

Hillgrove Resources (HGO)

Now producing copper

Net cashflow positive in February; Positive grade reconciliation

Recommendation

BUY

Price

19.0c

Valuation

43c

ASX / S&P Sector

Metals & Mining

HGO became a copper producer in November 2011, as originally scheduled.

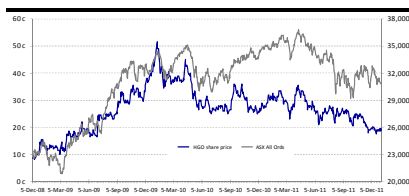
While HGO has had some hiccoughs in commissioning

- **The cost over-run has been resolved and will be paid progressively from April, AFTER the operations are producing net cash; and**
- **The increased working capital requirement from the slight delay to first product (from early to later November) and been resolved with an increase in debt lines; also**
- **Operations have out-performed expectations with higher ore grade, better recoveries, higher throughput and higher concentrate grades.**

Snapshot

Last Price	\$0.190
Market Cap.	\$151 million
Shares on Issue	794m
52 Week High	\$0.355
52 Week Low	\$0.175

Price Chart



HGO began producing copper from the Kanmantoo copper-gold mine in South Australia in November 2011 and is ramping up to 21kt/yr Cu in conc, with 9koz/yr Au and 177koz/yr Ag.

HGO expects operations to be cashflow positive from February 2012.

HGO has had some minor hiccoughs in commissioning, but these have been resolved and operations are producing at better than expected levels.

HGO also has very attractive exploration prospects in Indonesia as well as near the Kanmantoo mine.

See www.hillgroveresources.com.au

Analyst: Pieter Bruinstroop :

HGO is NOW a copper producer

- Kanmantoo produced its first product on 29 November and on 5 January 2012, HGO advised that had produced over 2,400t of dry concentrate to the end of December;
- Kanmantoo operations have out-performed all of Intersuisse's expectations during ramp-up
 - Ore mined and processed was 154kt in December, compared with our expectation of 203kt for the 3 months to January
 - Concentrate grade was 30% Cu and 5.3g/t Au, which is higher than our expectation at any time of the project
 - Cu recovery reached 85% by the end of December
- HGO has confirmed that it will be cashflow positive from February;

HGO fully funded

- The HGO share price was hit by its 8 November announcement of an unexpected cost over-run and the resulting market fear that further equity will be required.
- Since then, HGO has announced
 - An increase in debt funding available of \$A 10m, plus freeing a further \$A5m from the project financing account, at a cost of the issue of 27m options exercisable at 27c
 - The cost over-run will be satisfied by the payment of \$1m a month, beginning in April, which is after HGO becomes cashflow positive

Recommendation

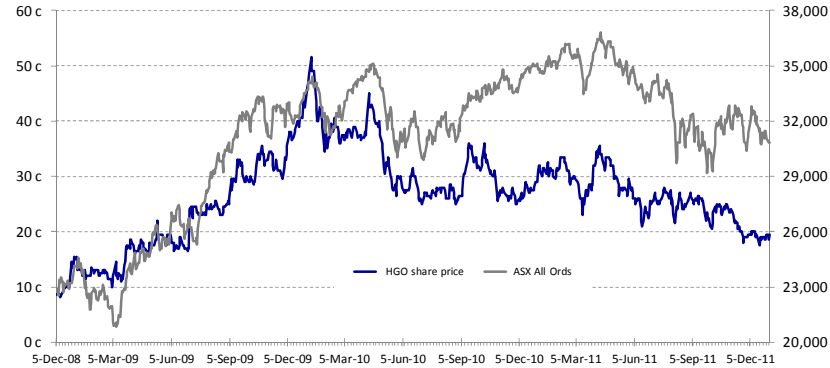
Intersuisse' base case valuation is 43c and we project e.p.s of about 3.5cps in 2012, putting HGO on a P/E of less than 6x.

