09 May 2013

HILLGROVE RESOURCES LIMITED (HGO)

Wilson HTM INVESTMENT GROUP | *A Leading Wealth Manager and Adviser to Emerging Companies*

BUY | HOLD | SELL

ACTION & RECOMMENDATION

With speculation of a growing surplus in the copper market and therefore downside price risk, we highlight HGO's in-the-money (~$30m) hedge book as a significant asset. As well as providing protection to earnings, it also provides HGO with the option to sell the hedge book and eliminate/reduce its outstanding debt ($50m). We prefer HGO to maintain some level of protection until production and cost performance at Kanmantoo improves. We are at the bottom of HGO's FY14 production guidance of between 18 kt and 20 kt of copper. Despite an attractive TSR, we maintain a SPECULATIVE BUY recommendation until consistent production performance is achieved.

12m Target Price (AUD)	**$0.22**
Share Price @ 09-May-13 (AUD)	$0.07
Fcst 12m Capital Return	214.0%
Fcst 12m Dividend Yield	0.0%
12m Total S'holder Return	**214.0%**

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Trading Update

Hedge book provides protection and options

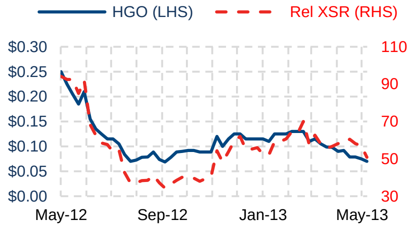
What's Changed

- While HGO's year-to-date share price performance has been in line with the ASX Small Resources index, it has underperformed the LME copper price by 24%. This is despite HGO's production being ~70% hedged out to June 2015 at an average copper price of A$3.61/lb, significantly better than the current spot copper price of A$3.25/lb.
- Growing copper inventory levels and reduced demand is causing concern in the market that the copper price has downside risk.
- We therefore highlight HGO's hedge book, which is currently ~$30m in-the-money, as a significant asset. The obvious benefit is that the forward commitments provide the company with cash flow and earnings protection. We estimate that a -10% change in the copper price reduces HGO's FY14 earnings by ~13%, significantly less than other copper producers under coverage with minimal to no hedging.
- A further benefit of an in-the-money hedge book is that it provides HGO with the option to sell and use the proceeds to pay down its outstanding debt. At the end of FY13, HGO had outstanding interest bearing debt of $50m.
- We would prefer HGO to maintain some level of price protection until production at Kanmantoo improves. Management guidance for FY14 is 18-20 kt of copper in concentrate (WHTMe: 18 kt).

Risks & Catalysts

- **Risk**: Production and cost performance at Kanmantoo.
- **Catalysts**: Revised Reserve/Resource statement expected mid-2013. Evidence of improved operating performance in the April quarter production report (due late May).

12m Share Price Performance



	1m	6m	12m
Abs. Return (%)	-20.5	-39.1	-68.9
Rel. Return (%)	-6.9	-1.1	-26.5

WHTM Return Re-investment Matrix

Return	Low Re-Investment	High Re-Investment
High	Cash Generator	Champion
Low	Challenged	**Potential**

WHTM Risk Assessment

	Low	Med	High	Spec
Share Price Risk				■
Business Risk				■

Year-end January (AUD)	FY12A	FY13A	FY14E	FY15E	FY16E
Revenue ($m)	11.6	115.4	139.6	159.5	166.4
EBITDA Margin (%)	-76	15	34	40	38
NPAT Norm ($m)	-8.7	-10.6	10.4	18.8	21.5
Consensus NPAT ($m)			12.5	19.8	38.8
EPS Norm (cps)	-1.1	-1.0	1.0	1.7	2.0
EPS Growth (%)	35	5	198	71	14
P/E Norm (x)	-6.4	-6.7	6.9	4.0	3.5
EV / EBITDA (x)	-10.7	5.5	2.0	1.5	1.5
CFM (x)	-3.2	2.5	2.4	1.4	1.3
DPS (cps)	0.0	0.0	0.0	0.0	0.0
Franking (%)	0	0	0	0	0

