



RESEARCH

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Cashed up...targeting a trifecta

NPAT estimate fine-tuned; 64% trading disc. to NAV

We have revised our NPAT estimates: FY09 +6%, FY10 -12%, FY11 -5% on the back of expectations for an accelerated depreciation profile (see Chart 1), positively countered by tax losses. NAV has reduced 14% to \$2.49ps for share issue under its recent successful placement. AVO's timing as an emerging A\$ gold producer is impeccable; we believe it is well positioned to achieve an enviable A\$ gold trifecta in FY09:

#1 Placement: Investor appetite exceeds expectations

AVO announced (16 Jan 2009) successful completion of a \$28.9M private placement, with newspapers reporting the accelerated bookbuild was "heavily over-subscribed". The \$28.9M figure represented a 15% increase over previously announced \$25M (\$15M paste fill plant, \$10M working capital). This is **very positive for AVO in the current market and indeed signals investor appetite for gold producers with quality assets, balance sheet and strong A\$ leverage**. We maintain our BUY and raise our 12 month target NAV multiple to 0.96x (in recognition of the successful bookbuild), and now price AVO at \$2.40ps.

#2 Production: Gearing up for better 2H FY09

For Dec qtr 2008, gold production increased 28% relative to Sept qtr. Trident mine production increased 36%, with mined grade flat, inline with expectations. We now conservatively estimate 143 koz (-16koz) for FY09, with ounces expected to double by June qtr 2009 (see Table 2), given recent start of ore development on the thick high grade (9.4g/t Au) 1005 level of Western Zone.

#3 Profit: maiden FY09 NPAT; 100% leverage to +A\$1300/oz

For FY09, we are expecting A\$ gold price to average around A\$1318/oz, driving earnings to \$40M, and a **A\$700/oz operating margin** (contingent on our production and cost expectations being met and ML economic assumptions).

ML Batting Order updated for NPAT growth expectations

Heading into CY08 reporting season (in Feb 2009) our top small to mid cap gold picks are SGX and OGC; we expect at least 2x yoy earnings. For longer term growth our ML batting order remains: AVO, SGX, OGC and KCN.

Stock Data

Price	A\$1.52
Price Objective	A\$2.60 to A\$2.40
Date Established	20-Jan-2009
Investment Opinion	C-1-9
Volatility Risk	HIGH
52-Week Range	A\$0.875-A\$2.91
Mrkt Val / Shares Out (mn)	US\$226 / 222.5
Average Daily Volume	645,121
ML Symbol / Exchange	AVORF / ASX
Bloomberg / Reuters	AVO AU / AVO.AX
ROE (2009E)	26.9%
Net Dbt to Eqty (Jun-2008A)	41.4%
Est. 5-Yr EPS / DPS Growth	299.9% / 0%
Free Float	100.0%



Estimates (Jun)

(A\$)	2007A	2008A	2009E	2010E	2011E
Net Profit b/f Abnormals	(4)	(1)	41	63	62
EPS	(0.023)	(0.006)	0.174	0.255	0.253
EPS Change (YoY)	-115.9%	73.6%	NM	47.1%	-1.1%
Dividend / Share	0	0	0	0	0
Free Cash Flow / Share	(0.123)	(0.649)	(0.005)	0.385	0.351

Valuation (Jun)

	2007A	2008A	2009E	2010E	2011E
P/E	NM	NM	8.76x	5.95x	6.02x
Dividend Yield	0%	0%	0%	0%	0%
EV / EBITDA*	-46.96x	-115.37x	5.00x	2.08x	1.63x
Free Cash Flow Yield*	-7.06%	-41.77%	-0.334%	27.91%	25.43%

* For full definitions of *iQmethod*SM measures, see page 8.

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Refer to important disclosures on page 9 to 11. Analyst Certification on Page 7. Price Objective Basis/Risk on page 7.