We affirm our BUY recommendation on HGO

Hillgrove Resources Limited (HGO) - Performance

Figure 1 shows that for the period until about mid 2009, the HGO share price moved with the general market; it then moved roughly sideways for nearly 18 months before sliding down.

Figure 1 : HGO share price v. ASX market

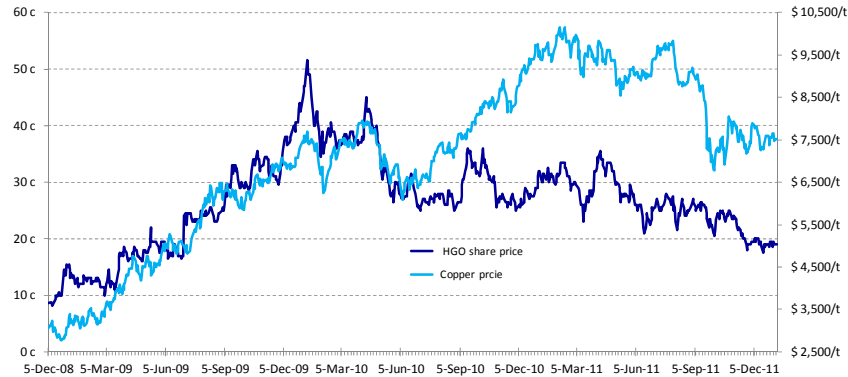


Source : IRESS, Intersuisse

HGO share price has lagged both the ASX and the copper price since mid 2010

Figure 2 shows that from late in 2008 until mid 2010, the HGO share price moved with the copper price. However, since then, the correlation between the HGO share price and the copper price has fallen, from 94% in the period from 1 January 2009 to 30 June 2010, down to 45% from 1 July 2010 to now.

Figure 2 : HGO share price v. Copper price (USD)



Source : IRESS, Intersuisse

The final approval for work to commence on site at Kanmantoo, the MARP (Mining and Rehabilitation Plan, since re-named PERP – Program for Environmental Rehabilitation and Protection) was granted on 8 April 2010.

It is not surprising that the HGO share price has under-performed since its focus has changed to project delivery, and now cashflow, which usually does not generate excitement in a stock as the share registry rotates from risk seeking to more risk averse investors.

Projected Financials

Intersuisse has described HGO’s operations in details in earlier notes’ in particular, our initiation research of 2 March 2011 and our update on 1 June, following our visit to the Kanmantoo site.

While Figure 2 shows that the HGO share price does not move with the copper price, the copper price is an important influence on our projected net cashflows, which drive our valuation.

Figure 3 details Intersuisse's assumptions and financial projections. It shows that Intersuisse has assumed commodity prices in the future in line with current prices.

Note that the year nominated as 2011 in Figure 3 is HGO's financial year ending on 31 January 2012.

