Australian Gold Fund Valuation and SWOT Analysis

Dacian Gold Limited (ASX: DCN)

Date	19/06/2019
Classification	Mid-Tier Gold Miner
Current Price	$0.545
No. Issued Stocks (m)	225.7
Net Cash + Bullion + 0.5 x GIC ($ m)	-$58.10
Last Dividend Payment ($ p.a.)	$0.00
Market Capitalisation ($ m)	$123.01
Enterprise Value ($ m)	$181.11
Resources (oz)	3,520,000
Reserves (oz)	1,389,000

Ranking	**Undervalued (Highly Speculative)**
Price Range	$0.29-$1.135
Annual Gold Production Guidance (oz p.a.) ***2020 guidance***	150 000-170 000
All-In Sustaining Cost Guidance ($/oz) ***2020 guidance***	$1 350-$1 450
EV/AISC-Adjusted Production Guidance ($/oz) ***2019 guidance***	$1,961.00
EV/AISC-Adjusted Production Range ($/oz)	$1 200-$2 500
EV/Resources ($/oz)	$51.45
EV/Reserves ($/oz)	$130.39

Summary

Dacian Gold Limited is an emerging mid-tier gold producing company that constructed the $200m Mount Morgan operations over the 2018 financial year after securing the bankable feasibility study late in the 2017 financial year. The company began pouring gold from their operations in late March 2018 and reached commercial production status early January 2019, having produced 34 155oz in 2018 and 102 250oz to date for the 2019 financial year. However, the company has recently reported that their Mount Morgan operations will be downgraded from an initial plan of 180 000-210 000oz p.a. at AISC of $1 000/oz over the next 10 years to the first five years of production at 160 000-180 000oz p.a. at AISC of $1 350-$1 450/oz. Furthermore, the 2019 financial year guidance would be 138 000-140 000oz at AISC of around $1 500/oz as a result of the June quarter production guidance being 36 000-38 000oz at AISC of $1 500-$1 600/oz, while the 2020 guidance would be 150 000-170 000oz at AISC of $1 350-$1 450/oz. The two-fold disappointment has led to shareholders punishing heavily the company, selling down the stock subsequently and resulting in the stock price falling as much as 85% from its peak this year of around $2.80 in late February to an intraday low of $0.38 before recovering to $0.545.

The downgrade of the short-term production and costs arise from underground contractor shortage and performance issues. However, the downgrade of the longer-term production arises from a downgrade of ore grade in the underground operations. The latter complicates the problem surrounding the company as they also have a significant debt of $123.5m to repay from their mine construction, of which around $40m is current debt (having made a further $10m repayment during the March quarter) while the remainder of the debt is as follows:

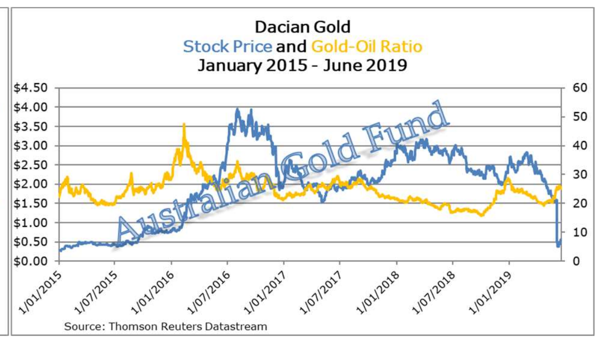
The principal repayment profile of the project debt facility at 31 December 2018 appears in the table below.

	6 months or less $'000	6-12 months $'000	1-2 years $'000	2-3 years $'000	3-4 years $'000
Bank Loan	28,000	17,850	27,450	32,100	28,100

The company's mining and ore processing may provide some minor comfort, having seen the March quarter deliver 695 000t of ore at grade of 1.66g/t while processing was at 688 000t at grade of 1.9g/t. The underground ore grade has declined sharply, however, to 3g/t in the March quarter. This is down from 4.2g/t in the June 2018 quarter, 3.3g/t in the September quarter and 4.2g/t in the December quarter. The underground ore is instrumental in keeping the mine costs lower as the open-pit ore grade is between 0.8-0.9g/t, which is marginally commercial even at the current gold price. What is reassuring is that the company is able to operate beyond the nameplate milling capacity of 2.5Mt p.a., in the short-term production levels will suffer due to mechanical breakdowns and weaker grade of ore being fed.

