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Hillgrove Resources (HGO)

COMPANY REPORT – INITIATION OF COVERAGE

Cash flow improving as performance stabilises

- **Synopsis:** In the last two months the Board have appointed a new CEO (the 4th since Kanmantoo started), restructured the debt, raised equity and topped up copper hedging. The debt repayments and hedging are now better matched to production and mine life. The restructure and cash generation from operations should enable the company to increase the mine life from 2019 to 2021 in the first instance and then lift its exploration effort to add new resources along strike.
- **Earnings update**: Jan FY14 and Dec FY14 have been the only two financial years when HGO has posted a profit since Kanmantoo started. The mine has been dogged with mining, processing and maintenance issues. CY17 looks like the year when productivity improvements and a focus on costs will deliver profits. Our valuation is 95cps and our earnings for CY15 are a loss of $6.6m and CY16 a loss of $7.6m. From CY17 onwards we are forecasting a return to profits.
- **Outlook:** We estimate mining costs represent over 80% of the site costs and more than 50% of the total cost of production. The company's focus on reducing mining costs and ongoing optimisation of the mine plan is the key to profitability and mine life. The reduction in mining and processing costs is expected to add two years to the open pit life, it also extends the period in which HGO has to assess the resource potential at depth and along strike. The increased cash generation will also allow them to repay debt and review the dividend payment policy.
- **Investment thesis**: The focus over the last two years has been on cutting costs and stabilisation of the mine/mill operating performance. Peak material movements will occur in CY15 and CY16 and the mine will transition from cash consumption to cash generation. The focus can then move from survival to exploration and life extension. However, we believe that investors will want ongoing evidence of sustainable cash generation and a turnaround in the copper price before re-rating the stock. We have therefore only used 50% of the mine NPV in setting our target price of $0.46 per share.

RECOMMENDATIONS

Rating	**BUY▲**
Risk	High
Price Target	**$0.46**
Share Price	$0.19

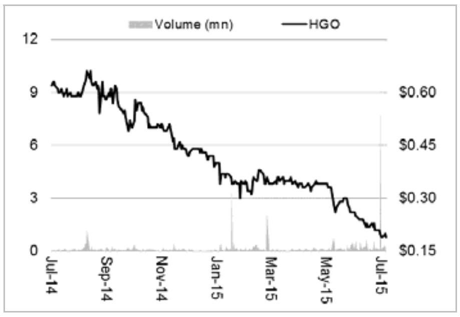
SNAPSHOT

Monthly Turnover	$2.9mn
Market Cap	$37mn
Shares Issued	188.1mn
52-Week High	$0.67
52-Week Low	$0.18
Sector	Materials

BUSINESS DESCRIPTION

Hillgrove Resources Limited (HGO) is an Australian mining company focusing on the operation of the Kanmantoo Copper Mine in South Australia..

12-MONTH PRICE & VOLUME



RESEARCH ANALYST

Warren Edney
+ 613 9602 9384 wedney@baillieuholst.com.au

Disclosure
The author owns no shares in HGO.

INVESTMENT SUMMARY

Year End: 31 December		2013 (A)	2014 (A)	2015 (E)	2016 (E)	2017 (E)
Revenue	$mn	116	140	147	162	183
EBITDA	$mn	12.4	36.6	30.9	31.7	61.8
EBIT	$mn	-14.9	7.4	-8.5	-11.4	17.0
Reported Profit	$mn	4.8	1.5	-6.6	-7.6	13.7
Adjusted Profit	$mn	-3.2	2.6	-6.6	-7.6	13.7
EPS (Reported)	¢	0.4	0.1	-3.3	-3.8	6.9
EPS (Adjusted)	¢	-0.3	0.2	-3.3	-3.8	6.9
EPS Growth	%	N/A	N/A	N/A	N/A	N/A
PER (Reported)	x	41.3	147.0	N/A	N/A	2.7
PER (Adjusted)	x	N/A	84.6	N/A	N/A	2.7
Dividend	¢	0.0	0.0	0.0	0.0	0.0
Yield	%	0.0	0.0	0.0	0.0	0.0
Franking	%	0	0	0	0	0

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Financial summary

Hillgrove Resources (HGO)