Key Changes		01-May	After	Var %
Revenue	**FY14**	140	140	0.0%
($m)	**FY15**	159	159	0.0%
	FY16	166	166	0.0%
EBITDA:	**FY14**	48.2	48.2	0.0%
($m)	**FY15**	63.5	63.5	0.0%
	FY16	63.2	63.2	0.0%
EPS:	**FY14**	1.0	1.0	-1.8%
Norm	**FY15**	1.8	1.7	-2.0%
(cps)	**FY16**	2.0	2.0	-1.8%
Price Target:		**0.22**	**0.22**	**0.0%**
Rec:		**BUY**	**BUY**	

Mkt Cap: $72m | **Enterprise Value:** $94m | **Shares:** 1,023m | **Sold Short:** 0.2% | **ASX 300 wgt:** 0.0% | **Median T'over/Day:** $0.1m

PRICE TARGET

	Valuation	Price Target
Kanmantoo	265.13	0.24
Exploration	44.89	0.04
Hedge Book	0.57	0.00
Other Equity	0.17	0.00
Corporate	-25.55	-0.02
Net (Debt)/Cash	-22.86	-0.02
TOTAL	262.35	0.24
12 Month Price Target		**0.22**

INTERIMS ($m)

Half Yr (AUD)	Jul 12	Jan 13	Jul 13	Jan 14
	1H A	2H A	1H E	2H E
Sales	49.7	65.7	61.5	78.1
EBITDA	1.5	15.6	17.5	30.7
EBIT	-14.8	5.3	4.2	13.7
Net Profit	**-12.5**	**1.8**	**1.9**	**8.5**
Norm. EPS	**-1.4**	**0.2**	**0.2**	**0.8**
EBIT/Sales	-29.7	8.1	6.8	17.5
Dividend (c)	0.0	0.0	0.0	0.0
Franking (%)	0.0	0.0	0.0	0.0

FINANCIAL STABILITY

Year-end January	FY13A	FY14E	FY15E
Net Debt	22.9	5.7	-41.1
Net Debt / Equity (%)	10.4	2.5	<0
Net Debt / EV (%)	**24.2**	**6.0**	**<0**
Current Ratio (x)	4.4	6.8	6.1
Interest Cover (x)	<0	5.9	11.2
Adj. Cash Int. Cover (x)	**5.2**	**12.2**	**23.9**
Debt / CashFlow (x)	1.8	1.7	0.6
Net Debt (cash) / share	0.0	0.0	<0
NTA / share ($)	0.2	0.2	0.2
Book Value / share ($)	0.2	0.2	0.2
Payout Ratio (%)	0	0	0
Adj. Payout Ratio (%)	0	0	0

EPS RECONCILIATION ($m)

	FY13A		FY14E	
	Rep.	Norm.	Rep.	Norm.
Sales Revenue	115	115	140	140
EBIT	-11.0	-9.4	17.9	17.9
Net Profit	**-11.8**	**-10.6**	**10.4**	**10.4**
Notional Earn.	0.0	0.0	0.0	0.0
Pref./Conv. Div.	0.0	0.0	0.0	0.0
Profit for EPS	**-11.8**	**-10.6**	**10.4**	**10.4**
Diluted Shrs(m)	1,023	1,023	1,023	1,023
Diluted EPS (c)	**-1.2**	**-1.0**	**1.0**	**1.0**

RETURNS

	FY13A	FY14E	FY15E	FY16E
ROE (%)	-4.9	4.6	7.7	8.0
ROIC (%)	-2.7	5.2	9.1	10.0
Incremental ROE	-11.1	200.9	46.8	11.4
Incremental ROIC	3.7	-973.9	-58.0	1.1

