Southern Cross Equities

19 March 2008

| Recommendation | Buy |
|---|---|
| **Price** | **$2.08** |
| **Target (12 mths)** | **$2.80** |

**Expected Return**

| | |
|---|---|
| Capital growth | 35.0% |
| Dividend yield | 0.0% |
| **Total expected return** | **35.0%** |

**Company Data and Ratios**

| | |
|---|---|
| Enterprise value | $452m |
| Market cap | $456m |
| Issued capital | 219m |
| Free float | 83% |
| 12 month price range | $1.26 - $2.72 |
| GICS sector | Materials |



Analyst
Fleur Grose 612 8224 2845
fgrose@sceq.com.au

Authorisation
David Whittaker 612 8224 2886
whittakerd@sceq.com.au

# Avoca Resources

## *First gold production within sight*

- Risk profile diminishes approaching start-up in June
- Funding secured for 2008
- Ongoing exploration success to continue to drive value
- Fully exposed to rising gold price

## Upgrade to Buy on share price weakness

Avoca Resources is developing the Trident deposit at the 100% owned Higginsville project in Western Australia. Trident is expected to be one of the lowest cost producers in Australia, and has full exposure to the rising gold price. Avoca's Higginsville tenements are highly prospective and we expect continued positive exploration news.

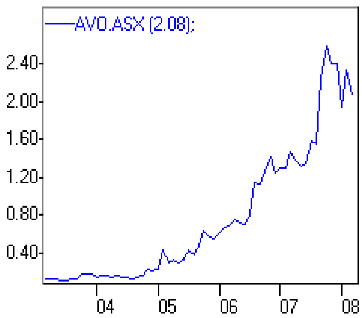
We value Avoca based on a 10 year mine life with production averaging 190koz in the later years. Using our gold price assumptions we derive a valuation of $1.41. However we believe the market discounts the forward curve for gold stocks, which implies a price of $2.76 in 24 months. We have left our target price of $2.80 unchanged which is 2x our NPV and consistent with the forward curve methodology. Given the recent share price weakness, without any fundamental change in the business, we have upgraded to Buy.

**Trident project remains on time and budget.** The development of the Trident mine is progressing and ore is being stockpiled. The 1Mtpa Higginsville treatment plant remains on time and budget for commissioning in June 2008. The original intention was that initial ore would be toll treated until the plant was commissioned. However, discussions with potential parties have failed to reach mutually acceptable terms, and stockpiled ore will now be treated through the Higginsville plant.

**Debt raised to cover cash shortfall.** Avoca has received approval for an A$71m debt facility. The primary purpose is to replace the revenue which would have been received from toll treatment, and provide liquidity until the Higginsville plant is commissioned. Part will also be used to refinance an existing A$21m facility, and cover the ongoing $11m p.a. exploration program.

**Interim accounts not yet reflecting production.** Avoca reported an interim profit of $0.3m, primarily due to interest revenue of $2.9m and a profit on sale of tenements of $0.4m.

**Absolute price**




***Source: Iress***

**Earnings Forecasts**

| **Year end June 30** | **2007a** | **2008f** | **2009f** | **2010f** |
|---|---|---|---|---|
| NPAT (reported) (A$m) | -4.4 | -0.5 | 44.2 | 47.7 |
| NPAT (adjusted) (A$m) | -4.4 | -0.5 | 44.2 | 47.7 |
| EPS (adjusted) (cps) | -3.0 | -0.3 | 29.0 | 31.3 |
| EPS growth (%) | na | na | na | 7.9 |
| PER (x) | na | na | 7.2 | 6.6 |
| P/CFPS (x) | na | na | 4.7 | 4.3 |
| EV/EBITDA (x) | na | na | 5.5 | 4.6 |
| Dividend (¢ps) | 0.0 | 0.0 | 0.0 | 0.0 |
| Yield (%) | 0.0 | 0.0 | 0.0 | 0.0 |
| ROE (%) | -4.4 | -0.4 | 22.4 | 17.6 |

