Australian Gold Fund Valuation and SWOT Analysis

Saracen Mineral Holdings (ASX: SAR)

Date	22/09/2020
Classification	Large Gold Miner
Current Price	$5.040
No. Issued Stocks (m)	1,102.9
Net Cash + Bullion + 0.5 x GIC ($ m)	$61.14
Last Dividend Payment ($ p.a.)	$0.00
Market Capitalisation ($ m)	$5,558.55
Enterprise Value ($ m)	$5,497.41

Operating Performance Metrics	
Annual Gold Production Guidance *2021 Estimate* (oz p.a.)	600 000-640 000
All-In Sustaining Cost Guidance *2021 Estimate* ($/oz)	$1 300-$1 400
Operating Margin (Sale Price less AISC)	$1,040.99
Resources (oz)	17,400,000
Reserves (oz)	8,500,000
Financial Year Cumulative Production (oz)	520,414
Production as % of 2020 Annual Guidance	104.08%
Financial Year Cumulative AISC ($/oz)	$1,101.00

Valuation Metrics	
Price Range	$4.32-$6.74
Overall Ranking	Undervalued
Current EV/AISC-Adjusted Production	$11,971.00
EV/AISC-Adjusted Production Range	$11 000-$15 000
Ranking	Undervalued
EV/Resources	$315.94
Ranking	Undervalued
EV/Reserves	$646.75
Ranking	Undervalued

Summary

Saracen Mineral Holdings is looking to enter the 2021 financial year with guns blazing after transforming themselves into a formidable large producing company with a joint venture with Northern Star Mines to acquire the Kalgoorlie Super Pit mine from Newmont-Goldcorp late last year. The progress in developing the Kalgoorlie Super Pit mine and the Thunderbox underground have seen the company increase its reserves and resources by the end of the year net of depletion. The company also repaid their debt from the acquisition to the point that they have over $60m of net cash including gold in circuit and bullion on hand. For the coming financial year, the company is expecting gold production to be 600 000-640 000oz at AISC of $1 300-$1 400/oz. The company also announced on 18th August 2020 their plan to producing 800 000oz p.a. by 2027 through organic development of their existing mines.

For the 2020 financial year, the company produced 520 414oz at AISC of $1 101/oz (compared to 2019's production of 355 077oz at $1 030/oz), a rather commendable result supported by Carosue Dam producing 203 281oz at $1 260/oz (2019: 199 744oz at $1 063/oz), Thunderbox producing 184 538oz at $730/oz (2019: 155 333oz at $999/oz) and Kalgoorlie Super Pit producing 132 595oz at $1 397/oz in the first seven months of production since acquisition. The significant increase in production at Thunderbox is a result of improved ore grade from 1.8g/t to 2.1g/t this year. The company delivered an operating cashflow net of maintenance capital expenditure over the year of approximately $265m (2019: around $67m). During the year, they sold 528 691oz of gold on average for $2 142/oz (2019: 350 904oz at $1 723/oz).

The outlook for Saracen in 2021 will prove to be very positive for the company especially due to the current climate of inflation underpinned by a combination of unprecedented government and central bank stimulus and an impaired global economy caused by what is emerging to be shown to be unnecessary economic lockdowns from the Wuhan/coronavirus "pandemic". We believe that management guidance is conservative at 600 000-640 000oz at $1 300-$1 400/oz. Carosue Dam is expected to see a jump in production to 240 000-250 000oz with the commissioning of an upgraded mill that will lead to processing to increase from 2.8Mt p.a. to 3.2Mt p.a. at a capital cost of $34m. The Thunderbox operation is expected to see a pulling back of production at 140 000-150 000oz as the C Zone deposit depletes and production will come also from stockpiled ore with lower grade being offset

by the Thunderbox Underground production coming into effect since July 2020. The Kalgoorlie Super Pit operations is expected to deliver an attributable production to Saracen of 220 000-240 000oz. Remediating the Eastern wall failure that occurred in 2018 will be a key priority in order to restore production to the long-term potential of over 600 000oz that this mine had enjoyed in its past. The open-pit mining fleet is also expected to be reviewed and replaced to increase its production rate from 36Mt p.a. in 2020 to a long-term annual rate of 75Mt p.a. over the next few years. Given the substantial capital expenditure being undertaken and also management having a history of over-delivering on their reasonable targets, we are at leisure to see this guidance being upgraded as the year progresses. With the tepid global economy keeping oil prices at the $35-45/bbl level, we believe that this may see AISC being lower than the current guidance, aided also by higher than expected production.

