Australian Gold Fund Valuation and SWOT Analysis

Kirkland Lake Gold Limited (ASX: KLA)

Date	10/01/2020
Classification	Major Gold Miner
Current Price	$63.500
No. Issued Stocks (m)	287.2
Net Cash + Bullion + 0.5 x GIC ($ m)	$1,002.92
Last Dividend Payment ($ p.a.)	$0.21
Market Capitalisation ($ m)	$18,124.85
Enterprise Value ($ m)	$17,121.93
Resources (oz)	36,212,000
Reserves (oz)	21,198,000

Ranking	**Fair Value**
Price Range	$48.32-$74.61
Annual Production Guidance (oz p.a.)	1 545 000-1 605 000
All-In Sustaining Cost Guidance ($/oz)	$1 100-$1 200
EV/AISC-Adjusted Production Guidance ($/oz)	$12,586.00
EV/AISC-Adjusted Production Range ($/oz)	$10 000-$14 000
EV/Resources ($/oz)	$472.82
EV/Reserves ($/oz)	$807.71

Summary

Kirkland Lake Gold is a dual-listed gold mining company that operates in Canada and Australia with dual-listing on the Toronto and Australian Stock Exchanges. The company was chaired by the legendary Eric Sprott until earlier this year when he stepped down from the board, but remained one of the major shareholders. Kirkland Lake Gold is possibly the lowest cost gold mining company on the ASX and has one of the strongest cashflow generation potential internationally, thanks to their Fosterville mine that produces gold at grades around 40g/t. The company just announced their update on the December quarter and the 2019 full year performance. They delivered production of 974 615oz for the year, on the back of a record quarter where 279 243oz were produced. Furthermore, they announced a C$4.9 billion (A$5.53 billion) acquisition of Detour Gold on 21st November 2019. This acquisition will propel Kirkland Lake Gold from a large gold producer to a major gold producer with annual production exceeding 1.5Moz. The company will have 4 operating mines (Fosterville, Macassa, Holt Complex and Detour Lake) across Canada and Australia, both tier 1 operating jurdisdictions.

Kirkland Lake Gold began the 2019 financial year with a production guidance of 920 000-1 000 000oz at AISC A$720-785/oz. After the half year, the guidance changed to 950 000-1 000 000oz at AISC A$760-$820oz. The company reported on 9th January 2020 their 4th quarter production that showed they met their upgraded guidance. The Fosterville mine delivered record production for the quarter at 191 893oz at 49.3g/t (Q3: 158 327oz at 41.8g/t), totalling 619 366oz at 40.5g/t for the year while the Macassa mine delivered 56 379oz at 20.5g/t for the quarter (Q3: 62 945oz at 23.3g/t) and 241 297oz at 24.2g/t for the year and the Holt Complex mine delivered 31 469oz at 4.1g/t for the quarter (Q3: 27 128oz at 4.2g/t) and 113 952oz at 4.44g/t for the year. The AISC for the year has not yet been reported, but they saw a US$90m increase in their cash balance over the quarter, including US$30m spent on stock buybacks. The company saw their cash balance increase over the year by US$373m (A$530m), which is clearly an impressive result. Even though the gold price increased 18.7% over the year, this cannot be used to detract from the impressive performance for Kirkland Lake this year.

The Detour Gold acquisition is an interesting one in that Kirkland Lake gold is adding a large open-pit mine to their existing properties that are all higher-grade underground mines. Furthermore, the Detour Lake mine is a large mine that produces around 600 000oz p.a., rivalling Fosterville. The key difference is that the Detour Lake mine is a relatively low-grade large-scale mine that produces gold at around 0.85-1g/t and the mine is relatively high cost with AISC around A$1 600-$1 800/oz. We believe the key reasons for the acquisition, despite the sharp contrast in the nature of the mine and its operations, are due to Detour Lake's proximity to their Holt, Taylor and Macassa mines (within 150km radius), the vast resources and reserves of 21.1Moz and 15.4Moz, respectively. Their plan is to increase the mine's efficiency and then continue to exploit the unexplored land that is within the rich Abitibi Greenstone Belt region.

