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Avoca Resources Ltd (AVO \$1.52) Buy, Upgrade from Hold

- ▶ **Price Target:** \$1.90
- ▶ **Reason For Update:** Mar Q'ly and Company Update
- ▶ **What we know:**

Mar Q'ly production of 28.8koz (Dec Q 27.8koz) from 289.6kt processed ore with average head grade of 3.2g/t (Dec Q 3,31%) and 97% recovery.

Average cash costs of A\$865/oz inclusive of A\$103/oz in royalties.

Sales of 29.0koz @ average price received of A\$1365/oz.

Commencement of stoping of the high grade 1005 Level in the Western Zone has boosted mill through-put grade, with average of 5.2g/t recently reported.

3 stopes now open: 2 on the Western Zone focussing on the high grade 1005 and 1041 Levels; and 1 on the Eastern Zone.

Stope production from the high grade Athena lode at the 1005 and 1006 levels will commence in the Jun Q.

AVO recently announced an unsolicited, full-scrip takeover offer for DIO, comprising 1 AVO share for 2.82 DIO shares, and is subject to FIRB approved.

This values the DIO bid at A\$49m or \$0.53/sh.

Successful acquisition will secure AVO an additional 80-90kozpa from the Frog's Legs (DIO – 49%) and South Kalgoorlie (100%) operations for circa 250kozpa from 2010.

In addition, AVO will acquire the 1.2mtpa Jubilee mill as well as DIO's 1,100sq km tenement position (3,800sq km for the combined entity).

DIO's reserves stand at 515koz (NB: 38koz sterilised by pit wall slip at HBJ pit) taking combined entity to ~1moz.

DIO's resources of +2.5moz to provide combined resource inventory of +4moz.

Cash and bullion of A\$41.8m. Undrawn debt of A\$1.2m.

Total debt of A\$66m (reduced from A\$71m) plus A\$38m in convertible bonds.

► **What we think:**

Trident Operations

AVO share price performance has decoupled from the spot gold price since Dec'08, and subsequently tracked sideways, weighed down by operational performance at Trident.

Cash costs and production numbers were in line with our forecasts for the Q. We believe that entry into the higher grade 1005 Level in the Western Zone will improve production and cash costs reported in the Jun Q.

We estimate production of circa 70koz @ ~ \$650/oz (inc. MS Royalty) for the 2H.

As the mine produces average head grades in line with the reserve grade of 5.3g/t, we believe that 45koz is likely for the Sep Q.

In addition, we view that there is strong potential for grade over calls in the next few Qs in light of the coarse gold component typical of the Athena lodes.

Development and capital expenditure commitments at the mine in the Jun H, will limit exploration spend. Accordingly, we do not anticipate any material increases to AVO's res'v/res'c position to be announced this H.

Similarly, we expect development activity at the other satellite deposits to be limited until free cash flow from FY'10 permits increased activity.

DIO Takeover

We view AVO's drivers for the bid as:

- Increased production profile of +240kozpa;
- Combined infrastructure capacity of 2.2mtpa;
- Highly prospective exploration tenure of 3800sq. km;
- Improved liquidity and access to capital through increased company size.

Our valuation for DIO, using av. cash costs of A\$820 and annual production of 85kozpa to 2015, is 0.66/sh (versus bid equivalent of 0.53/sh) implying that the AVO bid is opportunistic and a good deal for AVO shareholders on face value.

Modelling DIO's Frog's Legs and South Kalgoorlie assets into a merged model our resulting NPV increases to \$1.56/sh from our current AVO valuation of \$1.46/sh.

EV:Res'v' of A\$442/oz and EV:Res'c' of A\$124/oz are an improvement upon pre-transaction values of A\$740/oz and A\$320/oz respectively.

Upside exists with improved operating costs, underground exploration potential and operational synergies.

We believe La Mancha will look to exit Frog's Legs in the medium term, as it remains a non-core asset, with AVO to exercise the pre-emptive right acquired by the successful takeover.

