

Improving grade ahead

Poor quarterly production, but gold grade is improving

AVO gold grade declined in 3Q FY09 to 3.2g/t, which was disappointing but expected, given the news releases from the company. Gold output slightly increased QoQ by 6% to 28.8koz, thanks to higher ore treatment throughput. AVO earlier this week reported a record weekly gold production in April of 3.8koz with gold grade of 5.2g/t, with the feed from high grade 1005 level ore running at 7g/t, which we accept as evidence that grades will reach 5g/t+ during the June qtr. We cut our earnings NPAT estimates by in FY09 by -88%, FY10 -8% and FY11 -9%. FY09 reduction was 50% due to the quarterly, and 50% due to mark to market on the gold price and A\$/US\$. Cuts in later years were due to higher ongoing operating costs forecast. Our NPV fell -11% to \$2.41/sh so AVO remains very cheap.

Issue of grade

AVO has presented the market with a considerable amount of data on the reasons why the grade will improve substantially as mining moves below the 1005 level. We believe the company will see the grade rise, output increase and costs fall the \$450/oz guidance for the next 2yrs. Longer term the company faces the challenge of maintaining profitability, but the news flow over the next two quarters will be positive.

Valuation attractive, maintain Buy

Despite the disappointing quarterly results and lower NPV, we continue to believe the valuation is very attractive, trading at 37% discount to NPV, while mature gold producers usually trade at 2x NPV. We maintain buy rating and PO of \$3.2/sh (33% premium to NPV). The stock will be re-rated when the production ramps up with significantly improved grade, very likely in June qtr, in our view.

Estimates (Jun)

| (A\$) | 2007A | 2008A | 2009E | 2010E | 2011E |
|--------------------------|---------|---------|---------|-------|--------|
| Net Profit b/f Abnormals | (4) | (1) | 6 | 90 | 75 |
| EPS | (0.023) | (0.006) | 0.024 | 0.366 | 0.307 |
| EPS Change (YoY) | NA | 73.6% | NM | NM | -16.1% |
| Dividend / Share | 0 | 0 | 0 | 0 | 0 |
| Free Cash Flow / Share | (0.123) | (0.649) | (0.084) | 0.437 | 0.311 |

Valuation (Jun)

| | 2007A | 2008A | 2009E | 2010E | 2011E |
|-----------------------|---------|----------|--------|--------|--------|
| P/E | NM | NM | 63.21x | 4.12x | 4.92x |
| Dividend Yield | 0% | 0% | 0% | 0% | 0% |
| EV / EBITDA* | -46.57x | -114.71x | 8.43x | 1.89x | 1.45x |
| Free Cash Flow Yield* | -6.49% | -38.45% | -5.37% | 29.15% | 20.75% |

* For full definitions of *iQmethod*SM measures, see page 5.

Equity | Australia | Gold & Precious Metals
30 April 2009



RESEARCH

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Stock Data

| | |
|-----------------------------|------------------|
| Price | A\$1.51 |
| Price Objective | A\$3.20 |
| Date Established | 2-Apr-2009 |
| Investment Opinion | C-1-9 |
| Volatility Risk | HIGH |
| 52-Week Range | A\$0.875-A\$2.91 |
| Mrkt Val / Shares Out (mn) | US\$266 / 243.4 |
| Average Daily Volume | 1,383,963 |
| ML Symbol / Exchange | AVORF / ASX |
| Bloomberg / Reuters | AVO AU / AVO.AX |
| ROE (2009E) | 4.1% |
| Net Dbt to Eqty (Jun-2008A) | 41.4% |
| Est. 5-Yr EPS / DPS Growth | 74.2% / NA |
| Free Float | 100.0% |



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Refer to important disclosures on page 6 to 8. Analyst Certification on Page 4. Price Objective Basis/Risk on page 4.

