

North American  
Palladium Ltd.

Second Quarter  
Report  
2004



*Building  
Value*



## Management's Discussion and Analysis of Financial Results



### Second Quarter 2004

The following is Management's Discussion and Analysis of the financial condition and results of operations, to enable a reader to assess material changes in financial condition and results of operations for the three months and six months ended June 30, 2004, compared to those of the respective periods in the prior year. This Management's Discussion and Analysis has been prepared as of August 9, 2004. This Management's Discussion and Analysis is intended to supplement and complement the unaudited interim consolidated financial statements and notes thereto for the period ended June 30, 2004 (collectively, the "Financial Statements"), which are included in this Quarterly Report. You are encouraged to review the Financial Statements in conjunction with your review of this Management's Discussion and Analysis. This Management's Discussion and Analysis should be read in conjunction with both the annual audited consolidated financial statements for the three years ended December 31, 2003, and the related annual Management's Discussion and Analysis included in the 2003 Annual Report.

### Overview and Strategic Activities

North American Palladium Ltd. (the "Company") operates the Lac des Iles mine located 85 km northwest of Thunder Bay, Ontario. The mine is Canada's only primary producer of platinum group metals and contains one of the largest open pit bulk mineable palladium reserves in the world. In addition to palladium, the Company earns substantial revenue from by-product nickel, platinum, gold and copper. Palladium's primary use continues to be in the auto industry where it is an important component in controlling exhaust emissions as mandated by more stringent hydrocarbon emission standards for cars, light trucks and SUVs, particularly in the United States, Europe and Japan. In addition, palladium is consumed in the dental, electronics, jewellery and chemical sectors.

During the first quarter 2004, the Company announced the development of an underground mine at the Company's Lac des Iles operations. The decision to proceed with an integrated open pit and underground mine project was based on a full feasibility study prepared by Roscoe Postle Associates Inc. Capital costs for the underground development are estimated at \$40 million for direct and indirect costs and working capital. Mining equipment accounts for an additional \$15 million of

capital costs and the Company will finance this equipment through a vendor lease program.

The Company currently operates an open pit mine and mill at Lac des Iles with a design capacity of 15,000 tonnes per day. In late 2003, the Company commissioned a full feasibility study in response to scoping studies and a pre-feasibility study that indicated a higher grade sub-vertical ore body located directly beneath the open pit mine was a viable underground mine. The underground feasibility study defines, as its base case, a nominal 2,000 tonnes per day mechanized longhole stope mine accessed through a portal in the Lac des Iles open pit with an initial mine plan containing 3,542,000 tonnes of Proven and Probable Reserves. These underground reserves contain approximately 6.62 grams of palladium per tonne at a cut-off grade of 4.5 grams per tonne. In addition, these reserves contain approximately 0.40 grams of platinum, 0.34 grams of gold, 0.07 percent copper, and 0.08 percent nickel per tonne. The integrated production plan for the expanded Lac des Iles mine calls for the blending of higher grade underground ore with that of the open pit to generate a 7-year mine life at an average annual production rate of slightly over 300,000 ounces of palladium.

During the first quarter, the Company also decided to proceed with a secondary crusher installation for the Lac des Iles mill designed to maintain the fourth quarter 2003 throughput rate and reduce processing costs in the mill circuit. The estimated capital cost of this project is approximately \$10 million. The Company plans to finance the \$50 million total capital cost for the underground mine and secondary crusher projects with operating cash flow and a new senior credit facility which was negotiated in the second quarter.

The Company hedges the price of its palladium production under a long-term contract with a major automotive manufacturer (the "Palladium Sales Contract"). The hedge price is based on the monthly average spot price for palladium with a floor price of US\$325 per ounce for 100% of production and a ceiling price of US\$550 per ounce for 50% of production. The remaining 50% of production is sold at market prices or the contract floor, whichever is higher. The Palladium Sales Contract expires on June 30, 2005. In 2004, the Company also commenced a hedging strategy for a portion of its by-product metal production. The objective of this hedge strategy is to reduce the variability of cash flow associated with revenues derived from the sale of nickel, platinum, gold and copper.



Without the Palladium Sales Contract, the Company's profitability would be significantly impacted by the current depressed spot palladium price. In the near term, the Company does not expect to recognize palladium revenue above the Palladium Sales Contract floor price of US\$325 per ounce. The Company is optimistic that the fundamentals for palladium demand will improve in the medium term with the draw-down of surplus inventories held by automotive manufacturers and consumer response to platinum's price premium to palladium. In addition, recent news of a new diesel catalyst technology which may permit the use of palladium will give automobile manufacturers a cheaper alternative in their choice of materials for diesel emission control systems as compared to platinum.

#### Production Statistics

	Second Quarter June 30,		Six Months June 30,	
	2004	2003	2004	2003
Palladium (oz)	75,970	59,069	167,231	117,860
Payable Palladium (oz)	69,399	54,354	152,766	107,682
Platinum (oz)	6,319	5,216	13,302	10,501
Gold (oz)	6,249	5,050	14,004	9,614
Copper (lbs)	2,103,948	1,574,906	4,245,703	2,971,061
Nickel (lbs)	1,060,318	915,977	2,381,519	1,688,522
Ore Tonnes Milled	1,445,445	1,154,965	2,794,224	2,351,224
Ore Tonnes Mined	1,305,529	1,527,756	2,958,196	2,921,725
Waste Tonnes Mined	2,848,833	2,108,737	5,074,933	4,579,622
Waste Strip Ratio	2.18:1	1.38:1	1.72:1	1.57:1

#### Summary of Quarterly Results

(\$000, except per share amounts)	2002		2003				2004	
	3rd Qtr	4th Qtr	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr	1st Qtr	2nd Qtr
Revenue from metal sales	46,547	43,904	45,120	44,631	42,585	59,805	53,156	51,712
Net income	2,894	(1,579)	8,390	10,361	3,535	16,092	6,121	2,834
Net income (loss) per share	0.06	(0.03)	0.17	0.20	0.07	0.32	0.12	0.06
Full diluted net income (loss) per share	0.06	(0.03)	0.17	0.20	0.07	0.31	0.12	0.06

#### Results of Operations

In the second quarter of 2004, the Company's revenues from metal sales were substantially improved primarily due to increased production of metal at the Lac des Iles mine. Palladium production increased 29% compared to the second quarter of 2003. Additionally, second quarter by-product metal production was higher, particularly nickel increasing 16%, platinum increasing 21%, gold increasing 23%, and copper increasing 34%, respectively as compared to the second quarter of 2003.