20 January 2009

iQprofileSM Avoca Resources

Key Income Statement Data (Jun)	2007A	2008A	2009E	2010E	2011E
(A\$ Millions)					
Sales	0	4	142	244	226
Operating Expenses	(5)	(7)	(67)	(101)	(97)
EBITDA	(5)	(3)	75	143	128
Depreciation & Amortization	0	0	(28)	(51)	(44)
EBIT	(5)	(3)	47	92	84
Net Interest & Other income	1	0	(6)	(3)	4
Associates	NA	NA	NA	NA	NA
Pretax Income	(5)	(4)	42	89	88
Tax (expense) / Benefit	0	3	(1)	(27)	(27)
Net Profit b/f Abnormals	(4)	(1)	41	63	62
Non-Recurring Items	0	0	0	0	0
Net Income (Reported)	(4)	(1)	41	63	62
Avg F Diluted Shares Outstanding	194	218	235	245	245

Key Cash Flow Statement Data

EBITDA	(5)	(3)	75	143	128
Change in Working Capital	3	0	1	0	(1)
Deferred Taxation Charge	0	(2)	0	0	0
Other Adjustments, Net	1	7	3	3	3
Cash Flow from Operations	(1)	4	72	117	108
Capital Expenditure	(23)	(145)	(73)	(22)	(22)
(Acquisition) / Disposal of Investments	(2)	0	0	0	0
Other Cash Inflow / (Outflow)	0	0	0	0	0
Cash Flow from Investing	(25)	(145)	(73)	(22)	(22)
Shares Issue / (Repurchase)	76	6	30	0	0
Cost of Dividends Paid	0	0	0	0	0
Cash Flow from Financing	129	36	51	(22)	(22)
Free Cash Flow	(24)	(141)	(1)	94	86
Net Debt	(61)	48	16	(78)	(166)
Change in Net Debt	NA	NA	NA	NA	NA

Key Balance Sheet Data

Property, Plant & Equipment	50	204	246	214	185
Other Non-Current Assets	1	15	15	15	15
Trade Receivables	1	2	2	2	2
Cash & Equivalents	109	2	52	125	191
Other Current Assets	0	2	2	2	2
Total Assets	161	236	328	369	406
Long-Term Debt	35	44	46	25	7
Other Non-Current Liabilities	0	42	42	42	42
Short-Term Debt	13	6	22	22	18
Other Current Liabilities	0	4	4	13	9
Total Liabilities	59	120	142	120	93
Total Equity	102	116	187	249	313
Total Equity & Liabilities	161	236	328	369	406

iQmethodSM - Bus Performance*

Return on Capital Employed	-4.2%	-0.9%	17.2%	21.1%	17.7%
Return on Equity	-7.1%	-1.5%	26.9%	28.7%	22.0%
Operating Margin	NA	-	33.2%	37.9%	37.2%
		1,408,328.8			
		%			
EBITDA Margin	NA	-86.1%	52.9%	58.8%	56.8%

iQmethodSM - Quality of Earnings*

Cash Realization Ratio	0.1x	-2.2x	1.8x	1.9x	1.7x
Asset Replacement Ratio	66.1x	1,246.0x	2.6x	0.4x	0.5x
Tax Rate (Reported)	6.0%	66.0%	2.1%	30.0%	30.0%
Net Debt-to-Equity Ratio	-60.2%	41.4%	8.6%	-31.4%	-53.1%
Interest Cover	-7.5x	-7.5x	6.3x	12.3x	24.9x

Key Metrics

Franking	0%	0%	0%	0%	0%
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* For full definitions of iQmethodSM measures, see page 8.

Company Description

Avoca Resources is an emerging gold miner in Western Australia with its Trident deposit. First production is targeted 2H08 with an attractive growth profile and significant upside from exploration.

Investment Thesis

Avoca is a single gold mine developer ramping up to full production following a successful gold pour commissioning in July 2008. While production performance are risks, we see good value with full production expected very soon, and FY09 production of 160koz, moving up to 190koz in FY10. Exploration drill results and potential resource upgrades are also expected to be an ongoing positive feature in AVO newsflow.