***Source: SCEQ estimates***

MEMBER ORGANISATION OF THE AUSTRALIAN STOCK EXCHANGE

Southern Cross Equities Limited Incorporated ACN 071 935 441
Level 32, Aurora Place, 88 Phillip Street, Sydney NSW 2000
Telephone: (612) 9231 0880 • Facsimile (612) 9231 0588 • Internet: www.sceq.com.au • Email: general@sceq.com.au

## Within sight of production and cash flow

**Still on schedule to commission in June**

The Higginsville project remains on time and on budget, with the plant expected to be commissioned in June, impressive in itself in this resource constrained environment. High grade ore production commenced in the December 2007 half and stockpiles are increasing. We expect production in 2009 to be 150koz, ramping up to 170koz in 2010 and 2011, although Avoca is targeting ~20koz more each year.

**Expected to remain a relatively low cost operation**

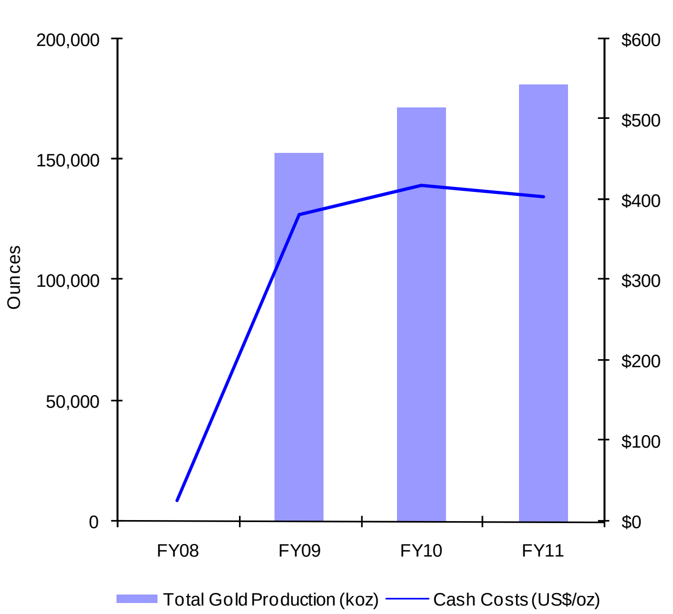
Cash costs were expected to be a weighted average of A$369/oz for the original four year life of the project according to the December 2006 feasibility study. Given current industry pressures we would expect costs to increase, but even at A$400/oz, this is favourable compared to industry peers. Avoca is confident that conservatism on the reserve grade could offset some cost pressure. In addition to mining costs Avoca is bound to pay a royalty to Morgan Stanley which should increase costs to the mid to high A$400's, however this level still remains competitive.

**Cashflow risk decreased with funding locked in**

Assessment of the December quarter cash flow report suggested that there was enough cash to see the project through to the end of April. The original intention was to toll treat the initial ore to fill the cashflow gap until the plant was commissioned. With negotiations yet to be concluded on a treatment contract, this may have been a source of concern to the market in times where obtaining funding is more difficult. However securing the $71m debt facility last week to cover the project until completion and ongoing exploration has provided liquidity through 2008.