#### Key Financial Statistics

	Second Quarter June 30,		Six Months Ended June 30,	
(\$000's)	2004	2003	2004	2003
Revenue from metal sales	51,712	44,631	104,868	89,751
Net income	2,834	10,361	8,955	18,751
Net income per share (dollars basic and diluted)	0.06	0.20	0.17	0.37
Operating cash flow	13,769	12,406	33,250	23,767
Long-term debt, including current portion			45,232	82,019
Shareholders' Equity			313,815	279,662
Common shares outstanding (as at June 30)			51,328,589	50,753,440



by-product metals were substantially higher in the second quarter of 2004, most notably platinum at US\$779 per ounce, nickel at US\$5.91 per lb. and copper at US\$1.21 per lb. Partially offsetting the higher realized metal prices was a strengthening Canadian dollar, which averaged US\$0.74 in the second quarter of 2004, compared to US\$0.71 in the second quarter of 2003.

The Company will deliver all of its palladium production for the balance of 2004 under the terms of the Palladium Sales Contract, which has a floor price of US\$325 per ounce. The realized price for palladium sales will depend upon market conditions and the selling prices of palladium, and could be above the US\$325 per ounce floor price.

The Company realized net income for the three months ended June 30, 2004 of \$2,834,000 or \$0.06 per share on revenues from metal sales of \$51,712,000 compared to net income of \$10,361,000 or \$0.20 per share on revenue from metal sales of \$44,631,000 for the corresponding period a year earlier. These results include a foreign exchange loss of \$264,000 in the current quarter compared to a foreign exchange gain of \$6,210,000 in the second quarter of 2003, which primarily relates to the Company's US dollar denominated long-term debt.

For the six months ended June 30, 2004 the Company reported net income of \$8,955,000 or \$0.17 per share on revenue of \$104,868,000 compared to net income of \$18,751,000 or \$0.37 per share on revenues of \$89,751,000 for the six months ended June 30, 2003. The results for the six-month period include a foreign exchange loss of \$1,046,000 compared to a foreign exchange gain of \$14,861,000 in the six months ended June 30, 2003.

During the second quarter, the mill processed 1,445,445 tonnes of ore, or an average of 15,884 tonnes per day, with a palladium grade of 2.22 g/t, producing 75,970 ounces of palladium at a recovery rate of 73.5%. This compares with the second quarter of 2003, when the mill processed 1,154,965 tonnes of ore, or 12,692 tonnes per day, with a palladium grade of 2.08 g/t, producing 59,069 ounces of palladium at a recovery rate of 76.6%. The improvement in palladium production in the second quarter was directly related to the 25% improvement in mill throughput along with a 7% improvement in feed head grade.

Production costs including overheads but excluding non-cash amortization were \$27,489,000 during the second quarter 2004 compared to \$24,009,000 during the second quarter 2003. The higher production costs in the current quarter primarily relate to major repairs to mine loading and haul equipment and increased volumes of secondary crushed mill feed, which is currently provided by a contractor. Smelter treatment, refining and freight costs increased by 61% to \$7,321,000 in the quarter compared to the second quarter of 2003. The increase in these costs was primarily the result of a 52% increase in the volume of concentrate treated. Additionally, costs were incurred in the quarter for transportation fuel surcharges and penalties related to concentrate quality.

Total unit cash costs to produce palladium (production costs including overhead and smelter treatment, refining and freight costs, net of by-product credits and royalties) decreased to US\$158 per ounce in the second quarter 2004 compared to US\$256 per ounce in the second quarter 2003. The increased production of platinum, gold, nickel and copper and the improvement in the prices for these by-product metals in the second quarter of 2004 made a significant contribution to operations and resulted in a reduction of the unit cash costs for palladium by US\$202 per ounce compared to a reduction of US\$155 per ounce in the second quarter of 2003. The decrease in unit cash costs was primarily due to a 29% increase in palladium production, which in part was offset by increased production costs.

At the end of the first quarter, the Company held an unusually high level of concentrate in inventory at the mine site as a result of the labour strike at the Falconbridge operations in Sudbury, Ontario. During the second quarter, the Company was able to reduce the back-log of concentrate held in inventory by nearly 900 tonnes containing 7,151 ounces of palladium and other by-product metals. Approximately \$4,350,000 was recognized as revenue from metal sales in the second quarter pertaining to this material.

Non-cash amortization expense increased to \$8,885,000 during the quarter compared to \$4,834,000 in the second quarter 2003. The higher amortization amount is attributable to the 29% increase in palladium production and an increase in the unit of production amortization rate due to the restatement of reserves at June 30, 2003.



As a result of the reduction in outstanding long-term debt, interest expense on long-term debt reduced to \$411,000 in the current quarter compared to \$657,000 in the second quarter of 2003. During the quarter, the Company repaid the project term loan from the proceeds of a new senior credit facility. Deferred financing costs related to the project term loan in the amount of \$788,000 were written off in the three months ended June 30, 2004. Exploration expense was \$518,000 in the second quarter of 2004 compared to \$778,000 in the corresponding 2003 period.

#### Cash Flow and Financial Position

Cash flow from operations, prior to changes in non-cash working capital, was \$13,769,000 in the second quarter 2004 compared to \$12,406,000 in the second quarter 2003. After allowing for working capital changes, cash provided by operations was \$20,150,000 in the second quarter of 2004 compared to \$20,823,000 in the second quarter of 2003. Cash flow from operations, prior to changes in non-cash working capital, was \$33,250,000 in the first six months of 2004 compared to \$23,767,000 in the first six months of 2003. After allowing for working capital changes, cash provided by operations was \$32,428,000 in the first six months of 2004 compared to \$31,182,000 in the first six months of 2003.

