there should be another method to evaluate Energold or any cyclical company. In my valuation model, I refer to the company's history. Energold reports its results in a reader-friendly manner. For example, it is very easy to find gross margins reported by the company's divisions since 2009, when the last bottom in the gold cycle was established. Assuming that:

1. The peak in this cycle was printed in 2012; and
2. Today we see another bottom in the gold cycle.

I am able to calculate the average gross margins reported by the company through the gold cycle. These margins, plus a few other assumptions, provide a basis for the calculation of the average company's value during the gold cycle.

The main assumptions:

1. Drill rig fleet as of the end of June 2015: 138 mineral drill rigs and 128 energy drill rigs.
2. Price paid by the customers for one meter of mineral drilling: C$164 (the average of data since 2005).

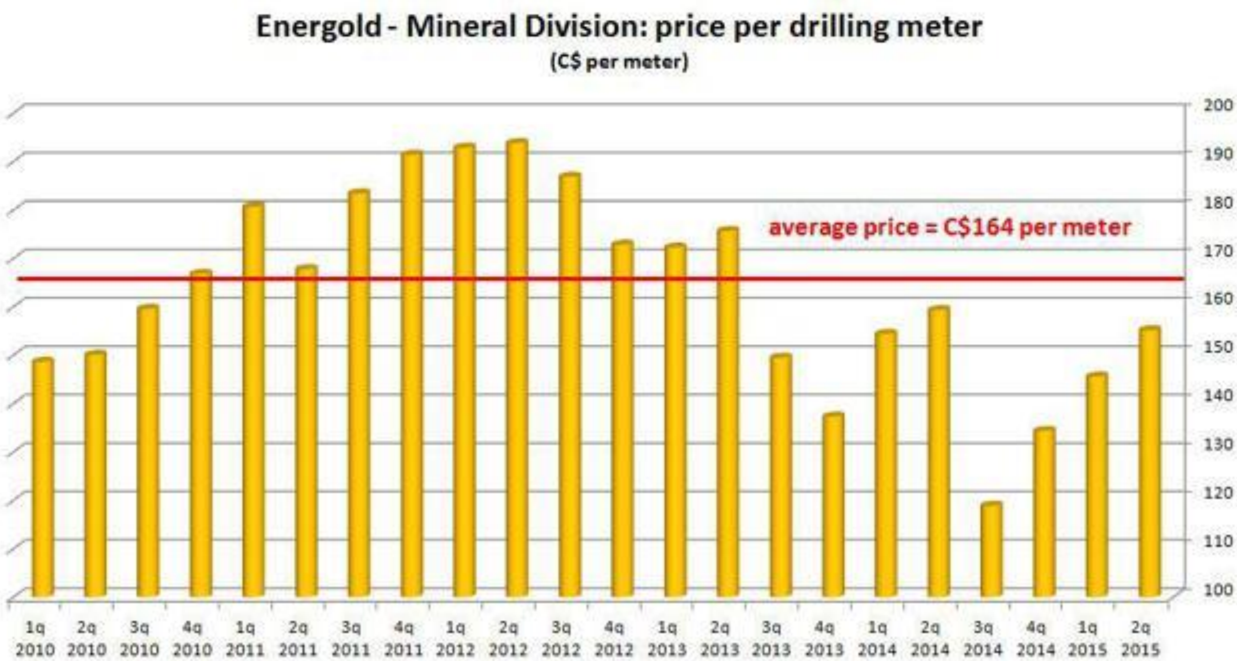
3. Price paid by the customers for one meter of energy drilling: C$78 (the average price since 2011 plus my assumption that next year the drilling prices will decrease by 25% to C$51 per meter drilled and will stay at that level for three years); I am assuming that this business is not set to collapse (as the oil sands sector); however, it is going to deliver lower revenue for a few years.

4. Meters drilled annually per drill rig: 2,966 for mineral drilling (the average drilling length since 2009) and 3,605 for energy drilling (the average drilling length since 2011).