Figure 3 : Detail of Intersuisse's financial projections for HGO

Intersuisse projects strong cashflow and earnings for HGO

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Copper price	US\$ 8,646/t	US\$ 7,500/t	US\$ 7,500/t	US\$ 7,500/t	US\$ 7,500/t	US\$ 7,500/t	US\$ 7,500/t	US\$ 7,500/t	US\$ 7,500/t	US\$ 7,500/t	US\$ 7,500/t
Gold price	\$ 1,570/oz	\$ 1,600/oz	\$ 1,600/oz	\$ 1,600/oz	\$ 1,600/oz	\$ 1,600/oz	\$ 1,600/oz	\$ 1,600/oz	\$ 1,600/oz	\$ 1,600/oz	\$ 1,600/oz
Silver price	\$ 35.2/oz	\$ 30.0/oz	\$ 30.0/oz	\$ 30.0/oz	\$ 30.0/oz	\$ 30.0/oz	\$ 30.0/oz	\$ 30.0/oz	\$ 30.0/oz	\$ 30.0/oz	\$ 30.0/oz
AUD / USD	1.040	1.011	1.002	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000
Copper produced	1,409 t	19,913 t	21,332 t	21,332 t	21,332 t	21,332 t	21,322 t	21,319 t	21,319 t	21,319 t	21,319 t
Gold produced	561 oz	7,929 oz	9,369 oz	9,369 oz	9,369 oz	9,369 oz	9,374 oz	9,376 oz	9,376 oz	9,376 oz	9,376 oz
Silver produced	11,157 oz	154,300 oz	178,988 oz	180,334 oz	180,334 oz	180,334 oz	180,322 oz	180,318 oz	180,318 oz	180,318 oz	180,318 oz
Copper Revenue	\$A 10.5m	\$A 149.3m	\$A 160.0m	\$A 160.0m	\$A 160.0m	\$A 160.0m	\$A 159.9m	\$A 159.9m	\$A 159.9m	\$A 159.9m	\$A 159.9m
Cu TC / RC	(\$A 1.0m)	(\$A 14.1m)	(\$A 14.9m)	(\$A 14.9m)	(\$A 14.9m)	(\$A 14.9m)	(\$A 14.9m)	(\$A 14.9m)	(\$A 14.9m)	(\$A 14.9m)	(\$A 14.9m)
By-products, net	\$A 1.0m	\$A 13.9m	\$A 16.8m	\$A 16.8m	\$A 16.8m	\$A 16.8m	\$A 16.8m	\$A 16.8m	\$A 16.8m	\$A 16.8m	\$A 16.8m
Cash Costs	(\$A 5.7m)	(\$A 69.2m)	(\$A 80.5m)	(\$A 82.7m)	(\$A 84.3m)	(\$A 85.9m)	(\$A 86.8m)	(\$A 86.9m)	(\$A 87.1m)	(\$A 87.4m)	(\$A 87.6m)
Royalties	(\$A 0.2m)	(\$A 2.2m)	(\$A 2.4m)	(\$A 2.4m)	(\$A 2.4m)	(\$A 3.8m)	(\$A 8.0m)	(\$A 8.0m)	(\$A 8.0m)	(\$A 8.0m)	(\$A 8.0m)
Corporate Costs	(\$A 6.2m)	(\$A 3.0m)	(\$A 3.0m)	(\$A 3.0m)	(\$A 3.0m)	(\$A 3.0m)	(\$A 3.0m)	(\$A 3.0m)	(\$A 3.0m)	(\$A 3.0m)	(\$A 3.0m)
Hedging	\$A 0.0m	\$A 6.2m	\$A 6.2m	\$A 8.8m	\$A 8.8m	\$A 0.0m	\$A 0.0m	\$A 0.0m	\$A 0.0m	\$A 0.0m	\$A 0.0m
Exploration	(\$A 3.5m)	(\$A 3.5m)	(\$A 3.5m)	(\$A 3.5m)	(\$A 3.5m)	(\$A 3.5m)	(\$A 3.5m)	(\$A 3.5m)	(\$A 3.5m)	(\$A 3.5m)	(\$A 3.5m)
Dep'n & Amort'sn	(\$A 3.0m)	(\$A 37.6m)	(\$A 39.6m)	(\$A 39.6m)	(\$A 39.6m)	(\$A 39.6m)	(\$A 19.8m)	\$A 0.0m	\$A 0.0m	\$A 0.0m	\$A 0.0m
E B I T	(\$A 8.0m)	\$A 39.9m	\$A 39.2m	\$A 39.5m	\$A 37.9m	\$A 26.1m	\$A 40.8m	\$A 60.4m	\$A 60.3m	\$A 60.0m	\$A 59.7m
Interest Expense	\$A 0.0m	(\$A 2.5m)	(\$A 3.5m)	(\$A 2.1m)	(\$A 0.7m)	(\$A 0.0m)	\$A 0.0m	\$A 0.0m	\$A 0.0m	\$A 0.0m	\$A 0.0m
Tax Expense	\$A 2.3m	(\$A 9.1m)	(\$A 9.1m)	(\$A 9.3m)	(\$A 9.4m)	(\$A 8.7m)	(\$A 13.0m)	(\$A 18.7m)	(\$A 18.6m)	(\$A 18.6m)	(\$A 18.5m)
N P A T	(\$A 5.8m)	\$A 28.3m	\$A 26.6m	\$A 28.1m	\$A 27.9m	\$A 17.4m	\$A 27.8m	\$A 41.7m	\$A 41.6m	\$A 41.4m	\$A 41.2m
e. p. s.	(0.7c)	3.6 c	3.4 c	3.5 c	3.5 c	2.2 c	3.5 c	5.3 c	5.2 c	5.2 c	5.2 c
cash costs	(196c/lb)	(165c/lb)	(173c/lb)	(177c/lb)	(180c/lb)	(187c/lb)	(198c/lb)	(198c/lb)	(198c/lb)	(199c/lb)	(199c/lb)

