Australian Gold Fund Valuation and SWOT Analysis

Evaluation of Acquisition of Atlantic Gold by St Barbara Mines Limited (ASX: SBM)

Date	22/05/2019
Classification	Mid-Tier Gold Miner
Current Price	$2.820
No. Issued Stocks (m)	693.4
Net Cash + Bullion + 0.5 x GIC ($ m)	$9.99
Last Dividend Payment ($ p.a.)	$0.12
Market Capitalisation ($ m)	$1,955.43
Enterprise Value ($ m)	$1,945.44
Resources (oz)	11,535,000
Reserves (oz)	5,800,000

Ranking	**Undervalued**
Price Range	$2.535-$4.17
Annual Production Guidance (oz p.a.)	457 000-473 000oz
All-In Sustaining Cost Guidance ($/oz)	$985-1 045
EV/AISC-Adjusted Production Guidance ($/oz)	$4,247.00
EV/AISC-Adjusted Production Range ($/oz)	$4 000-$6 000
EV/Resources ($/oz)	$168.66
EV/Reserves ($/oz)	$335.42

Summary

On 15th May, St Barbara went into a trading halt and announced their intention to acquire Canadian junior mining company, Atlantic Gold Corporation for C$2.90, giving the implied equity of the acquisition to be A$768m including stock options. Atlantic Gold Corporation is expected to produce for 2019 92 000-98 000oz at AISC C$695-$755/oz (A$755-820m). The company has $52.3m cash, $118.5m debt, 2.373Moz resources and 1.877Moz reserves. Based on these figures, the valuation metrics implied in this acquisition are as follows:

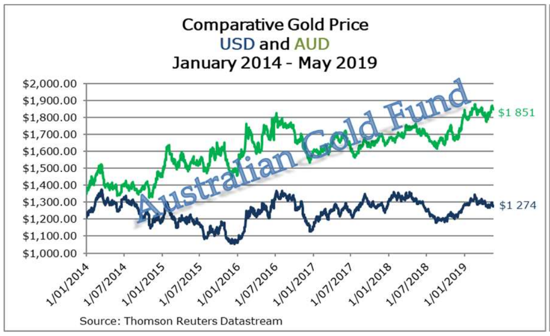
EV/AISC-Adj Prod	$6,902.95
EV/Resources	$351.54
EV/Reserves	$444.43

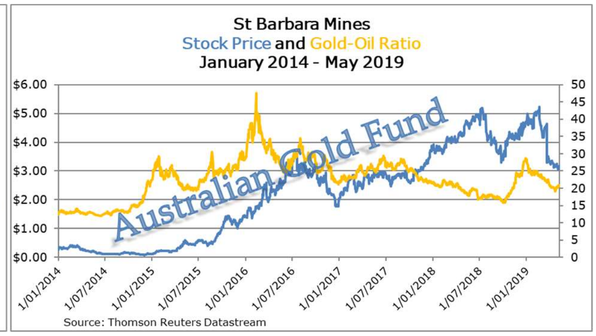
The EV/AISC-Adjusted Production of $6 902.95 for a junior mining company is considered to be very overvalued, at the level in which large gold mining companies such as Northern Star and Evolution Mining are trading at. Within this figure, it is worth noting that part of this is the acquisition premium. Based on past transactions, the acquisition premium can be around 40-50%. Thus, removing the acquisition premium, the EV/AISC-Adjusted Production would be around $4 600-$4 930. Even at this range, this is substantial. In terms of the EV/Resources and EV/Reserves of $351.54 and $444.43, respectively, the acquisition may be on the expensive side based on resources but fair value based on reserves.

Prior to the acquisition, St Barbara Mines was valued at EV/AISC-Adjusted Production in the range of $3 700-3 800/oz. The company suffered a significant decline in the stock price as a result of an announcement relating to the Gwalia Mass Extraction project in using trucks to transport ore in its underground mine. After the acquisition, the company is expected to deliver for 2019 457 000-473 000oz at $985-$1 045/oz AISC. The company will have a net cash position of $6m and a cash balance of around $118.5m, 11.535Moz resources and 5.8Moz reserves. The acquisition will place St Barbara at the foremost of the mid-tier mining companies, ahead of its current peers Regis Resources, Saracen Mineral Holdings and Resolute Mining.