KEY ASSUMPTIONS

Year-end January (AUD)	FY12A	FY13A	FY14E	FY15E	FY16E	FY17E	FY18E	FY19E
Copper Price (US$/lb)	4.00	3.60	3.67	3.65	3.54	3.47	3.36	3.02
A$/US$	1.03	1.04	1.03	1.00	0.93	0.90	0.84	0.80
Copper Production (kt)	1.3	13.7	18.0	20.2	20.2	20.2	20.2	20.2
Gold Produced (koz)	0.4	6.5	8.5	8.9	8.9	8.9	8.9	8.9
EBITDA Margin (%)	-76.2	14.8	34.5	39.8	38.0	39.3	36.2	30.7
EBIT Margin (%)	-143.4	-8.9	12.8	18.5	17.5	26.5	23.7	17.4
ROA (%)	-2.9	-3.5	3.3	5.7	6.5	9.1	8.0	5.6
Earnings Sensitivity (% Chg)								
+/- 10% A$/US$	0.0	0.0	2.6	3.7	17.0	31.9	33.9	43.5
+/- 10% Copper Price	0.0	0.0	13.3	9.1	19.5	33.1	35.3	45.7

PROFIT & LOSS ($m)

Year-end January (AUD)	FY12A	FY13A	FY14E	FY15E	FY16E	FY17E	FY18E	FY19E
Sales Revenue	11.6	115.4	139.6	159.5	166.4	166.0	170.6	159.8
EBITDA	-8.9	17.1	48.2	63.5	63.2	65.3	61.7	49.1
Depn & Amort	5.2	26.5	30.3	34.0	34.0	21.3	21.3	21.3
EBIT	**-14.0**	**-9.4**	**17.9**	**29.5**	**29.1**	**44.0**	**40.4**	**27.8**
Net Interest Expense	-1.6	5.7	3.0	2.6	-1.5	-3.2	-4.7	-6.0
Tax	-3.9	-4.5	4.5	8.1	9.2	14.2	13.5	10.1
Minorities / pref divs	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Equity accounted NPAT	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net Profit pre Sig. Items	**-8.7**	**-10.6**	**10.4**	**18.8**	**21.5**	**33.1**	**31.6**	**23.7**
Abn's / Ext's / Signif.	0.0	-1.2	0.0	0.0	0.0	0.0	0.0	0.0
Reported Net Profit	**-8.7**	**-11.8**	**10.4**	**18.8**	**21.5**	**33.1**	**31.6**	**23.7**

CASHFLOW ($m)

Year-end January (AUD)	FY12A	FY13A	FY14E	FY15E	FY16E	FY17E	FY18E	FY19E
EBITDA	-8.9	17.1	48.2	63.5	63.2	65.3	61.7	49.1
Interest & Tax	2.4	-4.0	-8.2	-11.8	-9.9	-14.2	-13.5	-10.1
Working Cap / Other	-15.8	15.3	-10.7	0.7	2.1	3.8	4.9	7.1
Operating Cash Flow	**-22.2**	**28.4**	**29.3**	**52.4**	**55.4**	**54.9**	**53.1**	**46.1**
Maintenance Capex	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Free Cash Flow	**-22.2**	**28.4**	**29.3**	**52.4**	**55.4**	**54.9**	**53.1**	**46.1**
Dividends Paid	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Development Capex	-132.1	-46.7	-12.2	-12.4	-12.4	-12.4	-12.4	-8.2
Invest. / Disposals	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other Inv. Flows	5.9	1.1	0.0	0.0	0.0	0.0	0.0	0.0
Cash Flow Pre Financing	**-148.2**	**-17.3**	**17.1**	**40.1**	**43.1**	**42.5**	**40.7**	**37.9**
Funded by Equity	0.0	17.8	0.0	6.8	0.0	0.0	0.0	0.0
Funded by Debt	51.1	6.2	-17.2	-12.3	-20.0	0.0	0.0	0.0
Funded by Cash	97.1	-6.7	0.0	-34.5	-23.1	-42.5	-40.7	-37.9