► **Investment Case:**

We have upgraded our recommendation to Buy. We believe that AVO will enjoy some strong Qs in terms of production and cash over the subsequent 12-18mnths as the high grade material is mined at Trident. Associated strong cash flow should begin to fund more aggressive exploration and satellite deposit development from FY'10. Associated news flow, market support for the stock and successful completion of the DIO transaction are all strong catalysts for the share price in a strong price environment.

Our price target of \$1.90/sh is a 1.3x multiple of our \$1.46/sh NPV, reflective of the multiples afforded to established gold producers in a strong price environment. Increased scale, exploration potential and strategic benefits are attributable to a successful outcome on the DIO bid and strengthen our valuation and price targets to \$1.56/sh and \$2.03/sh respectively.

AVOCA RESOURCES LTD (AVO)		YEAR END 30 JUNE			
MARKET STATISTICS					
Share Price	\$1.52 A\$/sh	Directors			
Issued Capital		R.Reynolds		Chair'n	
FP Ord	243.4m	R.Williams		Mgr Dir	
unlisted Emp Opt	12.6m	S.Unwin		Dir	
Convertible Bonds	22.9m	D.Quilivan		Dir	
Total Dil. FPOrd	249.4m	J. Castro		Dir	
Market Capitalisation	\$375m	Shareholders			
Enterprise Value	\$437m	Pala		13.75%	
Debt	\$105m	CBA		6.2%	
Cash	\$43m				
Hedging	nil				
ASSET VALUATION					
	A\$m	A\$/sh			
Higginsville	347	1.39			
Corporate	(10)	(0.04)			
Greater Higginsville Expl'n	150	0.60			
Unpaid Capital	12	0.05			
Debt (inc. conv. Bond)	(105)	(0.42)			
Cash	43	0.17			
Higginsville Royalty	(73)	(0.29)			
Total @ 10% real	365	1.46			
Total @ 0% real	492	1.97			
Total @ 5% real	419	1.68			
Total @ 15% real	322	1.29			
Unpaid Capital includes assumption for future development equity issue & options.					
FORECAST PRODUCTION					
Attrib. Prod'n (koz)	2008a	Jun H'09f	2009f	2010f	2011f
Higginsville	0	68	118	173	175
Total Attrib (koz)	0	68	118	173	175
Prices (A\$/oz)					
Avg Spot Gold Price	915	1,319	1,193	1,265	1,201
Avg Gold Price Rec'd	915	1,319	1,213	1,266	1,200
Cash Cost (A\$/oz)					
Higginsville	551	565	655	413	410
Higginsville - Morgan-Stanley Royalty	-	86	133	117	108
Avg Cash Cost (A\$/oz)	551	651	724	530	518
Avg Total Cost (A\$/oz)	691	1,121	1,156	980	723
RATIO ANALYSIS					
	2008a	Jun H'09f	2009f	2010f	2011f
CF (A\$m)	1	4	(9)	94	90
CF / Sh (Ac/sh)	0	2	(4)	38	36
CF Ratio (x)	441.6	-	(40.3)	4.0	4.2
Earnings (A\$m)	(1)	n/a	(12)	22	49
EPS (Ac/sh)	(0.4)	n/a	(4.9)	8.9	19.6
EPS Growth (%)	n/a	n/a	-1505%	-279%	121%
Earnings Ratio (x)	(406.4)	n/a	(30.8)	17.1	7.8
E'prise Val. (A\$m)	536	n/a	456	373	295
EV : EBITDA (x)	(1,367.2)	n/a	8.8	3.1	2.6
EV : EBIT (x)	(384.1)	n/a	(63.6)	9.5	4.0
Net Debt / ND+Eq (%)	59%	n/a	38%	-1%	-72%
Interest Cover (x)	(2)	n/a	(1)	12	33
EBIT Margin (%)	-49%	n/a	-5%	18%	35%
ROE (%)	-1%	n/a	-9%	15%	24%
ROA (%)	-1%	n/a	-3%	14%	24%
Div. (Ac/sh)	-	-	-	-	-
Div. payout ratio	0%	0%	0%	0%	0%
Div. Yield	0%	0%	0%	0%	0%
Div. Franking	0%	0%	0%	0%	0%