Source : Intersuisse estimates

There is upside potential to Intersuisse's projections as our cash costs are higher than guided and also the operations in December performed better than expected.

Other features shown in Figure 3 include :

- Intersuisse has calculated costs, on a Life of Mine basis, over the reserves, of \$1.72/lb, before royalties, compared with company guidance of \$1.61/lb
 - Figure 3 includes royalties in the cash cost estimate
- Royalties are 1.5% for a 5 year period before increasing to the "standard" rate in South Australia;
- Intersuisse has allowed for \$10m in exploration expedite, for Kanmantoo, Bird's Head and Sumba, of which 65% is capitalised and 35% expensed;
- Depreciation and Amortisation expense is based on published reserves, while Intersuisse expects that this will be increased during 2012.

Intersuisse's base case valuation for HGO is 43c a share, as detailed in Figure 4.

Figure 4 : Intersuisse's base case valuation for HGO

Intersuisse's base case valuation is 43c, which gives some value to present resources.

discount rate =	12%	31-Jan-11		09-Jan-12	
		100%	Product	per share	
Kanmantoo Reserves	100 %	\$A 135m	\$A 135m	16.7 c	27.1 c
fanking credits	60 %	\$A 36m	\$A 22m	2.7 c	3.0 c
Kanmantoo Resources	80 %	\$A 93m	\$A 74m	9.2 c	10.4 c
fanking credits	48 %	\$A 39m	\$A 19m	2.3 c	2.6 c
Kanmantoo Extensions	50 %	\$A 0m	\$A 0m	0.0 c	0.0 c
fanking credits	30 %	\$A 0m	\$A 0m	0.0 c	0.0 c
Corporate	100 %	(\$A 20m)	(\$A 20m)	(2.5c)	(2.5c)
Exploration - Sumba	100 %	(\$A 26m)	\$A 0m	0.0 c	0.0 c
Exploration - Bird's Hea	100 %	(\$A 26m)	\$A 0m	0.0 c	0.0 c
Exploration - other	100 %	(\$A 13m)	\$A 0m	0.0 c	0.0 c
Hedging	100 %	\$A 20m	\$A 20m	2.5 c	2.8 c
Cash / debt	100 %	\$A 118m	\$A 118m	14.6 c	(0.8c)
Investments	100 %	\$A 1.7m	\$A 1.7m	0.2 c	0.2 c
Options	100 %	\$A 0.4m	\$A 0.4m	0.1 c	0.1 c
TOTAL		\$A 358.1m	\$A 369.1m	45.8 c	42.9 c
Shares on issue		793.6m	FPO shares	13.0m	options

Source : Intersuisse estimates

Intersuisse is very positive on the mineralisation potential at Kanmantoo

Note from Figure 4 that Intersuisse has given

- Some value to the current resources that are not included in reserves, as we are confident of the potential for mining beyond the currently estimated reserves; and
- No value to HGO's Indonesian exploration.