Stock Data

Price to Book Value 1.8x

Problem-free placement; perhaps future hint

AVO's recent successful placement (issued at \$1.47 per share, a 4% discount to last AVO price) has proven that raisings can be done, even in the current depressed market. Key criteria on why AVO's raising prospered amidst the financial market turmoil are as follows:

- quality gold assets (with de-risked growth potential) run by a capable management team,
- conservatively managed balance sheet,
- purpose set out for fund deployment (construction of paste fill plant and future working capital) are expected to improve upon existing operation, given mine fill approach is industry best practice from a cost/benefit and also environmental perspective, and furthermore it was already budgeted in our numbers (in fact we had previously estimated 12% more capex to be required), and
- of course having BOTH the A\$ and gold price on their side. We expect this trend to continue to remain in place for sometime given our bleak outlook on the global economy. We expect continued weakness on the A\$, coupled with a flat to potentially rising gold price. Our current ML gold estimates: FY09: A\$1318/oz, FY10: A\$1291/oz, FY11: A\$1171/oz, FY12: A\$1100/oz.

Non-cash reduces NPAT; placement lowers NAV

Major drivers of NPAT estimate change are depreciation and application of tax losses. Given the relatively short mine life, we have now modelled assuming depreciation is accelerated for earlier years until more reserve is converted and included in the mine plan (see [Depreciation profile accelerated](#)), rather than our previously assumed flat A\$230/oz depreciation charge. As at FY08 result, A\$11.61M accumulated tax losses remain to be used, and to date (based on our modelled cashflows) we expect this figure to be around A\$13.82M. Previously, we had excluded the application of these tax losses as an offset against provisional income tax expense. The reduction in our NAV has been driven down by the issue of 20.5M shares at A\$1.47/sh.

Table 1: Breakdown of NPAT and NAV Estimate Change

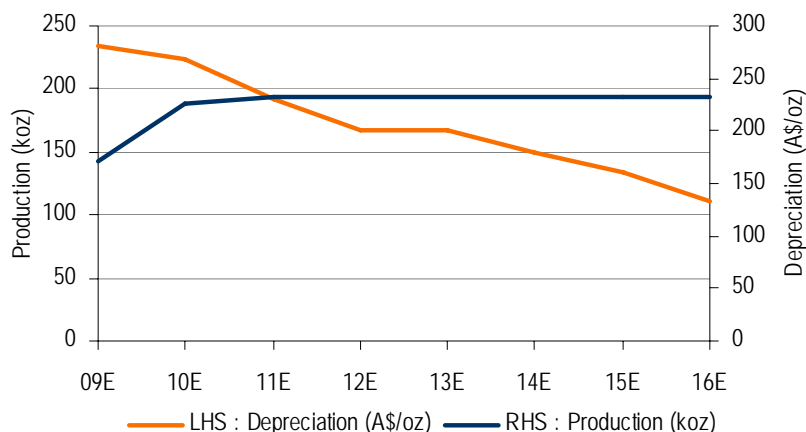
	NPAT (A\$M)			NAV
	FY09	FY10	FY11	A\$ps
Depreciation	-356%	-88%	-155%	27%
Tax Losses	365%	3%	8%	-6%
\$29.5M Private Placement	27%	7%	20%	-82%
Opex	26%	-28%	14%	-33%
Milling & Mine plan	23%	1%	3%	10%
Capex	12%	4%	10%	-18%
FX + gold price	3%	0%	0%	1%
Total	100%	-100%	-100%	-100%

Source: Banc of America Securities - Merrill Lynch Research

Depreciation profile accelerated

We have now applied an accelerated depreciation profile (see Chart 1) for Life of Mine (LOM) ounces inline with asset impairment expectations relevant to current reserve and mine life of around 4.5 years (expected to be depleted by end FY13E, assuming no additions). We expect the depreciation charge to reduce as more resource is converted to reserve. We expect AVO to add at least an additional two years production with A\$72M exploration spend over the next 8 years on non-Higginsville ore deposits), and consequently as other areas are included into the AVO mine plan: Two Boys (6 months), Chalice (+9 months), Musket (+12 months).

