Australian Gold Fund Valuation and SWOT Analysis

Dacian Gold Limited (ASX: DCN)

Date	4/09/2019
Classification	Mid-Tier Gold Miner
Current Price	$1.310
No. Issued Stocks (m)	225.7
Net Cash + Bullion + 0.5 x GIC ($ m)	-$59.06
Last Dividend Payment ($ p.a.)	$0.00
Market Capitalisation ($ m)	$295.68
Enterprise Value ($ m)	$354.74
Resources (oz)	3,520,000
Reserves (oz)	1,389,000

Ranking	**Fair Value**
Price Range	$0.69-$2.22
Annual Gold Production Guidance (oz p.a.) est *2020 guidance*	150 000-200 000
All-In Sustaining Cost Guidance ($/oz) *2020 guidance*	$1 250-$1 400
EV/AISC-Adjusted Production Guidance ($/oz) *2019 guidance*	$2,686.00
EV/AISC-Adjusted Production Range ($/oz)	$2 000-$3 500
EV/Resources ($/oz)	$100.78
EV/Reserves ($/oz)	$255.39

Summary

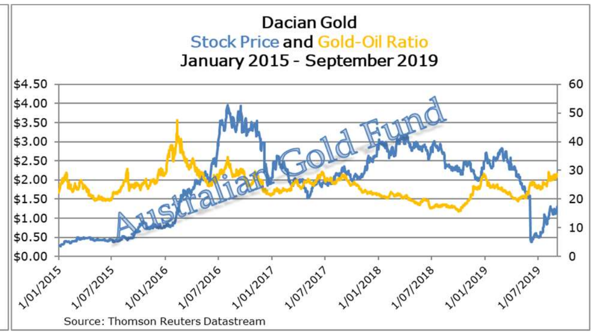
Dacian Gold released their June quarterly report on 31st July. The company delivered over the June quarter 36 658oz at AISC $1 519/oz, substantially underestimating the initial guidance of 50 000-55 000oz at AISC $1 050-$1 150/oz that was downgraded in early June to 36 000-38 000oz at AISC of $1 500-$1 600/oz. This downgrade led to the stock price collapse over the month of June that brought down the price by almost 85% from its peak. However, the company's management delivered an update on its 10-year mining plan in mid-July that showed production would average at 170 000oz p.a. at AIC of $1 330-$1 430/oz (August Diggers and Dealers Presentation) and a 2020 full year guidance of 150 000-170 000oz at AIC (all-in costs, which also includes development and growth capital) of $1 400-$1 500/oz. Since this 10-year mining plan was announced, the stock price made a substantial recovery over the month and the rally was further supported by the gold price rising even further in July by around 12% in Australian dollar terms.

Over the 2019 financial year, Dacian Gold delivered 138 908oz of gold but the AISC was only reported for the March and June quarters, while the first half-year's production did not have a reported AISC. This compared with the initial guidance of 180 000-210 000oz at AISC of $1 000-$1 100/oz that was downgraded to 150 000-160 000oz. The key drivers for the disappointing performance included the inability to access higher grade underground ore as well as the open-pit ore being of significantly lower grade of 0.8g/t for the first half of 2019 and improving to 0.9g/t in the March quarter and 1.4g/t in the June quarter. The processing plant, fortunately, has been running at a healthy rate throughout the year having processed 2.66Mt of ore, above the 2.5Mt nameplate capacity with a recovery rate of 95.3% over the year. The processing plant recovery rate was never being lower than 90% for any quarter.

The good news to investors is that the July operational update released on 12th August showed that the July monthly production is 16 188oz. There is an improvement in the mined ore grades with the underground grade reaching 3.5g/t while the open-pit grade being a pleasing 1.7g/t. The ore processed expressed in annualised terms approaches 3Mt p.a. at 2.2g/t. Should this continue, the annual production will exceed the 2020 guidance and the production costs will similarly be below the guidance range. It should be noted that the company announced the 2020 production cost guidance in terms of all-in costs to include any development and growth expenditure. Adjusting for this, we assume that the AISC will be around $1 250-$1 400/oz.

From the perspective of the financial position, Dacian Gold has a net debt position of $59.1m this quarter ($58.1m last quarter) and has sufficient liquidity to weather three to four quarters should the past be prologue. They currently have $35.5m in cash ($62m last quarter), $10.9m in bullion ($8.2m last quarter) compared against $105m in debt ($123m last quarter), of which $30m or so is due in the coming year. The Managing Director in the July conference call regarding the 10-year mine life plan reiterated that they do not intend or need to raise equity capital in light of the situation they are facing. We hold to the belief that their improved operational performance and the prevailing accommodative environment with a high gold-oil ratio will facilitate potential cashflow generation for the company.

Taking into account the company's operations turning around and the mine deposits seeing better ore grades going forward, we have decided to upgrade the valuation metrics to reflect this. This is further supported by the prevailing strength in the gold price and oil price trading in the mid US$50 range. The operational risks exist still and the company is now put on notice by investors so the valuation range we propose is below that of mid-tier peer companies. At the current stock price of $1.31, we believe that it sits below the midpoint of our price range of $0.69-$2.22, thus they are currently fairly valued. However, should the September quarter results show production is over 50 000oz at AISC of less than $1 400/oz, this may justify further re-rating to be at a comparable level to its peers.



