

# Company Review

Ord Minnett Research

Friday, 16 July, 2010

## Avoca Resources Ltd

### South Kal resource upgrade confirms outlook

Avoca Resources Ltd (AVO) has followed its recent reporting of a major lift in reserves and resources at its impressive Higginsville gold operations in WA with a major upgrade to gold resources at its nearby South Kalgoorlie (South Kal) operations. Key features of the South Kal upgrade and its ramifications are:

- Additional 2.9M ozs of resources at South Kal taking AVO's total resources to 6.7M ozs and South Kal total resources to 4.5M ozs of which 3M ozs is in the Hampton-Boulder-Jubilee (HBJ) area and 0.6M ozs is in the Mt Marion area
- Positive mining study for an HBJ Superpit underpins AVO's targeted increase in the company's total gold production to 400kozps pa in FY13
- Proposing to double capacity of the Jubilee treatment plant at South Kal (from 1.2Mtpa to 2.4Mtpa)
- Identified excellent scope for additional underground potential at HBJ plus resource extensions and new exploration discoveries within the project tenure

Ord Minnett Limited (OML) has made further changes to commodity price and FX forecasts and minor revisions to operating forecasts following release of preliminary 4Q10 data. These changes have flowed into revisions to earnings estimates and valuations. Our 'Buy' recommendation is retained as we have increased our base case and upside valuations to \$3.03 and \$4.16 per share respectively.

OML expects AVO to undergo a further re-rating that recognises its quality gold operations and high self-funded exploration potential at Higginsville and South Kal.

OML is forecasting AVO will produce over 280,000 ounces in FY11 at a competitive low cash cost of about \$691 per ounce, which is forecast to generate strong operating cash flow of around \$180M, putting the stock on a very low price to operating cash flow ratio of under 5 times and helping fund accelerated exploration.

#### Key Financials

Year to June	FY09A	FY10E	FY11E	FY12E	FY13E
Gold Price (\$US/oz)	896	1,093	1,250	1,250	1,225
Sales Revenue (\$M)	145.8	293.3	386.8	438.2	562.1
Mining Profit Before Tax <sup>1</sup> (\$M)	40.9	141.3	190.1	217.1	266.5
Reported NPAT (\$M)	(16.3)	55.5	74.9	97.9	118.5
Reported EPS (¢)	(6.7)	19.3	24.5	31.4	38.0
Normalised EPS (¢)	(4.1)	16.2	24.5	31.4	38.0
Op. Cash Flow Per share (¢)	22.2	39.4	56.6	65.1	71.7
Dividend (¢)	0.0	0.0	0.0	7.0	14.0
Net Yield (%)	0%	0%	0%	2.5%	5.0%
Franking (%)	0%	0%	0%	50%	75%
EPS Growth (%)	na	na	52%	28%	21%
Normalised P/E (x)	(67.8)	17.3	11.4	8.9	7.4
Price/Op. Cash Flow (x)	12.6	7.1	4.9	4.3	3.9
Normalised ROE (%)	-7%	23%	25%	26%	26%

Source: Iress, Company Data, Ord Minnett Estimates. Share price: \$ 2.80 July 16, 2010.

Note1. Mining Operating Profit Before Tax is the contribution from mining operations

**AVO A\$2.80**
**Recommendation  
Buy**
**Risk Assessment  
High**

#### Sector - Gold

Peter Arden

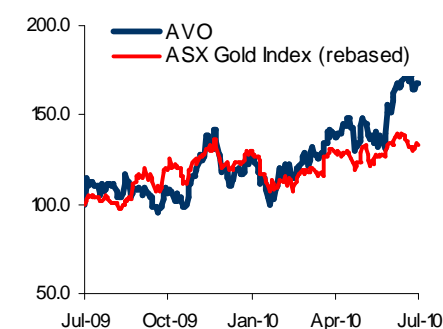
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#### Avoca Resources Limited

ASX Code	AVO
52 week range	\$2.96 - \$1.48
Market Cap (\$M)	872
Shares Outstanding (M)	290.1
Av Daily Turnover (\$M)	2.7
ASX All Ordinaries	4744.8
ASX Gold Index	6376.3
Net Debt 1H10 (\$M)	28.3

#### Relative price performance



Source: Iress

#### Consensus earnings

	FY10F	FY11F
NPAT	62.3	84.9
EPS	21.7	31.1
No of estimates	11	11

Source: Iress

## South Kal Resource Upgrade Confirms Its Potential

AVO has followed up its recent reserve and resource upgrade at its Higginsville operations with a substantial upgrade to resources at its South Kal operations. AVO has identified a major resource position at its HBJ mine and has now conducted mining scoping studies that indicate HBJ is capable of sustaining significant economic gold production using large scale equipment to mine a superpit.