BALANCE SHEET SUMMARY ($m)

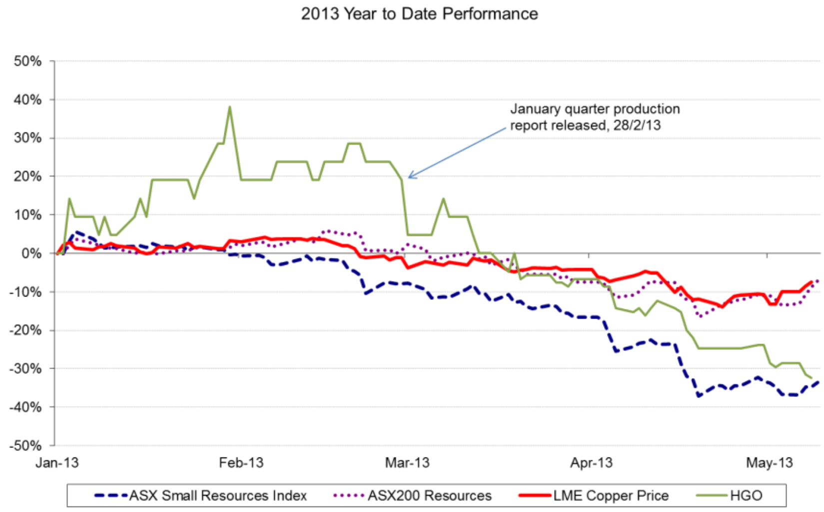
Year-end January (AUD)	FY12A	FY13A	FY14E	FY15E	FY16E	FY17E	FY18E	FY19E
Cash	20.7	27.4	27.4	61.9	84.9	127.5	168.2	206.1
Current Receivables	6.4	6.4	7.6	7.7	8.3	8.2	8.4	7.8
Current Inventories	9.3	19.7	14.8	14.6	14.9	15.3	15.7	16.0
Net PPE	229.4	233.2	208.9	176.8	144.8	125.5	106.2	87.0
Investments	4.2	5.3	5.3	5.3	5.3	5.3	5.3	5.3
Intangibles / Capitalised	19.8	28.1	34.3	44.6				
Other	10.0	15.9	15.9	15.9	70.9	81.3	91.7	97.8
Total Assets	**299.8**	**336.0**	**314.1**	**326.8**	**329.1**	**363.1**	**395.5**	**420.1**
Current Payables	17.2	40.0	24.6	24.3	24.9	25.5	26.1	26.7
Total Debt	51.2	50.3	33.0	20.7	0.7	0.7	0.7	0.7
Other Liabilities	21.3	25.1	25.4	25.2	25.5	25.7	26.0	26.3
Total Liabilities	**89.7**	**115.4**	**83.0**	**70.3**	**51.1**	**52.0**	**52.8**	**53.7**
Minorities / Convertibles	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Shareholder Equity	**210.1**	**220.6**	**231.0**	**256.5**	**278.0**	**311.1**	**342.6**	**366.3**
Total Funds Employed	**261.3**	**270.9**	**264.0**	**277.3**	**278.8**	**311.8**	**343.4**	**367.1**

