Australian Gold Fund Valuation and SWOT Analysis

Aurelia Metals Limited (ASX: AMI)

Date	28/09/2020
Classification	Junior Gold Miner
Current Price	$0.480
No. Issued Stocks (m)	874.0
Net Cash + Bullion + 0.5 x GIC ($ m)	$82.24
Last Dividend Payment ($ p.a.)	$0.01
Market Capitalisation ($ m)	$419.51
Enterprise Value ($ m)	$337.27

Operating Performance Metrics	
Annual Gold Production Guidance *2021 Estimate* (oz p.a.)	80 000-90 000
All-In Sustaining Cost Guidance *2021 Estimate* ($/oz)	$1 500-$1 750
Operating Margin (Sale Price less AISC)	$817.49
Resources (oz)	677,000
Reserves (oz)	356,950
Financial Year Cumulative Production (oz)	91,672
Production as % of 2020 Annual Guidance	101.86%
Financial Year Cumulative AISC ($/oz)	$1,507.59

Valuation Metrics	
Price Range	$0.38-$0.70
Overall Ranking	Undervalued
Current EV/AISC-Adjusted Production	$6,448.00
EV/AISC-Adjusted Production Range	$5 500-$8 800
Ranking	Undervalued
EV/Resources	$498.18
Ranking	Overvalued
EV/Reserves	$944.87
Ranking	Fair Value

Summary

Aurelia Metals (ASX: AMI) experienced a somewhat forgettable 18 months since the announcement of the departure of the previous CEO Jim Simpson, a cost blowout in the Peak Mine processing plant upgrade, a short interruption of operations at the Peak mine in March and the declining performance at the Hera mine. The positive news is that the tune may be changing as the company completed the Peak Mine processing plant upgrade, announced excellent drill results in the Federation deposit and delivered a robust June 2020 quarter. Despite seeing the company cash balance drain for the first three quarters of the year and having paid a 2c dividend (amounting to around $17m), the company ended up being able to deliver a strong cashflow in the last quarter. Over the year, the company decreased its cash balance by around 20% but this was due to substantial capital expenditures during the year and without having to resort to any debt or equity capital raising. We believe that the new CEO Dan Clifford should be commended for keeping the company on track during this difficult transition period that included both external and internal challenges. The company declared a 1c dividend to be paid on 2nd October (ex-dividend date 17th September).

The company started the year with a guidance of 85 000-95 000oz of gold produced at AISC of $1 050-$1 250/oz. The processing throughput for Hera would be expected to be similar to 2019 levels while Peak would be 580-610kt p.a. They also expected to spend $38m on the Peak Mine processing plant (initially slated to cost $35m but later revised upwards to $53m) and $15m on exploration. Given the challenges of the Wuhan/coronavirus pandemic that led to operations being scaled down substantially and the cost blowout in the Peak Mine processing plant, the company delivered 91 672oz at $1 508/oz. The Hera mine throughput was around 8% less than 2019 while the Peak mine throughput was slightly below the guidance range. This result is solid when we consider the peer companies that downgraded their production guidance, some of whom still could not meet that guidance either. The company started the year with a strong net cash and bullion position of $108.6m and ended the year with $80.9m, noting that in the March quarter their net cash balance was $51.4m.

The company released their Ore Reserves and Mineral Resources Statement on 20th July 2020. This report showed that the Hera mine is depleting its resources quite markedly and the exploration potential is either not yet being discovered or the potential is indeed on the decline. The decline in the gold reserves is especially significant as it amounted to almost 50% if not for a slight increase from upgrading of existing resources and a higher gold price during the year. The Peak mine is a different story with substantial increase in their gold, silver, lead and zinc reserves. This is due to the addition of the Kairos, Chronos and Peak North deposits being added to the booked reserves. The ore grades also improved for Peak while declined for Hera, though we note that the grades processed in these two mines exceed the reserves grade, suggesting that there was some high-grading in the Peak mine after it was acquired. The addition of the maiden Federation deposit of 66 000oz of gold at 0.8g/t is encouraging, though this deposit holds its merit on its exceptional zinc and lead, with resource grades of 7.7% and 13.5%, respectively. The Federation deposit is expected to replace the declining ore from the Hera mine. Based on the current throughput rates of around 400kt at Hera and 800kt at Peak, the reserve mine life for Hera is around 3 years and Peak is just over 4 years, though Peak has substantial resource life exceeding 13 years.