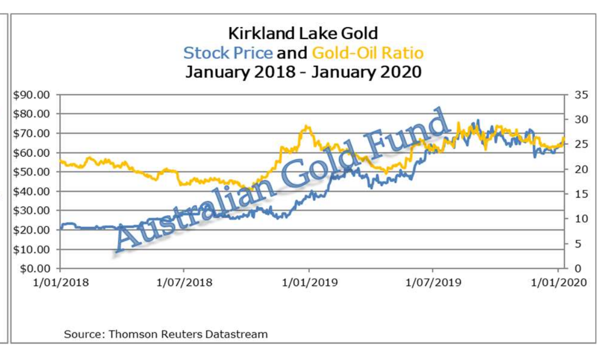
Looking into the acquisition metrics, we present the table below:

	Price
Detour Gold Acquisition	$5,528.90
Production	600,000
AISC Average	$1,643
Resources	21,132,000
Reserves	15,444,000
Price/AISC-Adjusted Production	$15,139
Price/Resources	$261.64
Price/Reserves	$358.00

The implied EV/AISC-Adjusted Production for the acquisition is around $15 000/oz, which is substantial, but this takes into account that a premium was paid over the production for control of the entity. The mine is high-cost so for this price, it appears to be an overpriced purchase. On the other hand, the EV/Resources and EV/Reserves of $262/oz and $358/oz, respectively, is fair. For comparison purposes, Saracen acquired a 50% stake of Kalgoorlie Super Pit at EV/AISC-Adjusted Production of $6 500/oz (mine only, not company control), EV/Resources of $188/oz and EV/Reserves of $302/oz while St Barbara acquired Atlantic Gold at EV/AISC-Adjusted Production of $6 900/oz, EV/Resources of $352/oz and EV/Reserves of $444/oz. Hence, this acquisition increases Kirkland Lake Gold's EV/AISC-Adjusted Production level but decreases the EV/Resources and EV/Reserves level. In other words, the company appears to be overpaying for its current production capacity but is seeking value in the longer-term growth potential.

Given the cashflow generating track record for Kirkland Lake Gold, this acquisition may be reasonable. However, time will tell whether their strategies in reducing production cost will pay off, instead of being similar to Northern Star's acquisition of the Pogo mine in October 2018 that brought the company some heartache. With 2020 being a year where the Federal Reserve and central banks may be further pressured to cut interest rates in light of potential geopolitical instability, President Trump's pressure to boost the economy and the volatility arising from the wrangling between US and China in cementing a trade deal, the gold price may further offer tailwinds. Thus, with Kirkland Lake Gold's strong track record in delivering cashflows, we believe the fair valuation range of EV/AISC-Adjusted Production of $10 000-$14 000/oz estimates the company's fair value to be between $48-$75 or so. At the current price of $63.50, we believe they are fairly valued.

Prevailing Environment



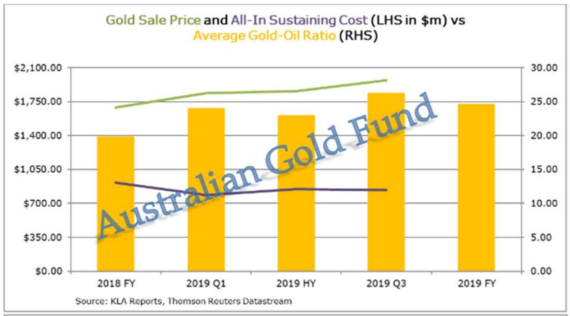
The gold price has had a positive trend over the year of 2019, especially since late May when it became apparent that the Federal Reserve would reverse on their initial plan to raise the Federal Funds Rate three times during the year to reducing it three times, being in late July, mid-September and late October. The Federal Funds Rate currently sits at 1.5-1.75%. This propelled the gold price from US$1 280/oz at the start of the year to US$1 500/oz at Christmas time. The gold price in USD peaked in early September at around US$1 550/oz**.** The price has retreated in the last three and a half months partly due to traders paring bullish positions in the Comex market as they returned from the northern summer break.

