Australian Gold Fund Valuation and SWOT Analysis

Aeris Resources Limited (ASX: AIS)

Date	12/02/2021
Classification	Junior Gold Miner
Current Price	$0.090
No. Issued Stocks (m)	1,897.0
Net Cash + Bullion + 0.5 x GIC ($ m)	-$10.90
Last Dividend Payment ($ p.a.)	$0.00
Market Capitalisation ($ m)	$170.73
Enterprise Value ($ m)	$181.63

Operating Performance Metrics	
Annual Gold Equivalent Production Guidance (oz p.a.)	160 000-170 000
All-In Sustaining Cost Guidance ($/oz)	$1 800-$1 900
Operating Margin (Sale Price less AISC)	$770.00
Resources (oz)	420,000
Reserves (oz)	146,250
Financial Year Cumulative Gold Equivalent Production (oz)	80,118
Production as % of 2021 Annual Guidance	48.56%
Financial Year Cumulative AISC ($/oz)	$1,726.00

Valuation Metrics	
Price Range	$0.105-$0.183
Overall Ranking	Undervalued
Current EV/AISC-Adjusted Production	$2,036.00
EV/AISC-Adjusted Production Range	$2 500-$3 800
Ranking	Very Undervalued
EV/Resources	$432.45
Ranking	Fair Value
EV/Reserves	$1,241.91
Ranking	Overvalued

Summary

Aeris Resources (ASX: AIS) was initially a junior copper producing company that had been struggling in the past few years as they had been weighed down by their debt as well as low copper prices. Their luck turned significantly when they purchased the ageing Cracow gold mine from Evolution Mining last June for $75m cash and up to $50m in royalty payments arising from production. The Cracow mine, with volume and grades beginning to decline, nevertheless offers Aeris the much-needed boost to the company's cashflows as well as its profile by elevating it from a junior copper producer to a junior gold and copper producer. Investors likewise reacted very positively to the company's acquisition that led to the company's stock price rallying by over 150% since the announcement of the acquisition, after factoring in a substantial equity issue that increased their stocks issued to by 1.5 billion units at $0.03. The company's market capitalisation has since increased by almost eight-fold, suggesting the acquisition was indeed value-accretive.

The first two quarters of performance with Cracow under their control have been commendable, with the mine producing 38 248oz of gold at AISC of $1 416/oz. The Tritton mine produced 11 889t of copper at AISC of $3.13/lb. The company's debt position has decreased by over $48m since the acquisition of Cracow. This has resulted in the net debt position being $10.9m. The company has been moderately cashflow positive, given that they have approximately 50% of their gold production hedged at $2 536.25/oz and approximately 75% of their copper production hedged at $4.13/lb for the December quarter. In the coming two quarters, they have hedged around 50% of their gold production at $2 536.25/oz and 50% of their copper production at around $4.167/lb.

The current gold reserves and resources for the company appear somewhat low at an estimated 146 250oz of reserves and 420 000oz of resources when taking into account both the Cracow and Murrawombie deposits, the Roses Pride resources is expected to be updated in the coming financial year given the announcement on 6th January 2021. Furthermore, the company is indicating that they will undertake further exploration drilling around the Cracow

mine to expand their existing mineral resources. Both the grade of the ore being mined and that being milled have declined over two quarters but this is expected given the age of this mine. The volume of ore being mined by Aeris compared to the last five years with Evolution Mining appears to suggest that the volume is not necessarily declining. This may need to be monitored for a few more quarters to see more clearly whether this is a result of the Aeris management being more aggressive in extracting the ore from the mine or whether this mine still has untapped potential to exploit. We are aware that management may sometimes be tempted to window-dress their result by exploiting a newly acquired mine more aggressively in the first few quarters in order to give the investors the impression this acquisition was profitable, only to deliver sharply declining performance thereafter (as was observed in the case with the Aurelia Metals' acquisition of the Peak Mine in 2018 that has now resulted in weaker performance recently than in the first two quarters since the transaction).

