Australian Gold Fund Valuation and SWOT Analysis

Oceanagold Corporation (ASX: OGC)

Date	25/02/2021
Classification	Mid-Tier Gold Miner
Current Price	$1.900
No. Issued Stocks (m)	704.0
Net Cash + Bullion + 0.5 x GIC ($ m)	-$159.72
Last Dividend Payment ($ p.a.)	$0.00
Market Capitalisation ($ m)	$1,337.58
Enterprise Value ($ m)	$1,497.31

Operating Performance Metrics	
2021 Annual Gold Production Guidance	340 000-380 000
2021 All-In Sustaining Cost Guidance ($/oz)	$1 370-$1 550
2020 Operating Margin (Sale Price less AISC)	$456.83
Resources (oz)	9,380,000
Reserves (oz)	5,378,333
Financial Year Cumulative Production (oz)	301,676
Production as % of 2020 Annual Guidance	94.27%
2020 Financial Year Cumulative AISC ($/oz)	$1,850.07

Valuation Metrics	
Price Range	$1.955-$3.32
Overall Ranking	Undervalued
Current EV/AISC-Adjusted Production	$5,968.00
EV/AISC-Adjusted Production Range	$7 000-$9 000
Ranking	Very Undervalued
EV/Resources	$159.63
Ranking	Undervalued
EV/Reserves	$278.40
Ranking	Undervalued

Summary

Oceanagold Corporation ended the 2020 financial year with a more upbeat tone for the coming five years after having gone through two years of transformation and also a period of setbacks in their operations, most notably Didipio. The company produced 301 675oz for the year at AISC of A$1 850/oz, a significant decline from its peak in 2017 when it produced over 500 000oz. Due to the prolonged suspension on the Didipio mine in the Philippines, the company decided to lay off their workforce and incurred an impairment charge of $80m. The company presented a multi-year outlook in mid-February detailing their plan to increase production over the next five years to over 500 000oz p.a., driven by several mine development plans in their Macares, Haile and Waihi operations. Two development plans that involve underground mining will contribute to production in this year alone.

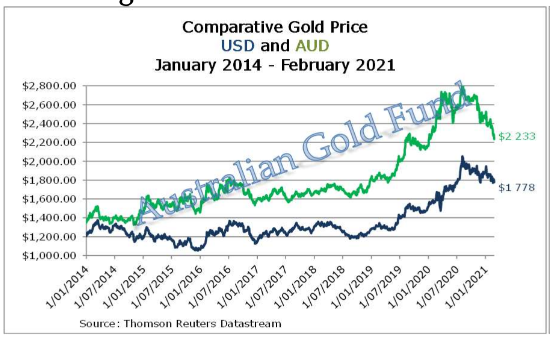
The last two years saw Oceanagold revert back to mid-tier producer status as a result of the loss of production in the Didipio mine as well as the Waihi mine entering into a transformation phase with the development of the Martha underground mine, which commenced to produce in the fourth quarter. The flagship Macraes mine appears to be ageing with ore grade falling gradually and hence production has also declined to 144 487oz at AISC of A$1 743/oz, from 172 475oz last year at AISC of A$1 604/oz. At the height of operations, the Macraes mine produced well over 200 000oz. The Haile mine delivered 137 414oz for the year at a rather high AISC of $1 942/oz, though this was a result of the slowdown in operations arising from last year's virus outbreak. The company reported a record fourth quarter producing 48 988oz at AISC of A$1 252/oz as a result of higher ore grades being mined and processed. The Waihi mine operations delivered 19 775oz at AISC of A$853/oz, though the mine produced only in the first quarter at Correnso (which production has now ceased as the deposit has been depleted) and the fourth quarter at the recently completed Martha Underground mine.