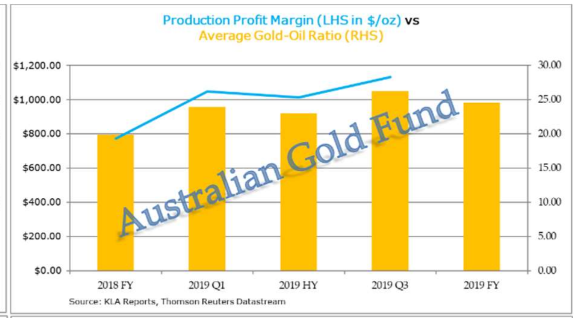
In Australia, the gold price has risen more sharply as a result of the Australian dollar weakening slightly during the year, sitting in the US67-72c range. The gold price started in 2019 at A$1 820/oz and peaked at A$2 320/oz on 8th January 2020 in the aftermath of Iran's retaliation against the US assassination of the Head of the Iranian Revolutionary Guard Qassim Soleimani near Baghdad Airport, Iraq. Currently, the gold price is around A$2 260/oz. The Reserve Bank of Australia also cut the 24-Hour Cash Rate three times during the year in June, July and October, and currently sits at 0.75%. The interest rate cuts have been rapid and have moved the interest rate to a new historic low. The economic outlook has been relatively pessimistic, especially with the Sydney and Melbourne property prices continuing to fall into around August-September despite the rate cuts. However, the prices have begun to turn around possibly spurred by an exodus from Hong Kong in light of the civil unrests that began in mid-June. Economic activity and consumer confidence are still relatively subdued, although commodity prices rising may provide a small boost.

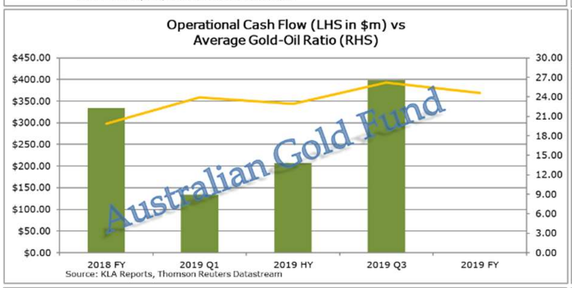
Regarding the oil price, over 2019 it traded in the US$50-65/bbl range. This has been accommodating lower costs for miners and also a boost to consumer spending. The oil price has started rising in December from US$56/bbl to around US$60/bbl, spiking to around US$64/bbl on 8th January 2020. However, tensions appear to have temporarily eased and oil is trading again below US$60/bbl and it remains to be seen whether this will continue. We hold the view that the oil price will trade in the US$55-$70/bbl range this year. Especially for gold miners, the gold-oil ratio has been sitting in the 25-30 level for much of the second half of the year as the gold price surged. Currently, the gold-oil ratio sits at 24.5. This is still a level that gold mining companies will find comfortable, especially those with larger scale operations and not undergoing new development.

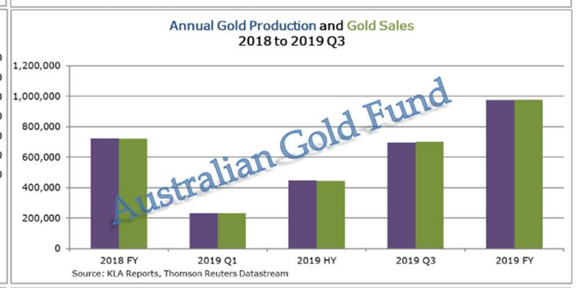
Operational and Financial Performance Charts

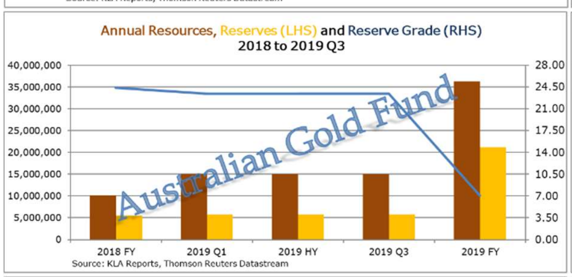
Note that the 4th quarter report released by Kirkland Lake Gold does not include AISC information

