Australian Gold Fund Valuation and SWOT Analysis

Evolution Mining Limited (ASX: EVN)

Date	11/08/2020
Classification	Large Gold Miner
Current Price	$5.850
No. Issued Stocks (m)	1,704.4
Net Cash + Bullion + 0.5 x GIC ($ m)	-$196.40
Last Dividend Payment ($ p.a.)	$0.13
Market Capitalisation ($ m)	$9,970.82
Enterprise Value ($ m)	$10,167.22

Operating Performance Metrics	
Annual Gold Production Guidance *2021 Estimate* (oz p.a.)	700 000-800 000
All-In Sustaining Cost Guidance *2021 Estimate* ($/oz)	$1 000-$1 100
Operating Margin (Sale Price less AISC)	$1,229.39
Resources (oz)	22,545,000
Reserves (oz)	9,496,000
Financial Year Cumulative Production (oz)	746,463
Production as % of 2020 Annual Guidance	102.96%
Financial Year Cumulative AISC ($/oz)	$1,044.14

Valuation Metrics	
Price Range	$4.74-$6.925
Overall Ranking	Fair Value
Current EV/AISC-Adjusted Production	$14,234.00
EV/AISC-Adjusted Production Range	$13 000-$15 000
Ranking	Fair Value
EV/Resources	$450.97
Ranking	Fair Value
EV/Reserves	$1,070.68
Ranking	Slightly Undervalued

Summary

Evolution Mining released their fourth quarter result on 23rd July and ended the year with a solid outcome, delivering 746 463oz of gold produced at AISC of $1 043/oz. This sits comfortably within the midpoint of the guidance at the start of the financial year of 725 000-775 000oz at AISC of $940-990/oz, and exceeds the downgraded guidance of 725 000oz in the second quarter. This is a commendable result given that the company, like many around the world, experienced a slowdown as a result of restrictions arising from the Wuhan/coronavirus. While the company adopted these measures that may have slowed down operations, their operational performance has been robust. Part of this is due to the company being able to process ore from stockpiles and hence not experience a substantial reduction in their production, despite mining activity being curtailed to comply with government guidance on social distancing.

Evolution Mining is entering into a next phase of operations going forward as a result of their purchase of the well-renowned Red Lake Complex in the March quarter, the mine that made Goldcorp a leading player in the industry, and selling their Cracow mine in the June quarter. This move is showing that the company is moving towards focusing on the larger mines and seek to join the ranks of the major players like Newcrest, Northern Star and Kirkland Lake going into the future. These mines require substantial capital to maintain and Evolution Mining is now able to do so, having shown their competence in the development of the Cowal and Mungari mines in the recent few years. However, we expect that 2021 will be a year where the company may take a step back to further expand their existing operations in order to move forward to increase mine production.

The company will release more details about their 2021 guidance with the full-year results, but we conservatively estimate that production will be around 700 000-800 000oz at AISC $1 000-$1 100/oz. Underlying our assumption is that Cowal will produce at a lower rate than 2020, Mount Carlton will continue to be weak while Mount Rawdon, Mungari and Ernest Henry will produce at a similar rate as in the fourth quarter 2020. We estimate Red Lake Complex to ramp up production over the year, but that the AISC will still be rather high. The higher grades at Red Lake Complex and Mungari may provide a turnaround in the AISC into the year, so we leave this open in our valuation.

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The company's financial position has been robust, with free cashflows being generated from operations. Removing the effect of the company borrowing $600m in order to fund the Red Lake Complex purchase at US$375m (plus US$100m in contingent payments upon discovery of further resources), the company increased their cash position by $300m during the year. This is no mean feat given the company's mine properties and exploration expenditures as well as the slowdown in operations. Further, the company has 300 000oz hedged from Jun 2020 to Jun 2023, with 25 000oz per quarter at an average of just under A$1 900/oz. This compares to their quarterly production that averages 180 000-220 000oz, which means the hedging loss is not significant compared against its peers, some of which have 30% of their production hedged. We expect the gold price to be around A$2 500-$3 500/oz, meaning that the company should be able to sell their gold production at an average of around $2 800/oz without much difficulty. Hence, the company will likely be in a comfortable position to increase their dividend payment and perhaps undertake further acquisitions of mine properties or even companies. We note that Musgrave Minerals (ASX: MGV) has risen sharply as a result of impressive discoveries in their Cue Project where there is a joint venture with Evolution Mining.