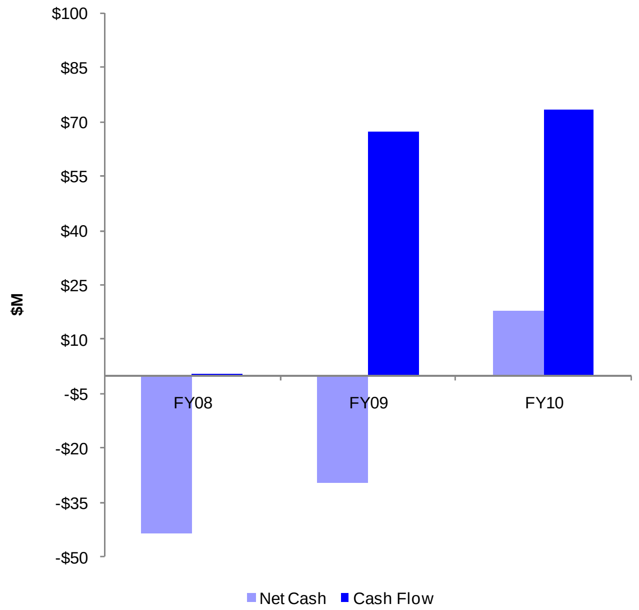
The risk does still remain that any delays to commissioning could jeopardise earnings, however as the project remains on track this risk is decreasing. On a longer term view Avoca is fast tracking exploration at Chalice which it believes could become its second production centre, and provide further flexibility.

**Figure 1 - Production profile**




***Source: Southern Cross Equities estimates***

**Figure 2 - Cash profile**



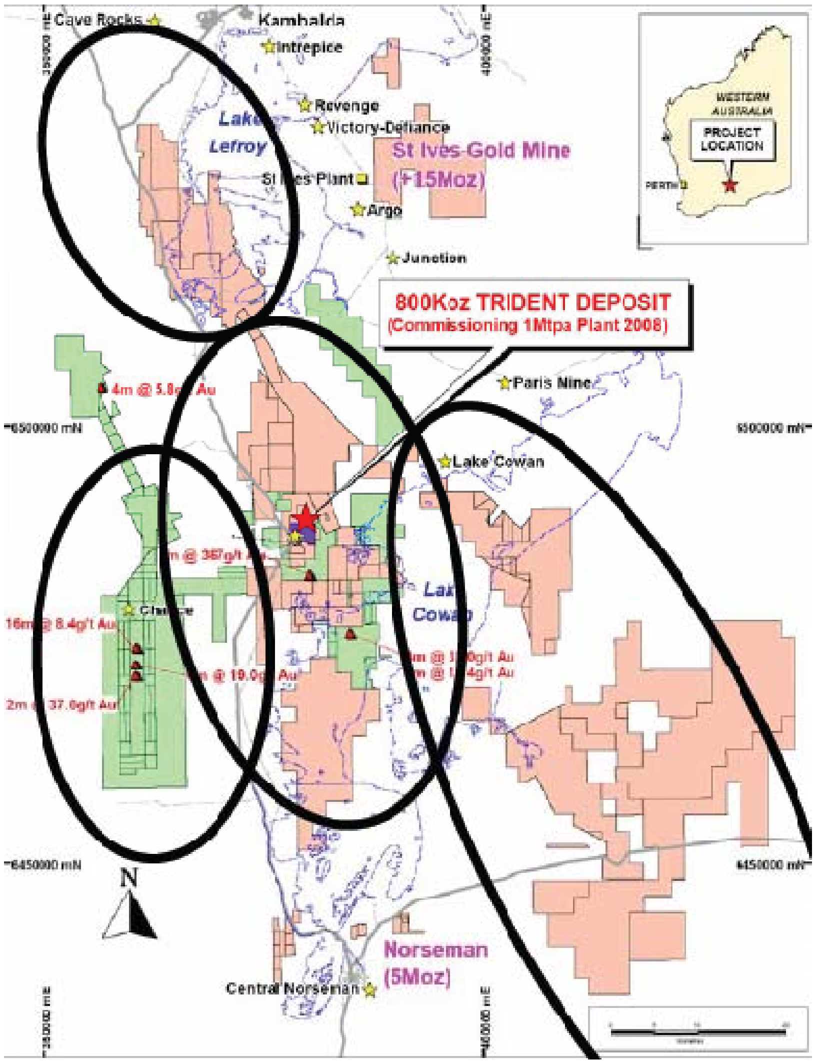

***Source: Southern Cross Equities estimates***

## Longer term growth potential

The feasibility study was approved based on a reserve of 581koz which should support a four year mine life. However, Avoca expects the resources to grow to 4Moz over time, and this should support a life of at least 10 years. Further growth potential is expected from:

- **Trident**. There are numerous high–grade intersections that are presently unclassified due to an insufficient drilling density. Once underground drill positions are established, many of the unclassified intersections should become part of future resources and subsequent reserve conversions.
- **Adjacent to Trident**. The near surface potentially open-pittable resources at Higginsville amount to 251koz and were considered uneconomic at A$450/oz gold in the 1990's, but at higher gold prices may be converted to reserves. Further drilling is targeting a 6km strike length from Trident in the north to Graveyard in the South.
- **Within Higginsville.** The average drill hole depth of the Higginsville gold field is only 45m providing plenty of scope for further exploration.
- **Adjacent to Higginsville.** Avoca believes the recently acquired Chalice underground deposit could become its second underground gold mine in the district. Exploration is focussing on upgrading the 79koz inferred resource below the Chalice pit and drill testing targets within previously unexplored regions of the Chalice gold belt.

**Figure 3 - Growth potential**




*Source: Company data*

## Recent weakness provides opportunity

**AVO has underperformed however risks are diminishing**

Avoca was one of the best performing stocks in 2007, as funding was secured and the gold price rallied. However YTD Avoca has underperformed the gold price and the majors as the market has moved away from stocks with funding risk. With the debt facility approved last week this risk has diminished.

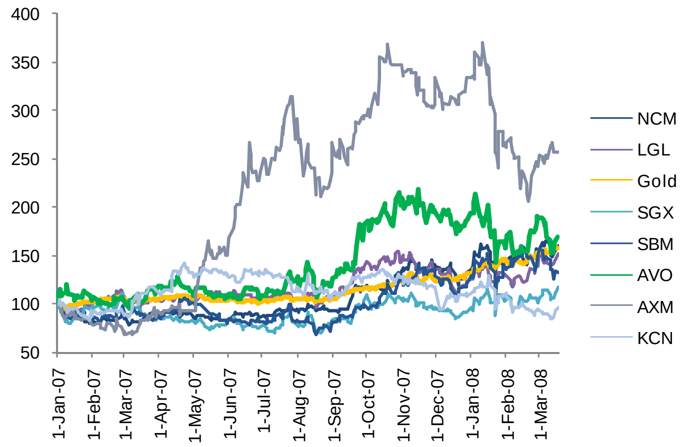
**Upgrade to Buy on weakness**

We value Avoca based on a 10 year mine life with production averaging 190koz in the later years. Using our gold price assumptions we derive a valuation of $1.41. However we believe the market discounts the forward curve for gold stocks, which implies a price of $2.31 or $2.53 in 12 months time. We have left our target price of $2.80 unchanged which is 2x our NPV and consistent with the forward curve methodology. We believe a 2x multiple is justified for an established >150koz producer which Avoca should be within 12 months. Given the recent share price weakness, without any fundamental change in the business, we have upgraded to Buy.

**Confident of at least 10 years life**

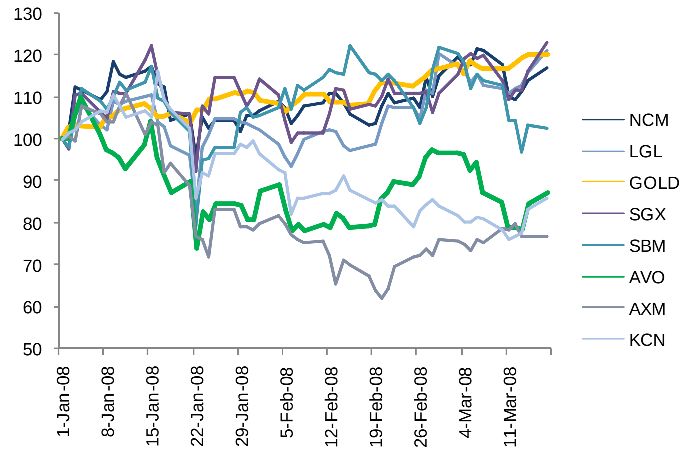
We value Avoca assuming 10 years life and a total of 1.8Moz of gold production. This is far greater than the feasibility study of 4 years life and reserves of 580koz, however with current resources of 1.35Moz and an historical conversion rate of 89% which implies reserves of 1.2Moz, and a targeted exploration program, we are confident this production profile can be fulfilled over time. Chart 6 highlights the risk if only 4 years life is only ever achieved.