Prevailing Environment

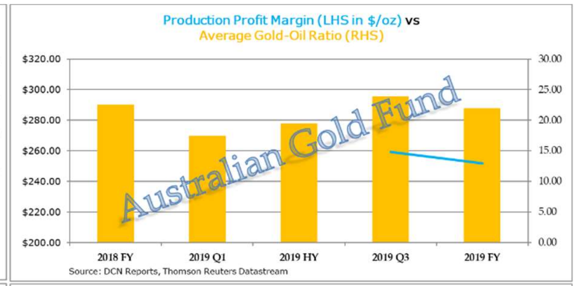
The first half of 2019 has seen the global financial markets make some recovery after a rather sharp decline in December 2018 as the Federal Reserve continued with their monetary policy of raising rates despite the real economy being weak, in conflict with the official economic and unemployment data. The tone of the Federal Reserve began to change as 2019 took its course. Should the Federal Reserve reduce interest rates in July, this would indicate the end of the rates cycle that began in the end of 2015 when the Federal Reserve began to raise interest rates from an unprecedented rock-bottom level of 0.125% and peaked at 2.375%.

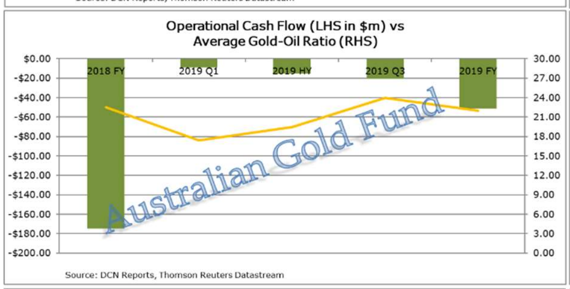
The change in the tone of the Federal Reserve is in conjunction with other central banks around the world taking a more dovish stance. The Reserve Bank of Australia surprised the market with a 0.25% reduction in early June 2019, taking it to 1.25%. This rate reduction comes as a result of a surprise return of the Coalition government in the 18th May election on the backdrop of promises by the government to try to boost a weakening jobs market and slow down an accelerating decline in the property markets in the eastern seaboard.

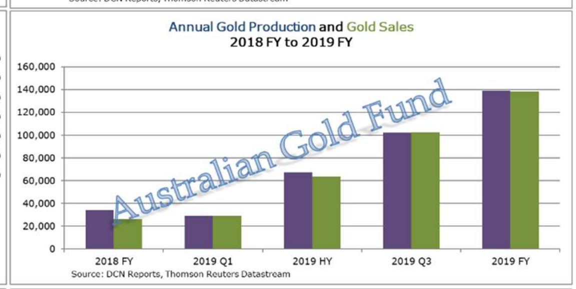
The gold price for most of early 2019 was rangebound between US$1 260-$1 350/oz, but this took a sudden turn after the June meeting on 19th June 2019 when the Federal Reserve indicated they were looking to start reducing rates as early as the July meeting scheduled on 30th-31st July. The gold price rose above US$1 400/oz on 24th June 2019, for the first time since 2013 after the sharp decline in April and June. At the same time, the gold price in Australian dollar terms went above $2 000/oz and supported further by a weaker Australian dollar. With the July meeting leading to the Federal Reserve reducing the interest rate by 0.25%, the gold price continued to head upwards. Most interestingly, the gold price surpassed US$1 500/oz at the same time a twenty-year gold sale agreement among leading central banks expired and was not renewed. While many know that the physical sales of gold and precious metals do not move market prices as they are determined by the paper contracts, this is symbolic of what may potentially be the end of the suppression of precious metal prices to give an illusion of a stable petrodollar financial system.

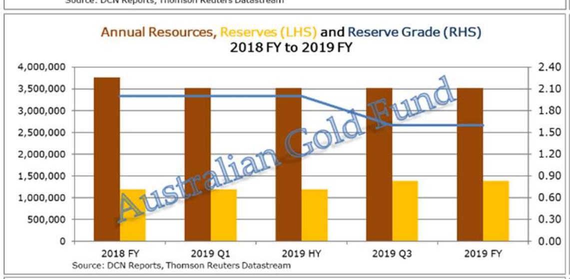
The oil price has been trading between US$50-$65/bbl on the backdrop of rising Middle East tension with Iran being in the spotlight. The US-Iran tension in the Persian Gulf and Strait of Hormuz briefly attracted much media attention and pushed the oil price above the US$60/bbl mark. This has now since been less at the forefront of market traders as increasing crude oil inventory and the escalation of the US-China trade wars takes a toll on economic activity and reduced the oil price approach US$50/bbl.