5. Annual revenue delivered by the manufacturing division: C$15,788 thousand (the average revenue since 2011).

6. Percentage gross margins provided by each division: 25.8% for mineral drilling, 22.2% for energy drilling and 18.0% for manufacturing (the average margins since 2009 and 2011).

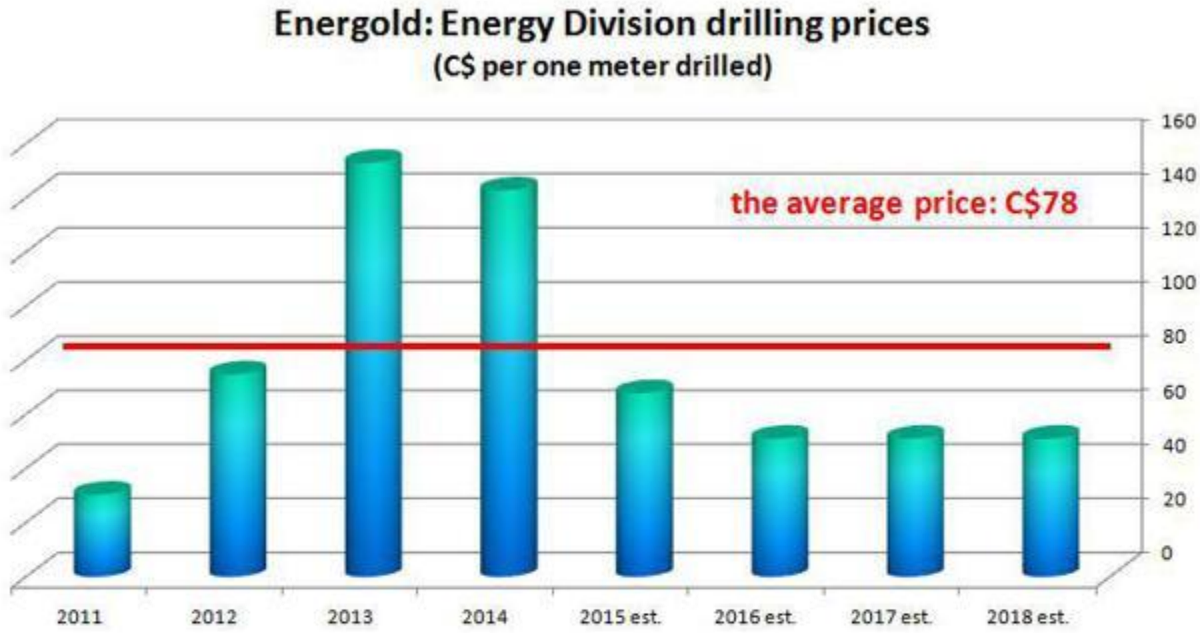
Note: the chart below shows the prices paid by Energold's customers for mineral drilling; as it is easily seen, the average price is C$164 per one meter drilled:
(click to enlarge)



source: Simple Digressions and the company's reports

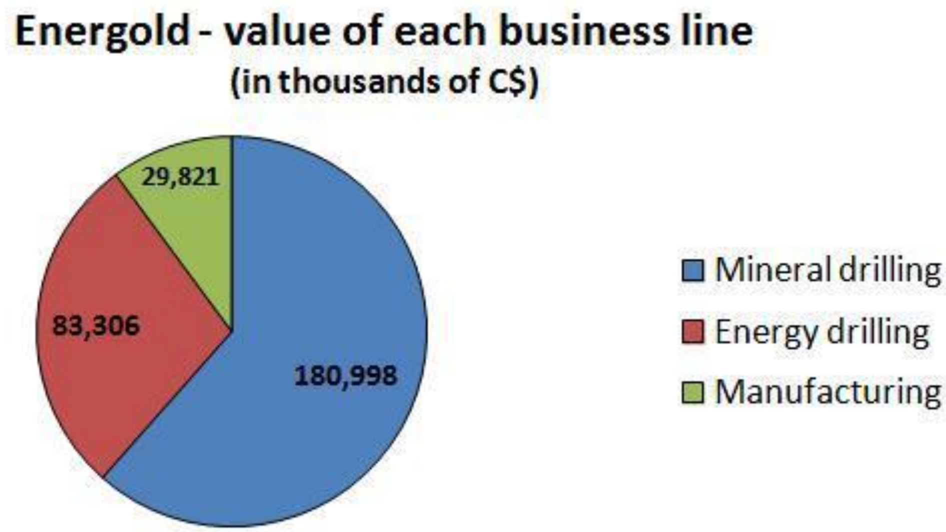
As for the energy drilling:

(click to enlarge)



source: Simple Digressions and the company's reports

Using these assumptions, I can calculate the value of each division through the gold cycle. These values, excluding fixed costs and additional working capital needs, are as follows:



source: Simple Digressions and the company's reports

As the chart shows, the highest value is attributable to mineral drilling (C$181 million), which is correct - this business is a primary one.

But it is not the end of story. Apart from direct costs, Energold incurs also fixed costs (C$18.7 million run rate). Additionally, to run its business at higher volumes than those reported today, the company would need higher net working capital. I assume that Energold would need C$28.0 million of additional net working capital investment. ***(WHY??)***

After taking into account all these assumptions (excluding net working capital needs) and using a discount rate of 9.54%, the forecasted company's enterprise value is standing at C$98.13 million.

Finally, to find the company's equity value, I will use the following formula:
Equity value = Enterprise value less debt (C$15.7 million as of the end of June 2015) less additional net working capital needs (C$28.1 million) plus cash at hand (C$11.4 million as of the end of June 2015)

As a result of the above calculation, I find that the forecasted equity value is C$65.8 million or C$1.37 per one share. Today, the shares of Energold are trading at C$0.68 so my valuation confirms that the Energold's shares are deeply undervalued. For those interested in figures - please, look at my detailed calculations below:
(click to enlarge)

Mineral Division	
Average price (C$)	164
Number of drilling rigs	138
Meters drilled per rig per year	2,966
Revenue per rig (000C$)	485
Total revenue (000$)	66,929
Margin	25.80%
Gross margin (000C$)	**17,267**

Total gross margin	**28,060**
General (fixed) expenses	18,698
Cash flow	**9,362**

Discount rate	9.54%
Growth rate	0.00%

Energold business enterprise value	**98,130**
Debt (as of June 31, 2015)	15,739
Cash (as of June 31, 2015)	11,449
Net working capital needs	28,035
Value of the Energold's equity	65,804
Share value (C$)	**1.37**

Energy Division	
Average price (C$)	78
Number of drilling rigs	128
Meters drilled per rig per year	3,605
Revenue per rig (000C$)	280
Total revenue (000$)	35,853
Margin	22.17%
Gross margin (000C$)	**7,947**

Manufacturing Division	
Average price (C$)	15,788
Margin	18.02%
Gross margin (000C$)	**2,845**

source: Simple Digressions and the company's reports
Note: Commodity markets go in cycles. My valuation method demonstrates the intrinsic value a company carries no matter at what stage the commodity market is. Therefore, through the entire commodity cycle a company's share prices may vary against its intrinsic value. In most cases, this difference is very high; additionally, periods of under- or overvaluation may last quite long.

Going back to Energold - in my opinion, its shares are undervalued today but this undervaluation may last because that is the nature of commodity markets. From a contrarian investor's point of view, periods of long lasting undervaluation create the best buying opportunities. And vice versa - periods of long lasting overvaluation create the best selling opportunities. In the case of Energold, it seems that now the company's shares present a buying opportunity…

IMPACT Silver Corp.