Considering the valuation aspect of Aeris, we understand that the current market capitalisation still somewhat understate its actual investment potential. We believe that the company's gold and copper metrics are being reported separately and there has been no intent to integrate the cost of the secondary operation to that of the primary operation, as would normally be the case for many mining companies. As a result, we have to exercise some discretion in combining the costs and converting it into gold equivalent terms. We take into account how the company expects to produce for the 2021 financial year 70 000-75 000oz of gold at AISC of $1 500-$1 600/oz and 23 500-24 500t of copper at AISC of $3.60-$3.75/lb. The copper hedging position is at a discount of the spot price of around $4.80/lb, though by the September 2021 quarter this hedge will end. Below are our estimates of the company's gold equivalent production and AISC for 2021 full year:

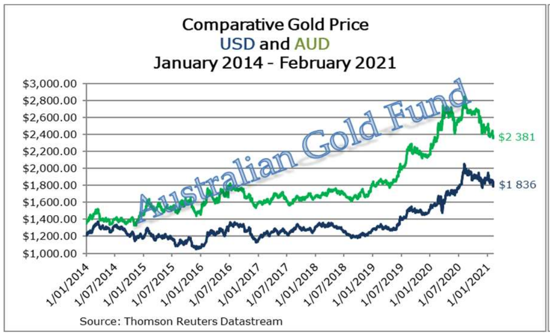
	Tritton 2021 FY	Cracow 2021 FY	Combined 2021 FY
Copper Produced (t)	24,000		
Sale Price ($/lb)	$4.40		
AISC ($/lb)	$3.68		
Gold Sale Price ($/oz)	$2,500.00	$2,500.00	$2,500.00
Equivalent Gold Produced	93,181	72,500	165,681
Equivalent AISC	$2,090.91	$1,550.00	$1,854.21

Taking these figures into account, we will assume a range of 160 000-170 000oz of gold equivalent produced at AISC of $1 800-$1 900/oz. The adjusted production for the half-year to date is given below:

	Tritton 2021 HY	Cracow 2021 HY	Combined 2021 HY
Copper Produced (t)	11,489		
Sale Price ($/lb)	$4.13		
AISC ($/lb)	$3.09		
Gold Sale Price ($/oz)	$2,500.00	$2,500.00	$2,500.00
Equivalent Gold Produced	41,870	38,248	80,118
Equivalent AISC	$1,870.46	$1,567.00	$1,725.59

We believe that the profit margin is approximately $770/oz and this implies a fair valuation range for EV/AISC-Adjusted Production of $2 500-$3 800 given the scale of this company's operations. The resulting fair value range for AIS stocks should be between $0.105-$0.183, thus the current price may offer substantial returns in the coming quarters should our predictions be realised.

Prevailing Environment

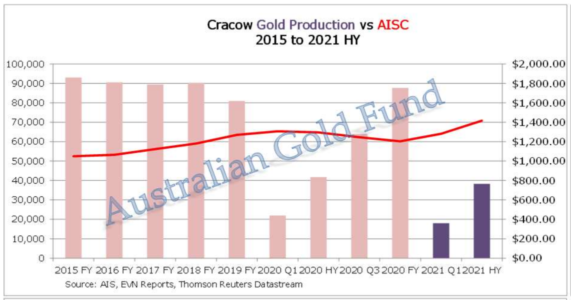


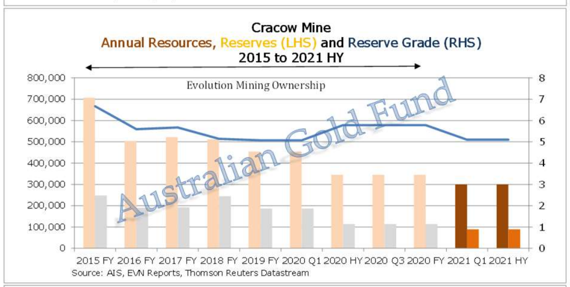
The recent six months have seen the gold price decline after having reached a peak in mid-2020 in the context of massive central bank cash printing and government spending to encourage economic activity during the Wuhan virus outbreak worldwide. The seasonal decline in the gold price from mid-September to mid-December continued into January 2021 as the Biden administration was inaugurated. Interestingly the market expected a higher stimulus package from the Biden administration than the $1.9 trillion that is currently agreed upon. On top of that, the cryptocurrency market appears to have attracted a lot of investors and hence this may have left the precious metals market stagnant.