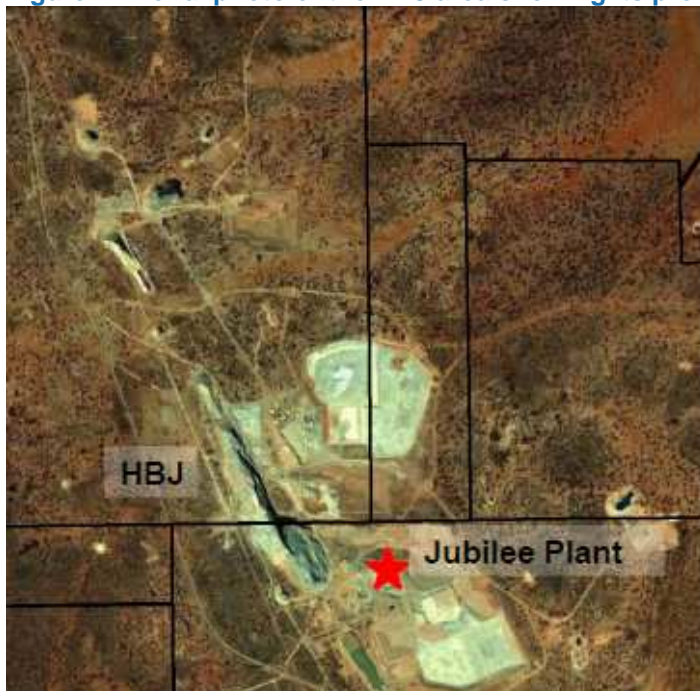
**AVO has lifted South Kal resources by 174% to 4.5M ozs.**

Key features of the South Kal upgrade and HBJ Superpit study are:

- Additional resources of 2.9M ozs at South Kal taking the total resources at South Kal to 4.5M ozs of which 3M ozs (addition of 2.3M ozs) is in the Hampton-Boulder-Jubilee (HBJ) area and 0.6M ozs (the other additional 0.6M ozs) is in the Mt Marion area
- Potential mining inventory of at HBJ Superpit of 15Mt averaging 1.5 g/t for almost 0.75M ozs
- Almost 0.7M ozs recovered assuming 92% recovery
- Combined operating and capital costs estimated at A\$ 790/oz
- Virtually all the resources within the scoping study Superpit shell are currently classified as Indicated Resources
- Potential stripping ratio for HBJ Superpit of 5.2
- Mining scoping study completed using gold price of A\$ 1,200/oz
- Assumes that the Jubilee treatment plant throughput is expanded from current 1.2Mtpa to 2.4Mtpa

Drilling below the HBJ Superpit shell demonstrates underground mine potential. OML believes there are excellent opportunities for additional resource extensions at HBJ with ongoing drilling planned. The deposit remains open at depth along its 2.6km length.

**Figure 1. Aerial photo of the HBJ area showing its proximity to the Jubilee plant**



Source: Avoca Resources

## Changes to estimates

Following changes to our commodity price and \$US/\$A exchange rate forecasts and minor revisions to operating forecasts following release of AVO's preliminary 4Q10 production report, OML has revised its earnings forecasts for the company as detailed in Table 1 below. These revisions show that despite a relatively flat gold price in Australian dollar terms and modestly rising unit cash operating costs, earnings and operating cash flow are now forecast to be very substantial over the next few years, enabling AVO to self-fund the development of its large and highly prospective exploration areas between Kalgoorlie and Norseman.