Prior to the end of May trading halt and corporate update, the company was well received by investors despite some tell-tale signs that need to be considered by careful investors in the future. Firstly, the company preferred to capitalise their development and production costs for the first three quarters of production and even the quarterly cashflow statements did not reflect the cash spent on production. This led to a difficulty in gauging the operating efficiency of the mine. Secondly, the company stock price was trading well above $500m even though annualised production was not even close to the nameplate capacity of 180 000-210 000oz, but around 110 000-150 000oz. The EV/AISC-adjusted production was over $5 000 at that time. With that high level in the valuation metric and the difficulty in tracking production costs and cash expended by production, we held back on investing in this company until after the June corporate update.

Going forward, at the current stock price of $0.545, the company appears to be undervalued but substantial risk remains. The lower production for the June quarter and anticipated downgrade of future production due to lower ore grade weighs on the company's valuation metrics. While many investors fear the company will go the way of Gascoyne Resources and enter into voluntary administration, we do not share this sentiment. The company's cash balance of $70m currently is expected to decline to $45-50m at the end of the 2019 financial year. However, the company has the benefits of lower oil prices going forward and they have approximately 155 000oz hedged over the next three years on a discretionary basis at $1 766/oz, allowing them partial exposure to the strong gold price rises in recent times. We value them using the 2020 guidance at a more conservative EV/AISC-adjusted production range of $1 200-$2 500, slightly lower than their peers given the current operating problems.

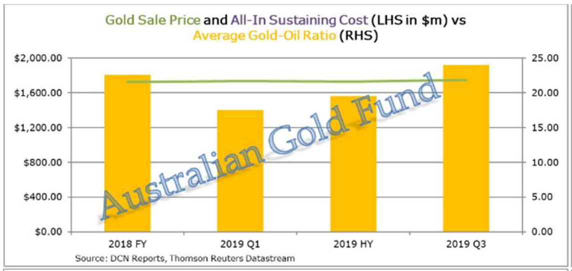


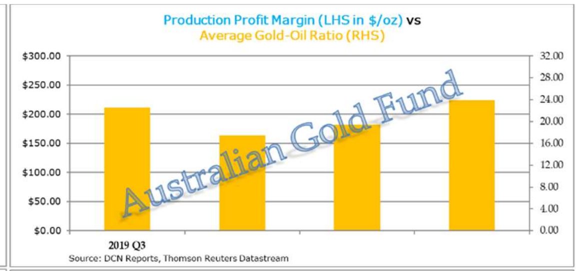
Prevailing Environment

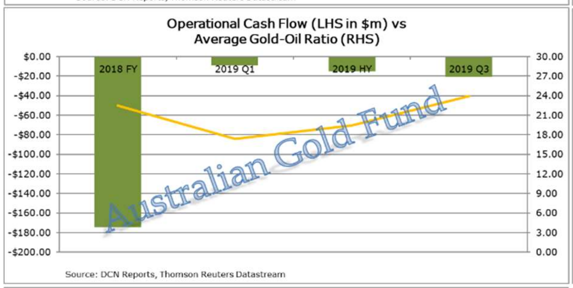
The March quarter has been a challenging one for many gold mining companies despite the gold price trading in the US$1 280-1 345/oz and A$1 790-1 880/oz range. Part of this is caused by the oil price rising 33% from US$45/bbl to US$60/bbl during the quarter, leading to the gold to oil ratio placing some pressure on costs. Since the December 2018 rate rise by the US Federal Reserve that brings the Federal Funds Rate to 2.25-2.5%, the gold price rose to over US$1 300/oz and reached as high as US$1 345/oz in late February. The corresponding rise in the oil price came as a result of higher demand during the northern hemisphere winter as well as increasing geopolitical tension in the Middle East. Furthermore, the oil price rose partly due to reduction in the US inventory. The gold to oil ratio for the March quarter started at a strong 28.3 and gradually fell to 21.5 at the end of the quarter, resulting in an average gold to oil ratio of 23.9 during this period.

