

Hillgrove Resources Ltd (ASX:HGO)

BUY

Sector: Base Metals

Target: \$0.30

COMPANY STATISTICS

Share Price	\$0.175
Valuation	\$0.30
12 Month Range	\$0.18 – \$0.36
Market Cap	\$138.9m
Enterprise Value	\$134.4m
Issued Shares	793.7m
Unlisted Options & Performance Rights	12.1m
Cash Balance (31 Oct 11)	\$34.5m
Hedging (MTM @ 3.25/lb Cu)	\$43.5m
Debt (31 Oct 11)	A\$30m

Top Shareholders (August 2011):

JPMorgan Chase	9.0%
BT Investment Management	7.5%
Renaissance Smaller Co	4.1%

Directors:

Dean Brown (Chairman)
 Drew Simonsen (Managing Director)
 Ronald Belz (Non-Executive Director)
 John Gooding (Non Executive Director)
 John Quirke (Non Executive Director)
 Edwin Zemancheff (Non Executive Director)

SHARE PRICE PERFORMANCE



VALUATION & MULTIPLES

Kanmantoo Copper Project (\$3.00/lb Cu)	\$0.27
Indonesian Projects	\$0.02
Listed Investment (84.8% ITT.ASX)	\$0.00
Cash (\$10m estimated Dec 2011)	\$0.01
Total NAV	\$0.30
Copper price upside (\$3.50/lb Cu)	\$0.09
EV/EBITDA (FY 2013)	2.0x
EV/EBITDA (FY 2014)	1.7x
EV/Resources	\$0.17/lb
EV/Reserves	\$0.41/lb

Source: Canaccord BGF estimates.
 HGO Financial Year ends in January.

Analyst:

J-François Bertincourt
 +61 2 9263 2711
jf.bertincourt@canaccordbgf.com

ROBUST CASH FLOWS AND EXTENDED MINE LIFE WILL DRIVE RE-RATING

Investment Perspective: HGO has successfully joined the ranks of Australia's copper producers and is expected to record its first revenue by late December. The additional debt funding negotiated with its bank has restored working capital and liquidity in the Company at a critical time. So far, the operations are performing well: grades in line, ore tonnages better than expected, good recovery and concentrate grade above expectations.

Going forward, one of the key issues is to stay on target with operating costs in the order of US\$1.60/lb LOM average, allowing for a higher cost in the first year due to ramp up. We have assumed US\$1.74/lb for the first year of operation.

In terms of extending the officially short 6-year mine life, recent drilling targeting the conversion of existing resource into reserve as well as new resources has been successful and we are confident that the mine life will be extended. We see the stock being re-rated as the Company moves into full production provided there are no commissioning problems, and additional reserves are included in the mine plan. Exploration in Indonesia also adds promising blue-sky appeal.

On a Net Asset Value basis, we have valued HGO at \$0.30 per share, applying a 10.4% discount rate to the NPV of the Kanmantoo Copper Mine. The valuation considers a flat copper price of US\$3.00/lb reflecting the degradation of the outlook for commodity prices for the foreseeable future. A copper price rise to US\$3.50/lb would increase the valuation to \$0.39 per share. Note that 50-55% of the production is hedged at a copper price of A\$3.73/lb. On an EV/EBITDA multiple basis, HGO trades at a significant discount to its peers: HGO 2.0x vs. OZL 3.7x, PNA, 5.1x and ABY 3.0x.

With the shares currently trading at a significant discount to our valuation, we rate HGO a **BUY**, with a price target of \$0.30.

Investment Highlights

Kanmantoo Copper Mine, South Australia (100%)

The mine has produced its first concentrate with initial concentrate grades (24-27%) above company expectations.

The first revenue is expected before the end of 2011. The ramp up period revenue is 100% covered by put options at a strike price of A\$7,500/t (or \$3.40/lb).

Discussions have progressed regarding an unexpected claim (\$10m) relating to the principal engineering contractor. HGO expects to announce a mutually acceptable outcome before end of January.

HGO has negotiated additional debt funding (\$10m + \$5m) to restore working capital and liquidity in the Company, thereby alleviating the need for an early equity issue.

Early resource reconciliation indicates ore body grades in line and ore tonnages significantly higher than predicted by the resource model.

Excellent near-mine exploration results increase confidence in mine life extension beyond the six years derived from current JORC reserves. We have assumed three additional years of operation in our financial model.

Resource to reserve conversion drilling closed at the end of November and updated resource and reserve JORC statements are expected in Q1/Q2 2012.