**Table 1. Revisions to Earnings Forecasts**

Year to June	FY10E			FY11E			FY12E		
	Previous	Current	Chge	Previous	Current	Chge	Previous	Current	Chge
Average Gold Price Forecast (US\$/oz)	1,100	1,093	-1%	1,200	1,250	4%	1,125	1,250	11%
Average US/A\$ FX forecast	0.88	0.88	0%	0.89	0.91	2%	0.89	0.89	0%
Gold Sales (000 ozs)	245	234	-4%	291	285	-2%	321	315	-2%
Average Realised Gold Price (\$A/oz)	1,241	1,253	1%	1,332	1,353	2%	1,249	1,387	11%
Sales Revenue (\$M)	304.6	293.3	-4%	389.5	386.8	-1%	402.8	438.2	9%
Mining Operating Costs (\$M)	(156.3)	(152.1)	-3%	(196.3)	(196.7)	0%	(218.3)	(221.1)	1%
Unit Cash Operating Costs (\$A/oz)	637	650	2%	674	691	3%	679	703	3%
Mine Operating Profit Bef. Tax <sup>1</sup> (\$M)	148.2	141.3	-5%	193.2	190.1	-2%	184.5	217.1	18%
Depreciation and Amortisation (\$M)	(56.1)	(55.6)	-1%	(64.0)	(64.2)	0%	(65.2)	(64.8)	-1%
Profit Before Tax (\$M)	78.5	70.4	-10%	110.8	107.0	-3%	107.2	139.9	30%
Reported Net Profit After Tax (\$M)	55.9	55.5	-1%	77.5	74.9	-3%	75.1	97.9	30%
<b>Normalised Profit (\$M)</b>	47.7	46.4	-3%	77.5	74.9	-3%	75.1	97.9	30%
<b>Normalised Earnings Per Share (¢)</b>	16.6	16.2	-2%	25.4	24.5	-3%	24.1	31.4	30%
<b>Operating Cash Flow After Tax (\$M)</b>	125.6	117.2	-7%	178.4	176.0	-1%	168.5	202.6	20%
<b>Operating Cash Flow Per Share (¢)</b>	42.2	39.4	-7%	57.5	56.6	-1%	54.3	65.1	20%
<b>Dividend Per Share (¢)</b>	0	0.0	nc	0	0.0	nc	5.0	7.0	40%

Source: Ord Minnett estimates

Note 1. Mining Operating Profit Before Tax is the contribution from mining operations

## Valuations

OML has revised its valuations of AVO following revisions to its forecasts for gold production at AVO's South Kal. operations and minor changes to our commodity price and \$US/\$A exchange rate forecasts. Table 2 below is a summary of our base case and upside valuations of AVO.

**Table 2. Summary valuations of Avoca**

	Base Case		Upside Case	
	\$M	Value (\$) per Share <sup>1</sup>	\$M	Value (\$) per Share <sup>1</sup>
Assessed value of gold mining operations <sup>2</sup>	687	2.25	820	2.67
Assessed value of other Higginsville assets <sup>3</sup>	72	0.28	135	0.48
Assessed value of South Kal. exploration assets <sup>3</sup>	131	0.47	267	0.90
Assessed value of other WA mineral assets	6	0.02	9	0.02
Sub total of mineral assets	896	2.92	1,230	3.98
Add - Net financial assets <sup>4</sup>	9	0.03	9	0.03
<b>Total net value</b>	<b>905</b>	<b>2.94</b>	<b>1,239</b>	<b>4.01</b>

Source: Ord Minnett estimates

- Notes:
1. Per share valuation does not add exactly as each component has been done on a diluted basis, for securities that are dilutive, making for duplication when summed
  2. Based on NPV at 10% discount rate using JORC reserves and resources and estimated deposit extensions for base case along with near mine exploration potential for upside case
  3. Estimated value of exploration projects and other assets derived by various methods including NPV
  4. Includes administration costs and assumes conversion of all convertible bonds

## Stock price catalysts and drivers

OML sees the following as the major catalysts and drivers for AVO in the short to medium term, which are expected to deliver ongoing market re-rating:

- Continued strong gold production at Higginsville at low cost
- Strong operating cash flow generation to fund accelerated exploration and mine development to support and sustain rising low cost gold production
- Continued strong financial position that enables self-funding exploration and is expected to result in AVO moving to a net debt free position during the next quarter (1Q11) and building a substantial cash balance thereafter (see Financial Summary on page 9)
- Significant exploration activity, principally at Higginsville (\$22M to be spent in FY11) but also at South Kal. (approx \$11M to be spent in FY11) while a major drill-out is also being carried out at the Frogs Leg mine by the joint venture
- Growing recognition of AVO's position as one of the leading mid cap gold producers on the ASX with a substantial and rising gold production profile from its substantial and successful, self-funded exploration program

## Risk factors

OML identifies the major risks for AVO as follows:

- Gold price and \$US/\$A exchange rates moving adversely
- Gold production and operating costs being significantly outside expectations
- Lack of exploration success or ability to turn resources into reserves
- Over-runs for capital expenditure or delays on new mine developments
- Inappropriate corporate activity (including mergers and acquisitions or buy-out of the Morgan Stanley gold royalty)
- Changes in government policy such as the imposition of an RSPT