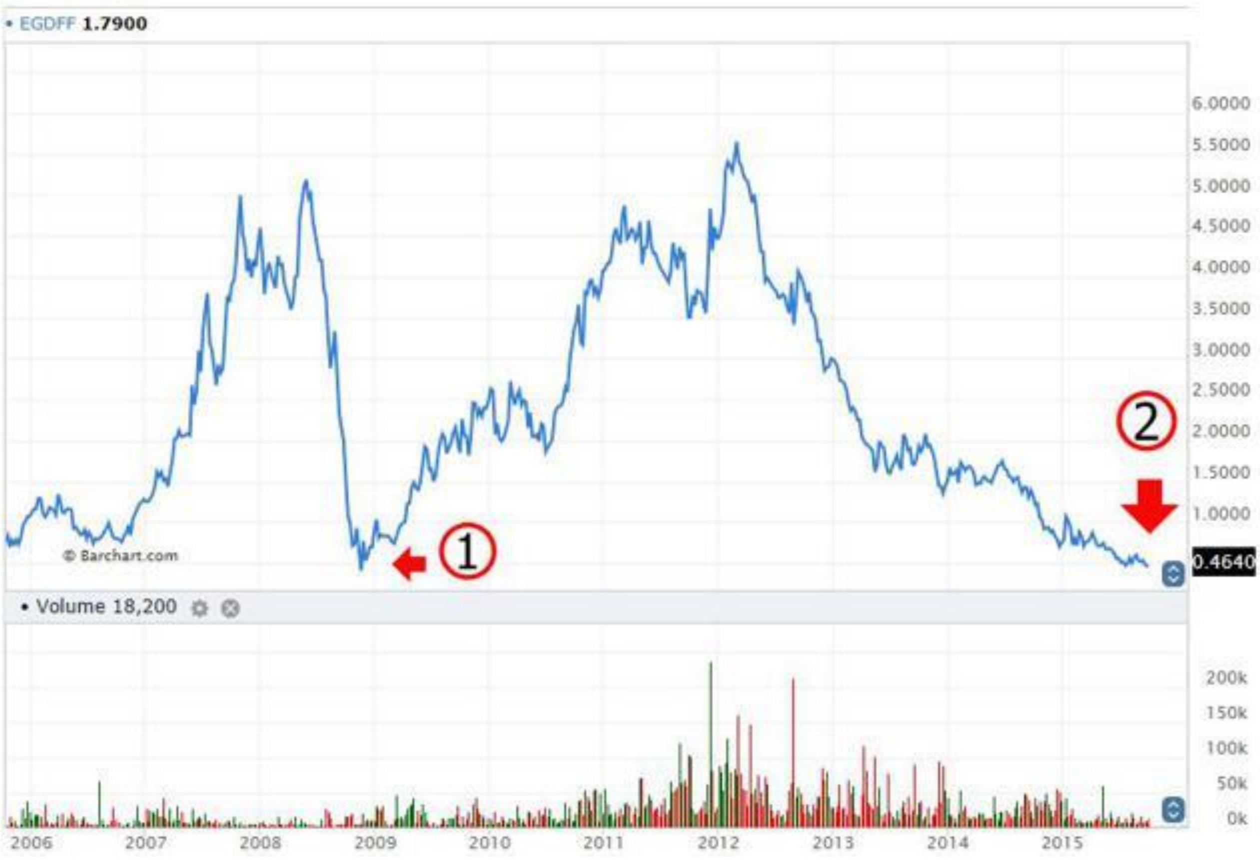
Apart from drilling services, Energold has a direct exposure to the precious metals market. The company holds a minority stake (6.98 million shares, or 10.2% of the issued shares) in IMPACT Silver Corp. (OTCPK:ISVLF), which is a small silver producer operating four mines in Mexico. Although Energold's stake in IMPACT is below 20%, the company exercises significant influence over IMPACT - IMPACT's CEO is Frederick Davidson, the CEO of Energold. Therefore, the investment in IMPACT is accounted for using the equity method of accounting. Using that method, as of June 30, 2015, this investment was carried on the company's balance sheet at C$5.6 million, while the market value of this stake is C$1.1 million today (80% below book value). Well, the shares of a majority of silver producers are at their multi-year lows now, and IMPACT's shares are no exception, trading much below their book value. However, this small silver producer is quite an interesting company - for example, in 2015, it plans to produce 1 million ounces of silver. The company's main products are silver-lead and zinc-silver concentrates, which are currently sold at C$66.37 per ton, which is a little bit below their direct production costs of C$70.04. Therefore, IMPACT is losing money, for example, in 1H 2015, it made an operating loss of C$1.46 million (in 1H 2014, the company lost C$2.93 million). On the other hand, IMPACT has a strong balance sheet - the company carries no debt and the only relevant payable, which could be classified as quasi-debt, is the amount due to Energold (C$1.49 million owed for contract drilling services).