Copper Price

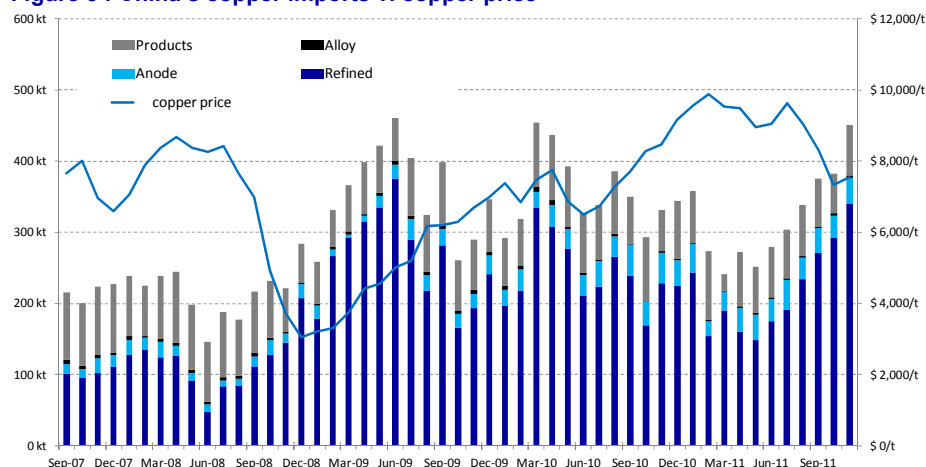
For many commodities, (vis. nickel, tin, zinc, lead, aluminium, thermal coal, coking coal and iron ore), the price is stuck in a band determined by marginal Chinese production, which begins and ceases production readily in response to price signals.

Copper is an exception; in 2010, of total global mine production of just over 16Mt, China mined 1.2Mt of copper and produced about 4.55Mt of copper metal.

China's copper imports are higher when copper prices are lower, and vice-versa.

Figure 5 charts China's monthly copper imports against the average copper price. It clearly shows that China's copper imports surged in the first half of 2009 as the copper price collapsed in the GFC.

Figure 5 : China's copper imports v. copper price



Source : Reuters, IRESS, Intersuisse

Figure 5 further shows that China's imports were at much reduced levels when copper prices were high in the first half of 2011.

Figure 5 suggests that China built up copper stocks when prices were subdued and has consumed these stocks when prices were high. While China imports much greater volumes of copper in concentrate, which is smelted into copper metal in China, stockpiling concentrate is problematic due to its fineness and its sulphur content.

Intersuisse believes that there is a significant difference between apparent and actual copper consumption in China

Consumption is usually measured as "apparent consumption, which is imports plus domestic production, which assumes that inventories are roughly stable. Figure 5 shows that this is not a valid assumption for China.

Figure 6 shows that, while copper demand can be expected to be related to Industrial Production, in China's case it can be very different.

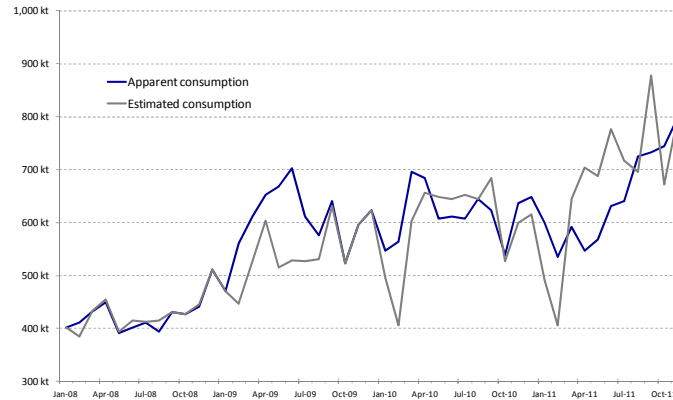
Figure 6 : China's apparent copper consumption v. IP

	2008	2009	2010
Refined production	3,755 kt	4,024 kt	4,521 kt
Refined imports	1,362 kt	3,112 kt	2,882 kt
change in ShFE	(8kt)	77 kt	37 kt
Apparent Consumption	5,125 kt	7,059 kt	7,366 kt
change, y-o-y	5.5 %	37.7 %	4.3 %
Industrial Production	12.6 %	11.4 %	15.3 %

Source : Shanghai Futures Exchange, China National Bureau of Statistics

An estimate can be made of actual consumption, based on IP growth, but with adjustments for the inclusion of land sales in IP, and instead focussing on production of copper intensive equipment. Figure 7 compares such an estimate with calculated apparent consumption.

