Australian Gold Fund Valuation and SWOT Analysis

Red 5 Limited (ASX: RED)

Date	20/09/2019
Classification	Junior Gold Miner
Current Price	$0.295
No. Issued Stocks (m)	1,243.2
Net Cash + Bullion + 0.5 x GIC ($ m)	$14.73
Last Dividend Payment ($ p.a.)	$0.00
Market Capitalisation ($ m)	$366.73
Enterprise Value ($ m)	$352.01
Resources (oz)	5,159,000
Reserves (oz)	2,128,950

Ranking	**Overvalued but substantial upside potential**
Price Range	$0.13-$0.265
2020 Annual Gold Production Guidance (oz p.a.)	110 000-120 000
2020 All-In Sustaining Cost Guidance ($/oz)	$1 350-$1 500
EV/AISC-Adjusted Production Guidance ($/oz)	$4,362.00
EV/AISC-Adjusted Production Range ($/oz)	$2 000-$3 500
EV/Resources ($/oz)	$68.23
EV/Reserves ($/oz)	$165.34

Summary

Two years since the game-changing opportunity for Red 5 to purchase the Darlot and King of the Hills gold mines, the company has put in some hard yards and is now able to gain momentum to become the next mid-tier gold mining company in the coming two years as a result of the discovery of substantial reserves and resources in the King of the Hills mine. Investors have similarly responded in excitement, resulting in Red 5 to become one of the biggest advancers in their stock price of all gold producing companies in the world (up 418% in a year to 20th September 2019). Going forward, management plans to develop the King of the Hills mine by upgrading their processing facility to have a 4Mt p.a. capacity, and thus being able to produce 140 000oz p.a. for ten years from its open-pit operations and more when including their underground operations.

For the 2019 financial year, Red 5 delivered production of 102 012oz at AISC $1 564/oz from the Darlot and King of the Hills operations. This compared with the 2018 financial production of 50 585oz at AISC $1 480/oz, when the company ramped up production over three quarters. The company managed to deliver over 30 000oz in the June quarter at AISC $1 331/oz, a solid result. For much of the year, the cost was over $1 500/oz, but this fell in conjunction with the King of the Hills mine delivering more high-grade gold. Further economies of scale is expected for 2020 with production being expected at 110 000-120 000oz at AISC $1 350-$1 550/oz. As the gold price continues to increase, this should provide the company with solid free cashflows for their next stage of development.

Most exciting for Red 5 investors is the announcement during the year regarding their King of the Hills mine booking 3.11Moz of resources in May and 1.45Moz of reserves in August, a substantial increase from 402 000oz of resources when they first purchased this mine from Saracen Mineral Holdings in August 2017. A pre-feasibility study conducted suggests that this mine could be upgraded into a 10-year open-cut mine with an average annual production of 140 000oz at AISC $1 167/oz and after including development costs, $1 325/oz. The total cost of developing this project is estimated to be $218m after including contingencies. The plan includes constructing a 4Mt p.a. processing plant that will cost $92m, and other construction costs adding up to a total of $166m. The existing underground operations offer further additional ounces and potential for cost reduction. Under their preliminary plans, the aim is to commence construction in early 2021 with the first gold pouring in late 2021 or early 2022. Put together, the King of the Hills mine has propelled to become one of the Top 20 deposits in Australia, and this was all purchased for $16m. Going back to 2013, when St Barbara Mines owned King of the Hills, the reserves and resources were 68 000oz and 491 000oz, respectively.

The Siana gold mine still remains in care and maintenance, although there appears to be positive signs from the government in terms of granting permission to resume operations. However, no confirmation has been secured. The company will consider the potential of selling the mine or developing its underground operations pending further directions from the government. For the purpose of valuation, we assume the Siana mine will contribute to no further value addition at this stage.

Red 5 has also seen their balance sheet improve markedly in the June quarter, thanks to the rallying gold price during that period. The operating cashflows net of maintenance capital expenditure was $13m, and the net cash position increased by $10.5m resulting from $7.7m increase in cash and $3.6m increase in bullion. At the rate they are performing and the timing of the major capital expenditure for the King of the Hills mine being scheduled in early 2021, they are well positioned to have sufficient internal funding without resorting to significant equity capital funding. This assumption is contingent on the gold price remaining strong, which is likely given the return to currency printing by central banks around the world.

Red 5 has clearly entered into a sweet spot of strong gold price alongside the prospect of a long-life gold mine that will propel to mid-tier status within the next 2 years. Given that the models for estimating resources and reserves are based on a conservative gold price of A$1 800/oz, more upgrading may be forthcoming. While the EV/AISC-Adjusted Production at the current stock price is $4 362/oz and would place it in the overvalued category, due to their low production, this does not take into account their growth potential ahead. Nonetheless, given that Red 5 will need to wait almost two years before being upgraded to mid-tier status, we have upgraded the valuation range to being between that of a junior and a mid-tier mining company. Our metrics suggest that Red 5 be deemed overvalued but with substantial upside potential.