VALUATION METRICS

Table 1: DCF Summary

FYE January	Unit	2013	2014	2015	2016	2017	2018	2019	2020	2021
Hedged Quantity ¹	t	10,500	11,000	11,000	7,000	-	-	-	-	-
Hedged Price ¹	A\$/lb	\$3.73	\$3.73	\$3.73	\$3.73	-	-	-	-	-
Assumed Spot Price	A\$/lb	\$3.00	\$3.00	\$3.00	\$3.00	\$3.00	\$3.00	\$3.00	\$3.00	\$3.00
Copper Production ²	t	18,000	20,000	25,000	25,000	25,000	25,000	25,000	25,000	25,000
Revenue	A\$m	136	150	183	179	165	165	165	165	165
Operating Costs ³	A\$m	69	70	88	88	88	88	88	88	88
NSR	A\$m	67	80	95	91	77	77	77	77	77
Royalties ⁴	A\$m	1	1	1	1	1	4	4	4	4
Capex/Debt Repayment	A\$m	15	27	15	15	5	5	5	5	5
Interest	A\$m	4	3	2	1	-	-	-	-	-
Exploration	A\$m	10	10	10	10	10	10	10	10	10
Overheads	A\$m	3	3	3	3	3	3	3	3	3
Pre-tax Cash Flow	A\$m	41	37	65	62	60	57	57	57	57
Pre-tax Cash Flow / share	A¢	4.3	4.5	8.0	7.6	7.3	7.0	7.0	7.0	7.0

Source: HGO, Canaccord BGF estimates. A\$/US\$ assumed 1.00.

Notes:

1. Project Finance hedging programme completed with approximately 50-55% of projected output for 40 months (debt repayment period) at average hedging price of A\$8,230/t (or A\$3.73/lb) commencing in June 2012. The ramp up period revenue (to June 2012) is 100% covered by put options at a strike price of A\$7,500/t (or \$3.40/lb).
2. Payable metals of 20,000 tpa Cu, 10,000 ozpa Au and 180,000 ozpa Ag, increasing to 25,000 tpa from 2015 with plant expansion to 3.5 Mtpa.
3. According to DFS, average LOM cash cost of US\$1.61/lb after US\$0.25/lb by-product credits @ US\$1,300/oz Au and US\$30/oz Ag. Cash cost estimated at US\$1.58/lb, using US\$1,500/oz Au and US\$30/oz Ag.
4. Royalties of 1.5% NSR for 5 years, 5% thereafter.

We have added three years of mine life taking into account the likelihood of further resource to reserve conversion.

We have ascribed a value of \$15m to HGO's Indonesian projects.

With the shares currently trading at a significant discount to our valuation, we rate HGO a **BUY**, with a price target of \$0.30. The valuation considers a flat copper price of \$3.00/lb reflecting the degradation of the outlook for commodity prices for the foreseeable future.

KANMANTOO COPPER PROJECT (100%)

LOCATION

The project is well appointed with readily available infrastructure

The *Kanmantoo Copper Project* is located in the Adelaide Hills region of South Australia. The project contains the old Kanmantoo copper mine pit, which was in operation from 1970 until 1976, but work by Hillgrove since 2004 has proved up an additional mineral resource of 32.2 Mt grading 0.9% copper and 0.2g/t gold, and completed a positive DFS in December 2007.

Since completion of the DFS, work has continued on further optimising and improving the project. This work has included additional drilling and internal company modeling for a mine plan based on ore amenable to conventional treatment methods and production of an export grade concentrate.

The project's location, 55 km by road from Adelaide, brings significant operating and capital cost advantages. The mine will have access to low cost grid power, recycled waste water from the nearby town of Mount Barker, matched by ready 50-minute access to a major capital city. The mine is 50 km to the export port of Port Adelaide and 3 km from the main dual carriageway that leads to Adelaide. The mine's location in the Adelaide Hills - one of South Australia's most attractive settings - will also help attract a high quality workforce. Note that it could also attract the scrutiny of environmental activists.

TREATMENT PLANT

The processing plant has spare capacity and throughput can be further increased with modest capex.

Hillgrove acquired the Western Australian Lennard Shelf Project's Pillara processing plant and associated mine equipment in late 2009. The plant was dismantled and transported to the Kanmantoo site and subsequently rebuilt. The mill has significant upside capacity from the planned run-of-mine throughput of 2.4 Mtpa to more than 3.0 Mtpa, allowing for additional processing if there is growth in the reserves through additional discoveries. The expected performance of the mill is significantly de-risked given the track record of past-operation. The project follows a standard flowchart and production process, with a relatively coarse grind of 212 microns. The mill is planned to run at a throughput rate of 2.4 Mtpa, but expected to achieve up to 2.7 Mtpa. Potential exists to increase to 3.5 Mtpa, with only \$12m of additional capital expenditure.