Our analysis assumes that the company will produce between 700 000-800 000oz at a relatively low AISC of $1 000-$1 100/oz. The gold price will be quite accommodative to Evolution Mining, expected to be between A$2 500-$3 500/oz, implying that the company's operating margin will be around $1 700/oz. Based on the current price, we find that the EV/AISC-Adjusted Production is $14 200/oz. The accommodative economic conditions and the company's strong operating performance means that we believe the company is currently at fair value based on its production. The company has over 9Moz of reserves with high grade reserves at Red Lake Mining approaching 7g/t and over 22Moz of resources. The current price may slightly underprice the company given its Ore Reserves and the potential for higher grade ore being discovered.

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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 three 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 50, which is still highly accommodative to gold producing companies in generating substantial operating margins. Going forward, we do expect that the currency creation will further push down currencies and may see the gold price increase. The price of oil should increase but at a slower rate given that the global economy is growing slower as parts of the world have seen structural damage arising from a combination of lockdowns and natural disasters.

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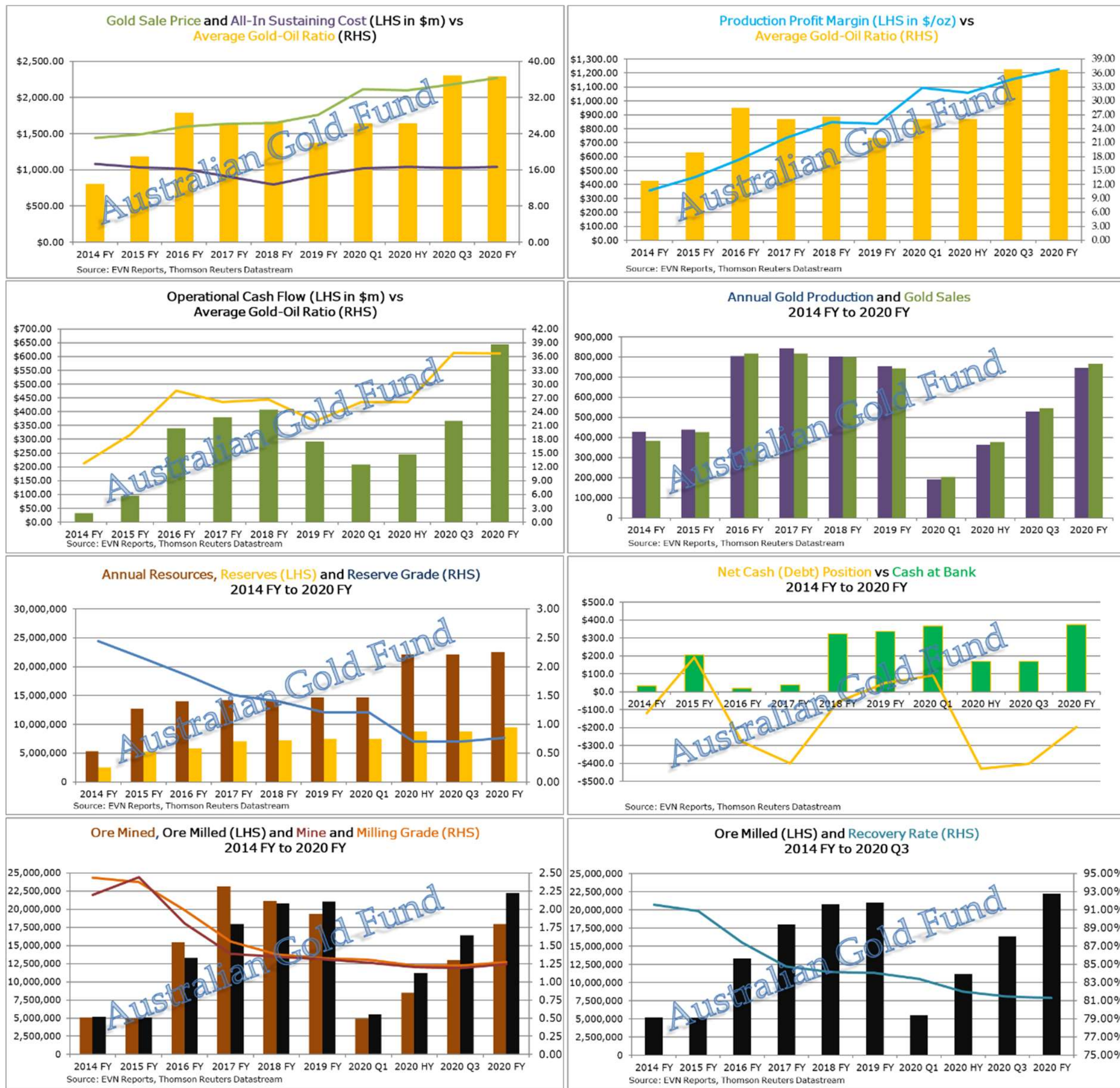
Operational and Financial Performance Charts