Code:	**HGO**	**Rating:**	**Buy**
Analyst:	**Warren Edney**	**Price Target:**	$0.46
Date:	20-Jul-15	**Upside/(Downside):**	143%
Share Price ($A):	$0.19	**Valuation:**	$0.95
Market Cap (A$m):	$35.7	**Risk:**	High
Enterprise Value (A$m)	$30.0		
Year End:	**31 Dec (previously Jan 31)**		

EARNINGS RATIOS	Jan-14A	Dec-14A	Dec-15E	Dec-16E	Dec-17E	Dec-18E
Reported NPAT	**1.5**	**3.8**	**(6.6)**	**(7.6)**	**13.7**	**49.2**
Attributable NPAT	**1.5**	**3.8**	**(6.6)**	**(7.6)**	**13.7**	**49.2**
EPS (cps)	1.0	2.6	-3.5	-4.0	7.3	26.2
EPS Growtrh	-	154%	-	-	-	260%
P/E (x)	18.8	7.4	-	-	2.6	0.7
CFPS (cps)	20.8	26.9	17.5	18.8	31.1	48.6
CFPS Growth (%)	108%	30%	-35%	8%	65%	56%
P/CF (x)	0.9	0.7	1.1	1.0	0.6	0.4
DPS (cps)	0	0	0	0	0	0
Dividend Yield (%)	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
EV/EBITDA (x)	0.8	0.5	1.0	0.9	0.5	0.3

KEY ASSUMPTIONS	Jan-14A	Dec-14A	Dec-15E	Dec-16E	Dec-17E	Dec-18E
Exchange Rate (A$/US$)	1.0050	0.9083	0.7769	0.7300	0.7300	0.7300
Copper Price (US$/lb)	3.32	3.13	2.70	2.65	2.59	2.81
Copper Price (A$/t)	7,288	7,590	7,656	8,012	7,806	8,491
Gold Price (US$/oz)	1,416	1,267	1,205	1,250	1,250	1,250
Silver Price (US$/oz)	24.19	19.39	16.71	18.43	19.40	20.20

PRODUCTION	Jan-14A	Dec-14A	Dec-15A	Dec-16A	Dec-17A	Dec-18A
Copper production (kt)	17.2	20.7	17.4	19.1	22.3	22.9
Payable copper (kt)	16.6	20.0	16.9	18.5	21.6	22.2
Payable gold (koz)	6.0	6.8	5.6	5.9	6.4	6.4
Payable silver (koz)	119.6	118.7	100.3	121.7	143.2	143.2
Payable Copper equivalent (kt)	18.1	21.5	18.3	20.2	23.5	23.9

CASH COSTS						
C1 Cash Costs (US$/lb)	2.46	1.97	2.12	2.02	1.50	1.06
C1 Cash Costs (A$/lb)	2.44	2.17	2.72	2.76	2.06	1.46
Totals costs (US$/lb)	3.30	2.75	2.98	2.83	2.30	1.83

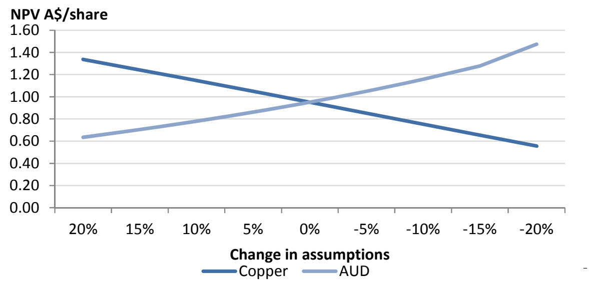
PROFIT & LOSS (A$m)		11mths				
	Jan-14A	Dec-14A	Dec-15E	Dec-16E	Dec-17E	Dec-18E
Sales Revenue	139.2	166.8	146.6	161.7	183.4	203.2
Other Income	0.3	0.1	-	-	-	-
Total Revenue	**139.5**	**166.9**	**146.6**	**161.7**	**183.4**	**203.2**
Operating Costs	97.1	109.5	114.2	128.4	120.0	95.5
Corporate/Other	5.8	(0.3)	1.0	1.0	1.0	1.0
Exploration/Write-Offs	-	-	0.5	0.5	0.5	0.5
EBITDA	**36.6**	**57.7**	**30.9**	**31.7**	**61.8**	**106.3**
Depreciation & Amortisation	29.2	35.9	39.5	43.1	44.9	42.3
EBIT	**7.4**	**21.8**	**(8.5)**	**(11.4)**	**17.0**	**64.0**
Net Interest	(5.5)	(3.6)	(0.9)	0.5	2.5	6.3
Pre Tax Profit	2.2	5.9	(9.4)	(10.9)	19.5	70.3
Income Tax Expense/(Benefit)	0.8	(2.1)	(2.8)	(3.3)	5.9	21.1
Reported NPAT	**1.5**	**3.8**	**(6.6)**	**(7.6)**	**13.7**	**49.2**
Attributable NPAT	**1.5**	**3.8**	**(6.6)**	**(7.6)**	**13.7**	**49.2**
Significant Items (After Tax)	1.1	6.3	-	-	-	-
Adjusted NPAT	**2.6**	**10.1**	**(6.6)**	**(7.6)**	**13.7**	**49.2**