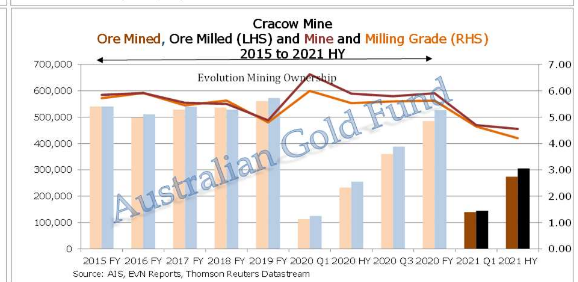
Given the unprecedented unusualness of events that have emerged worldwide the last year, we believe that events should not be taken at face value. We hold to the belief that the financial system is currently being heavily controlled by central banks and financial institutions intent on maintaining the illusion of status quo in the backdrop of their desired plan of “The Great Reset” to be implemented by the World Economic Forum. However, we believe that the sharp rise in the cryptocurrencies market, the need for Treasury Secretary Janet Yellen to intervene on behalf of hedge funds to regulate against investors seeking to short-squeeze selected stocks in the market led by WallStreetBets, are examples of how their plan will not be successful.

The Australian dollar has strengthened by around 8% against the US dollar over the past six months and hence the gold price is trading around the $2 300-$2 400/oz mark. The crude oil price has surprisingly jumped almost 35% over the last six months, though much of the rise occurred from December onwards as the world began to believe that President Trump was unable to overturn the election results that appeared to favour Joe Biden. Given that the Biden administration campaigned heavily on climate change and green energy, the US oil production industry would suffer when he assumed office. The reduction in oil supply by the US and increasing reliance once more of the Middle East has contributed to the rising oil price. In turn, higher oil prices and the gold price being relatively stagnant have led to gold mining companies not being able to enjoy as accommodative operating environment than they had in the past year. That being said, the gold-oil ratio is still over 30, providing conditions that are still conducive to supernormal profits for mining companies.