As an additional sweetener to this company stock, management announced around two weeks ago that they will introduce a dividend policy of 20-40% of NPAT (2020: $258m) being paid as dividends conditional on the net cash balance exceeding $150m (2020: $48m). Given the past year's performance, we believe that Saracen will likely be able to pay a dividend next year, perhaps at around 1-2c. We note that among its peers, Saracen is the last of them to be paying a dividend and we expect it to grow steadily as the need for major capital spending tapers into 2023.

Saracen stocks are currently $5.04 as at the close of 22nd September, implying a market capitalisation of $5.56 billion and an enterprise value of almost $5.5 billion. Taking into account the company's hedging schedule (see below), we expect that the company's profit margin in 2021 will be $1 200-$1 300/oz gold sold:

Quarter	Quantity	Price
	oz	A$/oz
Sep-20	70,800	1,977
Dec-20	63,300	2,020
Mar-21	61,800	2,039
Jun-21	58,800	2,057
Sep-21	52,300	2,090
Dec-21	54,200	2,116
Mar-22	45,500	2,171
Jun-22	38,500	2,222
Sep-22	26,000	2,262
Dec-22	18,000	2,280
Mar-23	4,000	2,480
Total	493,200	$2,094

The company's EV/AISC-Adjusted Production based on the 2021 guidance is $11 971/oz, EV/Resources $316/oz and EV/Reserves $647/oz, implying that it is somewhat undervalued. Given the company's strong track record of delivering their guidance, even after upgrading it and also their high-quality mines, we believe that the company's EV/AISC-Adjusted Production to Operating Margin multiple would reasonably be between 9-13, implying a fair valuation range of $11 000-$15 000 for the EV/AISC-Adjusted Production. This implies a stock price range of $4.32-$6.74.

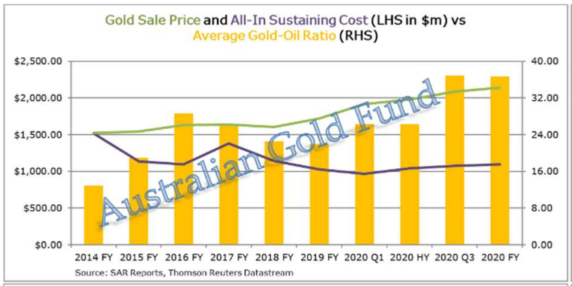
Prevailing Environment

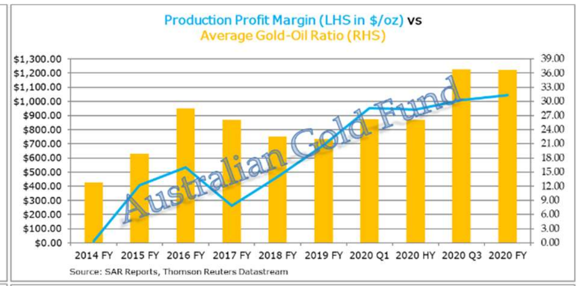
The global markets have been able to resist the experts' consensus opinions that it would fail soon and even rallied in the past six months. The reason for this is largely due to the extraordinary measures central banks and governments have taken to utilise stimulus packages in the form of currency creation, payments to businesses and households to cover for job and revenue losses in the midst of the lockdowns arising from the Wuhan/coronavirus as well as the recent reopening of many economies around the world resulting in spending due to pent-up demand. This market rally should not be mistaken as an economic recovery but due to the increase in velocity of currency and the reduction in the purchasing power of currencies around the world. With more currency created and a damaged supply chain, the amount of currencies available outweighs the amount of goods, services and assets that are exchanged, leading to price increases. This is inflation at work, not the CPI measured inflation that official agencies use that are hedonically adjusted to remove inflation from the view of the less discerning part of the population (which, sadly, is the predominant proportion).