CASH FLOW (A$m)	Jan-14A	Dec-14A	Dec-15E	Dec-16E	Dec-17E	Dec-18E
Operating Cash Flow	**11.0**	**44.2**	**30.2**	**32.3**	**64.5**	**102.1**
Capital Expenditure	(19.0)	(29.8)	(19.2)	(11.7)	(5.0)	(5.0)
Exploration & Evaluation	(3.8)	(0.3)	(1.0)	(1.0)	(1.0)	(1.0)
Other	0.5	0.2	0.0	0.0	0.0	0.0
Investing Cash Flow	**(22.2)**	**(30.0)**	**(20.2)**	**(12.7)**	**(6.0)**	**(6.0)**
Financing Cash Flow	**0.3**	**(21.9)**	**29.7**	**(7.7)**	**(22.7)**	**(8.8)**

BALANCE SHEET (A$m)	Jan-14A	Dec-14A	Dec-15E	Dec-16E	Dec-17E	Dec-18E
Cash	16.5	8.9	48.5	60.5	96.3	183.5
PPE + Development + Exploratic	225.7	211.4	191.1	159.7	119.9	82.6
Total Assets	**322.2**	**304.0**	**323.9**	**305.0**	**301.4**	**351.9**
Borrowings	41.7	19.0	39.0	31.4	8.7	(0.1)
Total Liabilities	**93.7**	**63.8**	**83.8**	**76.0**	**53.3**	**44.5**
Total Shareholder Equity	**228.5**	**240.3**	**240.1**	**228.9**	**248.0**	**307.3**
Gearing - ND/ND+E	10%	4%	-4%	-15%	-55%	-149%
EBITDA/ Net Interest	**(6.7)**	**(16.0)**	**(35.0)**	**63.9**	**24.5**	**16.8**
EBIT/ Net Interest	(1.4)	(6.1)	9.7	(22.9)	6.7	10.1

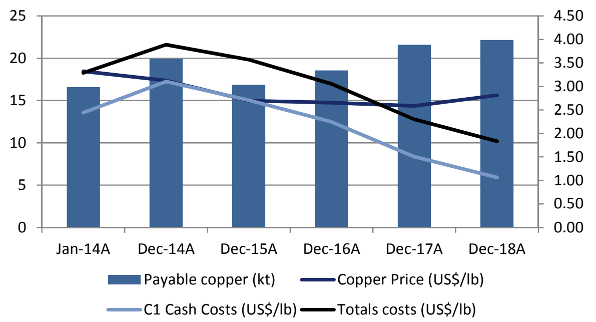
VALUATION		
NPV @ 10.6% WACC	**$m**	**$/sh**
Kanmantoo	184	0.98
Corporate	(11)	(0.06)
Net Cash/(Debt)	6	0.03
Exploration/Other	-	-
Net Asset Value (100%)	**179**	**0.95**
Price / NPV	0.20 X	

VALUATION SENSITIVITY



	NPV	CY15	CY16	CY17	CY18
Forecast	**0.95**	**-6.6**	**-7.6**	**13.7**	**49.2**
Copper +10% increase	0.20	9.3	10.9	12.3	13.9
Copper +US$0.10/lb increase		3.4	4.1	4.7	4.9
Gold +10% increase	0.02	0.6	0.8	0.8	0.9
Gold +US$100/oz increase		0.5	0.6	0.7	0.7
USD +10% increase	-0.17	-4.2	-6.8	-7.7	-9.9
USD +1¢ increase		-0.5	-0.9	-1.0	-1.4