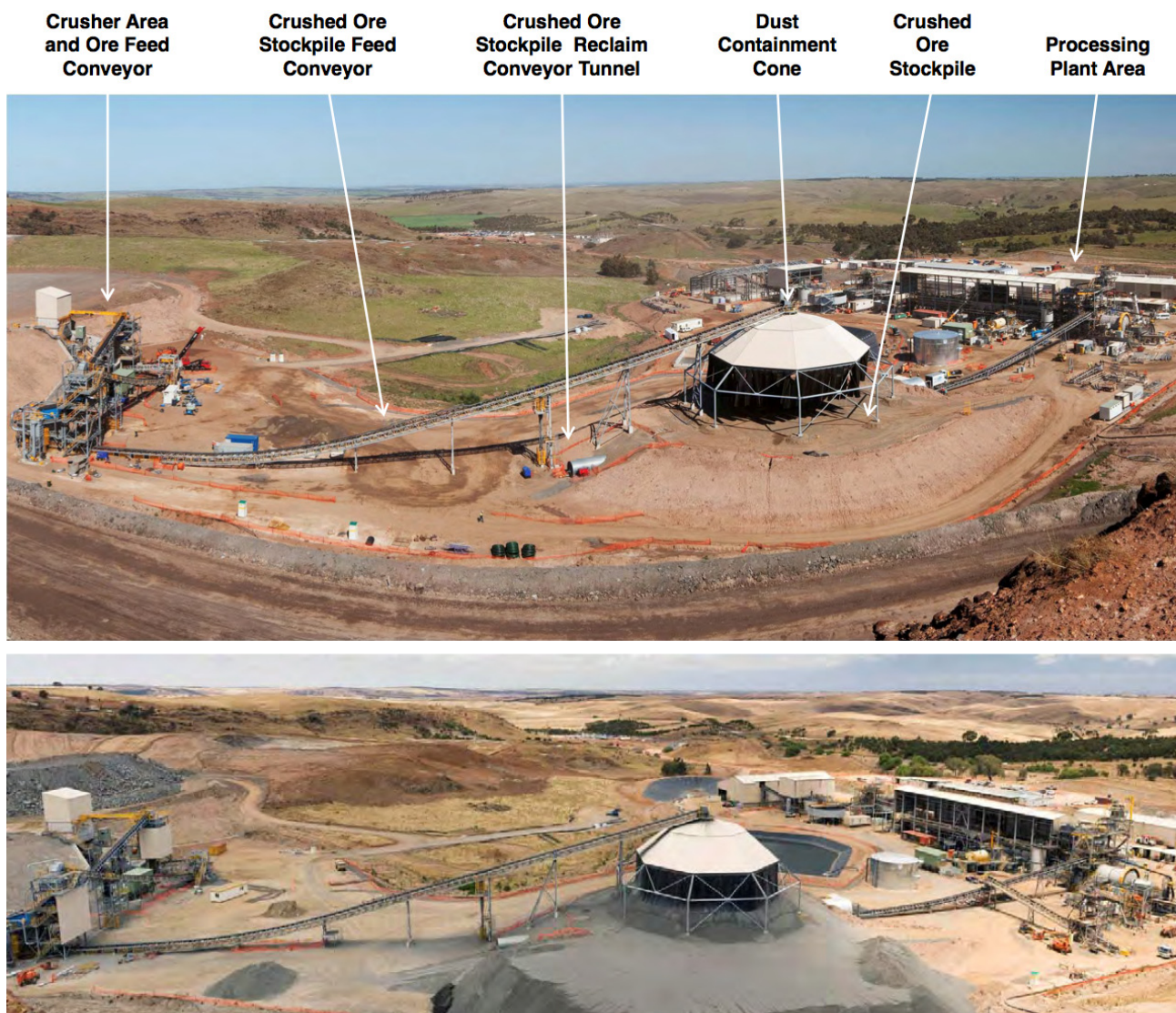
COMPLETION AND COMMISSIONING

Plant commissioned with early concentrate grades promising. With only a few weeks delay, first copper concentrate has been produced. Initial concentrate grades are in the range of 24-27%, which is excellent considering the low-grade feed (0.35% Cu) used for commissioning.

Early resource reconciliation positive. Grade control sampling indicates ore body grades in line with the resource block model. However, ore tonnages have been significantly higher than predicted by the resource model.

Ramp up to full production scheduled over the next six months. HGO is currently producing at a rate between 150 and 200 tonnes per day (tpd). Nevertheless, this rate is not achieved every day due to the commissioning and ramp up schedule. At full production, this is expected to average more than 200 tpd.