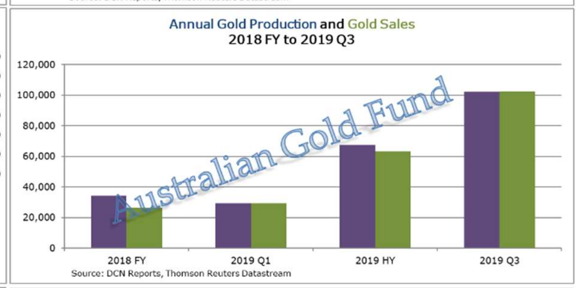
Since the end of the March quarter, the gold price weakened to below US$1 300/oz while oil held above US$60/bbl until late May when the US Federal Reserve had a change in tone regarding interest rate rises going forward. Some central banks have indicated rate cuts may occur in the future. Furthermore, the oil price weakened sharply as the US Department of Energy revealed that their crude oil inventory has increased. By mid-June, the gold price has risen to the US$1 330-$1 350/oz range, while breaking the all-time records for the Australian dollar. With oil price in the low 50's, this is an excellent backdrop for gold and other resources companies to operate. As foreshadowed in reports last month, the June to July period usually is one where fortunes turn for mining companies. 2019 appears to be no exception.

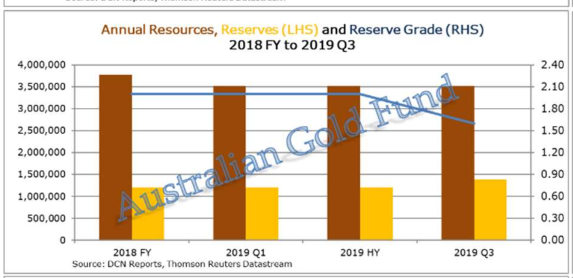
Operational and Financial Performance Charts