Prevailing Environment

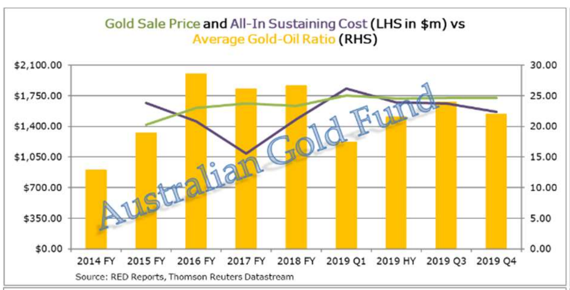
The first half of 2019 has seen the global financial markets make some recovery after a rather sharp decline in December 2018 as the Federal Reserve continued with their monetary policy of raising rates despite the real economy being weak, in conflict with the official economic and unemployment data. The tone of the Federal Reserve began to change as 2019 took its course. Should the Federal Reserve reduce interest rates in July, this would indicate the end of the rates cycle that began in the end of 2015 when the Federal Reserve began to raise interest rates from an unprecedented rock-bottom level of 0.125% and peaked at 2.375%.

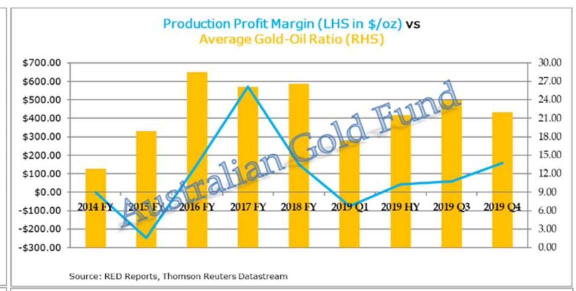
The change in the tone of the Federal Reserve is in conjunction with other central banks around the world taking a more dovish stance. The Reserve Bank of Australia surprised the market with a 0.25% reduction in early June 2019, taking it to 1.25%. This rate reduction comes as a result of a surprise return of the Coalition government in the 18th May election on the backdrop of promises by the government to try to boost a weakening jobs market and slow down an accelerating decline in the property markets in the eastern seaboard.

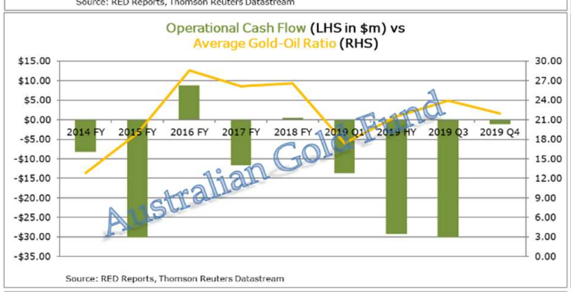
The gold price for most of early 2019 was rangebound between US$1 260-$1 350/oz, but this took a sudden turn after the June meeting on 19th June 2019 when the Federal Reserve indicated they were looking to start reducing rates as early as the July meeting scheduled on 30th-31st July. The gold price rose above US$1 400/oz on 24th June 2019, for the first time since 2013 after the sharp decline in April and June. At the same time, the gold price in Australian dollar terms went above $2 000/oz and supported further by a weaker Australian dollar. With the July meeting leading to the Federal Reserve reducing the interest rate by 0.25%, the gold price continued to head upwards. Most interestingly, the gold price surpassed US$1 500/oz at the same time a twenty-year gold sale agreement among leading central banks expired and was not renewed. While many know that the physical sales of gold and precious metals do not move market prices as they are determined by the paper contracts, this is symbolic of what may potentially be the end of the suppression of precious metal prices to give an illusion of a stable petrodollar financial system.

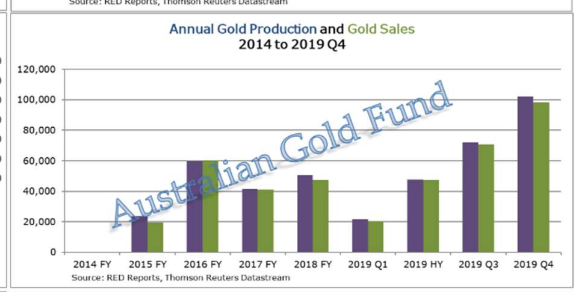
The oil price has been trading between US$50-$65/bbl on the backdrop of rising Middle East tension with Iran being in the spotlight. The US-Iran tension in the Persian Gulf and Strait of Hormuz briefly attracted much media attention and pushed the oil price above the US$60/bbl mark. This has now since been less at the forefront of market traders as increasing crude oil inventory and the escalation of the US-China trade wars takes a toll on economic activity and reduced the oil price approach US$50/bbl.

