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FAR EAST CAPITAL
The Mining Investment Experts

OZEQUITIES COMMENTARY
On Presentation

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Hillgrove Resources Ltd ("HGO")

"Another Emerging Copper Producer with Powerful Cash Flow Estimates "

A Third Tier Copper Hopeful

Hillgrove is another third tier copper hopeful, seeking to develop an open pit mine at Kanmantoo, only 50 km SE of Adelaide. It is blessed with a railway line and a main highway through the lease, the availability of all necessary infrastructure and a proximate workforce.

Studies are still being conducted but at this point the likely scenario is a 25,000t tpa (copper in concentrate) operation costing $70-80m to develop.

Previous Developed by North/South BH Coys

The Kanmantoo deposit was first discovered in the 1960s by North Broken Hill Holdings and BH South; two famous Collins Street companies from Melbourne. A mine was commissioned in 1972, and operated successfully for three years, but it closed in mid 1976 at a time when copper was viewed as a "social metal" due to overproduction from large mines in African countries that were kept afloat with government subsidies. CRA had a brief look at the mine in 1982, but after it walked away the remaining equipment was sold off at auction.

HGO acquired the mining lease in 2003, from a company in liquidation and joint ventured the surrounding exploration licence.

Exploration Has Added to Resources

The initial resource was 8.5 mill. tonnes at 1.2% Cu but there had been no assays taken for gold. Drilling more than doubled this to 18.5 mt at 1.1% Cu and 0.2 gpt Au, as at December 2004. Some of the increase was attributed to a satellite orebody to the south west, named Emily Star. There was another upgrade to 25 mt at 1% Cu and 0.2 gpt Au in 2006 (note the lowering of the grade). The in-situ resource now totals 248,000 tonnes of copper and 156,000 oz of gold. To place this in perspective (but we caution on using this comparison too readily), a copper resource of this size is the equivalent of 2 mill. oz gold orebody (assuming only 70% payment terms). What needs to be determined now is the proportion that is mineable.

Drill spacing is down to 20m x 20m in some areas, and 40m x 40m elsewhere. A likely waste to ore ratio is 5:1, mining to achieve a head grade of 1.18%

Further Exploration Upside

The regional environment seems prospective for additional mineralisation. The Company believes that the overall resource could easily be in the range of 30-40 mt within a year from now.

There is even the chance that there could be a discrete gold zone, judging by assays of 20m at 2 gpt and 13m at 5 gpt. This seems to be in a typical Eastern Goldfields-type shear zone in the footwall of O'Neills Zone, to the south east of the pit.

2-2.5 MTPA Mine Being Considered

Pre-feasibility studies are being conducted by Roache, on a 2-2.5 mtpa operation. This could cost up to $80m for annual production of about 27,500 tpa of copper in concentrates. HGO hopes to be in a position to commit to this by mid 2007, which would enable production by late 2008. Cash operating costs may be in the order of US$65-70¢/lb, after gold credits.

The chalcopyrite ore enables a relatively clean concentrate that would run at better than 25% Cu. It is possible that there may be some credits from garnet production as well. This is worth about US$150/pt of garnet. While Kanmantoo might produce 80-100,000 tpa, the world market is less than 800,000 tpa. Transport and the availability of markets would be the limiting factors here. Maybe it could find markets for 25-50,000 tpa.

Economics are Outstanding.

At 22¢, HGO has a market capitalisation of $39m (181 mill. shares). At US$3.00/lb for copper (it is currently US$3.30/lb after last night's rise) there is the potential for a cash flow of A$188m pa. or 80¢ a share (fully diluted for shares and options). As impressive as this sounds we should build in some dilution for equity capital on project funding. If we assume that the shares on issue doubles to raise $40m, giving a 50:50 debt to equity ratio, the cash flow drops to 44¢ a share. This translates into a cash generation multiple of significantly less than 1x.

Why Are the Shares So Cheap in the Market?

Are the markets that inefficient that a stock could be selling so cheaply on projected earnings? Well, yes. There continues to be many excellent resources situations out there selling on very low multiples. The lack of quality analysis and the gulf between institutional size stocks and the rest of the pack contribute to the inefficiencies.

Comparing HGO to CopperCo for example; CUO has raised its equity funds, debt is lined up and will be in production in 12 months time. HGO's production is about 30 months away, funding hurdles needs to be overcome and a commitment to develop is required. Both stocks represent excellent value at their respective stages of development but HGO, with a longer time frame before positive cash flow, runs a greater risk of coming on stream when the commodity price cycle turns down. Nevertheless, HGO shareholders should feel comfortable that they have solid opportunity. There is plenty of room for a substantially higher share price as the parameters of the project become more definite.

Gunnedah Coal Bed Methane is an Extra

The coal bed methane business is now a respectable industry with companies carrying high market capitalisations. HGO's exposure comes through a 32.5% interest in a joint venture in NSW with Eastern Star Gas and a US partner. So far it has spent $8m, at Gunnedah, which it states has 42% of Australia's known coal bed methane resources. The project has reserves of 2,828 PJ in the 3P category. The upside will come from the conversion of this to 2P reserves.

HGO has done a desk stop study that contemplates a four stage development strategy, commencing with the supply of gas to a small, local power station and progressing to a pipeline down to Sydney as reserves are proved up to justify the capital. The potential NPV is rather awesome but it warrants comment in a separate note. In the interim, it would make sense for some rationalisation of the joint venture, which would see a combination of the Hillgrove and the Eastern Star Gas interests into a specific purpose vehicle. Maybe they could be backed into Eastern Star Gas itself. It is a space to keep an eye on.

Cash Balance

With $5m in the kitty at present, and another $2m coming from Sepra in August to finance the BFS, HGO is well funded at this stage of the project.

