Southern Cross Equities

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14 October 2009

Avoca Resources (AVO)

Production, pricing outlook improves - upgrade to Buy

Recommendation
Buy
Price
$1.69
Target (12 months)
$2.20

FY10 has started well for AVO with good operating performance at the Trident mine and higher gold prices boosting margins. We have raised our target price to $2.20 ($1.85) and recommendation to Buy (Accumulate) due to greater confidence in AVO's ability to deliver on forecasts and upward revisions to the gold price.

Expected Return

Capital growth	**31%**
Dividend yield	**0%**
Total expected return	**31%**

Company Data & Ratios

Enterprise value	**$510m**
Market cap	**$459m**
Issued capital	**272m**
Free float	**76%**
12 month price range	**$0.87-2.00**
GICS sector	**Materials**

Operations going well, and to plan

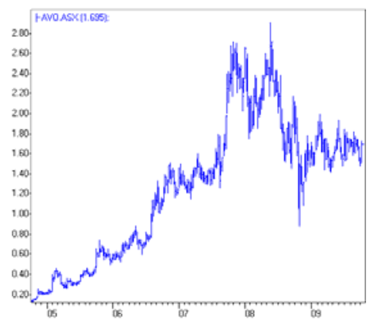
AVO reported September quarter production of 50,584oz from the Trident underground mine at cash operating costs of A$428/oz (A$556 including royalties). This puts the operation on target for +190,000oz for FY10 at estimated cash operating costs of A$452/oz as previously stated.

Upgrade to Buy

AVO's share price performance has been disappointing this year due to the spoiled DIO takeover and the time it has taken for the Trident mine to reach rated production. However, the September quarterly figures reflect a mine that is now operating well with a solid outlook. On the acquisition front, DIO still provides opportunities with AVO having moved to a 46% interest.

We have upgraded our valuation by around 20% with revisions to our FY10 and FY11 production forecasts (+10%) and higher gold prices (US$1050 FY10). Consequently, we lift the target price to $2.20 ($1.85) and the recommendation to Buy.

Absolute Price



SOURCE: SOUTHERN CROSS EQUITIES ESTIMATES

Earnings Forecast

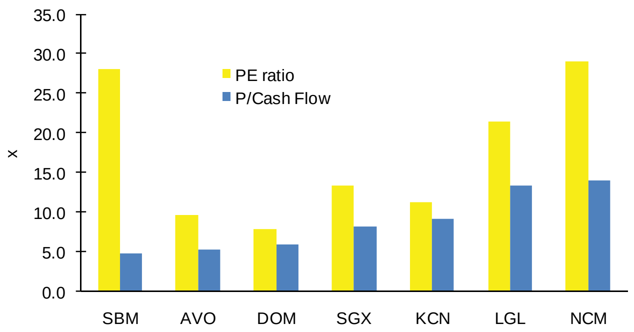
Year end June	2009a	2010f	2011f	2012f
NPAT (reported) (A$m)	-16.3	48.3	42.5	50.1
NPAT (adjusted) (A$m)	-6.8	48.3	42.5	50.1
EPS (adjusted) (cps)	-6.0	17.6	15.3	17.8
EPS growth (%)	na	na	-12.6	16.1
PER (x)	-28.2	9.6	11.0	9.5
P/CFPS (x)	8.8	5.3	6.1	6.1
EV/EBITDA (x)	13.4	4.6	4.4	3.4
Dividend (¢ps)	0.0	0.0	0.0	0.0
Yield (%)	0.0	0.0	0.0	0.0
ROE (%)	-10.3	17.3	11.8	11.1

SOURCE: SOUTHERN CROSS EQUITIES ESTIMATES

AVO's attractions:

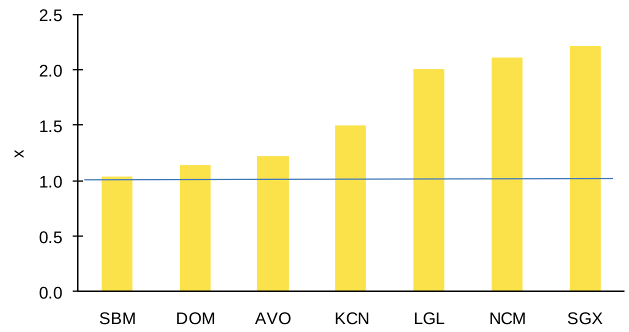
- The Trident underground mine is a quality cornerstone operation with production this year of 190koz at $600/oz (including royalties). Reserves (0.6moz) and resources (1.4moz) have excellent potential for extension.
- 160-200koz production targeted over the next ten years with the addition of new mines. Feasibility work continues at nearby Chalice and Fairplay North for underground; and Musket, Wills and Mitchell for open pits.
- Outstanding potential for additional exploration discoveries with 2,700km^2 of underexplored tenure. Higginsville Line of Lode is a focus.
- Solid balance sheet with net debt of $48m
- Strong earnings and valuation parameters: PEs 10-11 (Fig 1) and trading at a relatively small (20%) premium to NPV (Fig 2); although current resources are priced at a relatively high $320/oz, due to expectations of more discoveries (given AVO's strong exploration skills).
- An equity holding of 46% of DIO provides the potential for consolidation of operations in the region.
- Well placed in the mid cap gold sector, where it sits at the top of the $200-500m sub sector, where there is strong investor interest (Figures 3 and 4).

Figure 1 – Representative PE and CF multiples



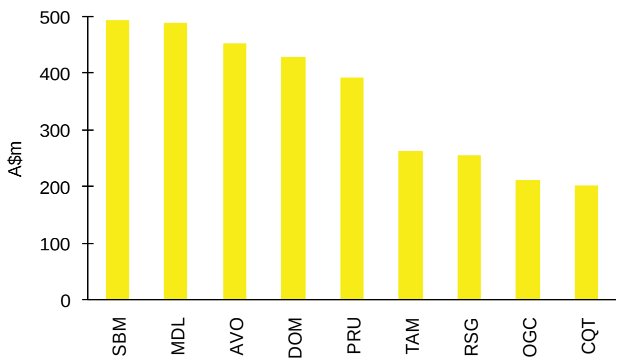
SOURCE: SOUTHERN CROSS EQUITIES ESTIMATES

Figure 2 – Price to NPV ratios



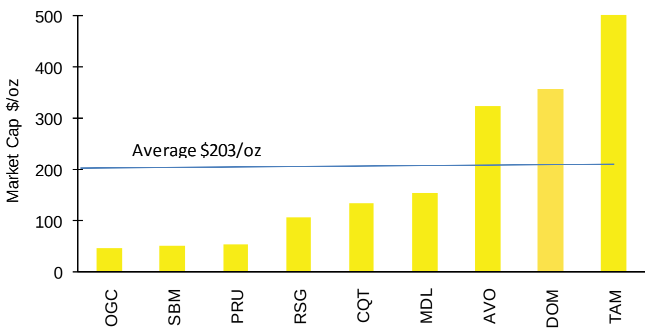
SOURCE: SOUTHERN CROSS EQUITIES ESTIMATES

Figure 3 - $200-500m market cap gold stocks



SOURCE: SOUTHERN CROSS EQUITIES ESTIMATES

Figure 4 – Mid Cap Mcap/Oz Resource



SOURCE: SOUTHERN CROSS EQUITIES ESTIMATES

Avoca Resources (AVO)

Investment view

AVO is a highly successful explorer and a new generation Australian gold producer with its core operation, the Trident gold mine, at full scale in FY09. Production is planned to reach 190kozpa and management is confident of ten years of production from the area. This is a quality mid cap gold company with potential to grow through exploration and acquisition.

Key operations – Trident mine at Higginsville

The Trident underground mine is located in the proven gold territory of Higginsville, between Kambalda and Central Norseman in WA. Trident was discovered by AVO adjacent to the old Poseidon South mine by exploiting the opportunity of deeper drilling. A new 1.0Mtpa treatment plant was constructed on site and is performing above rated capacity. The ramp up to full production was slow with low grades mined initially but design parameters are now being achieved. Operating costs are expected to settle down at under $650/oz (including royalties).

Opportunities – Exploration and Dioro

AVO's exploration expertise is almost certainly going to deliver additional resources and reserves. Nearby, Two Boys (u/g), Chalice (123koz u/g resource), Fairplay (o/c), Musket (o/c), Wills (o/c) as well as extensions to Trident provide opportunities. Regionally, prospects are the high grade Vine prospect and Musket.

AVO launched a $49m scrip offer for Dioro Exploration in April 2009 that operates the Frog's Leg and South Kalgoorlie mines. The offer closed in September with AVO holding 45% of DIO. A bid for DIO was also launched by Ramelius Resources, that is due to expire 2 November. RMS currently holds 12% of DIO. There is still the opportunity for AVO to benefit from its holding in DIO and the potential to consolidate operations in the region.