Figure 2: Processing Plant (22 September 2011)



Source: Company presentation and quarterly report. 1st photo 22 Sep 2011; 2nd photo 23 Nov 2011 Foreground: Crushed low-grade ore stockpiled adjacent to the live stockpile under the dust containment cone.

OFF-TAKE AND CASH FLOW

For every 2,500 tonnes of copper concentrate (~2 weeks production) delivered to Port Adelaide, HGO receives a first payment - 75% of the value of the copper in the concentrate – under the terms of its off-take agreement with JP Morgan Metals & Concentrate. The first payment is expected before the end of 2011.

Once 10,000 t of concentrate has accumulated at Port Adelaide (~ early Feb 2012), copper is loaded into a bulk ship and HGO receives a further 15% of the copper value.

The final 10% is payable based on final assays at the discharge port.

MINE LIFE EXTENSION

With 32 Mt @ 0.90% Cu of resource and 14.8 Mt @ 0.85% Cu of reserves, HGO first priority has been to convert resources into reserves by closer spaced drilling expecting to upgrade inferred resources (23% of the total) into the indicated category. The close-off date of 30 November 2011 has been set to allow for an updated resource and reserve statements in Q2 2012.

The conversion drilling has been highly successful with the majority of drilling likely to convert resources into reserves, as well as adding to resources. Wide intercepts with good copper grades are as follows:

- 18m @ 1.29% Cu from 135m (23m%)
- 14m @ 1.54% Cu from 75m (22m%)
- 31m @ 0.77% Cu from 99m (24m%)
- 23m @ 0.97% Cu from 112m (22m%)
- 16m @ 1.07% Cu from 52m (17m%)
- 12m @ 1.44% Cu from 60m (17m%)

The wider exploration focus is longer term but initially still based within the Mining Lease. Further geophysics (IP) is underway with geochemistry and field mapping to follow to generate new drilling targets.

We note that while copper has been mined in the project area for over 150 years, the exploration licence area covering 500 km² is relatively unexplored and the potential for further discoveries is considered high.

INDONESIAN PROJECTS

HGO's exploration assets in Indonesia offer significant exploration potential, and there is next to no value in the share price for these two projects.

Figure 2: Project Location Map



Source: Company reports

Sumba Island

HGO is an 80% shareholder in PT Fathi Resources Pte Ltd, which holds an exploration licence (999 km²) on the Sumba Island. A scout drilling programme of 8 holes for a total of 523m was completed targeting the better intersections reported by the trenching over the central Karipi hill area. Gold mineralization was encountered in all drill holes. Highlight intersections include:

- 8.5m @ 2.42 g/t from 0m
- 17m @ 3.72 g/t Au from 8m
- 20.2m @ 1.41 g/t Au from 6.1m

Although preliminary in nature, these initial drill intercepts are considered extremely encouraging and warrant follow up drilling along strike and down dip.

Bird's Head

Hillgrove is an 80% beneficial interest in PT Akram Resources Pte Ltd, which holds IUP40/2010 (992.3 km²) in the Bird's Head region of West Papua.

The commencement of drilling remains in limbo, awaiting the grant of the forestry permit (Ijin Pinjam Pakai) to drill within Limited Production Forest. Note that Production Forest allows for exploration and both underground and open cut mining. The tenements have the potential to host a significant porphyry copper gold deposit. Mapping and surface sampling has identified numerous areas of strongly anomalous copper mineralization associated with faulting and fractures. Rock chip sampling results range from 1 to 4.7% copper with additional silver and molybdenum.

RISKS & MITIGANTS

Capital cost risk: The impact of the claim has increased capital cost to \$138m, representing an approximate 14% overrun on the original budget of \$121m. HGO addressed the issue by negotiating additional debt funding for \$10m and a temporary reduction of \$5m in the minimum Proceeds Account balance. This has restored working capital and liquidity in the Company.

Completion risk: Having reached commissioning stage with a plant already operating at levels of 150 to 200 tpd close to full production level of 200 tpd, we are confident that HGO will reach a steady state of full production over the next 3 to 6 months. The production of high-grade concentrate from low-grade ore also augurs well with regards to recovery and plant performance going forward.

Operational cost risk: The DFS indicated an average LOM cash cost of US\$1.61/lb, including smelter charges and after by-products credits based on gold price of US\$900/oz and silver price of US\$13/oz and an A\$/US\$ exchange rate of 0.85. HGO recently revised this estimate using US\$1,300/oz gold, US\$30/oz silver and 1.00 exchange rate and derived the same average LOM cash cost of US\$1.61/lb.

We see the operational cost risk as the essential risk to be addressed during the ramp-up period, while other risks such as geological, reserve, mining and processing risks appear well mitigated by the recent performance of the operations. We have assumed higher operating costs for the first year of operation.

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