Investing activity in the second quarter required \$4,019,000 of cash, with the main capital spending activities being the completion of the next phase of open pit pre-stripping, completion of the first phase of construction of the underground mine access portal and decline ramp and major rebuilds to mine equipment. In addition, the Company completed site preparation and has begun foundation work for a new secondary crusher designed to improve mill throughput. The Company expects to have the secondary crusher operational in the fourth quarter after which its milling costs will be reduced by about \$2.00 per tonne.

The Company further strengthened its balance sheet during the quarter. Outstanding long-term debt, including current and long-term portions was reduced by a net amount of \$5,992,000, resulting in a long-term debt balance of \$42,224,000 (US\$31,500,000) at quarter end. During the quarter, the Company issued 215,492 common shares for total consideration of \$2,374,000, the majority of which was from the exercise of stock options. At June 30, 2004, the Company had cash and cash equivalents of \$24,832,000.

During the quarter the Company negotiated a new US\$20 million and C\$10 million senior credit facility with a leading equipment finance company. The credit facility was used to repay the Company's existing bank loan totaling approximately US\$19 million and will be used to purchase additional equipment, which is required as part of the mine expansion. The new facility will permit the Company to utilize free cash flow to finance the Lac des Iles underground mine and secondary crusher projects. The new credit facility is a five-year amortizing loan with an interest margin of 2.5% over LIBOR or Bankers Acceptances. The credit facility allows in certain circumstances, full repayment of outstanding loans any time during the term of the facility.

The Company also extended the term of its US\$20 million subordinated loan from its affiliate, Kaiser-Francis Oil Company, to June 30, 2006. US\$11.5 million is outstanding under this loan facility, and interest on the facility will be 2.5% over LIBOR.

Subsequent to the end of the quarter, the Company received \$7,148,000 as an interim payment against a claim filed with its insurance company relating to losses incurred in connection with the failure of the primary crusher in 2002. The Company will include this insurance recovery in income from mining operations in the third quarter.

#### Contractual Obligations as at June 30, 2004

(\$000's)	Total	Payments Due by Period		
		Less Than 1 Year	1 - 3 Years	4 - 5 Years
Senior credit facility	26,809	5,362	16,086	5,361
Kaiser-Francis credit facility	15,415	–	15,415	–
Capital lease obligations	3,008	1,196	1,291	521
Operating leases	2,504	945	1,389	170
Other purchase obligations	7,082	7,082	–	–
	54,818	14,585	34,181	6,052





## Critical Accounting Policies and Estimates

### 1. Change in Accounting Policy

#### Hedging Relationships

In 2003, the CICA finalized amendments to Accounting Guideline AcG-13, "Hedging Relationships" that clarified certain of the requirements in AcG-13 and provided additional documentation and application guidance. AcG-13 is applicable for the Company's 2004 fiscal year. As a result of AcG-13, the Company has marked-to-market its forward foreign exchange contracts beginning January 1, 2004. The impact of this change was a decrease to derivative income of \$257,000 in the three months ended June 30, 2004 and an increase to derivative income of \$213,000 in the six months ended June 30, 2004.

### 2. Critical Accounting Estimates

Critical accounting estimates represent estimates that are highly uncertain and for which changes in those estimates could materially impact the Company's financial statements. The following accounting estimates are critical:

#### (a) Amortization of mining interests

The Company amortizes a large portion of its mining interests using the units of production method based on proven and probable reserves. Changes in reserves as at June 30, 2003 caused amortization rates to increase by approximately 25%. Changes in reserve estimates are calculated periodically and could affect amortization expense prospectively.

#### (b) Impairment assessments of long-lived assets

Each year, the Company reviews the mining plan for the remaining life of mine. Significant changes in the mine plan can occur as a result of mining experience, new discoveries, changes in mining methods and rates, process changes, investments in new equipment and technology, metal prices and other factors. Based on year-end ore reserves and the current mine plan, the Company reviews annually its accounting estimates and makes adjustments accordingly.

The Company assesses long-lived assets for recoverability whenever indicators of impairment exist. When the carrying value of a long-lived asset is less than its net recoverable value as determined on an undiscounted basis, an impairment loss is recognized to the extent that its fair value, measured as the discounted cash flows over the life of the asset.

#### (c) The measurement of deferred income tax assets and liabilities and assessment of the need to record valuation allowances against those assets

The Company follows the liability method of tax allocation for accounting for income taxes. Under the liability method of tax allocation, future tax assets and liabilities are determined based on differences between the financial reporting and tax bases of assets and liabilities and are measured using the substantively enacted tax rates and laws that will be in effect when the differences are expected to reverse. The effect on future tax liabilities and assets of a change in tax rates is recognized in income in the period that the change occurs.

#### (d) The valuation of derivative instruments and measurement of gains and losses on cash flow and fair value hedges that are recorded in derivative income

#### Forward Metal Sales and Metal Price Swap Contracts

In the fourth quarter of 2003, North American Palladium updated its hedge policy to allow for managing the Company's exposure to market metal prices, particularly its platinum, nickel and copper price exposure. With the adoption of this policy and from time to time, the Company will enter into forward metal sales or cash settled swaps to establish fixed metal prices in order to manage metal price volatility.

North American Palladium has used fixed-price forward platinum sales contracts and cash settled nickel and copper price swap contracts to insulate its earnings and cash flows from changes in these metal prices. These contracts allow the Company to sell its platinum production to credit-worthy metal dealers at a fixed price under the forward sales contract. In the case of nickel and copper, the Company receives a fixed metal price in exchange for paying the floating price received under its physical sales contracts to acceptable counterparts under the metal price swap contracts. In the second quarter of 2004, the hedge position reduced to 8,140 ounces of platinum, 540 tonnes of nickel and 1,200 tonnes of copper.