Chart 1: AVO Gold Production vs Depreciation Charge



Source: Banc of America Securities - Merrill Lynch Research

FY09 production expectation now conservative

Following recent market update on AVO's Dec qtr 2008 production, we have conservatively reduced our anticipated production profile (-9koz Dec qtr inline with actuals, -7koz Mar qtr on expectation for lower mill throughput). We are now forecasting at a reduced level and below FY09 guidance of +150koz and 1.2Mtpa mill throughput. We believe that current and anticipated ore development grade (including contribution of 1005 level of Western Zone at reserve grade or better, coupled with small contribution of narrow vein Athena at 9-10g/t Au grade) and consequently milled grade has the potential to surprise to the upside.

Table 2: Quarter by Quarter AVO Production Profile

	Sep Qtr A	Dec Qtr A	Mar Qtr E	Jun Qtr E	FY09E
Mined Ore (kt)	179	243	260	290	971
Mined Grade (g/t Au)	3.8	3.9	4.9	6.3	4.9
Milled Ore (kt)	252	264	280	290	1,086
Milled Grade (g/t Au)	2.9	3.4	4.6	5.8	4.2
Recovery (%)	92.8%	96.8%	98.0%	98.0%	96.5%
Recovered Gold (koz)	22	28	40	53	143

Source: Banc of America Securities - Merrill Lynch Research

Maybe MS royalty close-out is the Quadrella?

Based on a 10% WACC and also our production and economic assumptions, we estimate the Morgan Stanley royalty to be valued at A\$113M (46cps). This has the potential to shift quite considerably, given the agreed terms are dependent on a combination of gold production from designated areas and also A\$ gold price threshold being exceeded. Since our estimate on the potential close-out amount is equivalent to around 33% of the current AVO market value (based on the current shares on issue) and expected to equate to around 30% of the AVO market value (with the additional shares expected to be issued post the private placement), and thus due to the size, we do not believe this will take place anytime soon. Given the response to the recent placement and if AVO continues to deliver and grow, we believe a further raising to close out this royalty would be supported in the future.

Profit & Loss

Table 3: Financial Statements & Ratio Analysis - YE June 30

Profit and Loss	07A	08A	09E	10E	11E
Sales	0.0	0.0	142.5	244.1	225.7
Other Revenue	0.0	3.9	0.0	0.0	0.0
Total Revenue	0.0	3.9	142.5	244.1	225.7
Operating Costs	-1.1	-0.7	-59.2	-92.8	-89.5
Exploration	-0.9	-2.9	-2.9	-2.9	-2.9
Other Costs	-3.0	-3.5	-5.0	-5.0	-5.0
EBITDA	-5.0	-3.3	75.3	143.4	128.3
Depreciation & Amortisation	-0.4	-0.1	-28.0	-51.0	-44.4
EBIT	-5.3	-3.4	47.3	92.4	84.0
Net Interest	0.6	-0.5	-5.7	-3.1	4.4
Pretax Profit	-4.7	-3.9	41.6	89.4	88.4
Tax	0.3	2.6	-0.9	-26.8	-26.5
Operating NPAT	-4.5	-1.3	40.7	62.6	61.9
OEI	0.0	0.0	0.0	0.0	0.0
NPAT (Normalised for FCA)	-4.5	-1.3	40.7	62.6	61.9
Significant Items	0.0	0.0	0.0	0.0	0.0
Reported NPAT	-4.5	-1.3	40.7	62.6	61.9
Normalised EPS (¢)	-2.3	-0.7	17.4	25.5	25.3
Reported EPS (¢)	-2.3	-0.6	17.4	25.5	25.3
PER (X)	-66.1	-250.2	8.8	6.0	6.0
DPS (¢)	0.0	0.0	0.0	0.0	0.0
Franking (%)	0.0%	0.0%	0.0%	0.0%	0.0%
Yield (%)	0.0%	0.0%	0.0%	0.0%	0.0%
EPS Growth	115.9%	n/a	2267.6%	47.1%	-1.1%
EBIT/Sales (%)	n/a	n/a	33.2%	37.9%	37.2%
Effective Tax Rate	6%	66%	2%	30%	30%
Interest Cover (X)	-0.1	0.1	-0.1	0.0	0.1
Dividend Cover (X)	0.0	0.0	0.0	0.0	0.0