Going forward, the company expects to deliver 80 000-90 000oz of gold at $1 500-$1 750/oz, with 5% increase in lead production and almost 20% increase in zinc production arising from the processing plant upgrade. The higher costs are due to expected increase in exploration spending and also the declining grades at Hera where gold production is expected to be 22 000-26 500oz at $1 750-$2 000/oz and both lead production is expected to be similar to last year and zinc production will rise by around 10%. The Peak mine gold production is expected to be 58 000-63 500oz at $1 350-$1 500/oz with lead production expected to increase by 10% and zinc and copper to be 50% higher.

The stock price at $0.48 implies the EV/AISC-Adjusted Production to be almost $6 450. Taking into account that the company is now unhedged and the AISC is expected to be around $1 625/oz, the company can realistically expect the profit margin to be around $1 100/oz for 2021. Being a junior producer, we believe that a profit margin multiple of 5.5-8 is reasonable. The company has relatively low reserves and resources relative to its peers but offset by the silver, copper, zinc and lead deposits. We believe that the stock is currently undervalued, though we are looking for more evidence of their ability to replenish the declining resources and reserves at the Hera mine and also sustained recovery at the Peak mine to justify upgrading our rating.

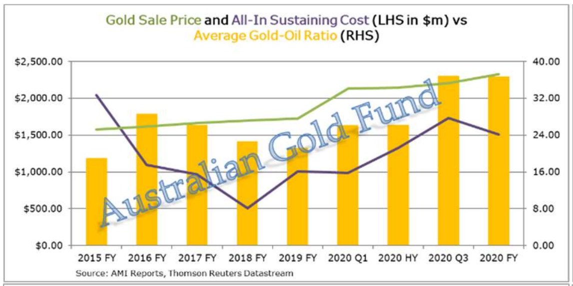
Prevailing Environment

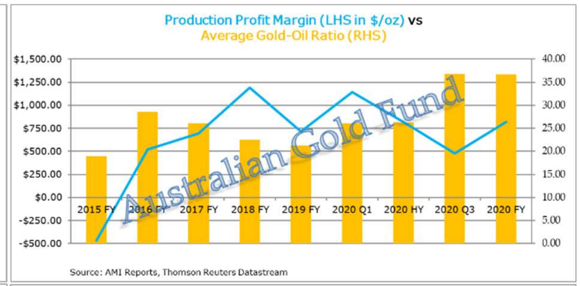
The global markets have been able to resist the experts' consensus opinions that it would fail soon and even rallied in the past six months. The reason for this is largely due to the extraordinary measures central banks and governments have taken to utilise stimulus packages in the form of currency creation, payments to businesses and households to cover for job and revenue losses in the midst of the lockdowns arising from the Wuhan/coronavirus as well as the recent reopening of many economies around the world resulting in spending due to pent-up demand. This market rally should not be mistaken as an economic recovery but due to the increase in velocity of currency and the reduction in the purchasing power of currencies around the world. With more currency created and a damaged supply chain, the amount of currencies available outweighs the amount of goods, services and assets that are exchanged, leading to price increases. This is inflation at work, not the CPI measured inflation that official agencies use that are hedonically adjusted to remove inflation from the view of the less discerning part of the population (which, sadly, is the predominant proportion).

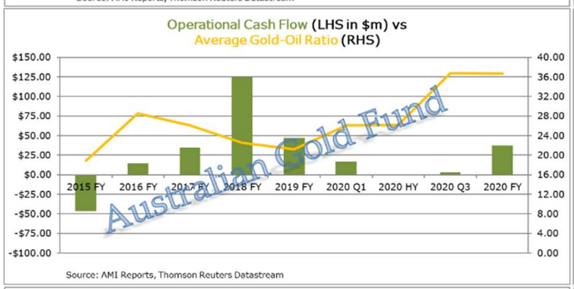
As inflation continues to take effect in the economy, we can see that the price of real assets such as precious metals, commodities, land and real estate continue to rise. The gold price in US dollar terms exceeded the all-time record high of US$1 921/oz in late July and then exceeded the psychological level of US$2 000/oz on 4th August 2020. This heralds a new era for precious metals becoming increasingly sought after by mainstream investors who have previously been steered away from gold due to the horrific bear market that ravaged many between 2012 to 2015. Furthermore, the US Department of Justice has levelled RICO charges on several bullion bank traders for manipulating the gold price (no longer a conspiracy theory). Unlike the past investigations by the CFTC and GATA, the US DOJ has extraordinary prosecutive powers and RICO charges are a heavy-handed measure once reserved for prosecuting Mafia bosses and their followers. We expect that the days of watching precious metal prices being pushed down through after-hour dumping are numbered. Oil prices, on the other hand, have recovered to around US$40/bbl, as we have foreshadowed in previous reports. This gives a solid gold-oil ratio of 46-50, which is still highly accommodative to gold producing companies in generating substantial operating margins.