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iQprofileSM Avoca Resources

| Key Income Statement Data (Jun) | 2007A | 2008A | 2009E | 2010E | 2011E |
|----------------------------------|------------|------------|-----------|------------|------------|
| (A\$ Millions) | | | | | |
| Sales | 0 | 4 | 148 | 268 | 262 |
| Operating Expenses | (5) | (7) | (102) | (111) | (110) |
| EBITDA | (5) | (3) | 46 | 157 | 152 |
| Depreciation & Amortization | 0 | 0 | (39) | (43) | (45) |
| EBIT | (5) | (3) | 7 | 114 | 107 |
| Net Interest & Other income | 1 | 0 | (8) | (3) | 0 |
| Associates | NA | NA | NA | NA | NA |
| Pretax Income | (5) | (4) | (1) | 111 | 107 |
| Tax (expense) / Benefit | 0 | 3 | 6 | (21) | (32) |
| Net Profit b/f Abnormals | (4) | (1) | 6 | 90 | 75 |
| Non-Recurring Items | 0 | 0 | 0 | 0 | 0 |
| Net Income (Reported) | (4) | (1) | 6 | 90 | 75 |
| Avg F Diluted Shares Outstanding | 194 | 218 | 235 | 245 | 245 |

Key Cash Flow Statement Data

| | | | | | |
|---|-------------|--------------|-------------|-------------|--------------|
| EBITDA | (5) | (3) | 46 | 157 | 152 |
| Change in Working Capital | 3 | 0 | 0 | 0 | 1 |
| Deferred Taxation Charge | 0 | (2) | (6) | 17 | (2) |
| Other Adjustments, Net | 1 | 7 | 23 | 3 | 3 |
| Cash Flow from Operations | (1) | 4 | 61 | 153 | 122 |
| Capital Expenditure | (23) | (145) | (81) | (46) | (46) |
| (Acquisition) / Disposal of Investments | (2) | 0 | 2 | 0 | 0 |
| Other Cash Inflow / (Outflow) | 0 | 0 | 0 | 0 | 0 |
| Cash Flow from Investing | (25) | (145) | (79) | (46) | (46) |
| Shares Issue / (Repurchase) | 76 | 6 | 36 | 0 | 0 |
| Cost of Dividends Paid | 0 | 0 | 0 | 0 | 0 |
| Cash Flow from Financing | 129 | 36 | 40 | 0 | 0 |
| Free Cash Flow | (24) | (141) | (20) | 107 | 76 |
| Net Debt | (61) | 48 | 30 | (77) | (153) |
| Change in Net Debt | NA | NA | NA | NA | NA |

Key Balance Sheet Data

| | | | | | |
|-------------------------------|------------|------------|------------|------------|------------|
| Property, Plant & Equipment | 50 | 204 | 227 | 227 | 227 |
| Other Non-Current Assets | 1 | 15 | 21 | 21 | 21 |
| Trade Receivables | 1 | 2 | 2 | 2 | 2 |
| Cash & Equivalents | 109 | 2 | 24 | 131 | 208 |
| Other Current Assets | 0 | 2 | 2 | 2 | 2 |
| Total Assets | 161 | 236 | 286 | 393 | 469 |
| Long-Term Debt | 35 | 44 | 54 | 54 | 54 |
| Other Non-Current Liabilities | 0 | 42 | 40 | 57 | 54 |
| Short-Term Debt | 13 | 6 | 0 | 0 | 0 |
| Other Current Liabilities | 0 | 4 | 5 | 5 | 6 |
| Total Liabilities | 59 | 120 | 129 | 146 | 144 |
| Total Equity | 102 | 116 | 157 | 247 | 325 |
| Total Equity & Liabilities | 161 | 236 | 286 | 393 | 469 |

iQmethodSM - Bus Performance*

| | | | | | |
|----------------------------|----|-------------|-------|-------|-------|
| Return on Capital Employed | NA | -0.9% | 1.6% | 30.8% | 20.0% |
| Return on Equity | NA | -1.5% | 4.1% | 44.4% | 26.3% |
| Operating Margin | NA | - | 4.8% | 42.4% | 40.9% |
| | | 1,408,328.8 | | | |
| | | % | | | |
| EBITDA Margin | NA | -86.1% | 31.1% | 58.5% | 58.1% |

