Australian Gold Fund Valuation and SWOT Analysis

Westgold Resources Limited (ASX: WGX)

Date	17/08/2020
Classification	Mid-Tier Gold Miner
Current Price	$2.270
No. Issued Stocks (m)	420.2
Net Cash + Bullion + 0.5 x GIC ($ m)	$137.40
Last Dividend Payment ($ p.a.)	$0.00
Market Capitalisation ($ m)	$953.92
Enterprise Value ($ m)	$816.52

Operating Performance Metrics	
Annual Gold Production Guidance *2021 Estimate* (oz p.a.)	270 000-300 000
All-In Sustaining Cost Guidance *2021 Estimate* ($/oz)	$1 460-$1 560
Operating Margin (Sale Price less AISC)	$603.83
Resources (oz)	8,799,000
Reserves (oz)	2,555,000
Financial Year Cumulative Production (oz)	235,150
Production as % of 2020 Annual Guidance	81.79%
Financial Year Cumulative AISC ($/oz)	$1,481.93

Valuation Metrics	
Price Range	$2.80-$4.24
Overall Ranking	Undervalued
Current EV/AISC-Adjusted Production	$4,326.00
EV/AISC-Adjusted Production Range	$6 000-$8 000
Ranking	Undervalued
EV/Resources	$92.80
Ranking	Very Undervalued
EV/Reserves	$319.58
Ranking	Undervalued

Summary

Westgold Resources finished the 2020 financial year in an optimistic note, having seen the development phase of resuming production at the Big Bell mine appearing to have finished. The company did substantially miss their 2020 guidance of 275 000-300 000oz at AISC $1 370-$1 420/oz by a significant margin by delivering 235 150oz at AISC $1 482/oz. Normally, this would lead to massive investor backlash but the company has had a rather disappointing performance track record and hence investors may have tempered their expectations. Investors holding this stock during the year ended the financial year up around 20% and around 35% up to the time of writing, with the stock price trading at the $1.40-$2.60 range. Compared to its mid-tier peers, Westgold was placed around the median. The company has issued the 2021 production guidance range to be 270 000-300 000oz at AISC of $1 460-$1 560/oz. Similar to last year, the production is expected to be backended with more production in the quarter ending June 2021.

The June quarter 2020 for Westgold saw the company deliver just under 60 000oz at AISC of $1 638/oz, with production rising 8% from the previous quarter and AISC surprisingly rising around a similar proportion. Production across the three mines appear to be improving. The most cost-effective of the three mine operations is Fortnum with production at just over 60 000oz at AISC of $1 309/oz, thanks to better ore grades that are now around 2.2-2.5g/t. The Meekatharra operations delivered over 104 000oz at AISC $1 487/oz, with higher AISC in the second half of the year as ore grades declined slightly and processing volumes fell. The Cue operations underperformed relative to initial expectations as it delivered just over 70 000oz at AISC$1 624/oz. Management has indicated that going forward, the Big Bell mine will begin to deliver more ore for processing, thus increasing the head grade. Currently Big Bell is contributing at a rate of 460 000t p.a. and assuming that this increases over time and the processing mill remains at around 1.2Mtp.a., we expect that the mine will deliver around 80 000oz p.a., if not more should the mill be expanded. Based on the company's 2021 production guidance, the ore grades for Big Bell mine may be aiming for as much as 100 000oz p.a. One thing that Westgold Resources has to its advantage is that the three operations appear to be on a positive trend of improving ore grades, which goes against the trend in this industry. As a result, the company may well experience higher production in the future even if the processing capacity does not change.

The company has indicated that they have spent over $250m over the three years in capital development and that the benefits will be felt in the coming years. In addition, the company divested their non-core assets (shareholdings in Musgrave Minerals and RNC, the owner of the Higginsville mine sold last June) and received over $50m as well as raising $42.5m during the quarter in order to increase their cash balance for future capital development. The timing of the divestments and capital raising, as well as the reasons provided appeared a little odd to us in light of what management has indicated. Given their record of overpromising on production guidance, we have grounds to be somewhat cautious about taking management guidance at face value. That being said, Westgold ended the year being able to repay its gold loan in full, raise cash and consolidate its portfolio of assets, thus they have over $137m of cash and bullion. This is a substantial war chest allowing the company to further set its path to consolidate their operations and also have flexibility to acquire other assets as it sees fit. The company has around 200 000oz of gold hedged with monthly delivery of 10 000oz at an average of A$2 062/oz, a modest amount that does not preclude the company's exposure to the upside of the gold price.