**Figure 4 – Performance from 1 Jan 07**



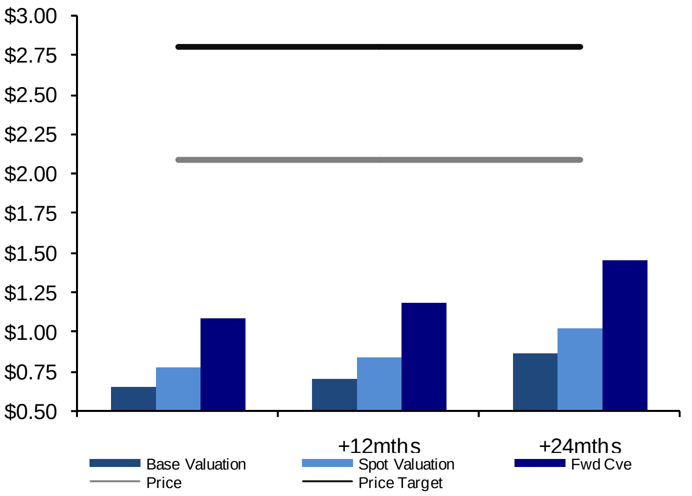

***Source: IRESS***

**Figure 5 - YTD performance**



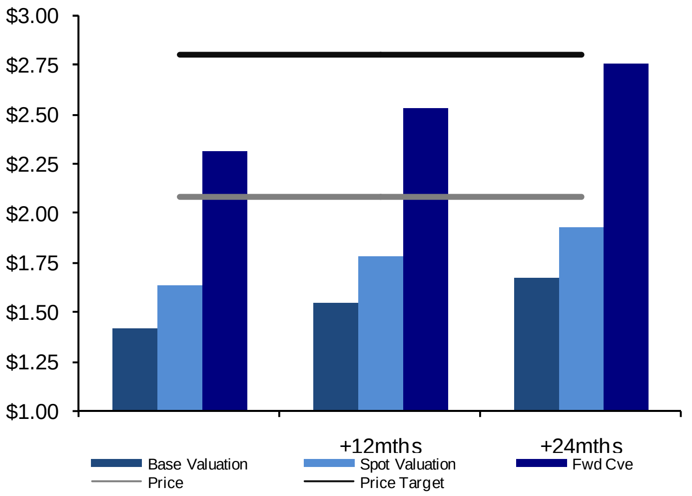

***Source: IRESS***

**Figure 6 - Valuation scenarios – 4 year life**




***Source: Southern Cross Equities estimates***

**Figure 7 - Valuation scenarios – 10 year life**




***Source: Southern Cross Equities estimates***

## Figure 8 – Financial Summary

**Avoca Resources (AVO)**
As at 19-Mar-08

**Share price: A$** $ 2.08
**Market Cap: A$** $ 456

| PROFIT AND LOSS (A$) | | | | | |
|---|---|---|---|---|---|
| **Y/e Jun 30** | **2006a** | **2007a** | **2008f** | **2009f** | **2010f** |
| Sales revenue | 0 | 0 | 0 | 150 | 170 |
| EBITDA | -2 | -4 | -1 | 88 | 95 |
| D&A | 0 | 0 | 0 | -23 | -26 |
| Other | 0 | 0 | 0 | 0 | 0 |
| **EBIT** | -2 | -4 | -1 | 65 | 69 |
| Other income (expenses) | 0 | 0 | 0 | 0 | 0 |
| Net Interest Expense | 1 | 1 | 0 | -2 | -1 |
| Pre-tax profit | -2 | -5 | -1 | 63 | 68 |
| Tax | 0 | 0 | 0 | -19 | -20 |
| Net Profit | -2 | -4 | -1 | 44 | 48 |
| Adjustments | 0 | 0 | 0 | 0 | 0 |
| **SCEQ adj profit** | -2 | -4 | -1 | 44 | 48 |
| One-off items | 0 | 0 | 0 | 0 | 0 |
| **Reported net profit** | -2 | -4 | -1 | 44 | 48 |

| CASHFLOW (A$) | | | | | |
|---|---|---|---|---|---|
| **Y/e Jun 30** | **2006a** | **2007a** | **2008f** | **2009f** | **2010f** |
| Receipts from customers | 0 | 0 | 0 | 150 | 170 |
| Payments to suppliers | -1 | -2 | -2 | -61 | -74 |
| Net interest | 0 | 0 | 3 | -2 | -1 |
| Tax paid | 0 | 0 | 0 | -19 | -20 |
| Other | 0 | 0 | -1 | -1 | -1 |
| **Operating cashflow** | -1 | -1 | 1 | 67 | 73 |
| | | | | | |
| Capex | 0 | -17 | -81 | -43 | -15 |