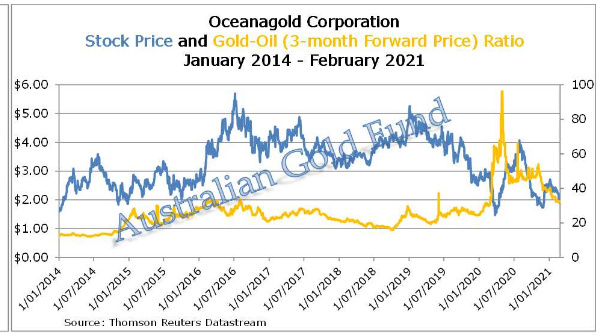
Oceanagold's multi-year outlook is quite positive and encouraging, with strong suggestions that the company's production expected to increase gradually. In Haile, the Haile Underground project is being developed with production expected to begin at the end of 2022. The Ledbetter Phase 2 is undergoing pre-stripping and production is expected to begin in 2024. The expected production for 2021 will increase to 150 000-170 000oz at AISC of A$1 300-$1 500/oz In Waihi, the Martha Underground mine is expected to deliver 35 000-45 000oz at AISC of A$1 600-$1 800/oz in 2021 while it continues to pursue its feasibility studies into their Gladstone, WKP and Martha Open-Pit projects. In Macraes, the development is under way to bring the Golden Point underground project to production by end of this year. Production for the Macraes operations is expected to be 155 000-165 000oz at AISC of A$1 350-$1 500/oz for 2021. Thus, the company's 2021 guidance to be 340 000-380 000oz at AISC of around A$1 370-$1 550/oz. Out of the company's budgeted capital expenditure of A$360-$410m, around 60% of this is in growth spending including building mining and processing facilities to increase production. This does not include the potential for Didipio to be brought back into production once the Filipino government approves of the company's proposed mine plan. From the time of approval to full production is expected to take around a year. Based on their current plan and outlook, production in 2022 will be above 400 000oz p.a. and rising to 530 000oz by 2024 when the Macraes Round Hill, the Haile Ledbetter Phase 2 and 3 and the Haile Underground operations begin production. The company's transformation should be substantial in 2026 when the WKP mine begins production, and this mine itself is expected to deliver a formidable 190 000-230 000oz p.a.

The current stock price for Oceanagold implies the company's enterprise value is $1.5 billion, given its net debt is almost $160m. Taking into account the company's management guidance and its current Resources and Reserves, the EV/AISC-Adjusted Production is $5 968/oz, EV/Resources is $160/oz and EV/Reserves is $278/oz. The company has a substantial 5.38Moz Reserves and 9.38Moz Resources, with its exploration program being able to cover for its depletion from mining. The Annual Resources and Reserves Statement is due in March and we expect substantial increase given the Waihi exploration and booking of WKP resources and reserves in this report, alongside discoveries in other mines. We understand that the company has not made any major acquisitions since 2015, preferring to invest in its existing operations and build mine infrastructure on these. However, this may also have been the source of investor frustration especially given the company appeared to be on its trajectory to be a large producer with annual production exceeding 500 000oz in 2017 and 2018, only to have its Didipio mine suspended at around the same time substantial development spending was needed in the Waihi and Haile operations.

At this stage, we believe that the company is beginning to see their substantial capital expenditure deliver some cashflows through increased production. With higher gold price expected due to the central banks continuing to debase currency, this may see Oceanagold generate more operating cashflows. Based on our belief that the fair valuation range is $1.955-$3.32, the company is undervalued.

Prevailing Environment



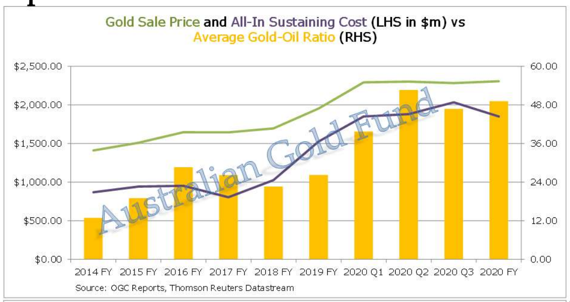


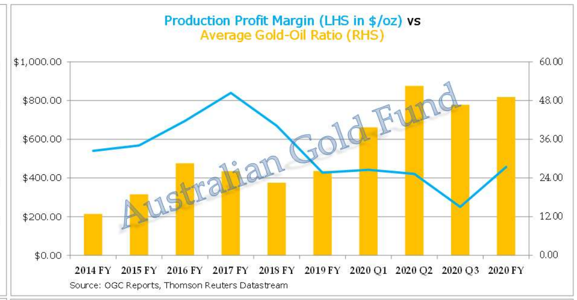
The recent six months have seen the gold price decline after having reached a peak in mid-2020 in the context of massive central bank cash printing and government spending to encourage economic activity during the Wuhan virus outbreak worldwide. The seasonal decline in the gold price from mid-September to mid-December continued into January 2021 as the Biden administration was inaugurated. Interestingly the market expected a higher stimulus package from the Biden administration than the $1.9 trillion that is currently agreed upon. On top of that, the cryptocurrency market appears to have attracted a lot of investors and hence this may have left the precious metals market stagnant.