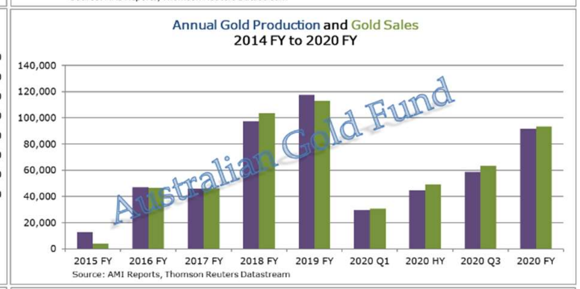
This week we have started to see the precious metals prices decline quite sharply. Based on our experience and seasonal analysis of precious metals prices, we believe this may be the beginning of the September to late-November weakness in the precious metals prices that will feed into the stock prices of precious metals mining companies. We have begun to exercise more caution on our positions as we keep a sharp lookout for quality gold mining companies that will have increasingly compelling value as prices adjust

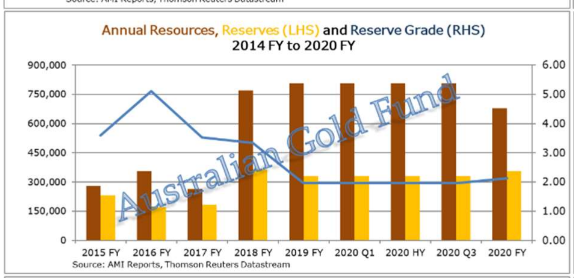
Operational and Financial Performance Charts