Hedge book provides protection and options

HGO SHARE PRICE PERFORMANCE IN 2013

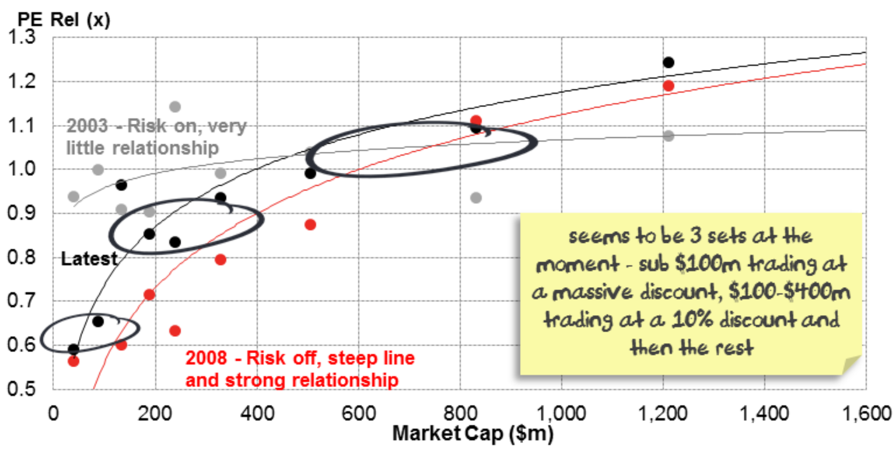
- Exhibit 1 shows that despite a strong performance at the beginning of 2013, the HGO share price has declined since the start of March. This coincided with the release of the company's January quarter production report.
- In the year to date (8 May 2013), the decline in the HGO share price is now in line with the rest of the small resources sector. Since the start of 2013, the HGO share price has declined 32%, slightly less than the ASX Small Resources Index which has declined 35%.
- We estimate HGO's FY14e PE multiple (6.9x) to be at a discount of ~50% to the ASX200 PE multiple of 14x. Exhibit 2 shows that this discount is in line with the discount for other small companies (market capitalisation >$100m) versus the rest of the market.
- Compared with the LME copper price, the HGO share price has underperformed by 24% in the year to date. As we will discuss, this is despite production in FY14 being ~70% hedged at an average copper price of A$3.71/lb which is significantly higher than the spot copper price of A$3.25/lb.