## Financial Summary

### Avoca Resources Ltd

Year end June

<b>Profit &amp; Loss Statement (\$M)</b>	<b>FY09A</b>	<b>FY10E</b>	<b>FY11E</b>	<b>FY12E</b>	<b>FY13E</b>
Sales Revenue	146	293	387	438	562
Mining Operating Costs	(105)	(152)	(197)	(221)	(296)
Mining Operating Profit Before Tax	41	141	190	217	267
Other Expenses and Net Income	(13)	(10)	(18)	(16)	(23)
<b>EBITDA</b>	<b>28</b>	<b>131</b>	<b>172</b>	<b>201</b>	<b>244</b>
Depreciation & Amortisation	(42)	(56)	(64)	(65)	(81)
<b>EBIT</b>	<b>(15)</b>	<b>75</b>	<b>108</b>	<b>136</b>	<b>163</b>
Net Interest (Expense) Income	(9)	(5)	(1)	4	6
<b>Pre-Tax Profit</b>	<b>(23)</b>	<b>70</b>	<b>107</b>	<b>140</b>	<b>169</b>
Tax (Expense) / Benefit	7	(20)	(32)	(42)	(51)
Reported NPAT	(16)	56	75	98	118
Adjustments (after-tax)	7	(9)			
<b>Normalised NPAT</b>	<b>(10)</b>	<b>46</b>	<b>75</b>	<b>98</b>	<b>118</b>
EBITDA Margin (%)	19%	45%	44%	46%	43%
Effective tax Rate (%)	30%	29%	30%	30%	30%
EPS Reported (cps)	(7)	19	25	31	38
EPS Normalised (cps)	(4)	16	25	31	38
EPS growth (%)	na	na	52%	28%	21%
DPS (cps)	0	0	0	7	14
Payout Ratio (%)	0%	0%	0%	22%	37%
Franking (%)	0%	0%	0%	50%	75%

<b>Cash Flow Statement (\$M)</b>	<b>FY09A</b>	<b>FY10E</b>	<b>FY11E</b>	<b>FY12E</b>	<b>FY13E</b>
Pre-Tax Operating Cash Flow	52	117	177	211	259
Tax Paid			(1)	(8)	(36)
<b>Operating Cash Flow</b>	<b>52</b>	<b>117</b>	<b>176</b>	<b>203</b>	<b>223</b>
Exploration & Development	(62)	(75)	(63)	(73)	(70)
Property, Plant & Equipment	(2)	(23)	(18)	(20)	(16)
Other Investing Items	0	(13)	(9)	(22)	(25)
<b>Investing Cash Flow</b>	<b>(63)</b>	<b>(112)</b>	<b>(90)</b>	<b>(115)</b>	<b>(111)</b>
Inc/(Dec) in Equity	29	34	20		
Inc/(Dec) in Borrowings	19	(30)	(62)		
Dividends Paid					(32)
<b>Financing Cash Flow</b>	<b>49</b>	<b>4</b>	<b>(41)</b>	<b>0</b>	<b>(32)</b>
<b>Net Inc/(Dec) in Cash</b>	<b>37</b>	<b>7</b>	<b>35</b>	<b>48</b>	<b>60</b>

<b>Balance Sheet (\$M)</b>	<b>FY09A</b>	<b>FY10E</b>	<b>FY11E</b>	<b>FY12E</b>	<b>FY13E</b>
Cash	39	46	81	129	189
Other Current Assets	9	14	15	21	49
Fixed Assets	177	266	256	265	247
Exploration & Development	40	91	122	172	200
Other Non Current Assets	23	9	9	9	9
<b>Total Assets</b>	<b>287</b>	<b>426</b>	<b>482</b>	<b>595</b>	<b>693</b>
Short-term Debt	21	41			
Other Current Liabilities	36	74	102	132	148
Long-term Debt & Convert. Bonds	66	28			
Other Non Current Liabilities	8	36	38	44	50
<b>Total Liabilities</b>	<b>130</b>	<b>179</b>	<b>140</b>	<b>176</b>	<b>198</b>
<b>Total Equity</b>	<b>157</b>	<b>247</b>	<b>343</b>	<b>419</b>	<b>496</b>
Net Debt (Cash)	48	16	(81)	(129)	(189)

<b>Significant Shareholders</b>	<b>Million</b>	<b>(%)</b>	<b>Date</b>
Pala Investments	68.0	23.4%	8/06/09
Commonwealth Bank of Australia	15.5	5.3%	28/06/10

<b>Assumptions</b>	<b>FY09A</b>	<b>FY10E</b>	<b>FY11E</b>	<b>FY12E</b>	<b>FY13E</b>
Gold (US\$/oz)	896	1,093	1,250	1,250	1,225
US\$/A\$	0.73	0.88	0.91	0.89	0.85
Gold (A\$/oz)	1,221	1,247	1,374	1,408	1,441