iQmethodSM - Quality of Earnings*

| | | | | | |
|--------------------------|--------|----------|--------|--------|--------|
| Cash Realization Ratio | 0.1x | -2.2x | 11.0x | 1.7x | 1.6x |
| Asset Replacement Ratio | 66.1x | 1,246.0x | 2.1x | 1.1x | 1.0x |
| Tax Rate (Reported) | 6.0% | 66.0% | 851.2% | 19.1% | 30.0% |
| Net Debt-to-Equity Ratio | -60.2% | 41.4% | 19.2% | -31.1% | -47.2% |
| Interest Cover | -7.5x | -7.5x | 0.9x | 17.4x | 16.4x |

Key Metrics

| | | | | | |
|----------|----|----|----|----|----|
| Franking | 0% | 0% | 0% | 0% | 0% |
|----------|----|----|----|----|----|

* For full definitions of iQmethodSM measures, see page 5.

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

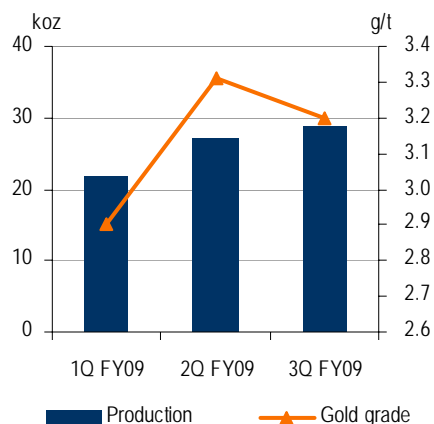
Avoca is a single gold mine developer ramping up to full production following a successful gold pour commissioning in July 2008. While production performance are risks, we see good value with full production expected very soon, and FY09 production of 143koz, moving up to 189koz in FY10. Exploration drill results and potential resource upgrades are also expected to be an ongoing positive feature in AVO newsflow.

Stock Data

Price to Book Value 2.3x

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Chart 1: Quarterly production and gold grade



Source: AVO, Banc of America Securities - Merrill Lynch research

Expecting gold grade to increase

AVO mined 271kt of ore, and produced 28.2koz gold in 3Q FY09 (Mar quarter), 12% and 6% higher than Dec quarter respectively. However, the gold grade declined this quarter. The mined grade in 3Q was 3.4g/t, below Dec quarter's 3.9g/t and our forecast of 4.9g/t. We had been expecting a lower number, but were unsure of the level. Similarly, head grade was 3.2g/t in 3Q FY09, below Dec quarter's 3.3g/t and our forecast of 4.6g/t.

Mainly due to the low grade, AVO's cash cost (net of royalties) on gold produced was ~40% higher than our estimate, at A\$762/oz (US\$514/oz). Assuming producing at the reserve grade of 5.3g/t, the implied cash cost would have been A\$458/t (US\$309/t).

The company is confident to control the cash cost at ~A\$450/oz in FY2010, on the basis that it is making rapid progress in improving the gold grade to >5g/t. For the week ending 23 April 09, the average head grade of the 22.5kt tonnes ore treated was 5.2g/t, while the 1005 level contributed 55% of the weekly mill feed.