### Forward Foreign Exchange Contracts

At June 30, 2004, the Company had forward foreign exchange contracts outstanding for US\$30,000,000 at an average exchange rate of \$1.35 maturing at various dates through December 31, 2004. At June 30, 2004, the fair value of these contracts was \$353,000, of which \$140,000 was included in revenue from metal sales as a mark-to-market adjustment for concentrate awaiting settlement, and \$213,000 was recorded as derivative income in the three months ended June 30, 2004.

### Fixed-price Forward Platinum Sales Contracts (the "Pt Hedge Position")

(as of June 30, 2004)

Platinum ounces hedged	8,140 (or less than 35% of 2004's expected production)
Maturity date of platinum sales contracts	December 2004
Weighted-average estimated platinum sales contract price up to maturity date	US\$769/oz. <sup>1</sup>
Delivery obligations	The Company will deliver platinum produced from its operations on a monthly basis to satisfy the forward sales contracts by the maturity date (currently December 31, 2004)
Unrealized mark-to-market value at June 30, 2004	Nil <sup>2</sup>

<sup>1</sup> Weighted-average estimated platinum price is based on the aggregate value of contracted prices for the expected delivery volumes for each respective delivery month divided by the total volume of platinum sold forward.

<sup>2</sup> At June 30, 2004, the spot platinum price was US\$794 per ounce and all of the platinum forward sale contracts had been taken into revenue.

### Fixed-price Nickel Swap Contracts (the "Nickel Hedge Position")

(as of June 30, 2004)

Nickel tonnes hedged	540 (or less than 35% of 2004's expected production)
Maturity date of nickel swap contracts	December 2004
Weighted-average estimated fixed nickel price up to maturity date	US\$12,500 per tonne (US\$5.67 per lb.) <sup>1</sup>
Payment obligations	The Company will pay on a monthly basis the floating nickel price (average monthly LME 3-mth nickel price) for the respective volume of nickel metal swapped and receive a fixed price from the counterpart for the period up to the maturity date (currently December 31, 2004)
Unrealized mark-to-market loss at June 30, 2004	US\$411,800 <sup>2</sup>

<sup>1</sup> Weighted-average estimated nickel price is based on the aggregate value of contracted fixed prices for the expected nickel volumes for each respective delivery month divided by the total volume of nickel under the swap contract.

<sup>2</sup> At a monthly average LME 3-mth nickel price of US\$14,037 per tonne for swap contracts which have not been taken into revenue as at June 30, 2004.

### Fixed-price Copper Swap Contracts (the "Copper Hedge Position")

(as of June 30, 2004)

Copper tonnes hedged	1,200 tonnes (or less than 40% of 2004's expected production)
Maturity date of copper swap contracts	December 2004
Weighted-average estimated fixed copper price up to maturity date	US\$2,548 per tonne (US\$1.16 per lb.) <sup>1</sup>
Payment obligations	The Company will pay on a monthly basis the floating copper price (average monthly LME 3-mth copper price) for the respective volume of copper metal swapped and receive a fixed price from the counterpart for the period up to the maturity date (currently December 31, 2004)
Unrealized mark-to-market gain at June 30, 2004	US\$7,700 <sup>2</sup>

<sup>1</sup> Weighted-average estimated copper price is based on the aggregate value of contracted fixed prices for the expected copper volumes for each respective delivery month divided by the total volume of copper under the swap contract.

<sup>2</sup> At a monthly LME 3-mth copper price of US\$2,535 per tonne for swap contracts which have not been taken into revenue as at June 30, 2004.



The Company has entered into Master Trading Agreements and Master Swap Agreements with various counterparts, which govern the terms of its forward metal sales and fixed price swaps. These counterparts have a long-term credit rating assigned by Standard & Poor's of "A" or better, or equivalent rating from other international credit rating agencies.

#### **Related Party Transactions**

The Company engaged Louis J. Fox in November 1999 to provide services in connection with the negotiation of palladium end-user supply contracts, project capital financing, smelting and refining agreements, metals price forecasting and marketing other metals. The services agreement was negotiated at arms-length prior to Mr. Fox becoming a director of the Company. Mr. Fox receives a fee in connection with the negotiations related to the Palladium Sales Contract. The amount payable to Mr. Fox for the second quarter of 2004 was \$141,000 and \$277,000 for the first half of 2004.

Pursuant to an agreement dated July 11, 2002, Kaiser-Francis, and certain other parties related to Kaiser-Francis, guaranteed the obligations of the Company under the Credit Facility. Kaiser-Francis is entitled to receive a guarantee fee of 0.5% per annum of the average outstanding loan balance during the previous calendar quarter. In December 2001, Kaiser-Francis also provided a US\$20 million non-revolving credit facility to finance the Company's working capital requirements. In the second quarter 2004, the Kaiser-Francis credit facility was extended to June 30, 2006. Interest payable is based upon the 30-day LIBOR plus 2.50% and the stand-by fee payable is 0.125% per annum. The amount payable to Kaiser-Francis for the guarantee fee, interest and standby fee for the second quarter was \$171,000. Kaiser-Francis holds 50.9% of the common shares of the Company.

#### **Exploration & Development**

During the second quarter of 2004, the Company entered into an agreement to complete a private placement of flow-through common shares for gross proceeds of \$4,050,000 by issuing 270,000 common shares. This transaction closed on July 7, 2004 and the funds will be used for the upcoming diamond drill programs on various exploration projects as well as to fund exploration on new acquisitions currently being pursued.

The Company was active on several projects during the second quarter of 2004. Nine holes totaling 1,347 metres were drilled on the Shebandowan and Roaring River projects. Drilling at Shebandowan returned the following intersections: 2.34m @ 2.28% Cu, 0.17% Ni from hole SP-04-02 and 10.8m @ 0.32% Ni, 0.506 g/t PGE from hole SP-04-01.

Fieldwork consisting of geological mapping, prospecting and ground geophysics commenced on the Shebandowan properties late in the second quarter. The immediate focus will be selected airborne anomalies associated with ultramafic bodies, which are the host lithologies for the adjoining, past producing, Shebandowan nickel mine. Additional drilling on the project is scheduled for later this summer.