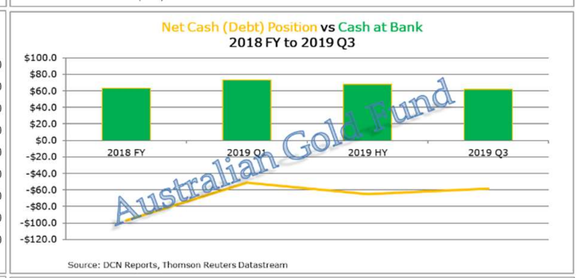


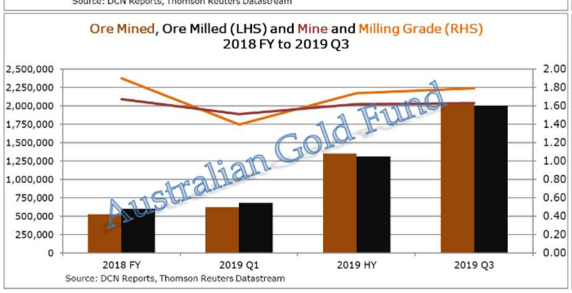


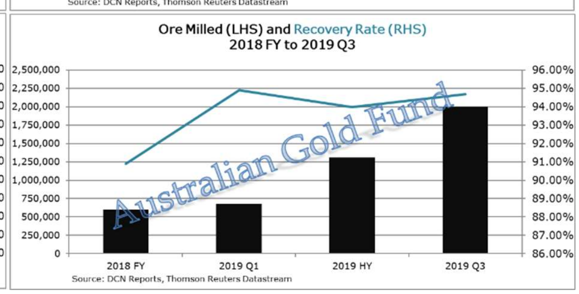








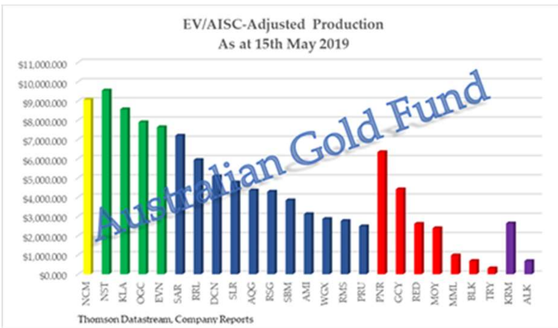


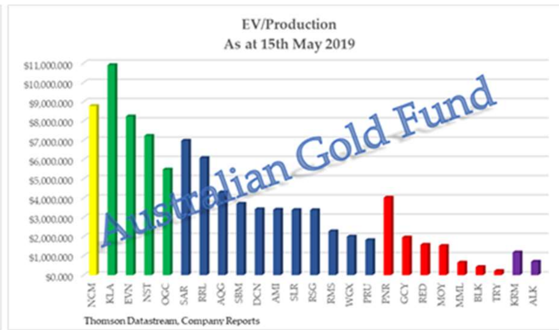


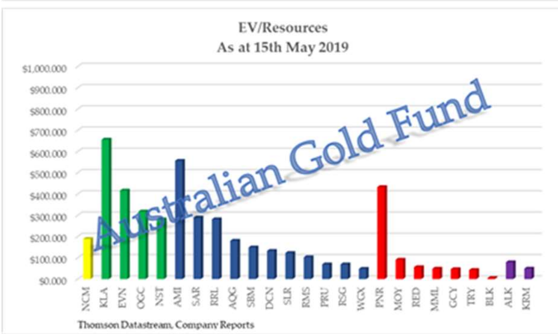
SWOT Analysis

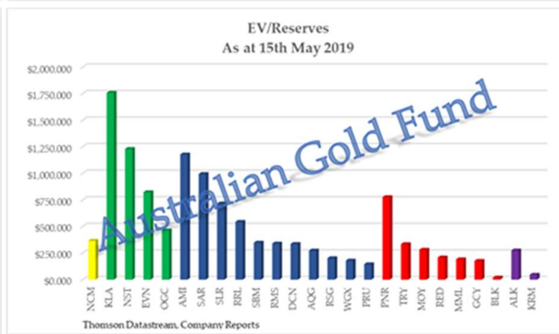
Strengths	Weaknesses
• Mine capacity of 2.5Mt p.a. should be able to offer some economies of scale. • Assuming reserves and resources are not significantly downgraded, the company has approximately 10 years of production life.	• Company in a fragile position, having delivered two consecutive quarterly downgrades followed by a significant downgrade on longer-term production targets. • Company has a significant debt load they have to repay in the next 24 months, while needing to weather the current storm of operational issues.
Opportunities	**Threats**
• Processing plant with substantial capacity may open itself up to toll processing with other mining companies if the company faces delay on its own mines. • Good gold intercepts reported in their various deposits during the last 6 months may deliver higher grade ore later.	• Downgrade of ore grades in the mines may lead to further selling down by investors. • A need to raise additional equity capital to increase liquidity, though this will be highly dilutive. • Further delays in extracting higher grade ore may push production costs higher and result in faster cash drain. • Contractor bottlenecks in the current climate may further exacerbate production costs.

Peer Comparison









Glossary

The gold mining companies are classified based on their production level on an annual basis. The classification used in this report is as follows – **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 **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 **EV/AISC-Adjusted Annual Production** is a *comparative measure* used for valuing companies in this report and can be used to determine relative value. 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). The AISC-adjusted annual production is measure whereby the annual production of gold per oz is divided by the AISC adjusted by a factor of 1 000. The intuition behind this measure is to value the company by taking into account annual production but giving favourable treatment for lower AISC and penalising for higher AISC. The factor of 1 000 is arbitrarily chosen. As an illustration, if a company produces 250 000oz p.a. at AISC of $1 250, the AISC-adjusted production is 200 000.

The metric is used to determine the Price Range for the company. This range takes into account the baseline range depending on the company's classification, as determined by the annual gold production level. The range can be adjusted upwards or downwards based on other factors that are presented in the SWOT Analysis section.

As a rough guide, the fair value ranges for different mining company classes are as follows:

Major and Large Companies - $6 000-8 000/oz

Mid-Tier Companies - $2 500-5 000/oz

Micro and Junior Companies - $800-1 800/oz

The metric is by no means perfect and other factors should be considered including reserve and resource life, projected production volume and costs, management quality and geographic location. Further, it is of a retrospective nature, focusing on past performance and this may not be a good indicator for future performance.

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.

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.

Disclaimer

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