Table 1: Profit and Loss and Key Assumptions

| A\$m YE June | 08A | 09E | 10E | 11E | 12E | 13E |
|---|-------------|----------------|----------------|----------------|----------------|----------------|
| Profit and Loss | | | | | | |
| Sales | 0.0 | 159.3 | 268.3 | 261.7 | 246.1 | 237.7 |
| Other Revenue | 3.9 | 0.1 | 0.0 | 0.0 | 0.0 | 0.0 |
| Total Revenue | 3.9 | 159.4 | 268.3 | 261.7 | 246.1 | 237.7 |
| Operating Costs | -0.7 | -97.8 | -104.1 | -102.3 | -100.4 | -99.3 |
| Exploration | -2.9 | -1.3 | -2.9 | -2.9 | -2.9 | -2.9 |
| Other Costs | -3.5 | -4.3 | -4.3 | -4.3 | -4.3 | -4.3 |
| EBITDA | -3.3 | 56.0 | 156.9 | 152.2 | 138.5 | 131.1 |
| Depreciation & Amortisation | -0.1 | -39.0 | -43.2 | -45.0 | -45.0 | -39.1 |
| EBIT | -3.4 | 17.0 | 113.8 | 107.2 | 93.5 | 92.0 |
| Net Interest | -0.5 | -7.6 | -2.5 | 0.3 | 3.6 | 8.8 |
| Pretax Profit | -3.9 | 9.4 | 111.3 | 107.5 | 97.1 | 100.8 |
| Tax | 2.6 | 6.3 | -24.4 | -32.2 | -29.1 | -30.2 |
| NPAT (Normalised for FCA) | -1.3 | 15.8 | 86.9 | 75.2 | 68.0 | 70.6 |
| Significant Items | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Reported NPAT | -1.3 | 15.8 | 86.9 | 75.2 | 68.0 | 70.6 |
| Key assumptions | | | | | | |
| Average Exchange Rate (A\$/US\$) | 0.90 | 0.72 | 0.69 | 0.75 | 0.74 | 0.72 |
| Gold Price (US\$/oz) | 811 | 897 | 1,025 | 1,000 | 925 | 875 |
| Gold Price (A\$/oz) | 901 | 1,249 | 1,491 | 1,338 | 1,259 | 1,215 |
| Gold production | | | | | | |
| Ore treated (t) | | 1,095,670 | 1,120,000 | 1,120,000 | 1,120,000 | 1,120,000 |
| Gold Grade (g/t) | | 3.6 | 5.2 | 5.6 | 5.6 | 5.6 |
| Gold Recovery (%) | | 96% | 97% | 97% | 97% | 97% |
| Gold output (ozs) | | 123,038 | 179,882 | 195,600 | 195,600 | 195,600 |
| Cash Costs (net of Royalties) (A\$/oz) | | 591 | 452 | 416 | 416 | 416 |
| Cash Costs (net of Royalties) (US\$/oz) | | 424 | 311 | 311 | 306 | 299 |

Source: AVO, Banc of America Securities-Merrill Lynch estimates

Takeover offer for Dioro - not in numbers yet

On 14 April 09, AVO announced offers of 1 AVO share for every 2.82 Dioro Exploration NL shares, which value Dioro at A\$0.53/share. AVO has already acquired a 14.95% interest in Dioro by entering into unconditional share purchase agreements with Dioro's two major shareholders, Harmony Gold and Baker Steel Capital Managers. AVO believes that the combined company will benefit from larger resource base, bigger production scale and cost synergy. The offer is conditional on AVO obtaining a relevant interest in at least 90% Dioro shares, on foreign investment approval and on certain other conditions.

We'll wait for material progress in this process, say receiving threshold interests, to merge the financial numbers.

Price objective basis & risk

Avoca Resources (AVORF)

Our 12 month PO of \$3.20/sh is priced at a 33% premium to our NAV of \$2.41/sh (5% real discount rate). Our PO is on an undemanding PER of 9x. We believe that once full production run rate is consistently achieved for a quarter, at this stage most likely the June 2009 quarter in our view, the company could re-rate and has the potential to trade significantly higher.

Risks to our valuation are exchange rate, gold prices, as well as grades and operating costs for the Higginsville project.

Analyst Certification

I, Mike Harrowell, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers.