Risks

The mining inventory is low at 0.6moz and has not been updated for some time. However, this is largely a consequence of the nature of the Trident mine being high grade and often narrow. Additional reserves and resources will need to be established to support a target of 10 years of mine life. AVO has debt of over $100m comprising a secured senior debt facility ($66m) and convertible bonds ($38m).

Board of Directors

Robert Reynolds (Ch), Rohan Williams (MD), Stephanie Unwin, David Quinlivan, Jan Castro.

Shareholders

Pala Invest. 22.5%, Rex Minerals 8.3%

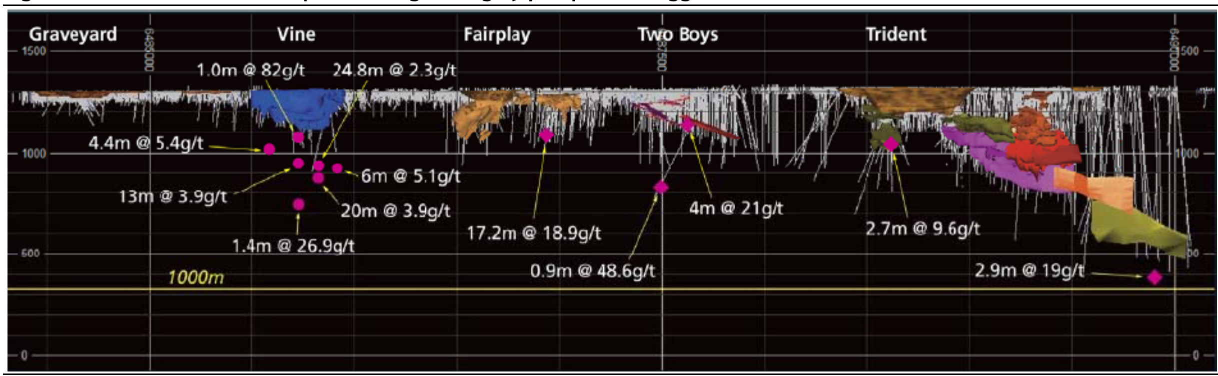
Resources

1.4moz, 3.7g/t

Reserves

0.6moz, 5.3g/t

Figure 5 – Trident and other deposits along the highly prospective Higginsville Line of Lode



SOURCE: COMPANY DATA

Avoca Resources
as at 14 October 2009

Recommendation	Buy
Price	$1.69
Target (12 months)	$2.20

Table 1 - Financial summary

Avoca Resources (AVO)

As at 14-Oct-09

Share price: A$ $ 1.69
Market Cap: A$ $ 459

PROFIT AND LOSS (A$)					
Y/e Jun 30	2008a	2009a	2010f	2011f	2012f
Sales revenue	0	146	237	231	238
EBITDA	-3	38	97	90	96
D&A	0	-42	-39	-35	-28
Other	0	0	0	0	0
EBIT	-3	-4	59	55	67
Other income (expenses)	0	0	0	0	0
Net Interest Expense	3	-9	-1	1	4
Pre-tax profit	-4	-14	57	57	72
Tax	3	7	-9	-14	-21
Net Profit	-1	-7	48	43	50
Adjustments	0	0	0	0	0
SCEQ adj profit	-1	-7	48	43	50
One-off items	0	-9	0	0	0
Reported net profit	-1	-16	48	43	50

CASHFLOW (A$)					
Y/e Jun 30	2008a	2009a	2010f	2011f	2012f
Receipts from customers	0	155	237	231	238
Payments to suppliers	-3	-98	-128	-130	-131
Net interest	4	-5	-1	1	4
Tax paid	0	0	-9	-14	-21
Other	0	0	-12	-12	-12
Operating cashflow	1	52	87	77	78
Capex	-134	-55	-20	-20	-14
Investments	0	0	0	0	0
Asset sales	0	0	0	0	0
Other	-11	-8	-10	-10	-10
Investing cashflow	-145	-63	-30	-30	-24
Change in borrowings	30	18	0	-20	-20
Equity raised	6	29	5	6	11
Dividends paid	0	0	0	0	0
Other	0	1	0	0	0
Financing cashflow	36	49	5	-14	-9
Net change in cash	-108	37	63	33	45
Cash at end of period	2	39	102	135	180