Source: AVO, Banc of America Securities – Merrill Lynch Research

Production Summary

Table 4: Production Statistics

	07A	08A	09E	10E	11E
Higginsville Production (koz)					
Gold	0	0	143	189	193
Cash Operating Costs¹					
Higginsville (US\$/oz)	0	0	357	337	347
Higginsville (A\$/oz)	0	0	585	491	464
Total Cash Costs¹					
Higginsville (US\$/oz)	0	0	528	522	519
Higginsville (A\$/oz)	0	0	865	759	695

Source: Banc of America Securities - Merrill Lynch Research

Name	ML Ticker		Price	Rating
Sino Gold	SIOGF	AUD	4.48	C-1-9
OceanaGold	OCGDF	AUD	0.29	C-1-9
Kingsgate Consol	KSKGF	AUD	3.44	C-2-8

¹ Banc of America Securities - Merrill Lynch Research estimate of cash operating costs, and total cash costs are inclusive of royalties. Includes a 4% NSR to Morgan Stanley after 100koz production and a 10% royalty for every dollar above a A\$600/oz gold price. A 2.5% royalty to WA government is also included in our estimates.

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Price objective basis & risk

Avoca Resources (AVORF)

Our 12 month PO of \$2.40/sh is at 0.96x our NAV (we have raised our target multiple in recognition of the recently completed, over-subscribed bookbuild) of \$2.49/sh (10% real discount rate). AVO is currently trading at 0.61x, ie below the current P/NAV for the Australian gold sector of 1.1x. We believe that once full production run rate is consistently achieved for a quarter, the company could re-rate and has the potential to trade significantly higher than its current level, and longer term trade at a gold premium to NAV. Risks to our valuation are exchange rate, gold prices, as well as operating costs for the Higginsville project.

Analyst Certification

I, Anna Kassianos, hereby certify that the views expressed in this research report about securities and issuers accurately reflect the research model applied in such analysis. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

Australia-Metals, Mining & Steel Coverage Cluster

Investment rating	Company	ML ticker	Bloomberg symbol	Analyst
BUY				
	Atlas Iron	ATLGF	AGO AU	Mike Harrowell
	Avoca Resources	AVORF	AVO AU	Anna Kassianos
	BHP Billiton Ltd	BHPLF	BHP AU	Olivia Ker, CFA
	BHP Billiton-ADR	BHP	BHP US	Olivia Ker, CFA
	BlueScope Steel	BLSFF	BSL AU	Mike Harrowell
	Energy Res Aust	EGRAF	ERA AU	Olivia Ker, CFA
	Felix Resources Limited	FLRFF	FLX AU	Stuart Howe
	Iluka Resources	ILKAF	ILU AU	Mike Harrowell
	Mount Gibson Iro	MTGRF	MGX AU	Mike Harrowell
	Newcrest Mining	NCMGF	NCM AU	Anna Kassianos
	OceanaGold	OCGDF	OGC AU	Anna Kassianos
	Rio Tinto Ltd	RTNTF	RIO AU	Olivia Ker, CFA
	Sims Group	SMUPF	SGM AU	Mike Harrowell
	Sino Gold	SIOGF	SGX AU	Anna Kassianos
NEUTRAL				
	Centennial Coal Company	CCOAF	CEY AU	Stuart Howe
	Kingsgate Consolidated Ltd	KSKGF	KCN AU	Anna Kassianos
	OM Holdings Ltd	XOMHF	OMH AU	Olivia Ker, CFA
	OneSteel	OSTLF	OST AU	Mike Harrowell
	Paladin Energy	PALAF	PDN AU	Olivia Ker, CFA
UNDERPERFORM				
	Alumina	AWCMF	AWC AU	Olivia Ker, CFA
	Alumina Ltd-ADR	AWC	AWC US	Olivia Ker, CFA
	Gloucester Coal	GCRLF	GCL AU	Stuart Howe
	Lihir Gold Ltd	LIHRF	LGL AU	Anna Kassianos
	Lihir Gold-ADR	LIHR	LIHR US	Anna Kassianos
	Macarthur Coal Ltd.	MACDF	MCC AU	Stuart Howe
	Minara Resources	MREJF	MRE AU	Mike Harrowell
	Murchison Metals	MUMTF	MMX AU	Mike Harrowell
	Panoramic Resources Ltd	PANRF	PAN AU	Mike Harrowell