EXHIBIT 1. PERFORMANCE OF HGO SHARE PRICE YTD



Source: IRESS

EXHIBIT 2. SMALL CAP DISCOUNT – P/E RELATIVE VS MARKET CAP

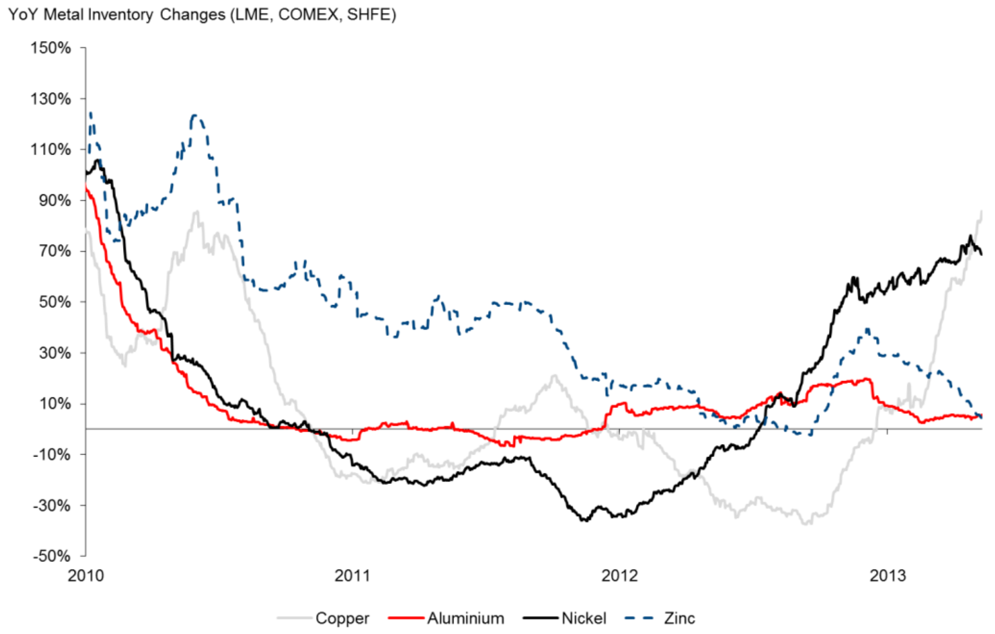


Source: IRESS, Bloomberg

COPPER MARKET UPDATE – GROWING CONCERN OF MARKET SURPLUS

- Copper inventories continue to grow causing concern in the market that the copper price has downside risk. In the past week, outright short positions in COMEX copper increased by 3.8%, while long positions were effectively flat. The net speculative short position is 23,999 contracts (equivalent to 272,144 tonnes). This is still short of the recent high of 28,000 contracts last month. (Source: Base Metal Weekly, 8 May 2013).
- Disappointing recent China PMI data supports the forecast by ICSG (International Copper Study Group) that the copper market will be in surplus in 2013 and 2014. However. recent disruptions to supply are causing this forecast to tighten.
- While inventory levels have been rising, there is some speculation that much of this stock is unavailable. The contango in the copper market makes financing deals more attractive. Therefore, restricted outflow of metal – at a time when demand in China and the USA traditionally peaks – could result in tighter markets than the headline inventory would suggest. Indeed, rising copper regional premia would support this thesis.

EXHIBIT 3. BUILD IN COPPER INVENTORIES CAUSING CONCERN

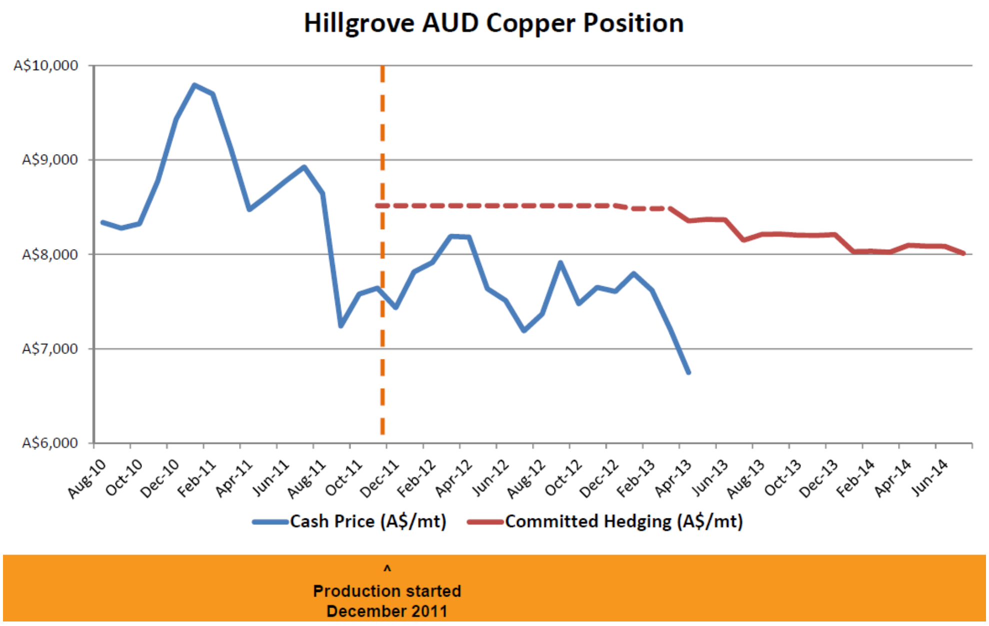


Source: Bloomberg

IN THE MONEY HEDGE BOOK PROVIDES HGO WITH OPTIONS

- Given the downside risk to the copper price, HGO's hedge book is a significant asset. We estimate that it is currently ~$30m in the money (based on a copper three-month price of A$6,430/t) and provides the company with protection for future cash flow and revenue.
- HGO has ~41 kt of copper committed out to June 2015 at an average price of ~A$7,950/t (A$3.61/lb).
- As Exhibit 4 shows, the price of the committed tonnes tails off towards June 2015. We estimate that in FY14 (12 months to 31 January 2014), HGO is ~78% hedged at an average price of A$8,178/t (A$3.71/t). This compares with the current copper price of A$3.25/lb.
- Obviously if the copper price declines further, then HGO's hedge book becomes more in-the-money. Potentially this provides the company with the option to sell its hedge book and use the proceeds to pay out its outstanding debt. At the end of January 2013, HGO's outstanding interest bearing debt was $50m.
- In our view, we would prefer HGO to maintain some level of price protection until production at Kanmantoo improves.