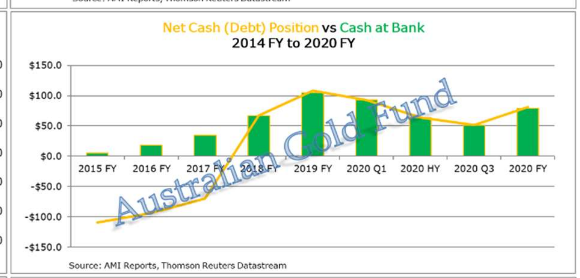


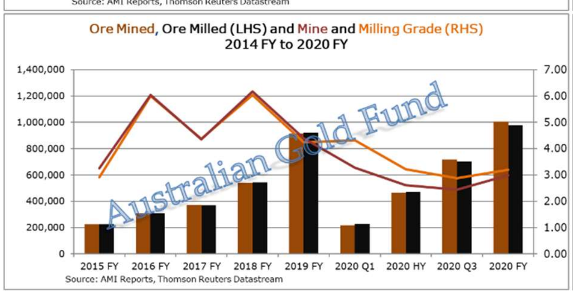


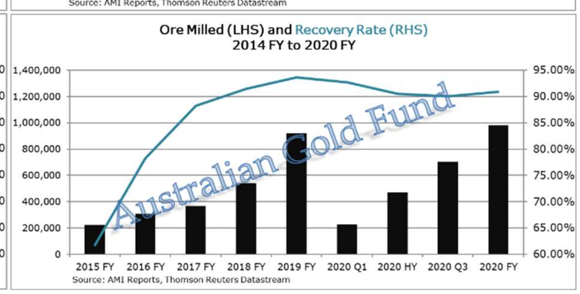








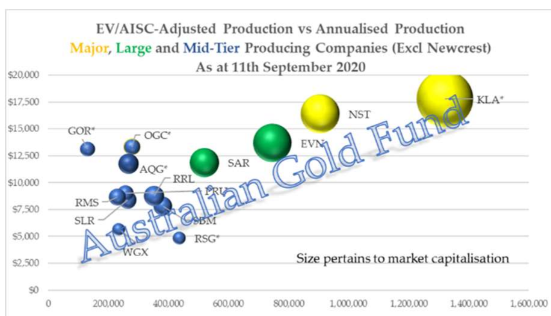


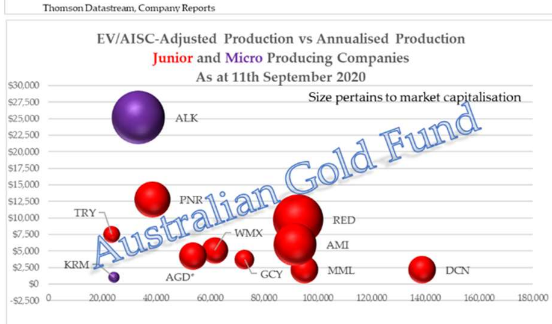


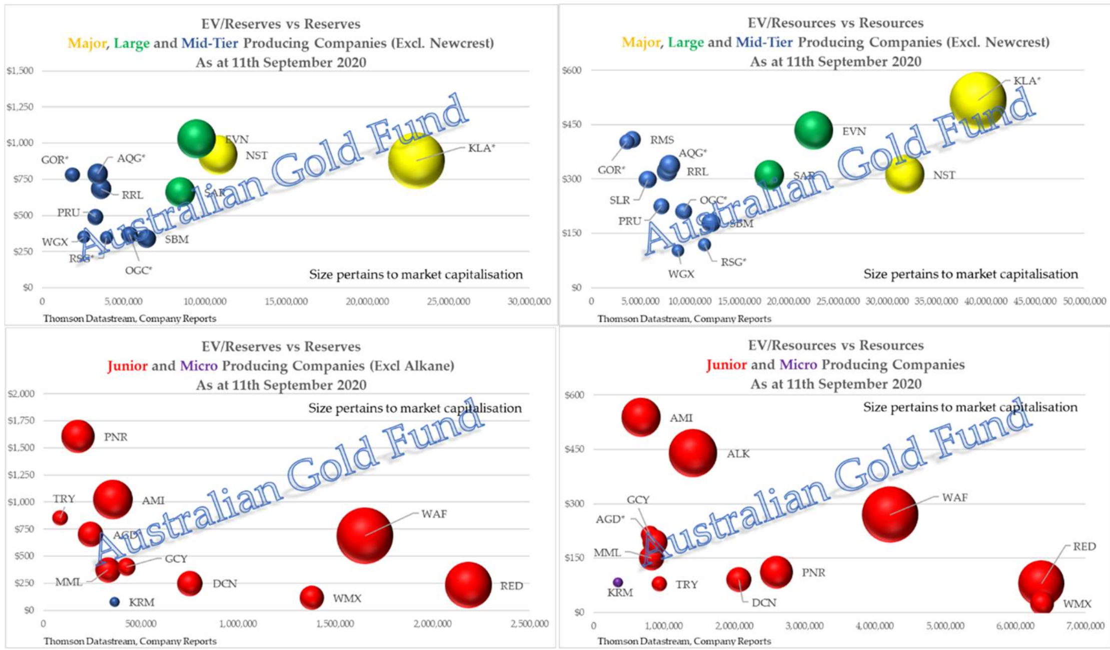
SWOT Analysis

Strengths	**Weaknesses**
• Strong cash balance and a track record of being able to generate operating cashflows. • Management and board have record of being able to weather crisis inside their company and emerge on top. • Diversification benefits due to mines producing base metals.	• Short mine reserve life leading to weaker valuation relative to peers. • Weak base metals prices have impacted on company's profitability. • The spectre of the last 18 months still is fresh on investors' minds.
Opportunities	**Threats**
• Cash balance substantial with balance sheet headroom for debt ($50m facility on deck) allows for acquisitions to expand company's scope. • The Peak mine and Federation deposit have yielded excellent intercept results that may underpin further booking of resources and reserves to extend mine life.	• The potential downgrading of resources and reserves in the Hera and Peak mines due to poor modelling can threaten the company's operating life. • The company may be a takeover target unless it can win investor confidence back.

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 Aurelia Metals 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.