Australian Gold Fund Valuation and SWOT Analysis

Red 5 Limited

Special Report – King of the Hills Mine Development and Equity Capital Raising Valuation

28th March 2020

Summary

Financial Metrics			
	Less Debt	More Debt	Average Debt
Cash + Bullion ($m)	$148.00	$148.00	$148.00
Debt ($m)	$50.00	$100.00	$75.00
Net Cash ($m)	$98.00	$48.00	$73.00
Capital Raised ($m)	$125.00	$125.00	$125.00
No. of Issued Stocks	1,937.611	1,937.611	1,937.611

Total Enterprise Value			
	Lower	Upper	Average
Darlot	$93.75	$266.67	$170.31
King of the Hills	$140.70	$553.55	$286.37
Company	$282.45	$918.21	$529.68
Estimated Stock Price	$0.146	$0.474	$0.273

Financial Metrics (No Capital Raising)	
	Less Debt
Cash + Bullion ($m)	$28.00
Debt ($m)	$20.00
Net Cash ($m)	$8.00
No. of Issued Stocks	1,243.167

Total Enterprise Value			
	Lower	Upper	Average
Darlot	$93.75	$222.22	$151.39
King of the Hills	$116.15	$329.68	$206.74
Company	$217.90	$559.91	$366.13
Estimated Stock Price	$0.175	$0.450	$0.295

This report outlines our opinions regarding the valuation of Red 5 Limited stocks in light of their proposed $125m equity capital raising at $0.18 per stock, with a view to strengthening their balance sheet to construct the processing facilities at the King of the Hills mine. This announcement has been met with disappointment by several investors, who did not expect the company to move so quickly to raise equity given that construction is unlikely to commence until closer to the end of the year. The company's cash and bullion balance is around $26.6m and with the Darlot mine delivering modestly positive operating cashflows, it did not appear that the company is in urgent need for cash.

Based on the uncertainty in the current market environment due to the coronavirus pandemic, central banks returning to currency printing and governments seeking to implement fiscal policy in order to spur spending and boost consumer confidence, the company management may be moving earlier to secure some funding. This is seen to be prudent, though at a discounted price of $0.18, will no doubt attract investor discontent.

We are of the view that the company's projection of the construction cost and subsequent operations for the King of the Hills mine appears to be optimistic for similar mine operations in Australia. Our estimates suggest that the mine's current enterprise value is between $140m-$554m, using our EV/AISC-Adjusted Production approach that considers both the level of production and the cost. The King of the Hills mine is a call option and it is subject to time and risk-based discounting for its uncertainty. We considered similar mines such as Evolution Mining's Mount Rawdon, Dacian Gold's Mount Morgans, Ramelius Resources' Mount Magnet and Regis Resources' Duketon North as our basis. However, we made adjustments downwards in light of the King of the Hills processing plant being newly constructed, having lower grade ore compared to the other mines and taking into account potential operational problems in the early stages of production.

In combination to the Darlot mine, which we estimate the enterprise value to be between $90m-$270m, and including the $125m equity capital and an estimated $50m-$100m debt financing we believe the company would be reasonably valued at an enterprise value of between $280m-920m, with an average value of $530m. This range is wide given the substantial value that the King of the Hills mine may offer to the company, but it will only begin production in 18-24 months' time. Optionality exists in this respect.

We believe that Red 5's stock price is fairly valued at around $0.273, with a range of $0.146-$0.474. This range takes into account the general sentiment of investors in the gold mining industry. We also considered the case where the company did not raise capital and considered the risk-adjusted values of the Darlot and King of the Hills mine. We found that the company's fair value would be around $0.295, with a range of $0.175-$0.45. The EV/AISC-Adjusted Production multiples were consistent with past valuation reports and would need to reduce compared to the case of the company now as the company has a less robust balance sheet and is almost certain to need material external capital funding to construct the mine. We found that the range is not too different to that we saw with the company in the past year.

We note that despite Red 5 would become a mid-tier producing company post-King of the Hills reaching commercial production, we have not used this in the valuation multiples as the company should not be considered a mid-tier company until it has at least completed the construction phase.

