Australian Gold Fund Valuation and SWOT Analysis

Dacian Gold Limited (ASX: DCN)

Date	14/04/2020
Classification	Junior Gold Miner
Current Price	$0.450
No. Issued Stocks (m)	553.6
Net Cash + Bullion + 0.5 x GIC ($ m)	$17.30
Last Dividend Payment ($ p.a.)	$0.00
Market Capitalisation ($ m)	$249.10
Enterprise Value ($ m)	$231.80
Resources (oz)	2,067,000
Reserves (oz)	754,000

Ranking	**Fairly Valued**
Price Range	$0.32-$0.62
Annual Gold Production Guidance (oz p.a.) ***2021 Guidance***	120 000-130 000
All-In Sustaining Cost Guidance ($/oz) ***2021 Guidance***	$1 400-$1 500
EV/AISC-Adjusted Production Guidance ($/oz)	$2,589.00
EV/AISC-Adjusted Production Range ($/oz)	$2 000-$3 500
EV/Resources ($/oz)	$112.14
EV/Reserves ($/oz)	$307.43

Summary

Dacian Gold has resumed trading after entering into a trading halt at the end of January upon posting their December 2019 quarterly update, citing that the company was going to review their Mineral Resources and Ore Reserves due to a material downgrade in their Westralia mine. The suspension was extended at the end of February upon the release of the Resources and Reserves Statement that saw their total reserves decline from 1.39Moz to 0.75Moz and total resources decline from 3.65Moz to 2.07Moz. Furthermore, the company released a three-year mine plan that saw its production decline from an average of around 160koz p.a. to 110koz p.a. Production for 2020 full year was further downgraded from 150koz-170koz at All-In Cost of $1 400-$1 500/oz to 138koz-144koz p.a. at AISC $1 550-$1 650/oz. The company then announced a recapitalisation plan and continued their trading halt. While this all occurred, the financial markets crashed resulting from the impact of the global coronavirus pandemic. This trading halt sheltered the stock price from plunging sharply during this period, or more correctly, delayed the plunge.

The company resumed trading on 14th April, opening at $0.43 and quickly fell to $0.38. However, buying interest in the morning took the stock price up to as much as $0.59. The afternoon saw some investors selling out to crystallise their profits during the day and it closed at $0.45.

The recapitalisation plan was announced on 8th April 2020 with the intention for the company to raise $98m at $0.30 each in order to reduce their existing debt, fund the pre-stripping activities at the Doublejay deposit, exploration activity funding and working capital. An initial placement of over 99m stocks at $0.30 combined with a 1-for-1 rights issue that would raise the remaining $58m, resulting in over 550 million issued stocks should the rights issue be fully subscribed by retail investors. Macquarie Group and Canaccord Genuity would underwrite up to $80m of the rights issue. The table below summarises the company's cash/debt position and number of issued stocks under the two cases – no retail participation and full retail participation:

	Pre-Recap	**$80m Recap**	**$98m Recap**
Net Debt ($m)	$79.80	$9.30	-$8.30
2020 Production (oz p.a.)	138 000-144 000	138 000-144 000	138 000-144 000oz
2020 AISC ($/oz)	$1 550-$1 650	$1 550-$1 650	$1 550-$1 650
No. of Issues Stocks (m)	225.7	492	553.6

The company currently holds $14.9m based on audited figures at the end of February with $94.7m of debt. The capital raising would seek to reduce the debt by $50m and with $15m of working capital and $4m of debt amendment and hedging costs, the company's debt position would be substantially reduced. Should the retail participation be 100%, the company will have a net cash position of $8.3m, not including the changes to the cash balance for the month of March.

Normally we would value the company based on the nearest upcoming annual outlook. However, this time, we consider valuing the company based on the 2021 production outlook using our adjusted figures. Given the new 3-year mine plan will be on lower production volume and lower ore grade, we consider comparable mine operations and adjust the projected AISC. We accept the company's projections on the mining and milling figures, but make upward adjustments on the AISC due to the economies of scale. We believe that the company's expectation of the 2021 AISC being $1 250-$1 350/oz from 2.8Mt p.a. of ore milled at a grade of 1.5g/t to produce 120 000-130 000oz to be too optimistic. A comparable mine processing at around that level would be producing at an AISC of $1 400-$1 500/oz, in our view. Furthermore, we take into account that the company's forecast AISC in the past was around $1 000/oz when the actual AISC ranged between $1 430-$1 730/oz as our basis that their figures need to be taken with a grain of salt. Applying our adjustments, our 3-year outlook on production and costs is as follows:

	2021	2022	2023
Ore Mined (Mt)	3.10	3.00	2.60
Ore Milled (Mt)	2.80	2.90	2.90
Ore Grade (g/t)	1.50	1.30	1.20
Recovery (%)	92.00	92.00	92.00
Estimated Production (oz)	120 000-130 000	100 000-110 000	100 000-110 000
AISC Range ($/oz)	$1 400-$1 500	$1 500-$1 650	$1 550-$1 700