<b>Equity Gold Production (000 ozs)</b>	<b>FY09A</b>	<b>FY10E</b>	<b>FY11E</b>	<b>FY12E</b>	<b>FY13E</b>
Trident	131.2	177.8	165.2	147.8	151.3
Fairplay and Challice		7.4	19.0	54.0	40.1
Frogs Leg and South Kalgoorlie		44.3	100.5	112.9	203.2
<b>Total</b>	<b>131.2</b>	<b>229.5</b>	<b>284.7</b>	<b>314.7</b>	<b>394.6</b>
Ave Cash Cost, incl. royalty (A\$/oz)	868	650	691	703	749

<b>Equity Share of JORC Resources</b>	<b>Owned</b>	<b>Mt</b>	<b>g/t Au</b>	<b>Au (koz)</b>
Trident - Western Zone	100%	0.9	4.8	135
- Athena Zone	100%	0.6	11.0	228
- Eastern Zone	100%	0.3	5.1	57
- Other	100%	3.9	4.2	519
- Total	100%	5.7	5.1	939
Fairplay Area	98%	3.5	1.8	205
Challice	100%	1.3	4.5	193
Other Higginsville (incl. Trident stockpiles)	100%	3.6	1.5	179
<b>Total Higginsville</b>		<b>14.3</b>	<b>3.4</b>	<b>1,572</b>
Frog's Leg	49%	2.7	6.6	569
South Kalgoorlie	100%	68.7	2.0	4,516
<b>Total</b>		<b>71.4</b>	<b>2.2</b>	<b>5,085</b>
<b>Total</b>		<b>85.7</b>	<b>2.4</b>	<b>6,657</b>

<b>Valuation Ratios (x)</b>	<b>FY09A</b>	<b>FY10E</b>	<b>FY11E</b>	<b>FY12E</b>	<b>FY13E</b>
Normalised P/E	-67.8	17.3	11.4	8.9	7.4
Price/Op Cash Flow	12.6	7.1	4.9	4.3	3.9
EV/EBITDA	33.1	6.8	4.6	3.7	2.8

<b>Leverage</b>	<b>FY09A</b>	<b>FY10E</b>	<b>FY11E</b>	<b>FY12E</b>	<b>FY13E</b>
Net Debt/Equity	30%	6%	-24%	-31%	-38%
Net Debt/Total Assets	17%	4%	-17%	-22%	-27%
Interest Cover (x)	3.2	26.4	221.2	-52.0	-37.8

<b>Valuation</b>	<b>Base Case</b>		<b>Upside Case</b>	
	<b>\$M</b>	<b>\$ per share<sup>1</sup></b>	<b>\$M</b>	<b>\$ per share<sup>1</sup></b>
Mining operations & exploration	713	2.33	856	2.79
Higginsville regional exploration	72	0.28	135	0.48
South Kalgoorlie exploration	131	0.47	277	0.94
Other WA exploration interests	6	0.02	9	0.02
Total Mineral Assets	922	3.00	1,277	4.13
Net Financials <sup>2</sup>	9	0.03	9	0.03
<b>Total</b>	<b>931</b>	<b>3.03</b>	<b>1,286</b>	<b>4.16</b>

<b>Valuation</b>	<b>Base:</b>	<b>\$3.03</b>	<b>Upside :</b>	<b>\$4.16</b>
Discount (premium) of share to valuation		8%		49%

Valuation sensitivity to:

+/- 10% move in gold price	\$0.83 ps	\$1.54 ps
+/- 10% move in the \$US/\$A rate	\$0.42 ps	\$0.79 ps
Current price		<b>\$2.80</b>
Recommendation		<b>Buy</b>
Risk rating		<b>High</b>
12-month price target		<b>\$3.60</b>

Source: Ord Minnett estimates, Company data.

Notes. 1. Does not add because of effects of dilution. 2. Includes admin costs, assumes conversion of convertible bonds.

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## Guide to Ord Minnett Recommendations

BUY	The stock's total return (nominal dividend yield plus capital appreciation) is expected to exceed 15% over 12 months.
ACCUMULATE	The stock's total return is expected to be between 5% and 15%. Investors may add to existing holdings, or initiate holdings on share price weakness.
HOLD	The stock is fairly priced, and its total return is expected to be between 0% and 5%.
LIGHTEN	The stock's total return is expected to be less than 0% and possibly down 15%. Investors should consider selling into share price strength.
SELL	The stock's total return is expected to lose 15% or more.
RISK ASSESSMENT	Classified as High, Medium or Low, denotes the relative assessment of an individual stock's risk based on an appraisal of its disclosed financial information, volatility, nature of its operations and other relevant quantitative and qualitative criteria.

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