Background

King of the Hills Mine Projected Performance										
	Ore Grade (g/t)			Production		AISC		AISC-Adjusted Production		
	Poor	Good	Average	Recovery	Production	Lower	Upper	Poor	Good	Average
Normal Performance	1.565	1.675	1.62	93%	154,993	$1,250.00	$1,500.00	103,329	123,995	113,662
Poor Performance	1.28	1.36	1.32	85%	129,855	$1,300.00	$1,600.00	81,160	99,889	90,524
Good Performance	2.08	2.22	2.15	97%	187,730	$1,100.00	$1,350.00	139,059	170,663	154,861

Red 5 Limited has reported their intention to develop the King of the Hills mine, with a Bankable Feasibility Study to be published by the September quarter, followed shortly after with plans to commence constructing the 4Mt p.a. processing plant and other facilities. The company expects that the processing plant will begin to mill ore in late 2021, with ore coming from the open-pit mine, a satellite deposit at Rainbow and also the existing underground mine.

The company has seen its stock price rise substantially from the end of 2018 at $0.06 to $0.395 in early 2020 as excitement gathered regarding the company's announcements of increasing their mineral resources to 4.07Moz at 1.4g/t and ore reserves of 1.45Moz at 1.24g/t. They expect to book more ore reserves in their underground deposit in the near future.

The company's parameters regarding the mine are as follows:

- 4Mt p.a. processing plant to be built at a cost of $218m.
- Current resources of 4.07Moz at 1.4g/t (supposedly includes already 1.1Moz of underground resources at 2g/t) and reserves of 1.45Moz with open-cut ore grade 1.24g/t.
- Annual processing of 4Mt p.a. ore at 1.24g/t (perhaps, expect it to be higher) with 93% recovery rate to produce approximately 140 000oz p.a. at AISC $1 167/oz.
- Part of the processed ore includes higher grade underground ore being extracted at 0.6Mt p.a.

Our Valuation

We hold to the view that the company has somewhat optimistic projections and this is further confirmed by their pre-emptive material equity capital raising. Our views are as follows:

- The processing plant will process blended ore from open-pit and underground deposits at an ore grade of between 1.2-1.8g/t for open-pit and 2-3.2g/t for underground. We consider this based on the company's reserves statement and the recent underground deposit ore grade. There will be predominantly open-pit ore being processed, with the average ore grade between 1.3g/t-2.2g/t. Our base case estimate is 1.6g/t.
- The company states that their recovery rate is around 92.8%, we have taken the recovery rate to vary in the 85-97% range, considering variations in processing. Our base case estimate is 93%.
- We have taken into account the potential for the company to mine higher grade underground ore to supplement their open-pit ore feeds. We therefore assume that the annual production level to vary between 130-188koz. Our base case estimate is 145koz.
- Based on Australian mines of comparable milling capacity and ore grades, we believe the AISC is within the $1 100-$1 600/oz range. Our base case estimate is $1 375/oz.

- The construction cost is expected to be $218m. We have considered this in the financing package of $125m equity and debt financing of $50m-100m, with the remainder amount being financed from operating cashflows from the Darlot operations. We believe that the company will want to retain an adequate cash buffer for normal operations and potential for the mine construction to go above budget (a common occurrence in mine construction).
- The company is expected to sell almost 700m stocks from the equity issue, and we estimate around $5-7m will be paid to underwriters.
- Given the mine will be constructed in 18-24 months' time, we have included a discount rate to account for the time value of money and risk associated with this mine. We have chosen a range of 10-15% p.a. to reflect the inherent risk and the current risk-free yield.