The thorn on the side for the company is that they incurred substantial debt in the construction of the mine infrastructure and entered into forward contracts that placed a ceiling on the upward gold price movements. The company's hedge positions currently stand as follows:

Hedging profile (as at 29 February 2020)

	Mar 2020	Jun-Q 2020	Sep-Q 2020	Dec-Q 2020	Mar-Q 2021	Jun-Q 2021	Total
Forward sales (oz)	12,499	37,768	13,200	19,119	20,205	22,164	124,955
Hedged gold price (A$/oz)	$1,812	$1,775	$1,990	$2,102	$2,112	$2,126	$1,968
Put options (oz)	-	3,600	27,477	15,210	10,818	10,503	67,608
Floor strike price net of option cost (A$/oz)	-	$2,081	$2,064	$2,049	$2,034	$2,018	$2,050
Total hedged production (forwards + options, oz)	**12,499**	**41,368**	**40,677**	**34,329**	**31,023**	**32,667**	**192,563**

	2HFY20[1]	FY21	FY22	FY23
% of production that is hedged	~100%	~57%	-	-
Hedge price (A$/oz)	$1,784	$2,092	-	-

1. From 29 February 2020 onward

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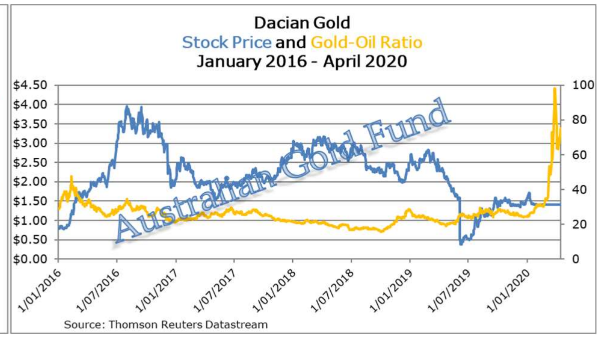
The company has hedged almost all their March to June 2020 production and over 75 000oz of around 125 000oz of the 2021 production (put options may be left to expire without exercise) at around $1 800/oz for 2020 and $2 090/oz in 2021, respectively. This leaves the company at a substantial disadvantage given the current gold price is over $2 600/oz. Given the rights issue, management may be able to renegotiate the hedge positions and unwind some of the more out-of-the-money positions.

Despite the company's awkward position, we see that the company's near-term risks should be eliminated and that there is upside potential in the future. The company's recording of high grade resources at Phoenix Ridge should not go unnoticed. Furthermore, even though the company has substantially downgraded their resources and reserves, rising gold prices and also further exploration drilling may bring these deposits back into play. Should they make discoveries of near-surface deposits that are of an economical grade, they may be able to readily increase their production. We also take into account that the replacement of the previous CEO Rohan Williams with former Doray Minerals Leigh Junk does bring some confidence around the company's prospects. Junk had a short-term career at Doray Minerals and saw the operations turn around and eventually saw it merge with Silver Lake Resources last April. The Deflector mine is now confirmed to offer Silver Lake excellent operating cashflows at low cost. The possibility of Junk being able to steer Dacian Gold to similarly turn around or perhaps even negotiate an advantageous merger with another gold mining company may bring some hope to shareholders who have been long-suffering with this company.

Given the company's high risk profile and also their awkward hedge position, we believe that the company's EV/AISC-Adjusted Production multiple should be lower than peer companies that have unhedged production. We adopt the $2 000-$3 500/oz range, putting it on a similar league to a high-cost junior producing company. This gives a fair valuation range of $0.32-$0.62. At the current price of $0.45, we believe the company stock is fairly valued. We anticipate further high volatility trading as many shareholders prior to the trading halt may be selling their stocks while those who purchase these stocks could be riding the volatility rather than holding. We believe that the $0.30 rights issue could be fully subscribed solely because of its highly discounted price, not so much because shareholders expect the company to recover substantially for the stock price to rally like it did last year. That being said, the Australian Gold Fund intends to subscribe for additional rights above our entitlements because the rights price is below our fair valuation range.