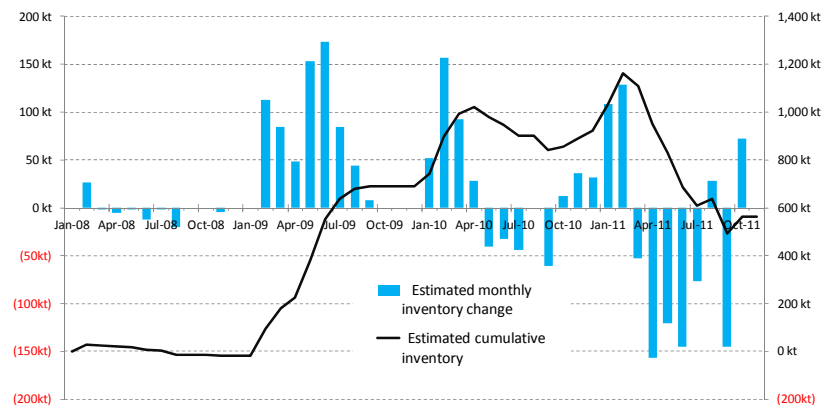
Figure 7 : Estimated v. apparent consumption of copper in China



Source : Shanghai Futures Exchange, China National Bureau of Statistics, Ecowin

Figure 8 shows the resulting estimated copper stock levels in China; it suggests that stockpiled copper reached nearly 1.2Mt in February 2011 and had fallen to about 565kt by October 2011.

Figure 8 : Estimated un-reported Chinese copper stocks



Source : Shanghai Futures Exchange, China National Bureau of Statistics, Ecowin, Intersuisse

Intersuisse estimates that Chinese built up copper stocks to over 1Mt and have run these stocks down during 20112, especially as money supply has remained tight in China.

Projections of copper supply v. demand balances is difficult; significant mine supply is expected over 2012 and 2013, of over 1Mt of mined copper in each year but realisation of expected has been very poor over the last 7 years.

However, if this supply increase is achieved, and if Chinese demand is estimated to increase by about 7% a year, compared with about 12% a year in recent history, then the copper market will swing into surplus.

Intersuisse feels comfortable with projected copper prices around current levels.

Acknowledging this possibility, Intersuisse has used roughly stable prices for its copper price assumptions as

- We see the much slower growth rates in Chinese consumption required to achieve a surplus as being too pessimistic;
- We are not confident that the projected increases in mine supply will be achieved, based on history and the fact that Chilean production, which is about one-third of global production, has stagnated over the last 7 years; and
- Cash costs are not as low as often thought, as reported cash costs exclude many necessary costs, such as stay-in-business capital.

Also, Figure 5 shows that China's imports have been increasing through 2011, while estimated stocks have been reduced.

Conclusions

HGO has become a copper producer and is expected to be cashflow positive from February 2012.

HGO is now a copper producer, fully funded and will soon be generating good cashflows.

HGO's 5 January 2012 announcement showed a much better start-up than Intersuisse had expected. This gives upside to our valuation.

The HGO share price was damaged by HGO's announcement on 8 November 2011 that the contractor had served a further claim on HGO for a \$10m cost over-run, with equity markets fearing that a further equity raising was forthcoming. This has since been resolved and HGO will pay the cost over-run from April 2012 onwards, which is after it is cashflow positive.

HGO has also secured access to further debt funding, at a cost of 27m options with a 27c exercise price.

Intersuisse affirms a BUY recommendation on HGO.

HGO has advised that it will be hosting a site visit in February 2012.

Intersuisse is positive on the copper price.

Intersuisse affirms its BUY recommendation on HGO.

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