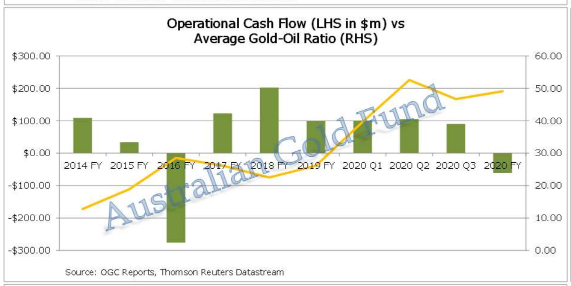
Given the unprecedented unusualness of events that have emerged worldwide the last year, we believe that events should not be taken at face value. We hold to the belief that the financial system is currently being heavily controlled by central banks and financial institutions intent on maintaining the illusion of status quo in the backdrop of their desired plan of “The Great Reset” to be implemented by the World Economic Forum. However, we believe that the sharp rise in the cryptocurrencies market, the need for Treasury Secretary Janet Yellen to intervene on behalf of hedge funds to regulate against investors seeking to short-squeeze selected stocks in the market led by WallStreetBets, are examples of how their plan will not be successful.

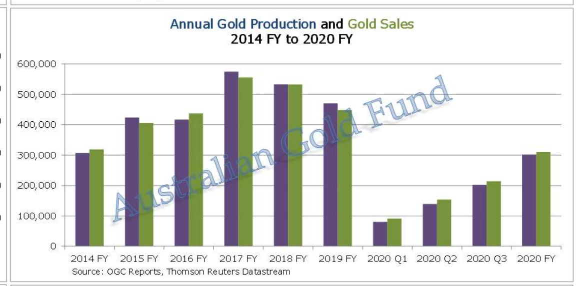
The Australian dollar has strengthened by around 8% against the US dollar over the past six months and hence the gold price is trading around the $2 300-$2 400/oz mark. The crude oil price has surprisingly jumped almost 35% over the last six months, though much of the rise occurred from December onwards as the world began to believe that President Trump was unable to overturn the election results that appeared to favour Joe Biden. Given that the Biden administration campaigned heavily on climate change and green energy, the US oil production industry would suffer when he assumed office. The reduction in oil supply by the US and increasing reliance once more of the Middle East has contributed to the rising oil price. In turn, higher oil prices and the gold price being relatively stagnant have led to gold mining companies not being able to enjoy as accommodative operating environment than they had in the past year. That being said, the gold-oil ratio is still over 30, providing conditions that are still conducive to supernormal profits for mining companies.

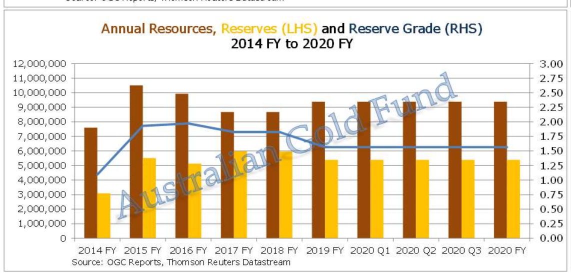
Operational and Financial Performance Charts