| Investments | 0 | 0 | 0 | 0 | 0 |
| Asset sales | 0 | 0 | 0 | 0 | 0 |
| Other | -5 | -8 | -11 | -11 | -11 |
| **Investing cashflow** | -6 | -25 | -92 | -54 | -26 |
| | | | | | |
| Change in borrowings | 0 | 53 | 50 | -20 | -20 |
| Equity raised | 11 | 79 | 2 | 1 | 0 |
| Dividends paid | 0 | 0 | 0 | 0 | 0 |
| Other | 0 | -3 | 0 | 0 | 0 |
| **Financing cashflow** | 11 | 129 | 52 | -19 | -20 |
| | | | | | |
| **Net change in cash** | 5 | 102 | -39 | -6 | 27 |
| | | | | | |
| **Cash at end of period** | 7 | 109 | 70 | 64 | 92 |

| BALANCE SHEET (A$) | | | | | |
|---|---|---|---|---|---|
| **Y/e Jun 30** | **2006a** | **2007a** | **2008f** | **2009f** | **2010f** |
| Cash | 7 | 109 | 55 | 49 | 76 |
| Receivables | 0 | 1 | 0 | 8 | 8 |
| Inventories | 0 | 0 | 0 | 12 | 14 |
| Investments | 0 | 0 | 0 | 0 | 0 |
| Other | 8 | 110 | 55 | 68 | 98 |
| **Current assets** | | | | | |
| | | | | | |
| PPE | 1 | 33 | 136 | 179 | 194 |
| Investments | 0 | 0 | 0 | 0 | 0 |
| Intangibles | 17 | 17 | 32 | 43 | 54 |
| Other | 1 | 1 | 3 | 3 | 3 |
| **Non-current assets** | 18 | 51 | 171 | 225 | 251 |
| **Total assets** | 26 | 161 | 226 | 293 | 349 |
| | | | | | |
| Payables | 2 | 11 | 0 | 15 | 17 |
| Debt | 0 | 48 | 98 | 78 | 58 |
| Provisions | 0 | 0 | 3 | 3 | 3 |
| Other | 0 | 0 | 0 | 0 | 0 |
| **Total liabilities** | 2 | 59 | 101 | 96 | 78 |
| | | | | | |
| Shareholders' equity | 23 | 102 | 125 | 197 | 271 |
| Minorities | 1 | 0 | 0 | 0 | 0 |
| **Total shareholders funds** | 24 | 102 | 125 | 197 | 271 |
| | | | | | |
| **Total funds employed** | 16 | 41 | 168 | 227 | 254 |
| | | | | | |
| **W/A diluted shares on issue** | 148 | 149 | 149 | 152 | 152 |