In my opinion, when silver prices start their next stage of the bull market, IMPACT is going to be one the most interesting Energold's assets. As a matter of fact, I think that IMPACT itself is worth another article presenting this company in a more detailed way.

Summary

As my valuation model indicates, Energold is currently deeply undervalued. Although the company offers its services to three business segments, it is its mineral drilling division, which is perceived as the primary business line. Most recently, this division has been negatively affected by unfavorable developments in the precious metals and base metals sectors. Due to the falling prices of gold, silver and base metals, the exploration budgets in these sectors have been severely cut - for example, junior precious metals companies hold practically no cash reserves to conduct any drilling. In my opinion, it is the classic example of a contrarian buying opportunity - "buy when there is blood in the streets" or "buy when there is no good news". As the chart below shows, Energold's share prices are at their multi-year lows (point 1 and point 2), which confirms my thesis on the company's undervaluation. However, those interested in buying the Energold's shares should keep in mind that the periods of deep undervaluation (or extreme overvaluation) may last long (please, refer to my note in the section "Valuation").

(click to enlarge)



source: Barchart.com

Excellent analysis. I've invested in this company during the previous downturn and have seen 5x gains. Timing it well this time around we can expect $5+ shares again. I'll add my analysis later.

12 Oct, 03:41 PMReply! Report AbuseLike1

- **Against the grain**
  Comments (6)| + Follow| Send Message

  Good article. Did it mention that it trades at less than half the working capital, lol. Also loved the globe and Mail article. Bravely go where no driller has gone before.
  Go Fred, go!!!!!!!!
  12 Oct, 05:40 PMReply! Report AbuseLike0

- **binary bets**
  Comments (2)| + Follow| Send Message

  Why if this company is so undervalued does the author not hold a position?
  I'll tell you why.
  The over head is lethal, and the working capital is based on assets that if they were liquidated would be nickels on the dollar.
  When the head of a company is an accountant, look out below.
  12 Oct, 07:11 PMReply! Report AbuseLike0

- **Simple Digressions**
  , Contributor
  Comments (131)| + Follow| Send Message

  Author's reply » The answer is simple. I am based in Poland where there is practically no broker, who offers stocks listed at the OTC market in the USA. I am writing "practically" because there is, in fact, one such a broker but its service is very, very expensive.
  What is more, I prefer brokers based in Poland - if there is something wrong with my account (and it happens sometimes) then all legal procedures are here, on spot. If such a case, it is much easier to keep control over my money than if my cash is somewhere abroad. I hope it explains why I do not own Energold.
  As for overhead - Energold cut its overhead quite substantially, from C$24.2 million in 2012 to C$18.4 million in 2014. Inventory - most of the Energold's inventory is attributable to supplies and raw materials. Do you think they are worth nothing?
  13 Oct, 04:15 AMReply! Report AbuseLike0

- **Against the grain**
  Comments (6)| + Follow| Send Message

  It's been a one step forward, two steps back situation, it seems. They came out of the last 2 market downturns steaming ahead, and I'm hoping they come out of this 3rd one even better. Who said the stairway to heaven was a straight one?
  13 Oct, 04:12 PMReply! Report AbuseLike0