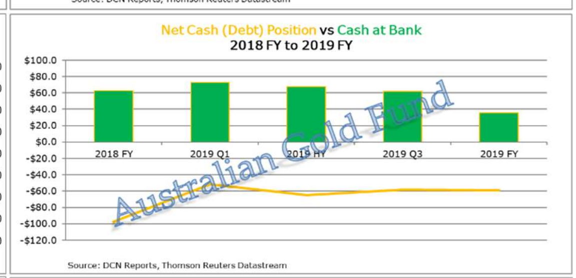
Operational and Financial Performance Charts

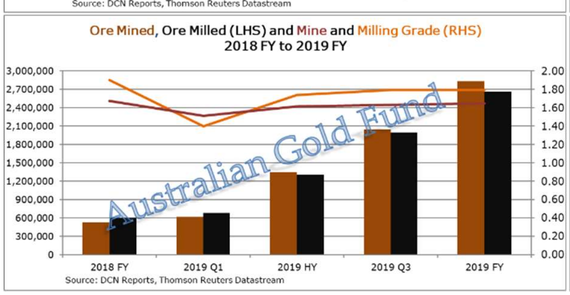


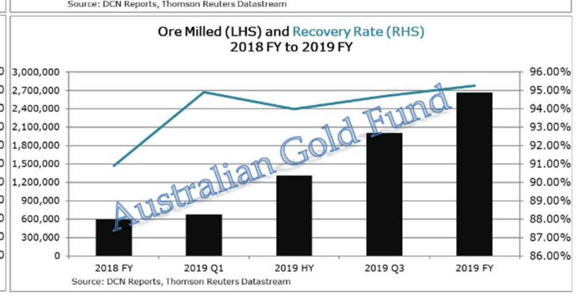








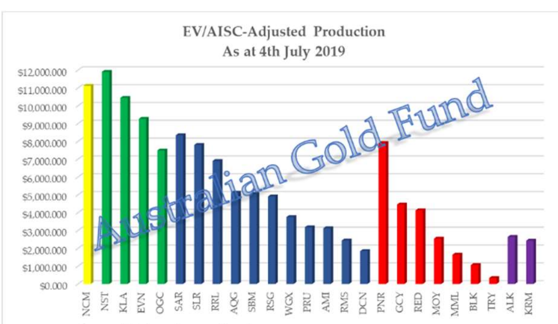


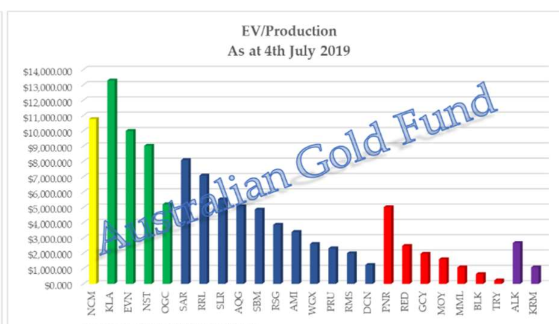


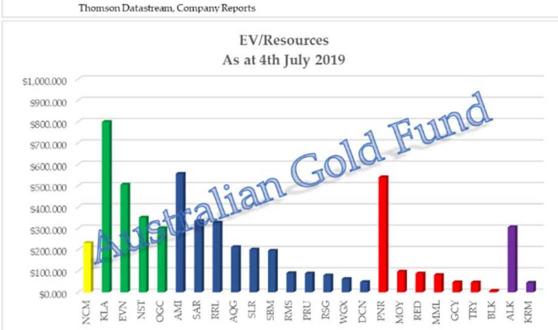
SWOT Analysis

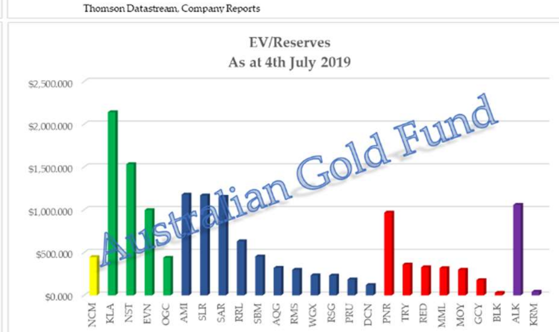
Strengths	Weaknesses
• Company explored and developed their own mine and managed to do so within a reasonable timeframe and budget. • Mine operations have both open-pit and underground deposits, allowing for economies of scale over longer term. • Mine has at least 8 years of production.	• Management optimism on operations led to very disappointing results for investors. • Inadequate transparency in reporting AISC and operational difficulties damaged the management's credibility.
Opportunities	**Threats**
• Higher gold-oil ratio will facilitate better operational results and improve financial position. • Upgrading the processing facility and further exploration may deliver lower cost ore and increase production.	• Cash balance of less than $40m may leave the company with a thinner margin of safety despite the current portion of debt being sufficiently covered by current cash. • Any further obstacles in mining could jeopardise their financial position, leading to external capital being needed.

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

Information in this report is not intended to be financial advice and should not be used as such. While every effort is made to ensure the information is reliable and accurate, errors and omissions may still exist. The interpretation of financial reports, market announcements and management commentary is subject to personal views and discretion. Users of this report are highly advised to seek professional financial advice before making their decisions.

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