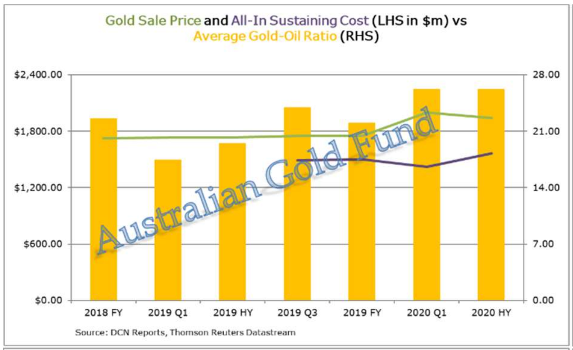
Prevailing Environment

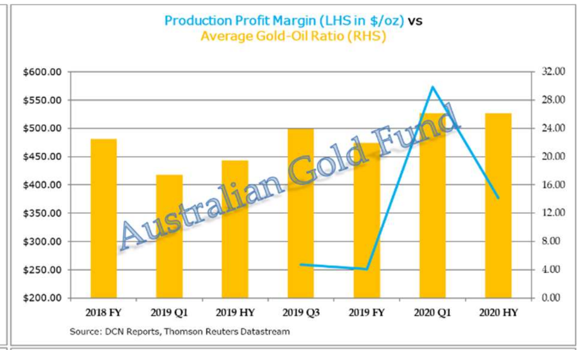


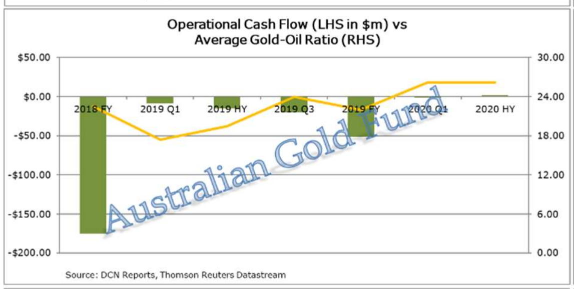
The recent two and a half months have seen the world and the global financial markets face some monumental events that have made a lasting impact, and will expect to steer the world in a different trajectory hereafter. A combination of events starting with the US-Iranian conflict (who still remembered this?) in early January, the spreading of the coronavirus leading to a pandemic starting late last year, the collapse of OPEC talks in early March and then the sharp global market crash from late February to March have shaken nations, corporations and households alike. In the midst of this, most market indices around the world declined 25-40%, most commodity prices fell (except for gold) and so did cryptocurrencies (though some have bounced to pare losses). The Federal Reserve cut their interest rate to 0-0.25% by mid-March, bringing them back to late-2008 at the onset of the subprime crisis. In addition, the Federal Reserve Board of Governors has indicated that they will have almost unlimited capacity to create currency to monetise debt in the bid to prevent the economies and markets from imploding. Other central banks have followed while the Reserve Bank of Australia has cut rates to 0.25%. Governments have announced stimulus packages and foreshadowing tax cuts to aid small businesses and households facing national lockdowns that have brought many cities to a standstill.

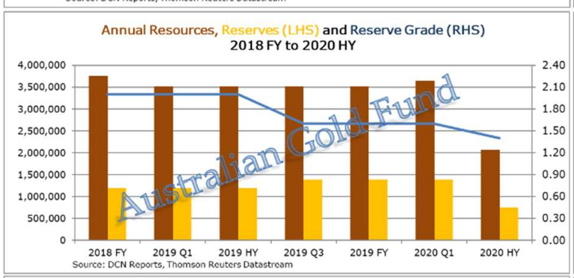
In the midst of all this, the gold price has seen a steady rise during this period with a short yet violent decline for a few days in March when it went below US$1 500/oz. However, gold demonstrated its safe haven status, laying claim to being one of very few assets that saw its price stand strong during the market-wide sell-off. The gold price started the year at US$1 520/oz and traded during this period in the US$1 460-$1 700/oz range. In Australian dollar terms, gold has broken out on the upside, starting the year at A$2 163/oz and peaking at over A$2 800/oz as the Australian dollar dipped to as low as US$0.56. The oil price has also seen a historic crash from US$64/bbl in early January in the wake of the drone strike by the US that killed the Iranian Revolutionary Guard Commander Qassim Soleimani to US$16.60/bbl in late March in the aftermath of OPEC facing potential breakdown after negotiations between Saudi Arabia and Russia on production targets failed on 6th March. The gold-oil ratio topped at almost 100 and is currently at 75. This should provide substantial tailwinds for mining companies and industries that are still running given input costs should be lower for a short while. At the time of writing, US President Donald Trump has indicated that OPEC+ (including the US and Canada) is looking to agree upon substantial production cuts that could bring petrol prices to above US$30/bbl. Even if this is to occur, mining companies should be able to enjoy the windfall of lower operating costs in the medium term.