PRODUCTION AND COSTS



RESERVES AND RESOURCES				
Reserves	**kt**	**%Cu**	**g/t Au**	**g/t Ag**
P&P	20.7	0.73	0.18	1.90
Stockpiles	1.4	0.46		
Total	22.1	0.71	0.17	1.78
Resources	**kt**	**%Cu**	**g/t Au**	**g/t Ag**
Measured	4.0	0.73	0.07	1.28
Indicated	22.3	0.81	0.22	2.16
Inferred	5.0	0.67	0.13	1.79
Total	31.3	0.77	0.19	1.99

No time to relax, time to deliver

- The recent equity raising and debt restructure provides HGO with funding to cover mine development and repayment profile better matching our expectations of cash generation. Our forecast reduction in costs also puts the company in a better position to weather the volatility in the copper market and add an additional couple of years to the mine life.
- HGO shareholders have not enjoyed significant returns from the company, and while they may not get a dividend in the next two years, the potential for returns is increasing. The last dividend payment was when it sold its 19% equity interest in Eastern Star Gas for $172m in July 2009 and posted a profit of $55m in the year to January 2010 - a dividend of 2cps was declared.
- Equity raising issuance since the decision to go ahead with Kanmantoo:
  - Year to January 2011 – SPP and Placement to raise $84.170m;
  - Year to January 2012 – no equity raising;
  - Year to January 2013 – SPP and issue to raise $18.949m;
  - Year to January 2014 – placement to raise $10.759m;
  - Share consolidation 8 for 1 in September 2014;
  - 2015 YTD – entitlement issue $10m (3 for 11 entitlement offer at $0.25 per share was taken up by ~50% of shareholders, 70% the 20.5m shares not subscribed for went to Freepoint Metals and Concentrates and 30% to Wilson HTM as underwriters, Freepoint now owns 12.3% of HGO).

No more equity raisings on the horizon.

HGO should be able to generate to fund mine extensions and dividends.

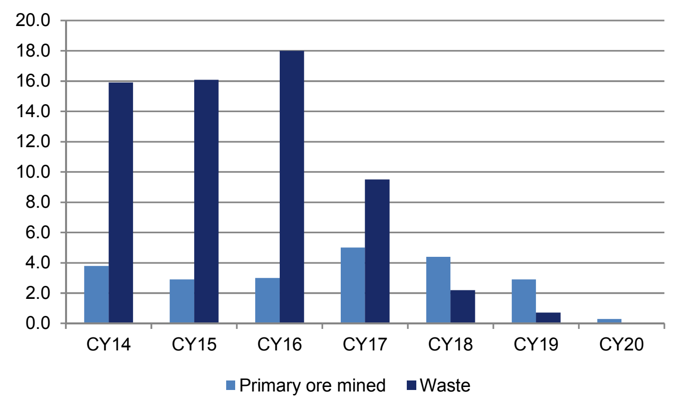
Focus on many fronts

- HGO's April presentation at SAREIC Conference showed the productivity improvements achieved over the last 17 months by the Mining team at Kanmantoo include:
  - 48% reduction in mining unit costs;
  - 81% increase in mining production;
  - 24% increase in truck efficiency;
  - 17% increase in drilling efficiency;
  - 17% decrease in blasting powder factor;
  - 24% decrease in fuel consumption;
  - 75% decrease in dilution.

Now time utilise mining improvements as material movement peaks

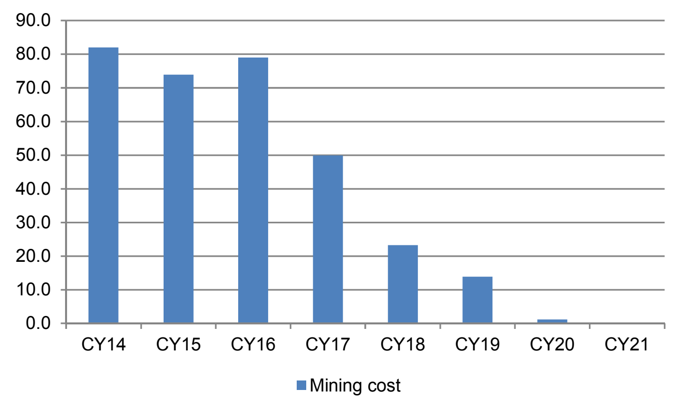
- The improvements above are admirable but they also highlight that site management have had a lot to deal with in terms of getting the production and costs on track. Having bedded down some of the gains and the evolution of the mine plan should see an improvement in cash flow.

