Australian Gold Fund Valuation and SWOT Analysis

Saracen Mineral Holdings Limited (ASX: SAR)

Date	24/12/2019
Classification	Large Gold Miner
Current Price	$3.100
No. Issued Stocks (m)	1,102.9
Net Cash + Bullion + 0.5 x GIC ($ m)	-$204.00
Last Dividend Payment ($ p.a.)	$0.00
Market Capitalisation ($ m)	$3,418.95
Enterprise Value ($ m)	$3,622.95
Resources (oz)	15,710,000
Reserves (oz)	6,950,000

Ranking	**Undervalued**
Price Range	$2.835-$4.46
Annual Production Guidance (oz p.a.)	595 000-615 000
All-In Sustaining Cost Guidance ($/oz)	$1 200-$1 250
EV/AISC-Adjusted Production Guidance ($/oz)	$7,335.72
EV/AISC-Adjusted Production Range ($/oz)	$7 000-$10 000
EV/Resources ($/oz)	$230.61
EV/Reserves ($/oz)	$521.29

Summary

Saracen Mineral Holdings has entered into a new stage of operations when they announced in mid-November that they would acquire a 50% of the stake of the Kalgoorlie Super Pit mine from Newmont-Goldcorp for US$750m (A$1.1bn). This acquisition was funded by a combination of $400m of senior debt and a 1 for 5.75 rights issue at $2.95 that raised around $800m. Prior to this, Saracen acquired Bligh Resources for $38m and the Sinclair nickel project from Talisman Resources (ASX: TLM) for $10m. Going forward, Saracen appears to be breaking ranks from the mid-tiers to graduate into a large gold mining company with a potential for producing base metals as well. Management has upgraded the 2020 calendar year management outlook to 595 000-615 000oz production at AISC of $1 220/oz (2020 financial year of 470 000-490 000oz), assuming that the Super Pit mine will produce around 245 000oz in the 12 months subsequent to the purchase. With Northern Star Mines (ASX: NST) declaring in mid-December that they have acquired the other 50% stake of the Super Pit mine, this could be an exciting joint venture that may offer synergies given that the two companies have complementary expertise in operating open-pit and underground mines, as well as both having a good track record of developing and expanding medium to large mines.

Saracen delivered 96 324oz of gold at AISC of $ 964/oz in the September quarter from their Carosue Dam and Thunderbox operations. This quarter has been one of the best quarters achieved in the recent years, especially as the Thunderbox mine has ramped up the underground production that will reduce the AISC. The ore grades being mined and processed at both Carosue Dam and Thunderbox have shown a positive jump compared to the previous quarters. We will await the December quarterly report to see if the September result surprise is a one-off or foreshadowing continual improvement in these two mines. Management also expects that the Carosue Dam mine development will deliver a 20% increase in production for the 2021 financial year when it is expected to deliver around 245 000oz and combined with Thunderbox, would bring annual production to 400 000oz p.a.

Exploration successes for the company saw the company's reserves increasing by 50% at Carosue Dam and 15% at Thunderbox after mine depletion, and resources increasing less than 10% for both mines during this time. This result is noteworthy as Saracen stood out against the industry peers this year with this reserves conversion. The company's exploration budget has been robust and delivers results consistently.

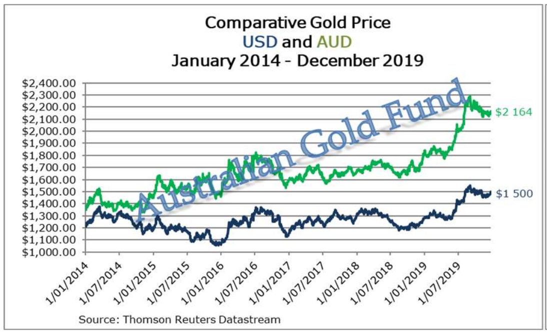
Regarding the Kalgoorlie Super Pit mine acquisition, the company paid US$750m (A$1.1bn) to acquire a 50% stake. The mine is projected to deliver 245 000oz attributable to Saracen in 2020 at AISC of approximately $1 470/oz. The mine produced around 730 000-755 000oz p.a. during 2016-2018 but declined to 490 000oz for the 2019 financial year as a result of a mine wall collapse. The mine comprises a processing plant with annual throughput capacity of around 13Moz p.a. and the ore grade processed averaged around 2g/t, except in 2019 when it fell to 1.42g/t. Recovery rate for the processing plant is consistently around the 82-85% range, which is not optimal compared to what is normally seen in a major Australian mine. The east wall that collapsed is expected to take 3.5 years to complete but mining will still be possible in that area in the first quarter of 2020. The mine currently has 7.3Moz of reserves with ore grade of 1.2g/t and 11.7Moz of resources, meaning that Saracen's share is 3.65Moz of reserves and 5.85Moz of resources. The following table summarises the various valuation metrics for this acquisition:

	Price
Super Pit Acquisition ($m)	$1,100.68
Production	245,000
AISC Average	$1,450
Resources	5,850,000
Reserves	3,650,000
Price/AISC-Adjusted Production	$6,514
Price/Resources	$188.15
Price/Reserves	$301.55

For a mine of this capacity, the Price/AISC-Adjusted Production level of $6 514/oz is deemed to be a reasonable value after taking into account the scope of the operation. Evolution Mining purchased Red Lake Gold at around $8 176/oz (assuming 155 000oz p.a. at AISC $2 300/oz for the most recent year), but this is due to the mine needing to undergo substantial development before being able to deliver at 200 000oz p.a. at AISC of around $1 500/oz in the long-run. In terms of the price paid per oz of resources and reserves being $188/oz and $302/oz, respectively, this is considered good value. In our end of May report, the company's EV/Resources and EV/Reserves were $289/oz and $993/oz. After this acquisition, they have fallen to $231/oz and $521/oz.

Post-acquisition, Saracen is expected to have approximately $204m of net debt. At the current price of $3.10 and considering the production guidance, the EV/AISC-Adjusted Production is around $7 300/oz. Given that Saracen is now a large gold mining company with a strong track record of under-promising and overachieving, we believe the fair valuation range of $7 000-$10 000/oz AISC-Adjusted Production is not unreasonable. Taking into account also that central banks reversing their monetary policy to keep easing will push gold price higher, this further reinforces our fair valuation range. At the current price, we consider Saracen to be undervalued. We eagerly await the December quarterly report for further updates regarding production results in Thunderbox and Carosue Dam as well as a clear strategy for fixing the wall at Super Pit.

Prevailing Environment

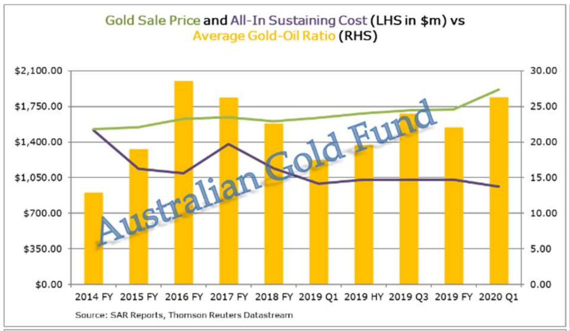


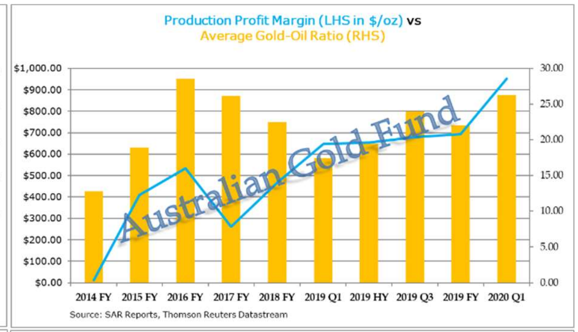
The gold price has had a positive trend over the year of 2019, especially since late May when it became apparent that the Federal Reserve would reverse on their initial plan to raise the Federal Funds Rate three times during the year to reducing it three times, being in late July, mid-September and late 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.

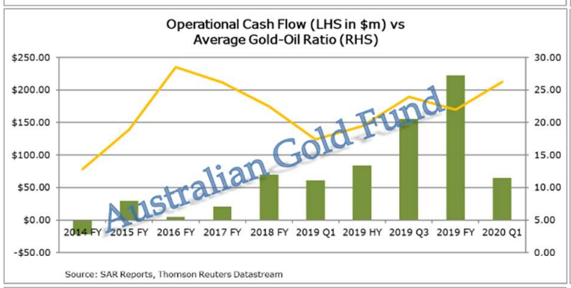
In Australia, the gold price has risen more sharply as a result of the Australian dollar weakening slightly during the year, sitting in the US67-72c range. The gold price started the year at A$1 820/oz and currently trades at A$2 164/oz at Christmas time, peaking at A$2 293/oz in early September. The 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.

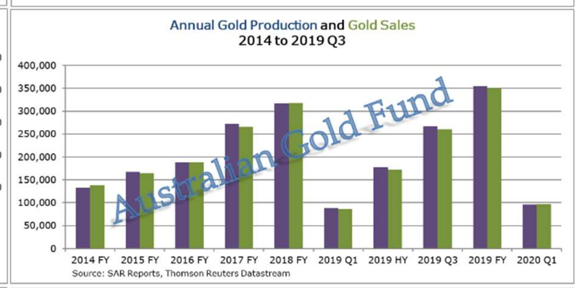
Regarding the oil price, over the year it has traded in the US$50-65/bbl range. This has been accommodating lower costs for miners and also a boost to consumer spending. The oil price has started rising in December from US$56/bbl to around US$60/bbl, and it remains to be seen whether this will continue into 2020. 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. By Christmas, with the oil price rising, 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.