BALANCE SHEET (A$)					
Y/e Jun 30	2008a	2009a	2010f	2011f	2012f
Cash	2	39	101	135	180
Receivables	2	3	12	12	12
Inventories	11	6	19	19	19
Investments	0	0	0	0	0
Other	17	48	132	165	211
Current assets					
PPE	173	177	196	216	229
Investments	0	0	0	0	0
Intangibles	0	40	50	60	70
Other	45	23	23	23	23
Non-current assets	218	240	269	299	322
Total assets	236	287	401	463	533
Payables	20	31	24	23	24
Debt	84	87	87	67	47
Provisions	3	5	5	5	5
Other	12	8	8	8	8
Total liabilities	120	130	123	103	83
Shareholders' equity	115	157	278	361	450
Minorities	1	0	0	0	0
Total shareholders funds	116	157	278	361	450
Total funds employed	199	205	263	293	317
W/A diluted shares on issue	218	272	275	277	281

VALUATION DATA (A$)					
Y/e Jun 30	2008a	2009a	2010f	2011f	2012f
Net profit adj ($m)	-1	-7	48	43	50
EPS (c)	-0.6	-6.0	17.6	15.3	17.8
EPS growth (%)	na	na	na	-13	16
P/E ratio (x)	na	-28.2	9.6	11.0	9.5
CFPS (c)	0.4	19.1	31.6	27.8	27.8
Price/CF (x)	415	8.8	5.3	6.1	6.1
DPS (c)	0	0	0	0	0
Yield (%)	0	0	0	0	0
Franking (%)	0	0	0	0	0
EV/EBITDA	na	13.4	4.6	4.4	3.4
EBITDA margin (%)	na	26	41	39	40
Valuation per share:					**1.37**
Target price (12 mth):					**2.20**
Total Return (including yield)					**31%**

PROFITABILITY RATIOS					
Y/e Jun 30	2008a	2009a	2010f	2011f	2012f
EBITDA/sales (%)	na	26	41	39	40
EBIT/sales (%)	na	-3	25	24	28
Return on assets (%)	-1	-6	12	9	9
Return on equity (%)	-1	-10	17	12	11
Return on funds empl'd (%)	-1	-8	18	15	16
Dividend cover (x)	0	0	0	0	0
Effective tax rate (%)	66	51	16	25	30

LIQUIDITY AND LEVERAGE					
Y/e Jun 30	2008a	2009a	2010f	2011f	2012f
Net debt/(cash) ($m)	83	48	-15	-68	-133
Net debt/equity (%)	72	30	-5	-19	-30
Net interest cover (x)	7	0	-50	39	16
Current ratio (x)	na	1	5	6	7
Inventory turnover	na	16	7	7	7
Inventory/sales	na	6	8	8	8

INTERIMS (A$)					
Y/e Jun 30 ($m)	2008a	2009a	2010f	2011f	2012f
Sales revenue	0	50	112	119	119
SCEQ adj profit	0	-15	21	23	25
One-off items	0	0	0	0	0
Reported net profit	0	-15	21	23	25

VALUATION (A$)				
	Current		12 mnth	24 mnth
	$M	$ps	$ps	$ps
Trident (100%)	384	1.41	1.23	1.05
Corporate	-59	-0.22	-0.20	-0.18
Exploration	65	0.24	0.24	0.24
Hedging	0	0.00	0.00	0.00
Investments	27	0.10	0.10	0.10
Options	4	0.01	0.01	0.01
Cash	-48	-0.17	0.05	0.25
Total	**374**	**1.37**	**1.43**	**1.47**

PRODUCTION (koz)					
Y/e Jun 30	2008a	2009a	2010f	2011f	2012f
Milled (kt)		1012	1160	1200	1200
Grade (g/t)		3.9	5.3	5.1	5.0
Recovery (%)		97.1%	97.5%	97.5%	97.5%
Production (koz)		**131**	**193**	**192**	**188**
Cash Cost (A$oz)		**911**	**611**	**623**	**641**

ASSUMPTIONS					
Y/e Jun 30	2008a	2009a	2010f	2011f	2012f
Gold Price (US$/oz)	823	875	1,045	1,000	950
A$	0.89	0.75	0.85	0.85	0.75
Gold Price (A$/oz)	920	1,171	1,229	1,176	1,267

SOURCE: SOUTHERN CROSS EQUITIES ESTIMATES

Recommendation structure

Spec Buy: Expect >30% total return on a 12 month view but carries significantly higher risk than its sector

Buy: Expect >15% total return on a 12 month view

Accumulate: Expect total return between 0% and +15% on a 12 month view

Reduce: Expect -15% and 0% total return on a 12 month view

Sell: Expect <-15% total return on a 12 month view

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Southern Cross Equities Ltd and its associates hold 20000 shares in AVO as at the date of this report. This position is subject to change without notice..