Management may have made the acquisition at this price taking into account that Atlantic Gold is a low-cost mining company that delivers at AISC levels that rival large gold mining companies. The author of this report holds reservation about how reasonable this acquisition is in terms of the price. The company has accumulated a large amount of debt and reduced their cash reserves that had been painstakingly built up in the past. Furthermore, this acquisition seems to confirm that the management is not particularly conservative in making acquisitions. There is little doubt management is competent in operating their mines, delivering cashflows and turning around their company's fortunes. But, we do not rank making prudently priced acquisitions as their forte.

Based on the stock price of $2.82, the implied EV/AISC-Adjusted Production is $4 247, EV/Resources $168.66 and EV/Reserves $335.42. The company's increase in its production and a lower projected AISC will make it undervalued, despite a clearly overvalued acquisition.



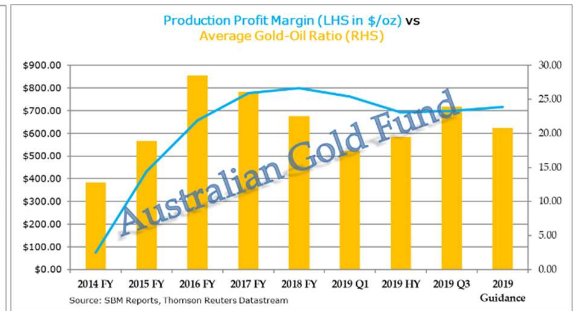


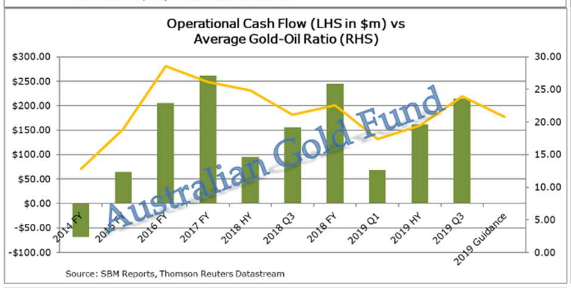
Prevailing Environment

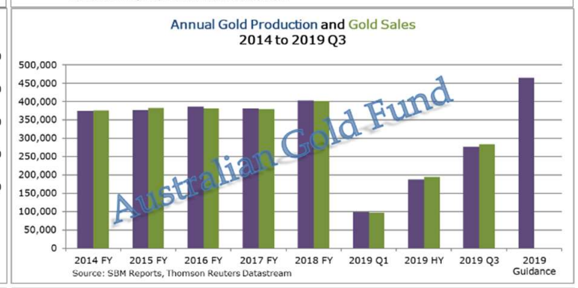
The March quarter has been a challenging one for many gold mining companies despite the gold price trading in the US$1 280-1 345/oz and A$1 790-1 880/oz range. Part of this is caused by the oil price rising 33% from US$45/bbl to US$60/bbl during the quarter, leading to the gold to oil ratio placing some pressure on costs. Since the December 2018 rate rise by the US Federal Reserve that brings the Federal Funds Rate to 2.25-2.5%, the gold price rose to over US$1 300/oz and reached as high as US$1 345/oz in late February. The corresponding rise in the oil price came as a result of higher demand during the northern hemisphere winter as well as increasing geopolitical tension in the Middle East. Furthermore, the oil price rose partly due to reduction in the US inventory. The gold to oil ratio for the March quarter started at a strong 28.3 and gradually fell to 21.5 at the end of the quarter, resulting in an average gold to oil ratio of 23.9 during this period.