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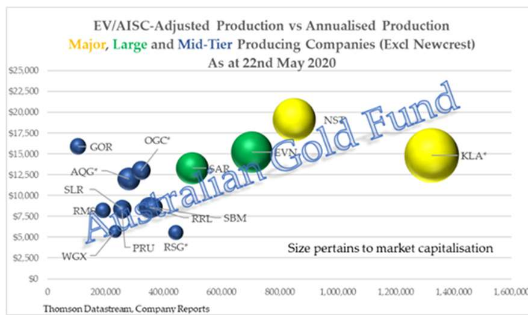
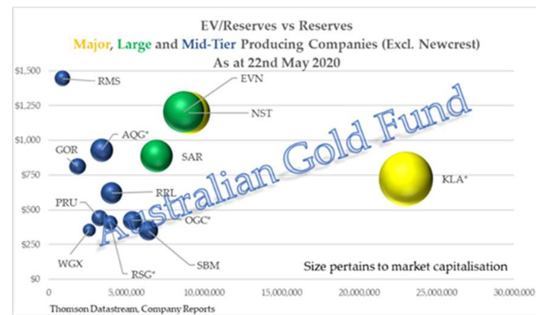
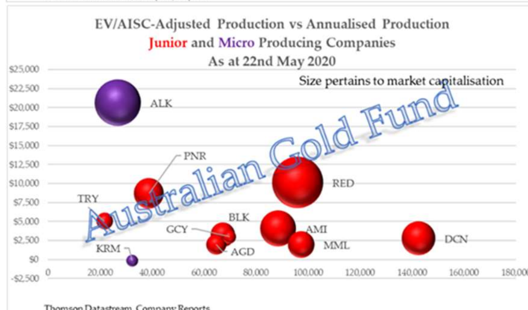
SWOT Analysis

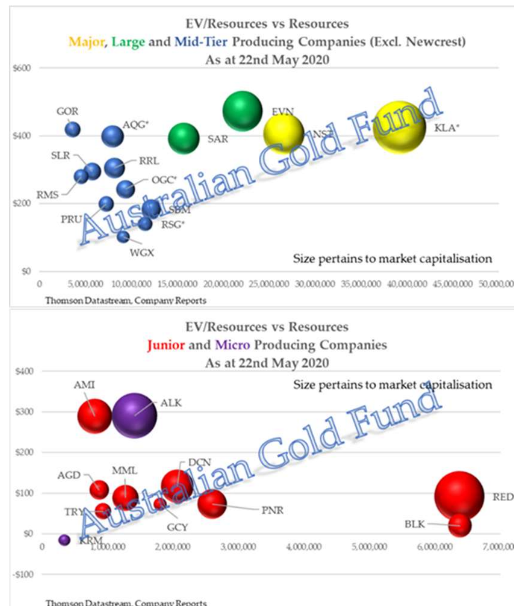
Strengths	Weaknesses
• Strong track record of delivering low-cost gold with mine properties in secure tier-1 jurisdictions (Australia and the US). • Positioning itself to become a major producing company with selling down of smaller mines and purchasing larger mines. • Solid balance sheet with excellent operating cashflow generating potential that underpins dividend payments.	• Some of the smaller mines, including Mount Carlton, have seen sharply falling ore grades that lead to write-offs and higher AISC.
Opportunities	**Threats**
• Potential acquisitions of large mines may offer further growth opportunities. • Joint ventures with Musgrave Minerals may further offer opportunities for the company to expand their mineral base.	• Delay in the underground development of their deposits at Cowal and Mungari could lead to higher cost in these flagship mines. • Red Lake Complex development may exceed budget and keep AISC higher than the longer-term trend for the company.

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.

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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.

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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 Evolution Mining 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.

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