Operational and Financial Performance Charts



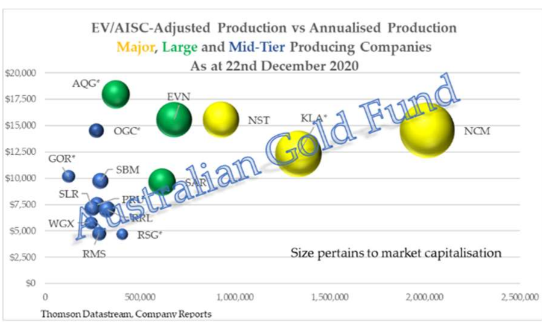


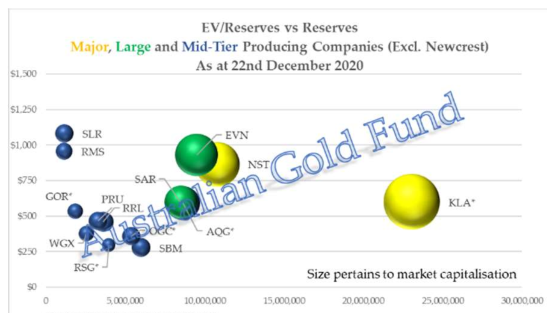


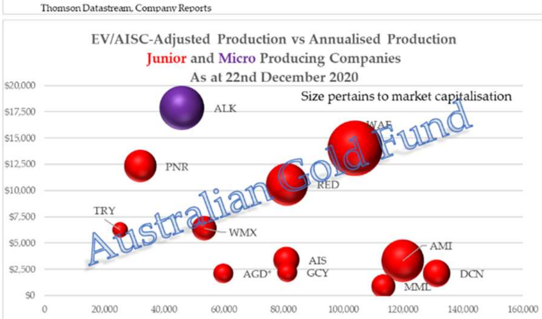
SWOT Analysis

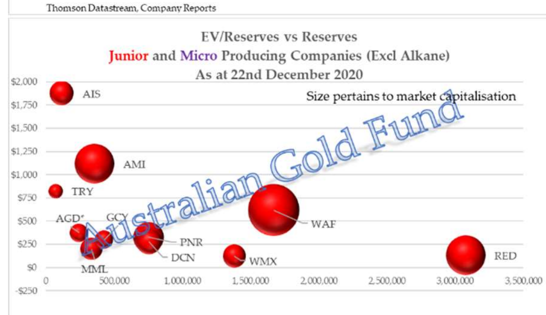
Strengths	Weaknesses
• Diversified gold and copper production that should be able to benefit from the upcoming inflation and resulting resources boom. • Management demonstrated boldness and strategic timing in executing the Cracow purchase. • Company able to turn around in their fortunes in a short period of time.	• The Cracow mine is ageing and mine life at present is relatively low, necessitating successful exploration results in the short term. • The Tritton copper mine has been a marginal operation and has caused much headache for management and investors.
Opportunities	**Threats**
• Increased cashflow generation offers the company the opportunity to explore more aggressively on their existing mine properties to increase their mine lives.	• Both mine operations are of a scale whereby there is little room for error that can detrimentally affect their economies of scale and cashflow generation. • Cracow is an ageing mine with limited surface potential and growth will be based on underground ore that may prove to be more expensive.

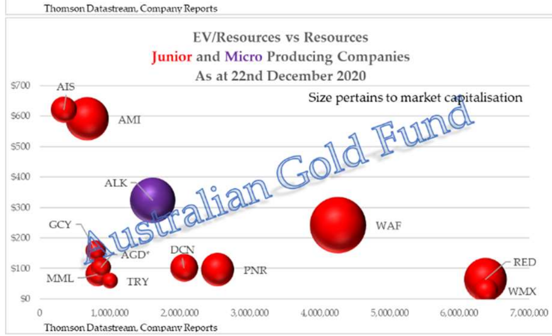
Peer Comparison











Valuation Thesis

Our key valuation metric is the **EV/AISC-Adjusted Annual Production** as we have found in our empirical study that the market valuation is most aligned to this metric, as opposed to earnings, resources and reserves. We also prefer a multiples method over the typical Discounted Cashflow Method for valuation because we understand that beyond even one year of projection, everything is highly speculative – whether it is the management outlook on production and costs as well as the gold price and broader economic drivers. To allow for comparison across all classes of producers, our metric can standardise by the company's scope of production as we observe that the market values the companies with higher production with a greater multiple. However, we scale production by AISC because we believe that not all ounces are equal. Companies that can produce gold at lower cost are naturally more profitable and deserve a higher multiple of their production and other operational or financial performance measures. We use the following classes for the different tiers of gold producing companies – **A** (major producer – 1Moz p.a. or more), **B** (large producer – 0.5-1Moz p.a.), **C** (mid-tier producer – 150 000-500 000oz p.a.), **D** (junior producer – 50 000-150 000oz p.a.) and **E** (micro producer – less than 50 000oz p.a.).

The **Enterprise Value** is the sum of the market value of equity (stock price multiplied by number of issued stocks) and net debt (total borrowings less cash and gold bullion, but excluding gold in circuit and ore stockpiles). This metric quantifies the market value of the company's assets deployed in the company's operations. The **AISC-Adjusted Annual Production** calculated as the annual production of gold per oz divided by the AISC adjusted by a factor of 1 000. The factor of 1 000 is arbitrarily chosen as a way to standardise the final metric. As an illustration, if a company produces 250 000oz p.a. at AISC of $1 250, the AISC-adjusted production is 200 000.