| VALUATION DATA (A$) | | | | | |
|---|---|---|---|---|---|
| **Y/e Jun 30** | **2006a** | **2007a** | **2008f** | **2009f** | **2010f** |
| Net profit adj ($m) | -2 | -4 | -1 | 44 | 48 |
| EPS (c) | -1 | -3 | 0 | 29 | 31 |
| *EPS growth (%)* | na | na | na | na | 8 |
| P/E ratio (x) | na | na | na | 7 | 7 |
| CFPS (c) | 0 | -1 | 0 | 44 | 48 |
| Price/CF (x) | -430 | -210 | 462 | 5 | 4 |
| DPS (c) | 0 | 0 | 0 | 0 | 0 |
| *Yield (%)* | 0 | 0 | 0 | 0 | 0 |
| Franking (%) | 0 | 0 | 0 | 0 | 0 |
| EV/EBITDA | -193 | -103 | na | 6 | 5 |
| *EBITDA margin (%)* | 0 | 0 | 0 | 59 | 56 |
| | | | | | |
| **Valuation per share:** | | | | | **1.42** |
| **Target price (12 mth):** | | | | | **2.80** |
| *Total Return (including yield)* | | | | | **35%** |

| PROFITABILITY RATIOS | | | | | |
|---|---|---|---|---|---|
| **Y/e Jun 30** | **2006a** | **2007a** | **2008f** | **2009f** | **2010f** |
| EBITDA/sales (%) | 0 | 0 | 0 | 59 | 56 |
| **EBIT/sales (%)** | 0 | 0 | 0 | 43 | 41 |
| Return on assets (%) | -6 | -3 | 0 | 15 | 14 |
| Return on equity (%) | -7 | -4 | 0 | 22 | 18 |
| Return on funds empl'd (%) | -10 | -11 | 0 | 19 | 19 |
| Dividend cover (x) | 0 | 0 | 0 | 0 | 0 |
| Effective tax rate (%) | 21 | 6 | 41 | 30 | 30 |

| LIQUIDITY AND LEVERAGE RATIOS (A$) | | | | | |
|---|---|---|---|---|---|
| **Y/e Jun 30** | **2006a** | **2007a** | **2008f** | **2009f** | **2010f** |
| Net debt/(cash) ($m) | -7 | -61 | 44 | 30 | -18 |
| **Net debt/equity (%)** | -31 | -60 | 35 | 15 | -7 |
| Net interest cover (x) | -8 | 8 | -8 | -32 | -73 |
| Current ratio (x) | 4 | 0 | 299 | 4 | 6 |
| Inventory turnover | 0 | 0 | 0 | 5 | 5 |
| Inventory/sales | 0 | 0 | 0 | 7 | 8 |

| INTERIMS (A$) | | | | | |
|---|---|---|---|---|---|
| **Y/e Jun 30 ($m)** | **2006a** | **2007a** | **2008f** | **2009f** | **2010f** |
| Sales revenue | 0 | 0 | 0 | 67 | 83 |
| EBITDA | -1 | -2 | 1 | 42 | 46 |
| D&A | 0 | 0 | 0 | -10 | -13 |
| Other | 0 | 0 | 0 | 0 | 0 |
| **EBIT** | -1 | -2 | 1 | 32 | 33 |
| Other income (expense) | 0 | 0 | 0 | 0 | 0 |
| Net interest | 0 | 0 | 3 | -1 | -1 |
| Pre tax profit | -1 | -2 | 0 | 31 | 33 |
| Tax | 0 | 1 | 0 | -9 | -10 |
| Net Profit | -1 | -2 | 0 | 22 | 23 |
| Adjustments | 0 | 0 | 0 | 0 | 0 |
| **SCEQ adj profit** | -1 | -2 | 0 | 22 | 23 |
| One-off items | 0 | 0 | 0 | 0 | 0 |
| Reported net profit | -1 | -2 | 0 | 22 | 23 |