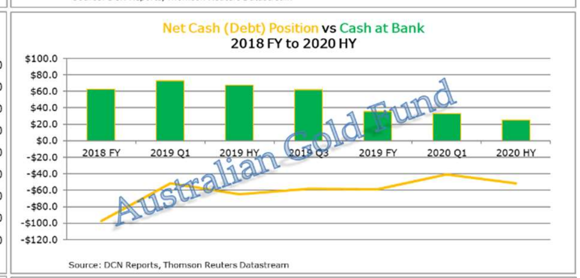
Operational and Financial Performance Charts

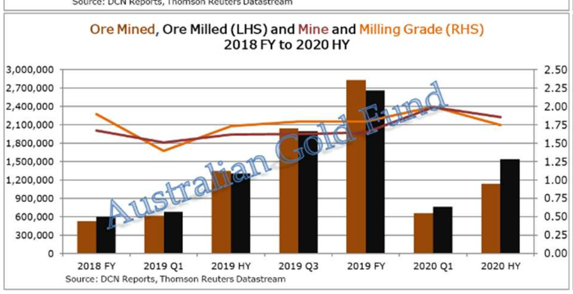


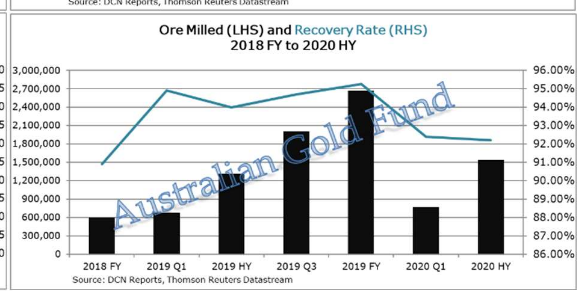








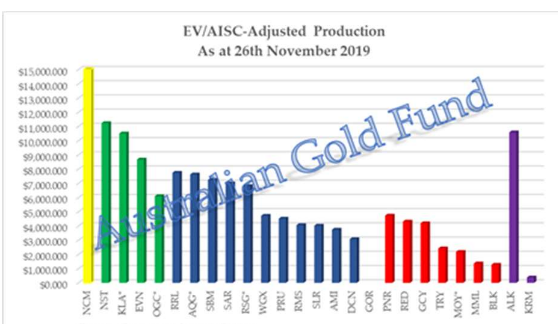


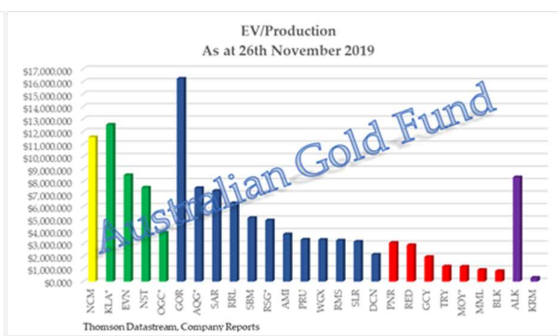


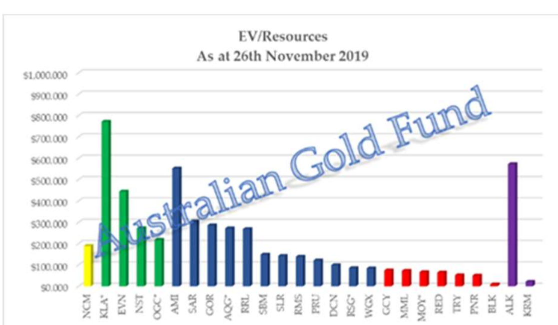
SWOT Analysis

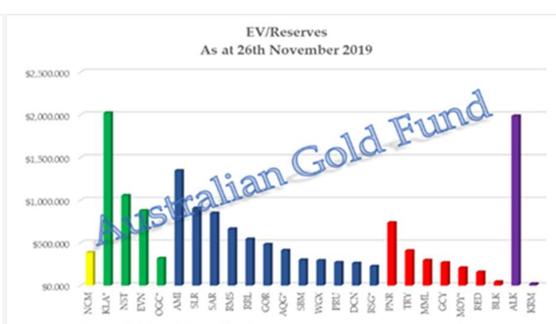
Strengths	Weaknesses
• Repaired their balance sheet and potentially become stabilised. • New CEO has a track record of turning around company fortunes. • Taking a more conservative approach to future operations, thus potentially reduce cash burn.	• Track record has been highly unreliable. • Out of the money hedges of production to mid-2021 stifling exposure to upside potential of gold price rally.
Opportunities	**Threats**
• Exploration upside in existing site, despite having downgraded resources and reserves. • Potential merger or takeover target given low market valuation as a result of loss of confidence.	• Lower than expected ore grade of the open-cut deposits at Heffernan could spell doom for the company similar to Gascoyne Resources. • Mining operation being suspended plus forward gold sale positions could lead to a Sons of Gwalia replay.

Peer Comparison









Valuation Thesis

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.).

We use the **EV/AISC-Adjusted Annual Production** as a *comparative measure* to evaluate the companies we study. This metric is able to standardise the production and production costs and hence allow for comparison across all classes of producers. 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 **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.

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*

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.

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 Dacian 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.