Based on our analysis, we believe that the King of the Hills mine is expected to deliver in its first year of production between 130-188koz of gold at an average AISC of $1 375/oz (ranging from $1 100-$1 600/oz), taking into account that the underground ore will add to the production to the open-pit deposits. Based on this level of production and AISC, we believe that the suitable EV/AISC-Adjusted Production multiple range would be $2 000-$4 000/oz, with an average of around $2 800/oz. This reflects well a mid-tier mine. Our scenarios are given below:

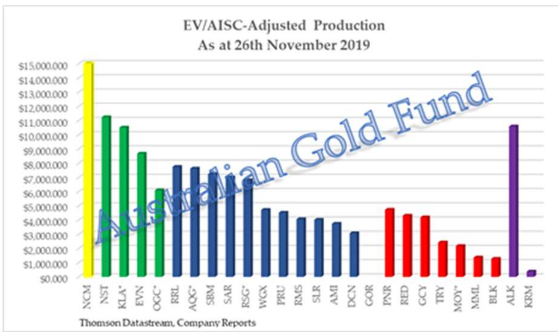
	AISC-Adjusted Production			EV/AISC-Adjusted Production			Discounted EV		
	Lower	Upper	Average	Lower	Upper	Average	Lower	Upper	Average
Normal Performance	103,329	123,995	113,662	$2,000.00	$3,200.00	$2,600.00	$179.13	$321.74	$247.66
Poor Performance	81,160	99,889	90,524	$2,000.00	$3,000.00	$2,500.00	$140.70	$242.99	$189.66
Good Performance	139,059	170,663	154,861	$2,500.00	$4,000.00	$3,250.00	$301.34	$553.55	$421.79

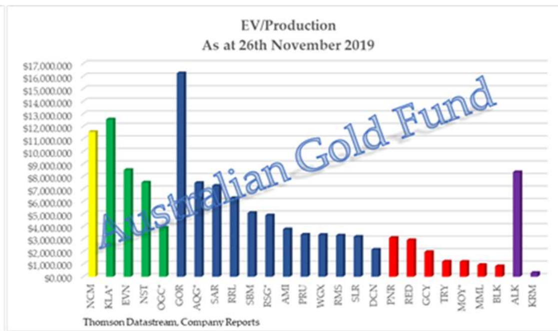
Thus, we suggest that the mine's current enterprise value ranges from $140m-$554m, with an average of around $250m. This is an optionality value, and hence is asymmetric and currently closer to the lower end of the range. With more certainty, and should conditions prevail, the mine should be ascribed higher value.

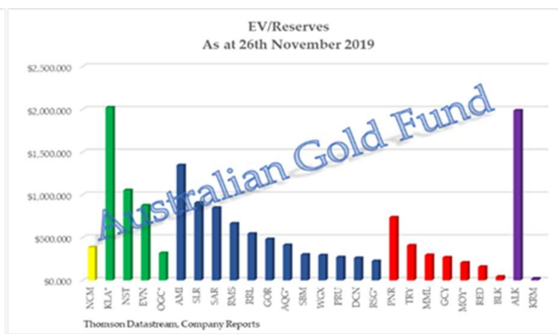
Regarding the Darlot mine, we take into account the company's most recent announcement regarding the downgrading of the March quarter production and hence the 2020 full year guidance from 110-120koz p.a. at $1 350-$1 500/oz to 100-105koz p.a. $1 550-$1 650/oz. We believe that the Darlot mine is going to continue processing at around 0.85-1Mt p.a. and hence produce 100-120koz p.a. at AISC $1 350-$1 600/oz. We prefer to keep the range a little wider to provide a wider range to determine what range the mine would be valued under different market conditions. Given the Darlot mine is a relative high-cost operation producing at a level similar to junior mining companies, we believe the EV/AISC-Adjusted Production multiple should be $1 500-$3 000/oz. This gives the mine an enterprise value ranging from $94m-$267m. We are willing to be a little more generous in valuing the Darlot mine for the sake of including the value of management and operational personnel and other intangible assets associated with the company.

In considering the case where the company did not raise capital and leaves it to later to arrange a funding package, we adjusted downwards the EV/AISC-Adjusted Production multiples for both mines to $1 500-$2 850/oz due to a weaker balance sheet. Furthermore, we included a substantially higher risk-adjusted discounting factor on the King of the Hills mine enterprise value as the company is going to need material funds outside of what they have to finance the project to fruition.

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

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.

Declaration of Interest

The Australian Gold Fund and its directors currently holds Red 5 stocks. We do not receive any income or benefits from the company as a result of our report.