PROFIT AND LOSS	2008a	Jun H'09f	2009f	2010f	2011f	
Gold Sales	0.0	90.1	143.2	219.0	209.4	
Hedging Revenue	-	-	-	-	-	
Deferred Revenue	-	-	-	-	-	
Interest Revenue	2.7	0.1	0.1	1.5	3.9	
Other Revenue	2.8	-	-	-	-	
TOTAL REVENUE	5.5	90.2	143.3	220.5	213.4	
Operating Costs	0.0	44.5	85.5	91.8	90.4	
Dep/Amort	0.0	32.1	51.0	77.7	35.9	
W/O & Provisions	1.0	2.6	8.1	5.2	5.2	
Corp O/H	3.2	2.6	5.8	5.0	5.0	
EBITDA	(0.4)	43.0	51.9	122.2	114.1	
EBIT	(1.4)	8.4	(7.2)	39.3	73.0	
Interest Expense	2.3	5.2	10.5	9.2	6.6	
NPBT	(0.9)	3.3	(17.6)	31.5	70.3	
Tax	-	1.0	(5.3)	9.5	21.1	
Minorities	-	-	-	-	-	
NET PROFIT	(1.1)	2.3	(12.3)	22.1	49.2	
Net Abnormal Gain/(Loss)	-	-	-	-	-	
NET PROFIT After Abn'l	(1.1)	2.3	(12.3)	22.1	49.2	
CASH FLOW						
	2008a	Jun H'09f	2009f	2010f	2011f	
Net Profit	(1.1)	2.3	(12.3)	22.1	49.2	
+ Working Capital Adj.	-	-	13.7	-	-	
+ Dep/Amort	0.0	32.1	51.0	77.7	35.9	
+ Provisions	1.0	2.6	8.1	5.2	5.2	
+ Tax Expense	-	1.0	(5.3)	9.5	21.1	
- Tax Paid	(1.1)	(6.3)	(6.3)	4.8	15.2	
- Deferred Revenue	-	-	-	-	-	
Operating Cashflow	1.0	44.2	61.4	109.7	96.2	
-Capex + Development	133.4	40.0	70.9	16.0	6.0	
-Exploration	11.0	7.2	11.8	12.0	12.0	
-Assets Purchased	0.0	-	-	-	-	
+Asset Sales	0.0	-	-	-	-	
+ Other	-	-	0.6	-	-	
Investing Cashflow	(144.4)	(47.2)	(82.1)	(28.0)	(18.0)	
+Equity Issues	6.2	29.0	29.1	0.9	6.9	
+Loan D'down/Receivable	30.0	-	20.0	-	-	
-Loan Repayment	-	8.0	8.0	20.0	28.0	
-Dividends	-	-	-	-	-	
Financing Cashflow	36.2	21.0	41.1	(19.1)	(21.1)	
Period Sur (Def)	(107.7)	18.0	20.5	62.5	57.1	
Cash Balance	1.6	22.1	22.1	84.7	141.8	
BALANCE SHEET						
	2008a	Jun H'09f	2009f	2010f	2011f	
Assets						
Cash	1.6	22.1	22.1	84.7	141.8	
Current Receivables	5.1	2.1	2.1	2.1	2.1	
Other Current Assets	1.3	11.5	11.5	11.5	11.5	
Non-Current Assets	201.3	236.1	236.1	174.3	144.4	
Total Assets	209.3	271.8	271.8	272.6	299.8	
Liabilities						
Borrowings	111.0	103.0	103.0	83.0	55.0	
Current Accounts Payable	19.0	25.6	25.6	25.6	25.6	
Other Liabilities	2.6	12.0	12.0	12.0	12.0	
Total Liabilities	132.6	140.6	140.6	120.6	92.6	
Net Assets	76.7	131.3	131.3	152.1	207.3	
RESOURCES AND RESERVES						
	Reserves			Resources		
	mt	g/t	koz	mt	g/t	koz
Trident/Athena	3.40	5.30	579	5.0	6.0	951
Fairplay				3.6	1.8	209
Palaoechannels				1.4	2.0	88
Chalice				0.7	5.2	123
Other				1.31	1.20	51
Equity Share Gold			579	8.7	4	1,422
Enterprise Value / oz (A\$)			754			307