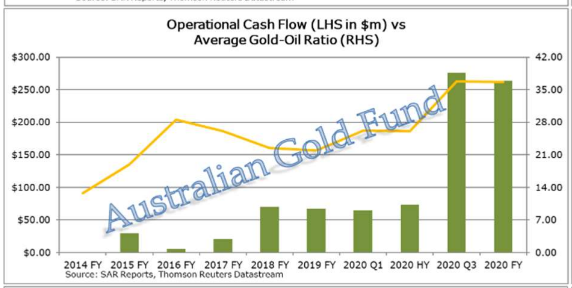
As inflation continues to take effect in the economy, we can see that the price of real assets such as precious metals, commodities, land and real estate continue to rise. The gold price in US dollar terms exceeded the all-time record high of US$1 921/oz in late July and then exceeded the psychological level of US$2 000/oz on 4th August 2020. This heralds a new era for precious metals becoming increasingly sought after by mainstream investors who have previously been steered away from gold due to the horrific bear market that ravaged many between 2012 to 2015. Furthermore, the US Department of Justice has levelled RICO charges on several bullion bank traders for manipulating the gold price (no longer a conspiracy theory). Unlike the past investigations by the CFTC and GATA, the US DOJ has extraordinary prosecutive powers and RICO charges are a heavy-handed measure once reserved for prosecuting Mafia bosses and their followers. We expect that the days of watching precious metal prices being pushed down through after-hour dumping are numbered. Oil prices, on the other hand, have recovered to around US$40/bbl, as we have foreshadowed in previous reports. This gives a solid gold-oil ratio of 46-50, which is still highly accommodative to gold producing companies in generating substantial operating margins.

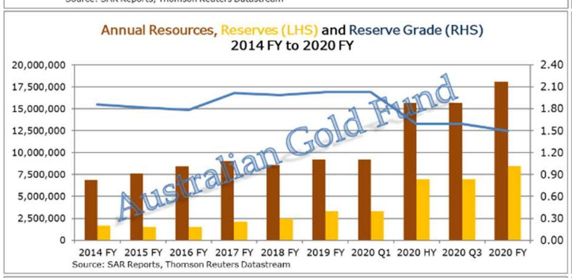
This week we have started to see the precious metals prices decline quite sharply. Based on our experience and seasonal analysis of precious metals prices, we believe this may be the beginning of the September to late-November weakness in the precious metals prices that will feed into the stock prices of precious metals mining companies. We have begun to exercise more caution on our positions as we keep a sharp lookout for quality gold mining companies that will have increasingly compelling value as prices adjust

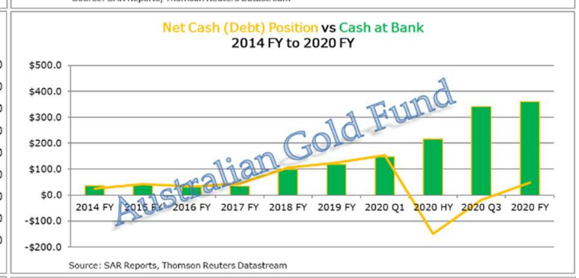
Operational and Financial Performance Charts