When determining the production ranges in our valuation metric, we take the management guidance as this is based on their access to information relating to their operations and progress. We believe that the market will use the guidance figures to base their valuation and investment decisions. This may not always be optimal given that some management may have their bias in reporting their outlook, as well as having a track record of announcing surprises. In such cases, we seek to qualify this in our SWOT analysis and adjust it in our EV/AISC-Adjusted Production multiple.

The **Price Range** determines a reasonable range for which the company stock price should be trading at. This range is relatively wide as it considers the **margin of safety**. A company whose stock price is currently outside the fair value range is significantly over or undervalued and investors should look more deeply into the company's operations, financial performance and recent market announcements. This range should not be taken as the sole driver for investment decisions, but as a starting point for further research to identify the potential causes for the current stock price.

We recognise that many analysts consider discretionary forecasts and adjustments on the company's production level, ore grade, cost levels, resources and reserves and economic factors into their valuation. We have studied many of these reports and recognise their merits. However, our view is that such subjective adjustments are dubious in terms of additional accuracy of their estimations. This is because with mining companies, both internal and external drivers that affect the company's future performance are unpredictable. Furthermore, we understand that while a company with substantial resources and reserves have potential to convert into substantial value in future, this is contingent on the successes in building the infrastructure, extracting the ore from the ground and processing it in a cost-effective manner. We recognise the criticism by many regarding our approach, but we have tried and tested our valuation against the actual price performance as well as through our own investment performance. We let these results speak for themselves.

Given the rise in gold price in the recent three months, we see reason to re-rate the gold mining companies' valuation metrics upwards to reflect their improving profitability as well as increased enthusiasm from investors. As a rough guide, the fair value ranges for different mining company classes are as follows:

***Major and Large Companies** - $8 000-$12 000/oz*

***Mid-Tier Companies** - $4 000-$7 000/oz*

***Micro and Junior Companies** - $1 500-$4 000/oz*

We also add that after reviewing our reports, we have found another metric that may inform the fair value ranges, namely the Operating Margin. The Operating Margin is the difference between the Gold Sale Price per oz and the AISC. A higher Operating Margin implies higher cashflow generation. We have also found that the market appears to take this into account when determining the price they will pay to purchase the stocks. We found that there is a link between the Operating Margin and our EV/AISC-Adjusted Production in that 8-12 times the Operating Margin gives a reasonable EV/AISC-Adjusted Production.

Glossary

The **All-in Sustaining Cost (AISC)** is a measure adopted by the World Gold Council as a standardised measure of production costs. This cost includes typically the **Cash Cost** associated with the direct production (extraction, transportation, processing and refining costs, staff salary and wages and relevant corporate costs) as well as **Sustaining Expenditure** that may include maintenance of mine equipment and infrastructure, insurance and administration costs over its production life. Companies may still have discretion in apportioning their expenses.

The **Net Cash/Debt** is the net amount of cash and bullion the company holds after their borrowings and interest-bearing debt are paid. This represents the liquidity position of the company, although this measure does not consider whether the debt is current (due within the next twelve months) or not. A company in a significant net debt position is owing more than they currently have in cash and bullion, which may potentially put them in financial distress if the debt is due soon.

The **Net Cashflow from Operations Excluding Maintenance Capital Expenditure** measures to what extent the company can generate cashflows from its operations after paying for its operating costs as well as Cash Paid for Purchases of Property, Plant and Equipment and the Cash Paid for Development Expenditure in the Investing Cashflows section of the Statement of Cash Flows. It does not include Cash Paid for Exploration and Evaluation, which is assumed to be growth capital expenditure. This is by no means a stable and comparable measure as different companies may have discretionary interpretation of what constitutes as Operating Activities and Investing Activities or Development, Exploration and Evaluation expenditures.

Disclaimer

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Declaration of Interest

The Australian Gold Fund and its directors currently own Aeris Resources stocks and may trade them subsequent to the report being published on their website. We do not receive any income or benefits from the company as a result of our report.