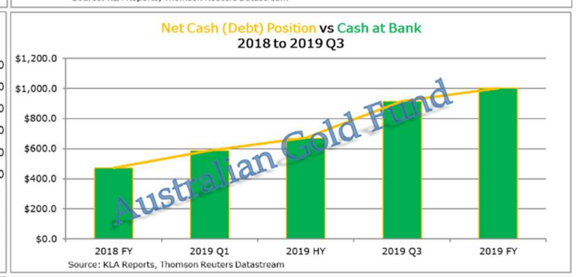


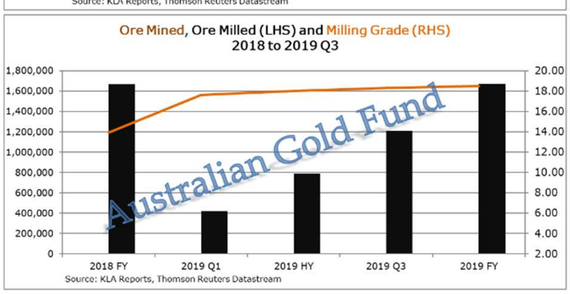


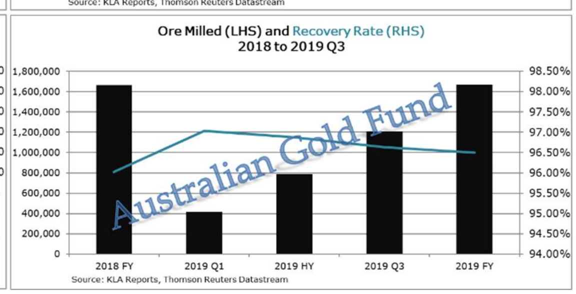








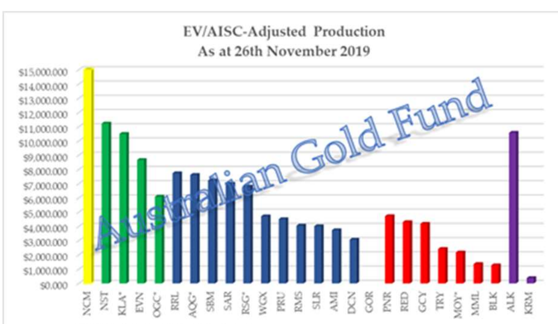


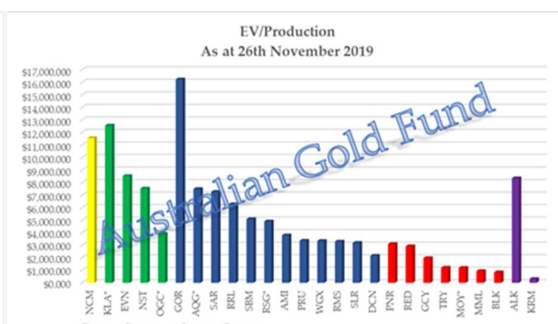


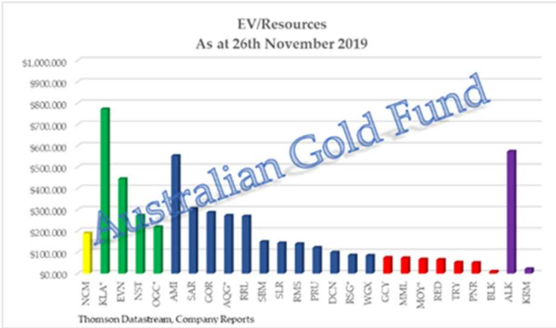
SWOT Analysis

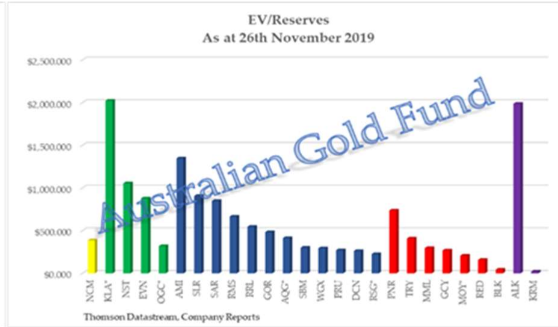
Strengths	Weaknesses
• One of the most well-managed and profitable gold mining companies in the world due to their high-grade mines (ore grades exceeding 20g/t) and excellent cashflow generation. • Strong track record of discoveries and mine development. • Substantial cash reserves with potential to expand and develop.	• Net of the Detour Gold acquisition, their existing reserve life is short compared to its peers. • Purchase of a high-cost, low-grade mine to the existing portfolio seems like a risky fit.
Opportunities	**Threats**
• Substantial exploration and development opportunities with their existing portfolio of mines that may leverage from proximity especially in Canada.	• The Detour Lake mine may require substantial capital investment to bring down costs, but may risk cost blowouts. • The high-grade Fosterville and Macassa mines have a relatively short mine life, thus costs could eventually begin to escalate over time if the reserves being replenished are of declining quality.

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-$11 000/oz*

***Mid-Tier Companies** - $3 000-$6 000/oz*

***Micro and Junior Companies** - $1 500-$2 500/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 do not hold Kirkland Lake stocks but may purchase prior to or 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.