EXHIBIT 4. HGO'S HEDGED COPPER PRICING SIGNIFICANTLY HIGHER THAN SPOT COPPER PRICE



Source: HGO Presentation, 1 May 2013

- Exhibit 5 shows the benefit of HGO's hedge book in a declining copper price environment. Both PNA and OZL have minimal hedging and therefore their earnings are fully exposed to a declining copper price.

EXHIBIT 5. HGO EARNINGS LESS SENSITIVE TO COPPER PRICE MOVE DUE TO HEDGING

EPS sensitivity to +/- 10% Cu Price			
(YE 31 Dec)	**FY13**	**FY14**	**FY15**
PNA	22%	19%	22%
OZL	250%	58%	38%
(YE 31 Jan)	**FY14**	**FY15**	**FY16**
HGO	13%	9%	19%

Source: WHTM Research

HGO GUIDANCE FOR FY14

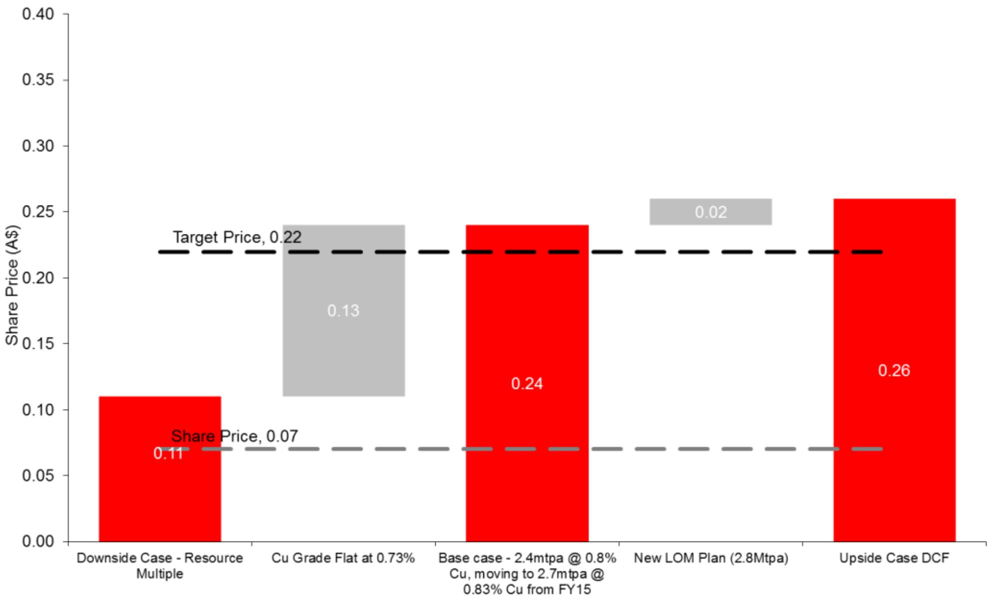
- HGO's production guidance for FY14 is 18- 20 kt of copper (WHTMe: 18 kt). HGO's guidance is weighted towards the second half of the year.
- Key to FY14 guidance is the installation of the new 2.8 Mtpa crusher and the increase in mill feed grade to +0.8% copper. HGO has reported that the new crusher has been installed and is operating to design. HGO will release its April production report towards the end of May. We expect management to provide guidance that mill feed grades towards the end of the quarter have improved.