In valuing this company, we recognise that it is moving towards delivering almost 300 000oz p.a. and this should imply a higher EV/AISC-Adjusted Production multiple in the range of $7 000-$10 000/oz in this current climate. However, as mentioned before, the company has not been able to deliver on its guidance so we have discounted the multiple range. The company has its strengths in being a diversified mining company with three operations, no debt, a substantial cash and bullion holdings and an adequate 2.56Moz reserves and 8.8Moz resources that would give them around 8-10 year mine life from its reserves with good upside from its resources. Other shortcomings include the company not being deeply traded possibly owing to investors knowing this company's recent history and hence avoiding it and the opacity in the company's reporting (even though admittedly its report is of a substantial length). Taking the management guidance for 2021, we have selected the EV/AISC-Adjusted Production multiple range of $6 000-$8 000/oz and we find that even at the current price of $2.27, the company is undervalued. The multiples relative to its reserves and resources are similarly undervalued. Thus, we believe that the current stock price may be attractive should management expectations be met this coming year.

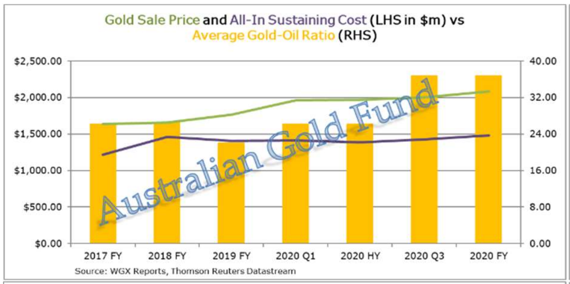
Prevailing Environment

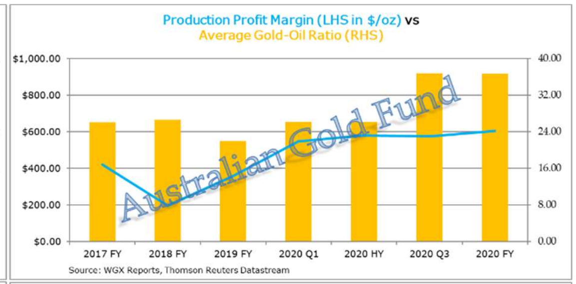
The global markets have been able to resist the experts' consensus opinions that it would fail soon and even rallied in the past three months. The reason for this is largely due to the extraordinary measures central banks and governments have taken to utilise stimulus packages in the form of currency 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).

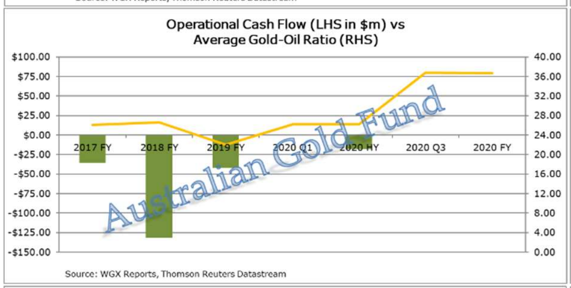
As inflation continues to take effect in the economy, we can see that the price of real assets such as precious metals, commodities, land and real estate continue to rise. The gold price in US dollar terms exceeded the all-time record high of US$1 921/oz in late July and then exceeded the psychological 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 50, which is still highly accommodative to gold producing companies in generating substantial operating margins. Going forward, we do expect that the currency creation will further push down currencies and may see the gold price increase. The price of oil should increase but at a slower rate given that the global economy is growing slower as parts of the world have seen structural damage arising from a combination of lockdowns and natural disasters.

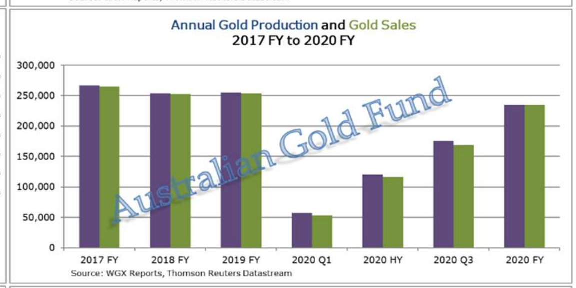
http://goldfund.com.au

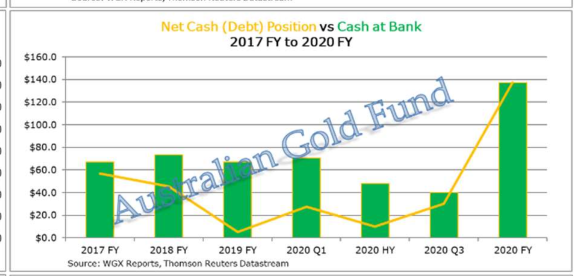
Operational and Financial Performance Charts