FIG.1: MATERIAL MOVEMENTS (Mt)



Source: Baillieu Holst, HGO

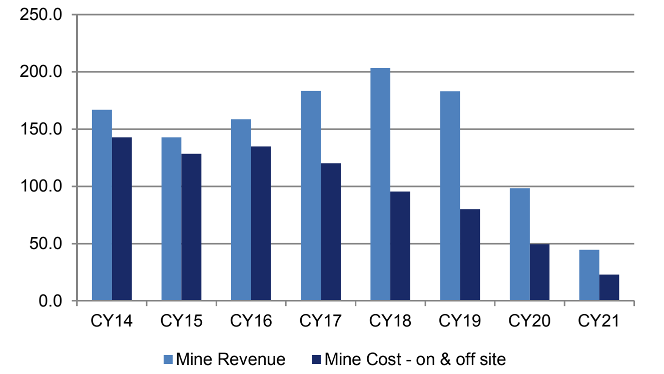
FIG.2: MINING COST (A$M)



Source: Baillieu Holst, HGO

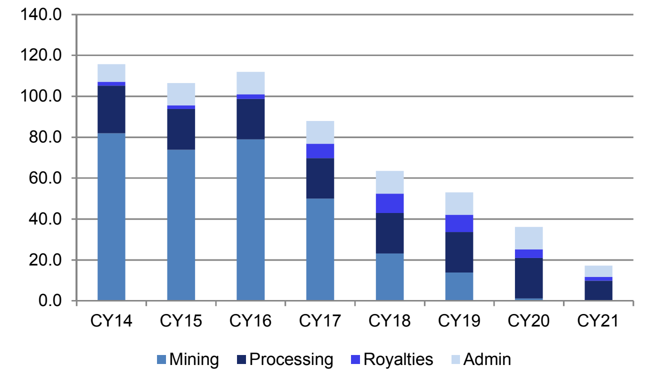
- Mining costs in absolute terms are forecast to peak in in CY16 in line with completion of the Giant cut back.
- Mine cash flow should start improving this year as mining costs fall from over 70% of the cost of production. Mining costs continue to decline as strip ratio falls and the pit deepens.

FIG.3: MINE REVENUE & COSTS (A$M)



Source: Baillieu Holst, HGO

FIG.4: SITE CASH COSTS (A$M)