- **RbarPNW**
  Comments (151)| + Follow| Send Message

  In terms of equipment, they've been using inventory for spare parts to save money. They have plenty of idle equipment that may also be getting picked at for spare parts. The company is losing money; the drilling industry for both minerals and oil is challenging.
  If one wants leveraged exposure to increasing gold prices there are institutional quality gold miners (low cash costs, low risk mine locations, proven reserves and future production growth) available at great discounts, too.
  Energold is also bogged down by risk in the Canadian dollar; some very thoughtful people are concerned about a mortgage/real estate bubble pop in Canada. And Energold is a Canadian microcap which limits liquidity.
  Energold regularly does shareholder unfriendly financing via bought deals. Was buying Dando a good idea in retrospect? Will the next acquisition have equal challenges? Are the insiders buying at these prices in any meaningful quantity? Don't buy if they aren't buying in volume.
  This stock may rise again, but the risks in owning it are substantial.
  14 Oct, 01:00 AMReply! Report AbuseLike0

- **profplum**
  Comments (4)| + Follow| Send Message

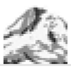
  I would also add financing as a risk. None of us know when profitability will recover but if the company has to do a dilutive equity raise in 18 months time then it may not be the current equity shareholders reaping the rewards. There is an expensive convertible in there with (unspecified) covenants. With losses and cash burn

substantial that may breach. Incidentally, management appear to have bought some of this convertible when issued but have yet to pay for it.
20 Oct, 04:27 AMReply! Report AbuseLike0

- 
roojoo
Comments (135)| + Follow| Send Message

"The company offers so-called mobile drilling rigs, most of which are manufactured at the company's subsidiary, Dano Drilling International"

Are you sure that is correct? My understanding was that Dando mainly makes water drilling rigs, which are generally sold to NGOs. I thought EGD's mineral drilling rigs were sourced from an external party. I might be wrong.
9 Nov, 04:27 AMReply! Report AbuseLike0

- 
RbarPNW
Comments (151)| + Follow| Send Message

Nothing portable is featured on Dando's web site:

http://www.dando.co.uk

Energold was using portable rigs long before Dando needed to be saved/acquired.
10 Nov, 12:23 AMReply! Report AbuseLike0

- 
Simple Digressions
, Contributor
Comments (131)| + Follow| Send Message

Author's reply » I'll check it out
10 Nov, 05:07 PMReply! Report AbuseLike0

- **Against the grain**
Comments (6)| + Follow| Send Message

Okay, so i did a little more research, being the true value investor that i believe i am. From what i can gather, the price to book value ratio was 2 to 1 back in 2011...a little pricey for this market right now, i know, but how does a 0.2 to 1 ratio look? Any other deep value investors out there care to chime in....

13 Nov, 12:20 AMReply! Report AbuseLike0

- 

  RbarPNW
  Comments (151)| + Follow| Send Message

  Will there be any value until mineral drilling recovers? If gold prices drop, any drilling recovery will be delayed. 2011 stock prices were based on growing earnings and market share. You can't declare deep value without making appropriate assumptions. At this point, such assumptions include guesswork. How is the Canadian dollar doing? What is Energold doing to make ends meet that doesn't show up in the figures? Why aren't insiders buying lots of shares? Will gold prices rise or fall?
  14 Nov, 01:32 AMReply! Report AbuseLike0

-

  Against the grain
  Comments (6)| + Follow| Send Message

  Here is my guesswork. The world does not revolve around gold. They can drill any metal, and they have diversified their drilling activities over the past 5 years to include energy, geothermal, water, and also manufacturing....lots of growth. Moving in the right direction with decisions that are execution related, not stock market related.
  14 Nov, 09:04 AMReply! Report AbuseLike0

http://classicvalueinvestors.com/i/2013/11/fred-davidson-from-energold-drilling/