EXHIBIT 6. HGO GUIDANCE VS WHTM FORECASTS FOR FY14

FY14	HGO Guidance	WHTMe
Production		
Concentrate (kt)	75 - 85	78
Copper (kt)	18 - 20	18
Gold (koz)	5 - 6	5
Costs		
C1 Costs (US$/lb)	2.25 - 2.50	2.24
Processing Grade		
Average	0.75%	0.77%

Source: HGO, WHTM Research

VALUATION OF HGO



- Our 12-month price target (A$0.22/sh) is calculated using a probability weighting of our base case DCF valuation ($0.24/sh), our upside DCF valuation ($0.26/sh), and our downside DCF valuation (A$0.11/sh).
- Our probability weighting reflects our conviction for each scenario occurring. Our current probability weighting is 20% upside scenario, 60% base case and 20% downside scenario.

RETURN RE-INVESTMENT MATRIX

Return		Low Re-investment	High Re-investment
	High	Cash Generator	Champion
	Low	Challenged	**Potential**

Currently progressing a 20 ktpa copper mine in South Australia. Project largely de-risked and should provide consistent returns. We also consider ability to grow organically as likely.

RISK MEASURES

	Low	Med	High	Spec
Share Price Risk				■
Business Risk				■

Share price risk - earnings subject to copper price exposure and strength of AUD.

Business risk - main risk is that project does not deliver forecast copper production profile. Further risk is that exploration potential in South Australia and south-east Asia is not realised.

BUSINESS DESCRIPTION

HGO is an Australian mining company focused on the operation of the Kanmantoo Copper mine in South Australia, and exploration on its Indonesian tenements. In Indonesia, HGO is targeting the discovery of epithermal gold and porphry copper/gold deposits. The Kanmantoo copper mine is located less than 55 km from Adelaide. Ramp-up of the open pit mine and processing circuit is progressing to an initial throughput of 2.4 Mtpa producing ~80 kt of concentrate per annum (~20 ktpa of copper metal).

INVESTMENT THESIS

HGO recently completed a $19m raising to provide sufficient working capital to allow the company to address elevated grade dilution and low mining rates at its Kanmantoo mine. In our base case, operational improvements are achieved and we value the company at $0.24/sh. The current share price approximately reflects the replacement value of the Kanmantoo mine. While we highlight the near-term operating risks, we do see value should these issues be resolved. We rate a Speculative Buy.

REVENUE DRIVERS

- Copper and gold prices
- Improved mining rates and copper feed grades to the mill
- Successful exploration at Kanmantoo and Indonesia

BALANCE SHEET

- Equity: 1,022.8m
- Options: 50m
- Cash: $27m (31-Jan-13)
- Debt: $50m (31-Jan-13)

KEY ASSETS

Kanmantoo copper mine (South Australia): is an open-cut mine with throughput of 2.8 Mtpa, producing approximately 80,000 tonnes of concentrate, containing about 20,000 tonnes of copper metal and 10,000 ounces of gold with exploration potential for further copper.

RESERVES & RESOURCES

- Kanmantoo
- In-situ Resource: 31.2 Mt @ 0.82% Copper
- Long-term stockpile Resource: 1.6 Mt @ 0.37% Copper

KEY ISSUES / CATALYSTS

- Mill feed grades achieving 0.8% by end of April 2013
- Increased Resource at Kanmantoo to increase mine life towards 10 years
- Exploration success in Indonesia provides optionality for HGO

RISK TO VIEW

- Inability to achieve and maintain full production capacity at Kanmantoo

CONTACT DETAILS

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BOARD

- Dean Brown (Chairman)
- John Gooding (Non-Executive Director)
- John Quirke (Non-Executive Director)
- Douglas Snedden (Non-Executive Director)
- Edwin Zemancheff (Non-Executive Director)

MANAGEMENT

- Mr Greg Hall (Managing Director)
- Russell Middleton (Chief Financial Officer)
- Shanthi Smith (Company Secretary)
- Steven McClare (General Manager (Kanmantoo Copper Mine)

MISCELLANEOUS AND OTHER

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Return Reinvestment Matrix and Risk Measures

Definitions at http://www.wilsonhtm.com.au/Disclosures

Recommendation Structure and Other Definitions

Definitions at http://www.wilsonhtm.com.au/Disclosures

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