At the Lac des Iles mine site the Magnetotellurics and 3D Magnetic Inversion data were remodeled. This new information, as well as various geochemical, geophysical (detailed airborne magnetics and resistivity, ground gravity) will provide greater target definition for a fourth quarter drill program.

#### **Risks and Uncertainties**

The price of palladium is the most significant factor influencing the profitability of the Company. In the second quarter of 2004, sales of palladium accounted for approximately 62% of the Company's revenue. Many factors influence the price of palladium, including global supply and demand, speculative activities, international political and economic conditions, and production levels and costs in other platinum group metal-producing countries, particularly Russia and South Africa. To offset the price risk, the Company entered into the Palladium Sales Contract and other hedge contracts to cover a portion of expected annual production as set out below.

The possible development of a substitute alloy or synthetic material, which has catalytic characteristics similar to platinum group metals, may result in a future decrease in demand for palladium and platinum.

Currency fluctuations may affect cash flow since production currently is sold in United States dollars, whereas the Company's administration, operating and exploration expenses are incurred in Canadian dollars. As a result, changes in the exchange rate between Canadian and United States dollars can affect revenue and profitability. The Company has outstanding hedges for US\$30,000,000 of its revenue for 2004 at an average C\$/US\$ exchange rate of approximately 1.35.





The Company is dependent on one mine for its metal production. The business of mining is generally subject to risks and hazards, including environmental hazards, industrial accidents, metallurgical and other processing problems, unusual and unexpected rock formations, pit slope failures, flooding and periodic interruptions due to inclement weather conditions or other acts of nature, mechanical equipment and facility performance problems and the availability of materials and equipment. These risks could result in damage to, or destruction of the Company's properties or production facilities, personal injury or death, environmental damage, delays in mining, monetary losses and possible legal liability. Although the Company maintains insurance in respect of the mining operations that is within ranges of coverage consistent with industry practice, such insurance may not provide coverage of all the risks associated with mining.

In addition, you are encouraged to review the Company's Annual Information Form on file with Canadian Securities regulators for a discussion of other risks and uncertainties.

#### Non-GAAP Measure

North American Palladium has included in this document a non-GAAP performance measure for cash cost per ounce. This non-GAAP measure does not have any standardized meaning nor is it necessarily comparable with similar measures presented by other companies. North American Palladium believes that certain investors use this information to evaluate the Company's performance. This data is intended to provide additional information and should not be considered in isolation or as a substitute for measures of performance prepared in accordance with GAAP.

#### Reconciliation of Cash Cost per Ounce to Financial Statements

	Three Months Ended June 30	
(\$000)	2004	2003
Production costs including overhead	\$ 27,489	\$ 24,009
Smelter treatment, refining and freight costs	7,321	4,549
	34,810	28,558
Less: by-product metal revenue	(19,502)	(10,752)
	15,308	17,806
Divided by ounces of palladium	72,130	51,290
Cash cost per ounce (C\$)	212	347
C\$ exchange rate at quarter end	1.3405	1.3554
Cash cost per ounce (US\$)	158	256

#### Outlook

As we progress into the third quarter of 2004, production from the Lac des Iles mine continues to be ahead of budget owing to favourable palladium ore grades and mill throughput. Additionally, we are progressing well on our secondary crusher and underground projects. The secondary crusher is on schedule and we expect this facility to be operational during the fourth quarter. Construction of the access ramp at the underground mine is on track for an expected production ramp-up in the fourth quarter of 2005.

While metal prices were softer in the second quarter of 2004, continued weakness in the U.S. dollar and strong fundamentals has spurred renewed investor interest in precious and base metals. Platinum and palladium have found support at levels around US\$820 and US\$220 respectively, but continue to trade in a narrow range. Providing support for both metals is the continued concern about the viability of planned mine expansion and new projects as the South African rand to the U.S. dollar exchange rate goes below 6 to 1. The world's leading platinum producer, Anglo Platinum, has warned that it may be forced to curtail its expansion plans further due to the continued rand strength.



North American Palladium Ltd.

**Consolidated Balance Sheets**

(Canadian funds in thousands of dollars)

While we constantly stay on top of the safety, operational, and construction progress at Lac des Iles, we are shifting more and more of our corporate effort toward the growth of our business. We are pleased with our performance thus far in 2004 and our continued progress in strengthening our financial position. Continued focus on enhancing our operations and financial position remain our top priority as we move forward with our growth strategy.

**Other Information**

Additional information regarding the Company is included in the Company's Annual Information Form and Annual Report on Form 40-F which are filed with the Canadian securities regulators and the United States Securities and Exchange Commission, respectively. A copy of the Company's Annual Information Form is posted on the SEDAR website at [www.sedar.com](http://www.sedar.com). A copy of the Annual Report or Form 40-F can be obtained from the United States Securities and Exchange Commission's website at [www.sec.gov](http://www.sec.gov).

Respectfully,

**André J. Douchane**

PRESIDENT AND  
CHIEF EXECUTIVE OFFICER

August 9, 2004

June 30  
**2004**  
(Unaudited)

December 31  
2003

<b>Assets</b>		
CURRENT ASSETS		
Cash and cash equivalents	\$ 24,832	\$ 11,950
Short-term investments	1,116	1,813
Concentrate awaiting settlement, net - Note 3	97,122	94,610
Inventories	8,584	9,141
Crushed and broken ore stockpiles - Note 4	8,278	6,251
Future tax asset	-	84
Accounts receivable and other assets	1,768	1,387
	<b>141,700</b>	125,236
Mining interests, net	237,919	247,116
Mine closure deposit - Note 5	5,333	4,733
Deferred financing costs	267	1,290
Crushed and broken ore stockpiles - Note 4	3,230	5,983
Future tax asset	6,505	9,334
	<b>\$ 394,954</b>	\$ 393,692
<b>Liabilities and Shareholders' Equity</b>		
CURRENT LIABILITIES		
Accounts payable and accrued liabilities	\$ 15,521	\$ 16,041
Taxes payable	2,561	1,311
Future tax liability	61	216
Current portion of obligations under capital leases	1,196	1,070
Current portion of senior credit facility - Note 6	5,362	34,538
	<b>24,701</b>	53,176
Mine closure obligation	7,446	7,300
Obligations under capital leases	1,812	1,015
Senior credit facility - Note 6	21,447	7,272
Kaiser-Francis credit facility - Note 6	15,415	14,866
Future tax liability	10,318	10,108
	<b>81,139</b>	93,737
<b>Shareholders' Equity</b>		
Capital stock - Note 8	318,166	313,489
Contributed surplus	228	-
Deficit	(4,579)	(13,534)
Total shareholders' equity	<b>313,815</b>	299,955
	<b>\$ 394,954</b>	\$ 393,692

North American Palladium Ltd.