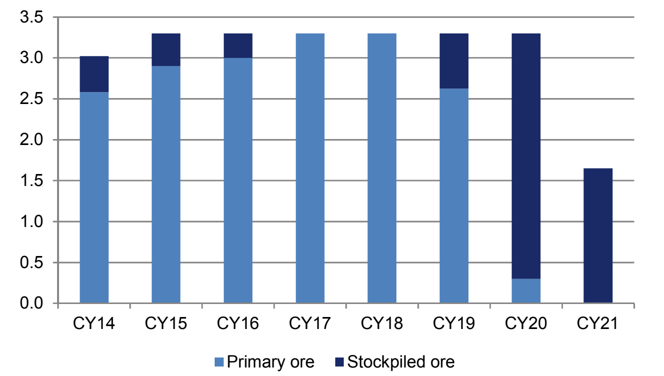


Source: Baillieu Holst, HGO

Processing costs improvement

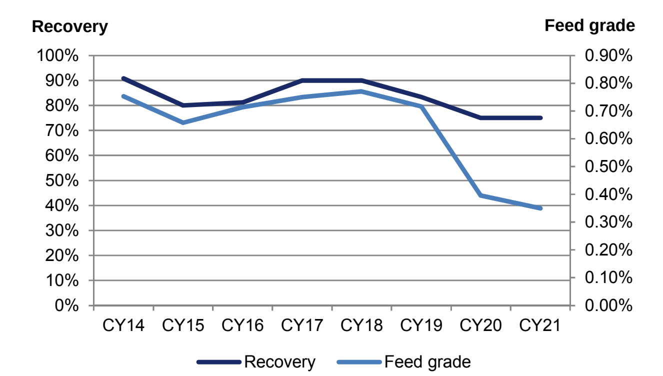
- Comminution circuit has plagued the operations since production first started with poorly designed feed systems or crushers which may have been low cost to refurbish but did not turn out to be economical.
- A new jaw crusher in April 2013, followed by modifications to screening, changes in the flotation circuit, the addition of the CPS circuit and improved process stream monitoring has improved the performance of the mill in terms of output and operating cost. The mill has started to deliver consistent throughput and treatment rates between 2.8Mtpa to 3.5Mtpa. We have factored treatment rates of 3.3Mtpa made up of ROM and stockpiles.
- Being able to cope with stockpile feed is therefore important. The previous mine plan did include processing more oxide and transition ore into the mill in the late CY15 and early CY16 which would have seen recoveries fall to 70%. In order to balance out the impact of changing feed type the company has now decided to batch process the oxide and transition ore. We have tried to estimate the impact of blending the feed but it will probably take us a couple of quarters to refine these estimates. Some history of the performance of the CPS plant and the impact on costs will allow us to refine our assumptions for CY19 to CY21, when we have assumed that the bulk of the ore treated is from stockpiles.

FIG.5: PROCESSING RATES (Mt)



Source: Baillieu Holst, HGO

FIG.6: GRADE AND RECOVERY

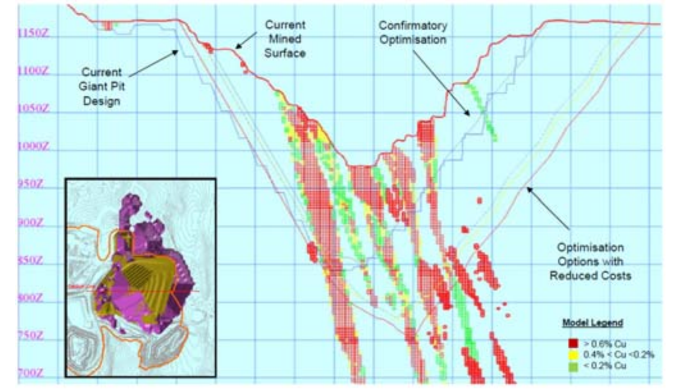


Source: Baillieu Holst, HGO

Life extension and exploration

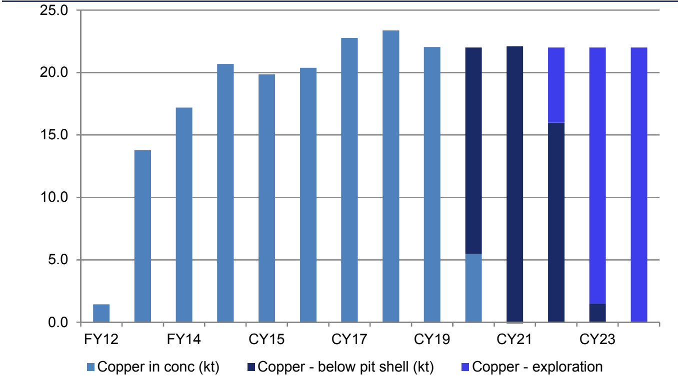
- Management believe that the reduction in mining and processing costs is sustainable and that with further fine tuning could be reduced further.
- The figure below shows the current Giant Pit design (optimised profile in blue), however by including achieved lower costs the pit shell is dragged lower and has the potential to increase the mine life by two years. The company has indicated that getting an extension permit to mine until 2021 is achievable based on the recent extension granted by the SA Government to allow them to mine until 2019. Essentially the company is required to firm up a new Life of Mine plan before applying for the extension of the PEPR to 2021.