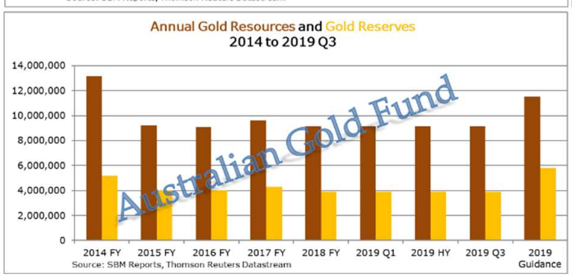
Since the end of the March quarter, the gold price has further weakened while the oil price has increased. The gold to oil ratio has fallen to the 20-21 mark, but there are signs that the gold price is nearing a bottom while the oil price is falling. The months of April and May tend to be cyclical bear periods for gold, with June and July seeing its price recover. This may be repeated in 2019 as the global stock markets are again approaching a peak.

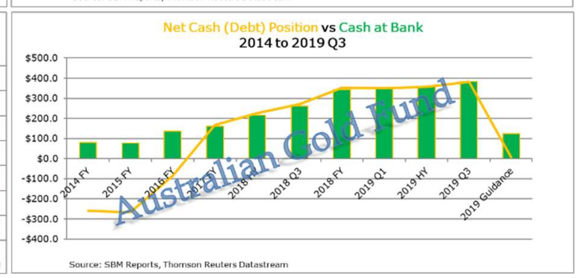
Operational and Financial Performance Charts



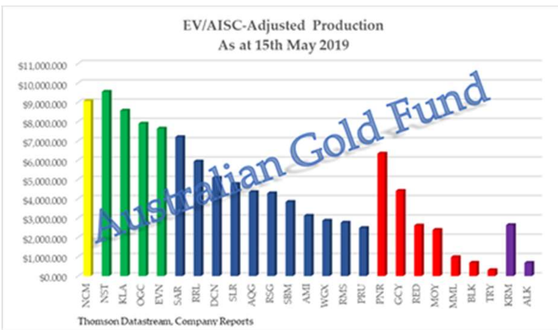


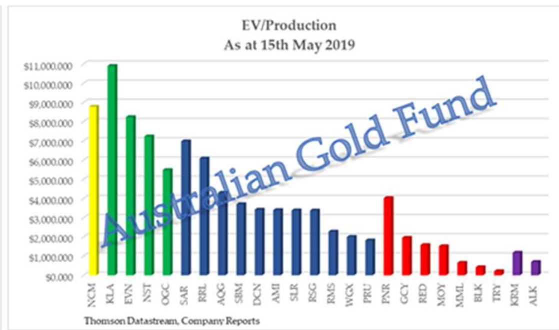


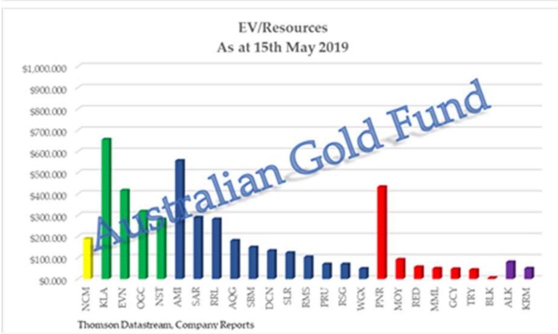


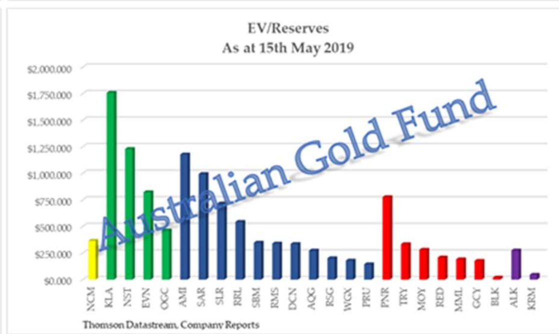


Peer Comparison









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.

As a rough guide, the fair value ranges for different mining company classes are as follows:

Major and Large Companies - $6 000-8 000/oz

Mid-Tier Companies - $2 500-5 000/oz

Micro and Junior Companies - $800-1 800/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

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