

Avoca Resources Limited \$1.53**Recommendation: BUY****Analyst: Josh Welch****Tel: +618 9263 1668****Event**

- AVO has launched a A\$49m all-scrip takeover for Dioro Exploration NL (DIO) on a 1 AVO share for every 2.82 DIO shares basis, with AVO entering into unconditional share purchase agreements totalling 14.95% of DIO with Harmony Gold and Baker Steel.
- AVO advised it has engaged preliminary discussions with DIO however we understand the offer is unsolicited and we await a response from DIO. AVO's offer is subject to 90% minimum acceptance and FIRB approval.
- DIO operates the 1.2mtpa Jubilee Mill (80km north of AVO's Trident Mill), open pit operations at South Kalgoorlie, and 49% of the Frogs Leg underground mine (La Mancha 51%).

Impact

- **Rationale.**
 - **Operating synergies.** The combined group would bring together DIO's South Kal and Frogs Legs mines and AVO's Trident mine, with targeted group production of c.250kozpa. AVO expects to extract tangible operating synergies on production, exploration and administrative fronts given close proximity to one another however, as yet these synergies remain unquantified.
 - **Expanded market presence and resource base.** Following two wall failures (HBJ pit /Mt Marion crown pillar) and the impact on ore production, DIO has struggled to gain market traction and would conceivably benefit from the enlarged group however, AVO is yet to confirm when it will generate meaningful free cash. Nonetheless, we share AVO's view that the combined group would offer superior institutional appeal, expanded production and a proven exploration team. Proforma group resources increase to c.4moz implying combined EV:Resources of A\$130/oz versus AVO's current A\$333/oz rating and sector average of A\$164/oz.
 - **Pooled exploration model.** The combined entity would have the largest land holding (3800sq.km) between Kalgoorlie and Norseman and while subject to extensive previous exploration, sits well with AVO's district scale exploration methodology which has delivered considerable success at Higginsville.
- **Implications.** There was little detail at the conference call so we await further information in the Target and Bidder Statement's (proforma balance sheet, DIO's environmental liabilities etc). However, on a first pass basis the transaction is NPV accretive for AVO and importantly, cash flows from Frogs Leg would mitigate any looming cash squeeze from the slow ramp-up at Trident.
- On the assumption AVO issues 32m shares (1 for 2.8 basis), and based on first-pass information on DIO's assets, we derive a post-transaction NPV of A\$1.42/per AVO share (see below) - a 14% increase on our A\$1.25/sh pre-transaction NPV.

Valuation	A\$m	A\$/sh
Higginsville Gold	342.2	1.18
Frogs Leg (attributable)	63.0	0.22
South Kal	19.8	0.07
Exploration	63.5	0.22
Corporate	(11.0)	(0.04)
Unpaid Capital	7.1	0.02
Cash est.	32.0	0.11
Debt est. (inc. CB)	(104.8)	(0.36)
NPV	412	1.42
(@ 8% Discount rate)		
Price Target		2.13
(1.5x NPV)		

- **DIO Assets.** Frogs Leg (49% DIO) in our view is underappreciated by the market with an imminent reserve upgrade and ramp-up to c.80kozpa progressing to schedule. Given its modest scale, we envisage there will be impetus to consolidated the asset on a 100% basis and assume the combined group would make this a priority.
- **South Kal (100% DIO).** We have modelled up the current reserve 4.4mt @ 1.5g/t Au (220koz), and assigned exploration value to remaining project resources (29mt @ 1.7g/t Au for 1.7moz) given uncertainty over the quality of these ounces.
- **BUY retained, awaiting DIO response.** We reiterate our BUY recommendation and existing A\$1.90/sh price target ahead of further clarity on the proposed transaction. However, we caution that AVO is likely to report a weak March Q (PSL forecast 28.7koz @ A\$882/oz) reflecting lower grades in the upper zones however, higher grades will come through in the September Q as the 1005 Level is processed.

Regards,

Josh Welch

Director, Research

D: +61 8 9263 1668 | F: +61 8 9325 6452 | E: JWelch@psl.com.au | W: www.psl.com.au

Patersons Securities Limited AFSL No. 239 052

Level 23, Exchange Plaza, 2 The Esplanade PERTH WA 6000