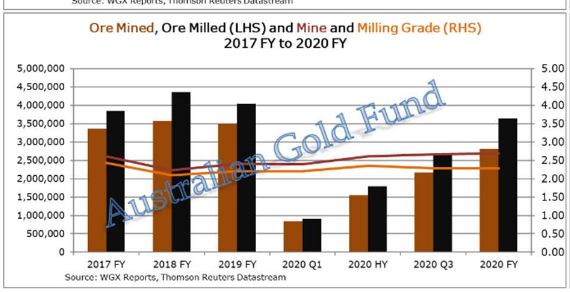


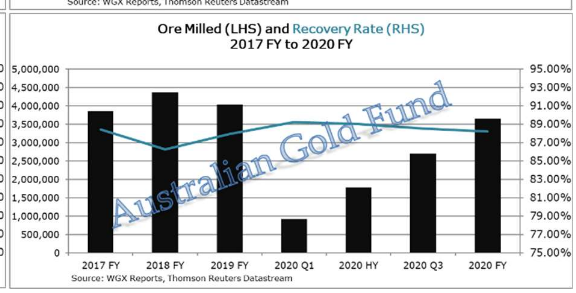








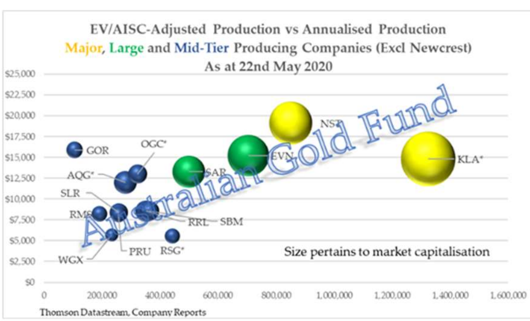


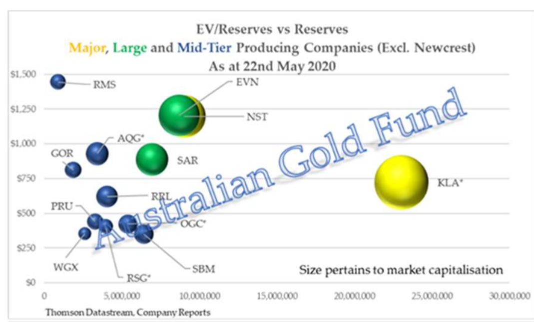


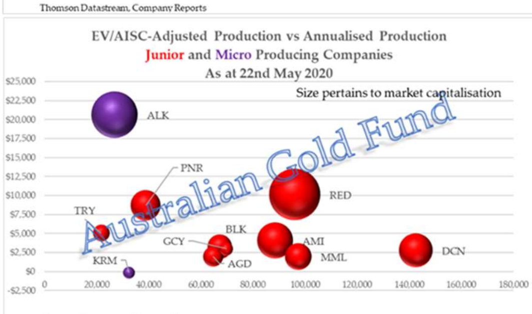
SWOT Analysis

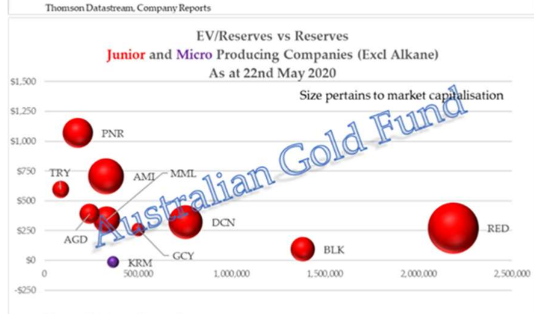
Strengths	Weaknesses
• Diversified company with three operating mines in a Tier 1 jurisdiction. • Balance sheet is now robust with sufficient flexibility for internal development and expansion via acquisitions. • Currently undervalued with potential for upside rewards this year.	• Company management has disappointed investors for several years with hopeful guidance that are not fulfilled. • Investors generally treat this company with caution, so the stock is more volatile than its peers especially on downside risk.
Opportunities	**Threats**
• Ramping up of existing mine operations should see production increase, as will the successful exploration campaigns delivering sizable length intercepts with good ore grades. • A relatively large 8.8Moz resources base may convert to reserves and thus extend the mine life to as much as 15-20 years with current gold price trends.	• Further delay in ramping up the Big Bell mine may be a result of more fundamental issues with the mine, leading to further outlay needed. • Persistent undervaluation may lead to a hostile and unwelcomed takeover, especially if the company is beginning to turn the corner and attract attention of other companies.

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 Westgold Resources 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.