## Consolidated Statements of Earnings and Deficit

(Canadian funds in thousands of dollars, except share and per share amounts)  
(Unaudited)



	Three Months Ended June 30		Six Months Ended June 30	
	2004	2003	2004	2003
<b>Revenue from metal sales</b> - Note 10	\$ 51,712	\$ 44,631	\$ 104,868	\$ 89,751
Deduct: smelter treatment, refining and freight costs	(7,321)	(4,549)	(12,652)	(8,048)
Net revenue from mining operations	44,391	40,082	92,216	81,703
<b>Operating expenses</b>				
Production costs including overhead	27,489	24,009	52,487	52,228
Amortization	8,885	4,834	18,731	9,715
Administrative expenses	1,072	692	2,289	1,610
Provision for mine closure costs	223	127	466	259
Total operating expenses	37,669	29,662	73,973	63,812
<b>Income from mining operations</b>	6,722	10,420	18,243	17,891
<b>Other income (expenses)</b>				
Interest on long-term debt	(411)	(657)	(898)	(1,725)
Exploration expense	(518)	(778)	(947)	(1,101)
Foreign exchange gain (loss)	(264)	6,210	(1,046)	14,861
Derivative income - Note 2(c) and 11(d)	(257)	-	213	-
Write-off of deferred financing costs	(788)	-	(788)	-
Loss on disposal of capital assets	(491)	(2,710)	(623)	(2,710)
Interest income	67	71	114	145
Interest expense	(1)	-	(11)	-
Total other income (expenses)	(2,663)	2,136	(3,986)	9,470
<b>Income before income taxes</b>	4,059	12,556	14,257	27,361
Provision for income taxes - Note 7	1,225	2,195	5,302	8,610
<b>Net income for the period</b>	2,834	10,361	8,955	18,751
Deficit, beginning of period	7,413	43,147	13,534	51,537
<b>Deficit, end of period</b>	\$ 4,579	\$ 32,786	\$ 4,579	\$ 32,786
<b>Net income per share</b>	\$ 0.06	\$ 0.20	\$ 0.18	\$ 0.37
<b>Diluted net income per share</b>	\$ 0.06	\$ 0.20	\$ 0.17	\$ 0.37
Weighted average number of shares outstanding - basic	51,254,953	50,744,304	51,114,948	50,711,677

**Consolidated Statements of Cash Flows***(Canadian funds in thousands of dollars)**(Unaudited)*

	Three Months Ended June 30		Six Months Ended June 30	
	2004	2003	2004	2003
<b>Cash provided by (used in)</b>				
<b>Operations</b>				
Net income for the period	\$ 2,834	\$ 10,361	\$ 8,955	\$ 18,751
Operating items not involving cash				
Future income tax expense	464	2,048	3,261	7,959
Amortization	8,885	4,834	18,731	9,715
Foreign exchange loss (gain)	(217)	(7,674)	549	(15,627)
Loss on disposal of capital assets	491	2,710	623	2,710
Write-off of deferred financing costs	788	–	788	–
Provision for mine closure costs	223	127	466	259
Stock-based compensation	44	–	90	–
Derivative income - Note 2(c) and 11(d)	257	–	(213)	–
	13,769	12,406	33,250	23,767
Changes in non-cash working capital - Note 9	6,381	8,417	(822)	7,415
	20,150	20,823	32,428	31,182
<b>Financing Activities</b>				
Repayment of project term loan	(32,584)	(11,545)	(41,810)	(24,310)
Increase in senior credit facility	26,809	–	26,809	–
Issuance of common shares	2,374	222	4,677	465
Mine closure deposit	(300)	(300)	(600)	(600)
Obligations under capital leases	(673)	(273)	(876)	(524)
	(4,374)	(11,896)	(11,800)	(24,969)
<b>Investing Activities</b>				
Short-term investments	704	(34)	697	(62)
Additions to mining interests	(5,144)	(7,485)	(8,894)	(10,397)
Proceeds on disposal of capital assets	421	108	451	108
	(4,019)	(7,411)	(7,746)	(10,351)
<b>Increase (decrease) in cash and cash equivalents</b>	11,757	1,516	12,882	(4,138)
Cash and cash equivalents, beginning of period	13,075	5,882	11,950	11,536
<b>Cash and cash equivalents, end of period</b>	\$ 24,832	\$ 7,398	\$ 24,832	\$ 7,398

## Notes to the June 30, 2004

### Consolidated Financial Statements

(in thousands of Canadian dollars except per share and per ounce amounts)  
(Unaudited)



#### 1. Basis of Presentation

These unaudited interim consolidated financial statements have been prepared using disclosure standards appropriate for interim financial statements and do not contain all the explanatory notes, descriptions of accounting policies or other disclosures required by Canadian generally accepted accounting principles for annual financial statements. Such notes, descriptions of accounting policies and other disclosures have been included in the Company's audited annual consolidated financial statements included in the Company's annual report to shareholders for the year ended December 31, 2003. Accordingly, these consolidated financial statements should be read in conjunction with the audited annual consolidated financial statements for 2003.