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***iQmethod*SM Measures Definitions**

Business Performance	Numerator	Denominator
Return On Capital Employed	$\text{NOPAT} = (\text{EBIT} + \text{Interest Income}) * (1 - \text{Tax Rate}) + \text{Goodwill Amortization}$	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A

Quality of Earnings

Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense

Valuation Toolkit

Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	$\text{EV} = \text{Current Share Price} * \text{Current Shares} + \text{Minority Equity} + \text{Net Debt} + \text{Sales} + \text{Other LT Liabilities}$	
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

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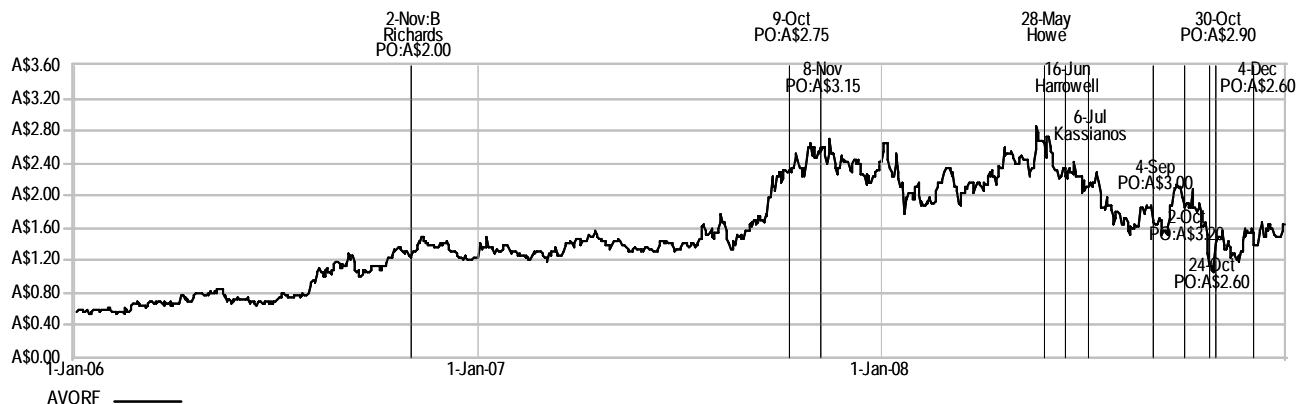
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Important Disclosures

AVORF Price Chart



B : Buy, N : Neutral, S : Sell, U : Underperform, PO : Price objective, NA : No longer valid

*Prior to May 31, 2008, the investment opinion system included Buy, Neutral and Sell. As of May 31, 2008, the investment opinion system includes Buy, Neutral and Underperform. Dark Grey shading indicates that a security is restricted with the opinion suspended. Light grey shading indicates that a security is under review with the opinion withdrawn. The current investment opinion key is contained at the end of the report. Chart is current as of December 31, 2008 or such later date as indicated.

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Investment Rating Distribution: Non-Ferrous Metals/Mining & Minerals Group (as of 01 Jan 2009)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	54	39.42%	Buy	19	40.43%
Neutral	30	21.90%	Neutral	5	20.00%
Sell	53	38.69%	Sell	8	20.00%

Investment Rating Distribution: Global Group (as of 01 Jan 2009)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1297	38.46%	Buy	314	26.81%
Neutral	859	25.47%	Neutral	210	28.23%
Sell	1216	36.06%	Sell	229	20.71%

* Companies in respect of which MLPF&S or an affiliate has received compensation for investment banking services within the past 12 months. For purposes of this distribution, a stock rated Underperform is included as a Sell.

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster*
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

* Ratings dispersions may vary from time to time where BAS-ML Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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