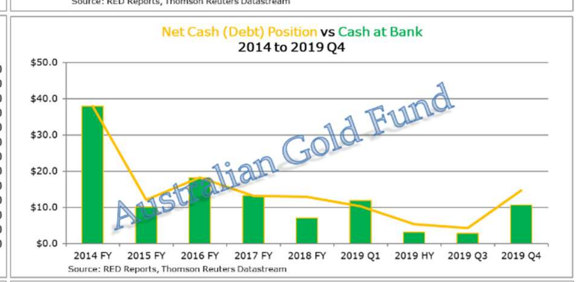
Operational and Financial Performance Charts

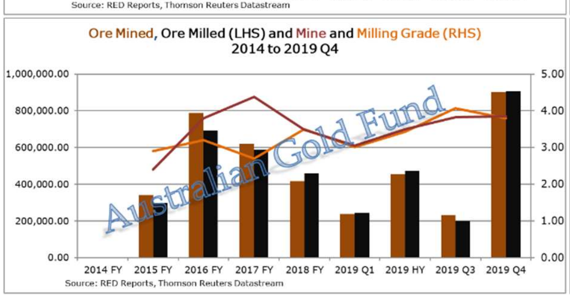


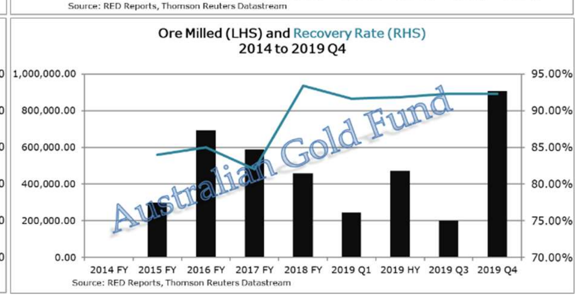








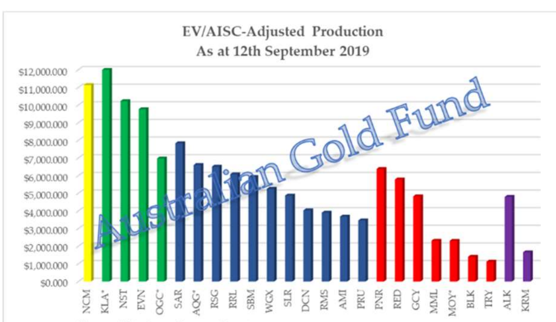


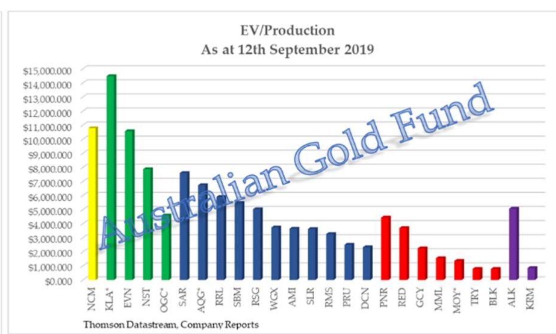


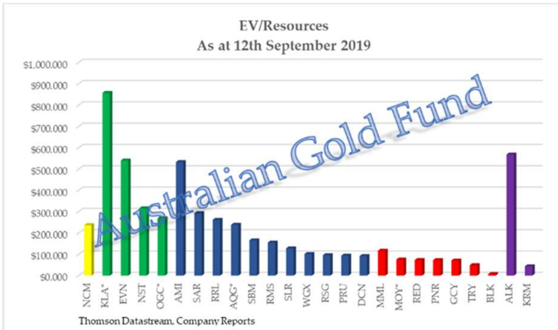
SWOT Analysis

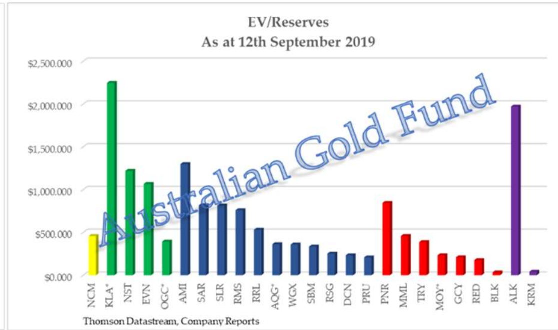
Strengths	**Weaknesses**
• Secured potential to become a mid-tier producing company with the King of the Hills mine. • Company operations are relatively positive and facilitate building of cash necessary for the major development project ahead.	• The company's operations are still of a smaller scope so performance is volatile. • The Siana mine operates in a jurisdiction with uncertainty and its suspension has been a drag on the company's desirability as a stable investment.
Opportunities	**Threats**
• The King of the Hills development project is a game-changer and the timing allows for the company to rely more on internal funding than dilutive capital raising. • The Darlot mine still offers substantial opportunity, though overshadowed by the King of the Hills mine. • A favourable ruling from the Filippino government on the Siana mine may further boost the company's prospects.	• A retreat in the gold price or oil price spike could again be a menace on their cash balance. • Ore grade decline or processing delays are material risks.

Peer Comparison









Glossary

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.).

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 **EV/AISC-Adjusted Annual Production** is a *comparative measure* used for valuing companies in this report and can be used to determine relative value. 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 metric is used to determine the Price Range for the company. This range takes into account the baseline range depending on the company's classification, as determined by the annual gold production level. The range can be adjusted upwards or downwards based on other factors that are presented in the SWOT Analysis section.

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.

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.

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.

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 hold Red 5 stocks and may purchase or sell their holdings prior to or subsequent to the report being published in their website. We do not hold a substantial stake and do not receive any income or benefits from the company as a result of our report.