#### 2. Changes in Accounting Policies

##### (a) Stock-based Compensation

As discussed in the audited annual consolidated financial statements, effective January 1, 2003, the Company changed its method of accounting for stock options from the intrinsic value method to one that recognizes as an expense the cost of stock-based compensation based on the estimated fair value of new stock options granted to employees and directors. The fair value of each stock option granted is estimated on the date of the grant using the Black-Scholes option pricing model. An expense of \$44 was recorded in the three months ended June 30, 2004 (three months ended June 30, 2003 - nil) and \$90 in the six months ended June 30, 2004 (six months ended June 30, 2003 - nil).

##### (b) Asset Retirement Obligations

Also, as disclosed in the audited annual consolidated financial statements, effective January 1, 2003, the Company adopted a new accounting standard of the Canadian Institute of Chartered Accountants ("CICA") for asset retirement obligations which harmonizes the accounting with Generally Accepted Accounting Principles in the U.S. This standard significantly changed the method of accounting for future site restoration costs. Under this new standard, asset retirement obligations are recognized when incurred and recorded as liabilities at fair value. The amount of the liability is subject to re-measurement at each reporting period. The liability is accreted over time through periodic charges to earnings. In addition, the asset retirement cost is capitalized as part of the asset's carrying value and depreciated over the estimated life of the mine. This change in accounting policy was applied retroactively and, accordingly, the consolidated financial statements of prior periods were restated. An

expense of \$223 and \$466 was recorded in the three months and six months ended June 30, 2004 respectively for accretion of the mine closure obligation and amortization of mining interests. This change in accounting policy did not have a material impact on the financial statements for the six months ended June 30, 2003.

##### (c) Hedging Relationships

In 2003, the CICA finalized amendments to Accounting Guideline AcG-13, "Hedging Relationships" that clarified certain of the requirements in AcG-13 and provided additional documentation and application guidance. AcG-13 is applicable for the Company's 2004 fiscal year. As a result of AcG-13, the Company has marked-to-market its forward foreign exchange contracts beginning January 1, 2004. The impact of this change was a decrease to derivative income of \$257 in the three months ended June 30, 2004 and an increase to derivative income of \$213 in the six-months ended June 30, 2004.

#### 3. Concentrate Awaiting Settlement

The gross value of concentrate awaiting settlement represents the value of all platinum group metals and base metals from production shipped to the smelters for up to a seven month period prior to the balance sheet date. At June 30, 2004, concentrate awaiting settlement included 155,025 ounces of palladium (December 31, 2003 - 147,570). Concentrate awaiting settlement was entirely from two domestic customers at June 30, 2004 and December 31, 2003. Revaluations of the net realizable value of concentrate awaiting settlement are included in revenue at each reporting period and are adjusted for the effects of hedging instruments, sales contracts and foreign exchange.

#### 4. Crushed and Broken Ore Stockpiles

Crushed and broken ore stockpiles are valued at the lower of average production cost and estimated net realizable value. The amount of stockpiled ore that is not expected to be processed within one year is shown as a long-term asset.

#### 5. Mine Closure Plan

As part of the expansion project, the Company has established a revised mine closure plan with the Ontario Ministry of Northern Development and Mines (the "Ministry"), which requires a total amount of \$7,800 to be accumulated in a Trust Fund controlled by the Ministry. At June 30, 2004, the Company had \$5,333 on deposit with the Ministry and has agreed to make monthly deposits of \$100.





## 6. Long-Term Debt

During the quarter, the Company negotiated a new US\$20 million and C\$10 million senior credit facility with a leading equipment finance company. The credit facility was used to repay the Company's existing project term loan totaling approximately US\$19 million. The new credit facility is a five-year amortizing loan with an interest margin of 2.5% over LIBOR or Bankers Acceptances. The lender received a first priority security interest in all of the Company's existing and future assets excluding its production leases and claims. The credit facility allows in certain circumstances, full repayment of outstanding loans any time during the term of the facility.

The Company also extended the term of its US\$20 million subordinated loan from its affiliate, Kaiser-Francis Oil Company, to June 30, 2006. US\$11.5 million is outstanding under this loan facility, and interest on the facility will be 2.5% over LIBOR.

The Company's long-term debt, comprising its senior credit facility and Kaiser-Francis credit facility, is denominated in US dollars. At June 30, 2004, the outstanding long-term debt, including current and long-term portions was \$42,224 (US\$31,500) compared to \$56,676 (US\$43,844) at December 31, 2003.

## 7. Income taxes

The variance between the income taxes as computed at the combined statutory rate and the effective rate for the Company is reconciled as follows:

	Six Months Ended June 30	
	2004	2003
Income tax provision using statutory income tax rates	\$ 5,489	\$ 11,114
Increase (decrease) in taxes resulting from:		
Resource allowance	(1,459)	(1,924)
Non-taxable portion of capital gains	(899)	(1,625)
Changes in income tax rates and laws	—	(539)
Federal large corporations tax	430	396
Ontario mining taxes	1,468	1,379
Other	273	(191)
Income tax expense	\$ 5,302	\$ 8,610

## 8. Capital Stock

	June 30, 2004		June 30, 2003	
	Shares	Amount	Shares	Amount
Common shares issued, beginning of period	50,895,338	\$ 313,489	50,647,955	\$ 311,983
Common shares issued Pursuit to stock options exercised	394,223	4,215	—	—
To Group RRSP participants	39,037	462	105,485	465
Common shares issued, end of period	51,328,598	\$ 318,166	50,753,440	\$ 312,448

At June 30, 2004, the Company had 890,276 options outstanding at a weighted-average exercise price of \$9.69, expiring at various dates from March 3, 2005 to June 23, 2012. In the second quarter of 2004, the Company granted 287,300 options to directors, officers and employees at an exercise price of \$11.90 per share. The fair market value of the options grant was \$5.48 per option and has been estimated at the date of grant using the Black-Scholes option pricing model with the following assumptions: risk free interest rate of 3.7%, expected dividend yield of nil, expected volatility of 55% and expected option life of 4 years. The estimated fair value of the options is being expensed over the three-year option vesting period.