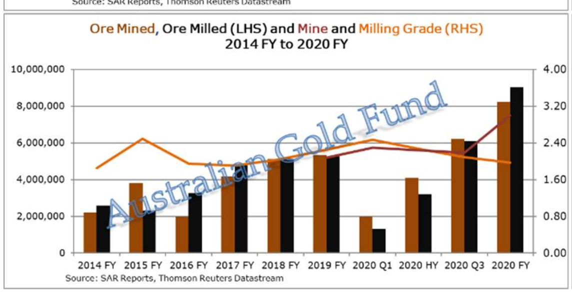


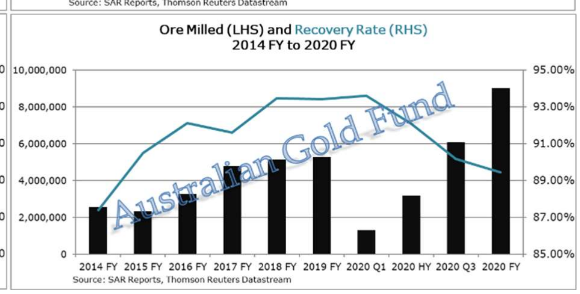








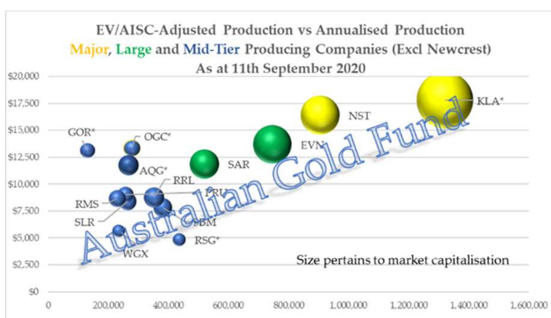


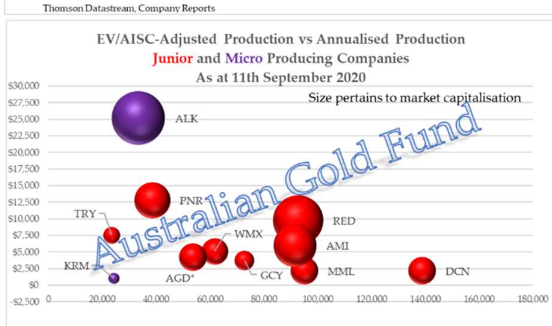


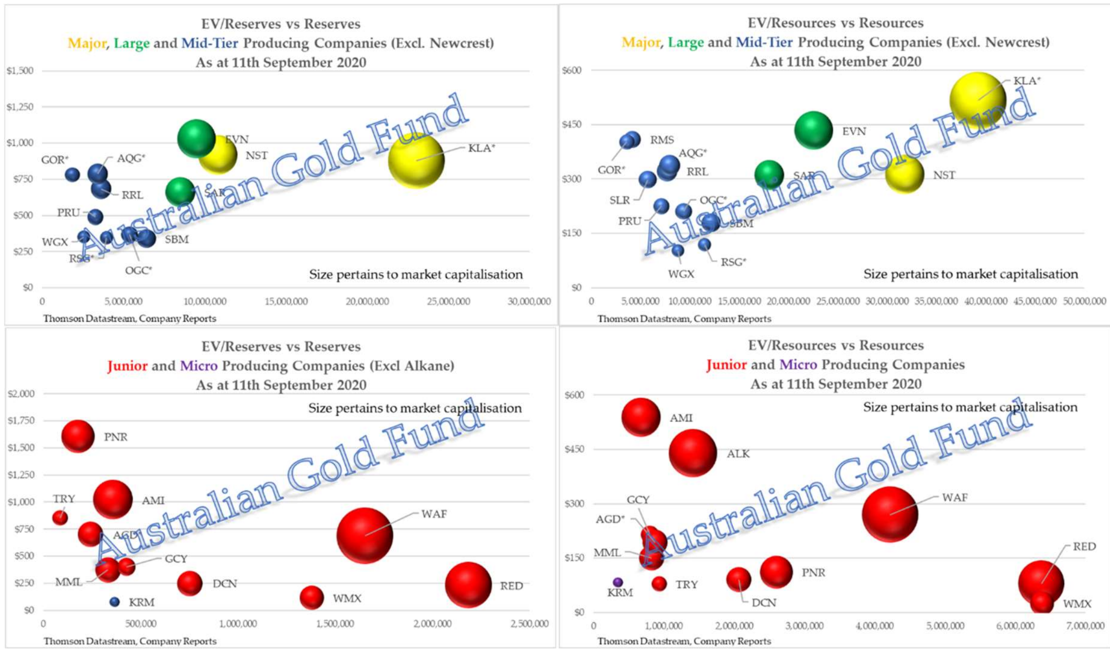
SWOT Analysis

Strengths	Weaknesses
• Strong management with track record of delivering above guidance. • All three mines are in Australia and have substantial economies of scale with low AISC. • Dividends expected to be paid out of reliable operating cashflows and a robust, steadily growing cash balance.	• The purchase of the Kalgoorlie Super Pit, while increases the company's production profile, increases the company's overall AISC. • Despite strong cashflow generation, Saracen stands out among its peers as not yet paying any dividends, though this is expected to change. • 40% of the 2021 expected production is hedged at around $2 025/oz, as gold trades at $2 600/oz.
Opportunities	**Threats**
• Capital expenditure expected to boost production across the three operations leading to possible outperformance against guidance. • As consolidations in the industry continues with companies needing more resources to feed its mills, Saracen has a strong cash balance and operating cashflow to fund further expansion.	• Lower grade underground ore in their properties may potentially increase AISC in longer term even though they have mills that benefit from economies of scale.

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 Saracen 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.