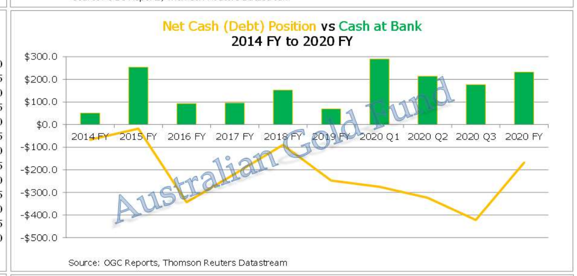


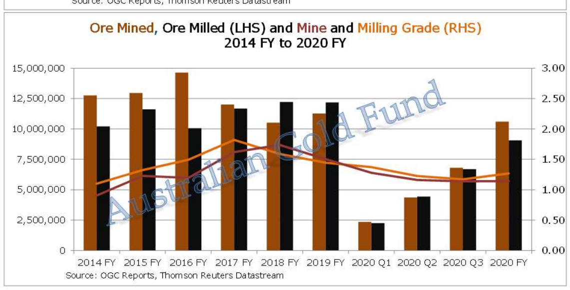


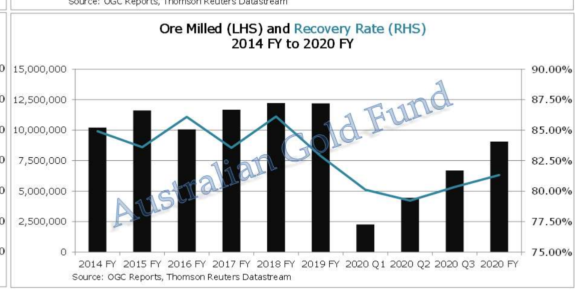








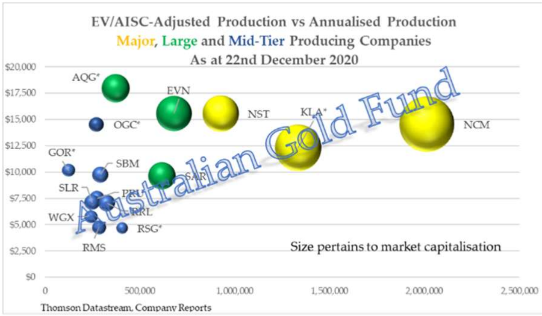


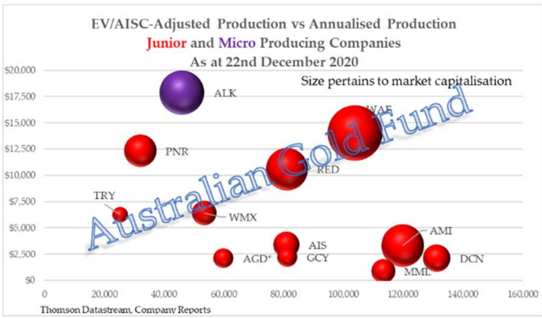


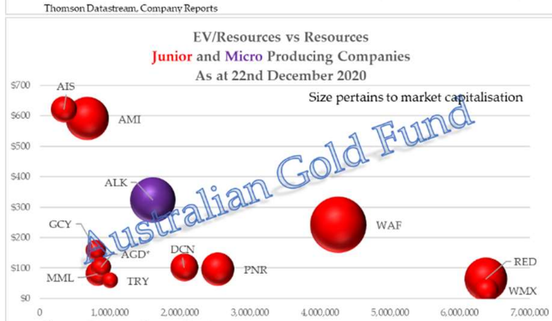
SWOT Analysis

Strengths	Weaknesses
• Company appears to be on a growth phase with production to rise gradually, increasing 75% over five years. • Management has a track record of delivering turnarounds and being resilient during difficult times. • Diversified company with four mine operations in three different continents.	• Resignation of experienced CEO in midst of company downturn has weakened investor confidence, which has already been low. • Production slump arising from closure of the highly lucrative Didipio mine places pressure of cashflow generation. • Balance sheet has been weighed down by debt, leading to no dividends paid for the last 18 months.
Opportunities	**Threats**
• Didipio mine operation resuming is contingent on government approval of their restart plan within 12 months. • Underground mine production will be an increasing part of the company's operations starting with Martha Underground and Macraes Underground mines this year. • Further conversion of resources and reserves as a result of extensive exploration programs will help to restore confidence and maintain its competitive position among peer companies.	• With several development projects in the pipeline, balance sheet stability may be under pressure should there be cost blowouts coupled by lower production. • At current price, future growth potential may be cut short if a competitor decides to offer a low-ball takeover bid while it is down.

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.

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.

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 Oceanagold 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.