## 9. Changes in Non-Cash Working Capital

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
Decrease (increase) in:				
Concentrate awaiting settlement	\$ 3,478	\$ 4,349	\$ (2,512)	\$ 3,578
Inventories and stockpiles	1,366	(330)	1,283	1,519
Accounts receivable and other assets	(452)	527	(168)	639
	4,392	4,546	(1,397)	5,736
Increase (decrease) in:				
Accounts payable and accrued liabilities	2,094	4,143	(520)	1,570
Taxes payable	(105)	(272)	1,095	109
	1,989	3,871	575	1,679
Changes in non-cash working capital	\$ 6,381	\$ 8,417	\$ (822)	\$ 7,415



## 10. Revenue from Metal Sales

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
Palladium (a)	\$ 31,423	\$ 22,593	\$ 63,146	\$ 46,801
Palladium forward contracts (b)	—	9,803	—	20,437
Adjustments for mark-to-market	786	1,483	3,098	685
Nickel	7,029	4,077	13,258	7,925
Platinum	6,227	3,317	11,761	7,461
Gold	2,398	1,863	5,704	3,478
Copper	3,104	1,283	6,016	2,564
Other metals	745	212	1,885	400
	<u>\$ 51,712</u>	<u>\$ 44,631</u>	<u>\$ 104,868</u>	<u>\$ 89,751</u>

(a) The Company entered into a Palladium Sales Contract with a major automobile manufacturer, which provides for a floor price of US\$325 per ounce on 100% of palladium production and a cap of US\$550 per ounce on 50% of palladium production delivered by June 30, 2005. Palladium revenue includes the impact of the Palladium Sales Contract.

(b) The Company entered into palladium forward contracts in 2001 for 100,800 ounces of palladium at an average price of US\$922 per ounce, the revenue from which was fully realized by June 30, 2003. The effect of palladium forward contracts represents the difference between the fixed price realized under the palladium forward contracts and the palladium price at the time of revenue recognition.

## 11. Commitments

The Company enters into forward contracts from time to time to hedge the effects of changes in the prices of metals it produces and foreign exchange on the Company's revenues. Gains and losses realized on derivative financial instruments used to mitigate metal price risk are recognized in revenue from metal sales when the hedge transaction occurs.

### (a) Platinum Forward Contracts

At June 30, 2004, the Company had forward sales contracts for 8,140 ounces of platinum at an average price of US\$769 per ounce maturing at various dates through December 2004. As at June 30, 2004, the fair value of these forward sales contracts approximated their carrying value.

### (b) Nickel Swap Contracts

At June 30, 2004, the Company had swap contracts for 1,190,000 lbs. of nickel at an average fixed price of US\$5.67 per lb. maturing at various dates through December 2004. As at June 30, 2004, the fair value of these swap contracts was below their carrying value by \$552.

### (c) Copper Swap Contracts

At June 30, 2004, the Company had swap contracts for 2,645,000 lbs. of copper at an average fixed price of US\$1.16 per lb. maturing at various dates through December 2004. As at June 30, 2004, the fair value of these swap contracts was above their carrying value by \$10.

### (d) Forward Foreign Exchange Contracts

At June 30, 2004, the Company had forward foreign exchange contracts outstanding for US\$30,000,000 at an average exchange rate of \$1.35 maturing at various dates through December 31, 2004. At June 30, 2004, the fair value of these contracts was \$353, of which \$140 was included in revenue from metal sales as a mark-to-market adjustment for concentrate awaiting settlement, and \$213 was recorded as derivative income.

## 12. Subsequent Events

### (a) Insurance Recovery

Subsequent to the end of the quarter, the Company received \$7,148 as an interim payment against a claim filed with its insurance company relating to losses incurred in connection with the failure of the primary crusher in 2002. The Company will include this insurance recovery in income from mining operations in the third quarter.

### (b) Flow-Through Financing

On July 7, 2004, the Company completed a private placement of flow-through common shares for gross proceeds of \$4,050 by issuing 270,000 common shares.



### Forward-Looking Statements

Certain statements included in this 2004 second quarter interim report, financial statements for the period ended June 30, 2004 and management's discussion and analysis are forward-looking statements which are made pursuant to the "safe harbor" provisions of the United States Private Securities Litigation Reform Act of 1995. They include estimates and statements that describe the Company's future plans, objectives and goals, including words to the effect that the Company or management expects a stated condition or result to occur. When used herein, words such as "estimate", "expect", "intend", and other similar expressions are intended to identify forward-looking statements. In particular statements relating to estimated cash flows, capital costs, ore production, mine life, financing and construction are forward-looking statements. Such forward-looking statements involve inherent risks and uncertainties and are subject to factors, many of which are beyond our control, that may cause actual results or performance to differ materially from those currently anticipated in such statements. Important factors that could cause actual results to differ materially from those expressed or implied by such forward-looking statements include among others metal price volatility, economic and political events affecting metal supply and demand, fluctuations in ore grade, ore tonnes milled, geological, technical, mining or processing problems, future profitability and production, and availability of financing on acceptable terms. For a more comprehensive review of risk factors, please refer to the Company's most recent Annual Report under "Management's Discussion and Analysis of Financial Results" and Annual Information Form under "Risk Factors" on file with the U.S. Securities and Exchange Commission and Canada provincial securities regulatory authorities. The Company disclaims any obligation to update or revise any forward-looking statements whether as a result of new information, events or otherwise. Readers are cautioned not to put undue reliance on these forward-looking statements.

## Corporate Information

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Steven R. Berlin  
André J. Douchane  
James D. Excell  
Louis J. Fox  
Richard H. Sutcliffe  
Greg J. Van Staveren,

### OFFICERS AND SENIOR MANAGEMENT

André J. Douchane  
President and Chief Executive Officer

George D. Faught, C.A.  
Vice President - Finance and  
Chief Financial Officer

Ray J. Mason, B.Sc.  
General Manager

Bruce W. Mackie, P.Geo.  
Vice President, Exploration and  
Corporate Development

Douglas H. Bache  
Treasurer

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