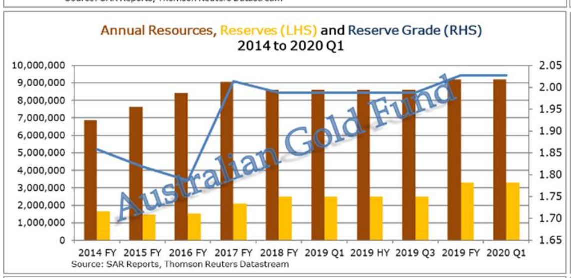
Operational and Financial Performance Charts

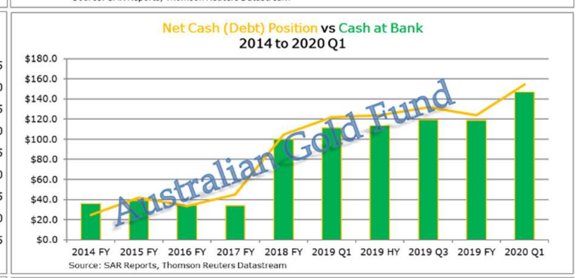


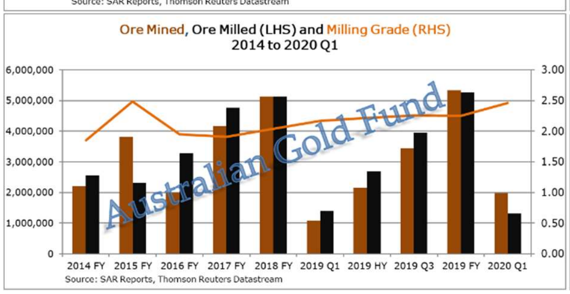


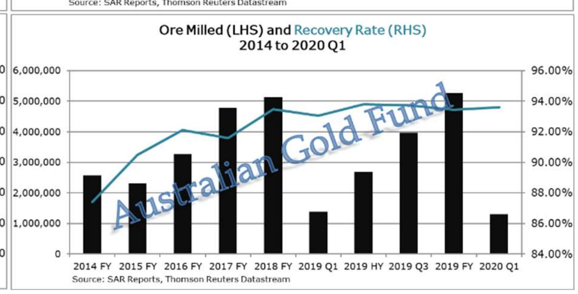








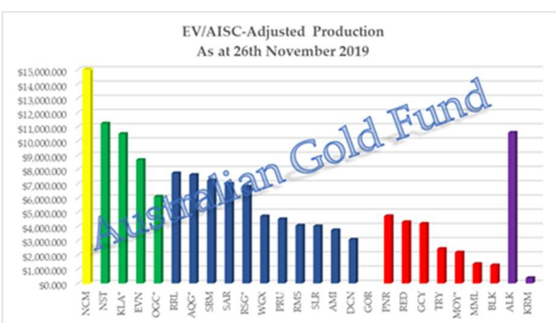


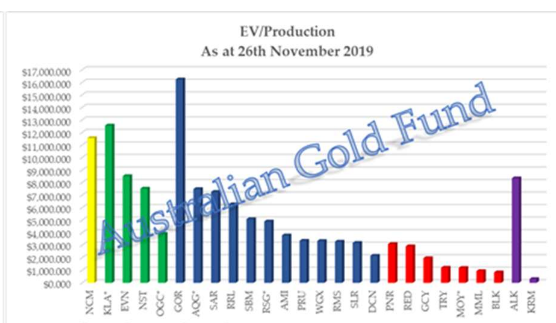


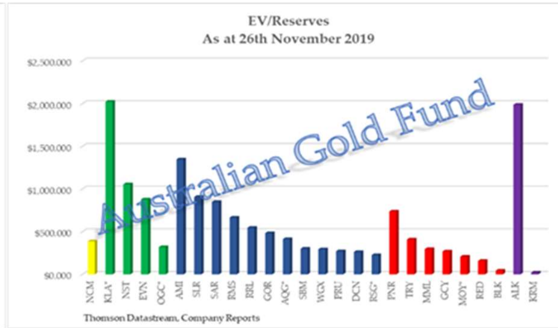
SWOT Analysis

Strengths	**Weaknesses**
• Considered one of the best ASX-listed gold mining companies in terms of stability and performance given its operations are low cost and have been reliable. • Well-renowned management team with a reputation for being able to deliver results. • The acquisition will further underpin mining life and provide substantial growth opportunities due to the large resources endowment of the Super Pit mine.	• The stock price for Saracen has risen strongly in the last 18 months and may imply certain investors want to take profits at this stage. • Stock price has fallen 30% from its peak in the last 6 months despite little news to support its decline. • Underground production, while relatively low cost for now, has been underpinned by low grade ore (<4g/t).
Opportunities	**Threats**
• Joint venture with Northern Star in the Super Pit mine may unlock further potential of this mine. • The expansion of the Carosue Dam will continue further increase low-cost ounces to Saracen's production.	• Saracen is now in a net debt position and any delays or complications with the Super Pit wall remediation program will place pressure on its balance sheet.

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

Declaration of Interest

The Australian Gold Fund and its directors currently do not hold Saracen 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.