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 | | | | |
| | Avoca Resources | AVORF | AVO 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 | Mike Harrowell |
| | OceanaGold | OGDCF | OGC AU | Mike Harrowell |
| | OZ Minerals Ltd | OZMLF | OZL AU | Mike Harrowell |
| | Rio Tinto Ltd | RTNTF | RIO AU | Olivia Ker, CFA |
| | Sims Metal Mgt | SMUPF | SGM AU | Stuart Howe |
| | Sino Gold | SIOGF | SGX AU | Mike Harrowell |
| NEUTRAL | | | | |
| | Atlas Iron | ATLGF | AGO AU | Mike Harrowell |
| | BHP Billiton Ltd | BHPLF | BHP AU | Olivia Ker, CFA |
| | BHP Billiton-ADR | BHP | BHP US | Olivia Ker, CFA |
| | Centennial Coal Company | CCOAF | CEY AU | Stuart Howe |
| | Kingsgate Consolidated Ltd | KSKGF | KCN AU | Mike Harrowell |
| | Lihir Gold Ltd | LIHRF | LGL AU | Mike Harrowell |
| | Lihir Gold-ADR | LIHR | LIHR US | Mike Harrowell |
| | OM Holdings Ltd | OMHLF | OMH AU | Olivia Ker, CFA |
| | OneSteel | OSTLF | OST AU | Stuart Howe |
| | 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 |
| | BlueScope Steel | BLSFF | BSL AU | Stuart Howe |
| | 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 |

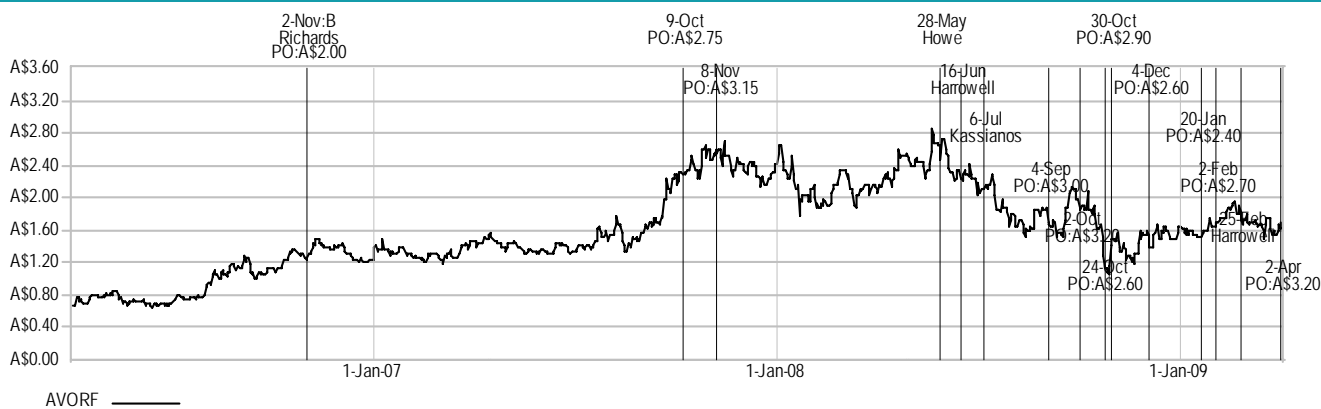
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AVORF Price Chart



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 March 31, 2009 or such later date as indicated.

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

| Coverage Universe | Count | Percent | Inv. Banking Relationships* | Count | Percent |
|-------------------|-------|---------|-----------------------------|-------|---------|
| Buy | 50 | 42.37% | Buy | 16 | 39.02% |
| Neutral | 26 | 22.03% | Neutral | 9 | 42.86% |
| Sell | 42 | 35.59% | Sell | 11 | 32.35% |

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

| Coverage Universe | Count | Percent | Inv. Banking Relationships* | Count | Percent |
|-------------------|-------|---------|-----------------------------|-------|---------|
| Buy | 1243 | 38.21% | Buy | 520 | 46.39% |
| Neutral | 841 | 25.85% | Neutral | 349 | 47.04% |
| Sell | 1169 | 35.94% | Sell | 388 | 36.30% |

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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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