| Production (koz) | | | | | |
|---|---|---|---|---|---|
| **Y/e Jun 30** | **2006a** | **2007a** | **2008f** | **2009f** | **2010f** |
| | | | | | |
| Milled (kt) | | 0 | 0 | 900 | 1000 |
| Grade (g/t) | | | | 5.5 | 5.5 |
| Recovery (%) | | | 97% | 97% | 97% |
| Production (koz) | | | 0 | 153 | 172 |

| Cash Cost (A$oz) | | | | | |
|---|---|---|---|---|---|
| **Y/e Jun 30** | **2006a** | **2007a** | **2008f** | **2009f** | **2010f** |
| Trident | na | na | na | 381 | 418 |

| ASSUMPTIONS | | | | | |
|---|---|---|---|---|---|
| **Y/e Jun 30** | **2006a** | **2007a** | **2008f** | **2009f** | **2010f** |
| Gold Price (US$/oz) | 523 | 638 | 858 | 925 | 838 |
| A$ | 0.75 | 0.79 | 0.91 | 0.93 | 0.87 |
| Gold Price (A$/oz) | 701 | 811 | 943 | 1000 | 968 |

***Source: Southern Cross Equities estimates***

## Recommendation structure

| | |
|---|---|
| Buy: | Expect >15% total return on a 12-month view |
| Speculative Buy: | Expect >30% total return on a 12-month view but carries significantly higher risk than its sector |
| Fair Value: | Expect total return between –15% and +15% on a 12-month view |
| Sell: | Expect <-15% total return on a 12-month view |


## Southern Cross Equities Limited

Level 32, Aurora Place
88 Phillip Street, Sydney NSW 2000
PO Box R234, Royal Exchange NSW 1225
Telephone: (612) 9231 0880 Fax: (612) 9231 0588
www.sceq.com.au


## Research Team


| | | | | |
|---|---|---|---|---|
| Robert Bishop | Resources Analyst | Mid Caps/Commodities | 612 8224 2859 | rbishop@sceq.com.au |
| Peter Chapman | Senior Resources Analyst | Energy/Gold | 612 8224 2847 | pchapman@sceq.com.au |
| Fleur Grose | Resources Analyst | Gold/Coal | 612 8224 2845 | fgrose@sceq.com.au |
| TS Lim | Financials Analyst | Banks/Regionals | 612 8224 2810 | tslim@sceq.com.au |
| Alexandra McPhee | Industrial Analyst | Consumer/Rural | 612 8224 2894 | amcphee@sceq.com.au |
| Tim Mann | Industrial Analyst | Contractors/Services | 612 8224 2880 | tmann@sceq.com.au |
| Sarah McCloy | Production Manager | Client Services | 612 8224 2885 | smccloy@sceq.com.au |
| Andrew Peros | Analyst | Consumer/Rural | 612 8224 2838 | aperos@sceq.com.au |
| Dinesh Pillutla | Real Estate Analyst | Developers/Trusts | 612 8224 2833 | dpillutla@sceq.com.au |
| David Radclyffe | Head of Resources | Diversifieds/Metals | 612 8224 2829 | dradclyffe@sceq.com.au |
| Stuart Roberts | Industrial Analyst | Healthcare/Biotech | 612 8224 2871 | sroberts@sceq.com.au |
| Lafitani Sotiriou | Analyst | Financials/Industrials | 612 8224 2813 | lsotiriou@sceq.com.au |
| Joel Weiss | Assistant Analyst | Database/Client Services | 612 9231 0880 | jweiss@sceq.com.au |
| David Whittaker | Head of Research | Diversified Industrials/Materials | 612 8224 2886 | dwhittaker@sceq.com.au |



Fleur Grose
**Analyst**

David Whittaker
**Authorisation**




**Disclosure of Interest**

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