FIG.7: NEW PIT PROFILE



Source: HGO

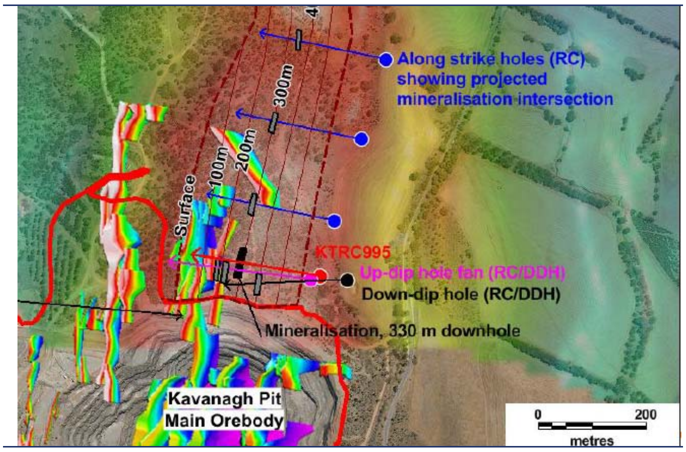
FIG.8: EXTENSION OF MINE LIFE POSSIBLE BUT NOT MODELLED



Source: Baillieu Holst, HGO

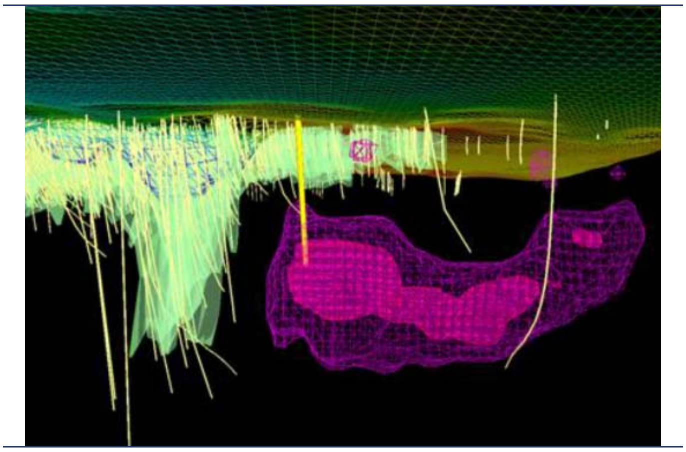
- An additional two years of mine life would give the company sufficient time to drill out the gravity and magnetic anomaly shown in the figures below. If the anomaly turns into a resource and then a reserve. HGO will be well positioned to utilise the existing infrastructure which will be largely depreciated.
- It has been some time since exploration has been a driver of the company's share price performance however we believe that this will change over the next 18 months as work begins on drilling the magnetic anomaly along strike from the Kavanagh Pit.

FIG.9: DRILLING OF GRAVITY ANOMALY



Source: HGO

FIG.10: ANOMALY ADJACENT TO KAVANAGH PIT



Source: HGO

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ABN 74 006 519 393
Australian Financial Service Licence No. 245421
Participant of ASX Group
Participant of NSX Ltd

www.baillieuholst.com.au

Melbourne (Head Office)
Address Level 26, 360 Collins Street
Melbourne, VIC 3000 Australia
Postal PO Box 48, Collins Street West
Melbourne, VIC 8007 Australia
Phone +61 3 9602 9222
Facsimile +61 3 9602 2350
Email melbourne@baillieuholst.com.au

Bendigo Office
Address Cnr Bridge & Baxter Streets
Bendigo, VIC 3550 Australia
Postal PO Box 40
North Bendigo, VIC 3550 Australia
Phone +61 3 5443 7966
Facsimile +61 3 5442 4728
Email bendigo@baillieuholst.com.au

Geelong Office
Address 16 Aberdeen Street
Geelong West Vic 3218
Postal PO Box 364
Geelong Vic 3220 Australia
Phone +61 3 5229 4637
Facsimile +61 3 4229 4142
Email geelong@baillieuholst.com.au

Newcastle Office
Address Level 1, 120 Darby Street
Cooks Hill, NSW 2300 Australia
Postal PO Box 111
The Junction, NSW 2291 Australia
Phone +61 2 4925 2330
Facsimile +61 2 4929 1954
Email newcastle@baillieuholst.com.au

Perth Office
Address Level 10, 191 St Georges Terrace
Perth WA 6000 Australia
Postal PO Box 7662, Cloisters Square
Perth, WA 6850 Australia
Phone +61 8 6141 9450
Facsimile +61 8 6141 9499
Email perth@baillieuholst.com.au

Sydney Office
Address Level 18, 1 Alfred Street
Sydney, NSW 2000 Australia
Postal PO Box R1797
Royal Exchange, NSW 1225 Australia
Phone +61 2 9250 8900
Facsimile +61 2 9247 4092
Email sydney@baillieuholst.com.au