

Hillgrove Resources Ltd

Kanmantoo delays lead to capital expenditure increases

Mid tier gold and copper/gold group Hillgrove has indicated that the construction of its Kanmantoo Copper Project in South Australia is slightly behind schedule. The company previously had a 1 November 2011 deadline; however, Practical Completion is now expected to be closer to mid to late November. The delay has led to an increase in capital costs and in our view has the potential to lead to a cash squeeze during the ramp up phase. This may affect sentiment in the short term, and we move our recommendation to Accumulate. We note that the re-rating of the company may be slightly pushed back until the potential cash squeeze is overcome.

- We understand that a delay in the energisation of the plant has led to pushing out the construction completion date. While construction is not fully complete as yet, commissioning of certain parts of the plant has commenced and first ore through the mill and concentrate production is expected within 7–10 days.
- The cost for Kanmantoo has increased by around \$10m to about \$135m due to a late and unexpected claim from a contractor. Previous estimates for capital expenditure were \$120–125m, though the increase is in line with our estimates, reflecting the cost inflation seen across the industry in recent times.
- The delay has led to first concentrate production in mid-November (approximately 2-4 weeks late) with first revenue expected in December. Hillgrove is progressing a number of options to address potential working capital requirements.
- **We move our recommendation down to an Accumulate, and slightly reduce the price target** – We still see Hillgrove as good value as it transitions from developer to producer. However, we have slightly pushed back Kanmantoo's production profile which has led to a slight reduction in our July 2012 price target to 41cps (from 42cps), as well as a reduction in FY12 and FY13 earnings.

Recommendation: Accumulate

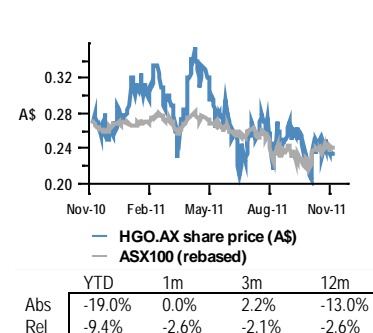
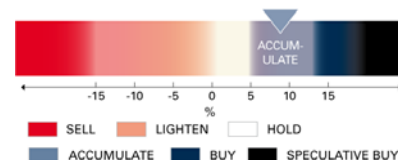
Risk: High

HGO.AX

\$0.23

Price Target: \$0.41

Previous: \$0.42



Hillgrove Resources Ltd (Reuters: HGO.AX, Bloomberg: HGO AU)

Year-end Jan (\$)	FY11A	FY12E	FY13E	FY14E	FY15E
Total Revenue (\$ mn)	4	18	141	194	188
EBITDA (\$ mn)	-27.5	-7.7	53.5	97.5	88.7
Net profit after tax (\$ mn)	-14.17	-10.12	24.19	56.26	51.48
EPS (\$)	-0.014	-0.013	0.030	0.071	0.065
P/E (x)	NM	NM	7.5	3.2	3.5
Cash flow per share (\$)	-0.080	-0.044	0.044	0.130	0.137
Dividend (\$)	0.000	0.000	0.000	0.000	0.000
Net Yield (%)	0.0%	0.0%	0.0%	0.0%	0.0%
Normalised* EPS (\$)	-0.020	-0.013	0.030	0.071	0.065
Normalised* EPS chg (%)	-116.3%	37.2%	337.6%	132.5%	-8.5%
Normalised* P/E (x)	NM	NM	7.5	3.2	3.5

Source: Company data, Bloomberg, Ord Minnett estimates.

Company Data	
52-week range (\$)	0.36 - 0.20
Market capitalisation (\$ bn)	0.18
Market capitalisation (\$ bn)	0.19
Fiscal Year End	Jan
Price (\$)	0.23
Date Of Price	08 Nov 11
Shares outstanding (mn)	793.7
ASX100	3,499.5
ASX200-Ind	5,740.2
NTA/Sh^ (\$)	0.35
Net Debt^ (\$ bn)	0.02

Kanmantoo construction delays

Hillgrove had planned to have Practical Completion for its Kanmantoo Copper Project, located near Adelaide in South Australia, by 1 November 2011. However, delays in the energisation of the plant have meant it has now pushed past that date. The company has indicated that final construction is due within the next week or two.

Whilst construction is not fully complete as yet, HGO has commenced commissioning certain parts of the plant including the crushing circuit, and wet testing certain parts of the plant. To this end, first ore through the mill and then concentrate production is expected within 7 to 10 days.

However, the delays have led to an increase in the startup costs for the project. The company has indicated that the project cost has increased by c.\$10m to c.\$135m, due to a late and unexpected claim from a contractor. Previous estimates were for costs in the range of \$120 – 125m. However, the higher cost is in line with our estimates, as we had factored in capital item cost inflation that has been seen in most mining construction projects in recent times. In addition, we are not surprised by the delays to the project, along with industry wide cost inflation, we cannot remember a project that has been completed 'on time and on budget' in recent times.

Potential working capital issues

First concentrate production is now scheduled for mid-late November, some 2-4 weeks behind plan. Consequently, first revenue is now expected in December via the early payment facility (with Ord Minnett Metals and Concentrates LLC).

HGO had sufficient and undrawn debt facilities (\$73m as at 31/7/11) to fund the remaining construction cost of \$25m. Based on this construction update, these costs have increased to c.\$35m, still leaving sufficient cash to complete construction.

However, we see the main issue lying in the potential working capital requirements. The delay to first production will lead to a delay in first cash, thereby squeezing working capital over the next few months. This may become critical whilst the plant is still ramping up until Kanmantoo becomes cash flow positive, which we estimate should be in 2Q CY12. Hillgrove has indicated that it is progressing a number of options to address any potential working capital requirements. We would expect the main options to include either a small raising, or an increase in debt.

Valuation update

Following the delays in completion, we have pushed back our production profile for Kanmantoo. We previously had production of 2.3kt of copper metal in concentrate during FY12, we have now reduced this to 1.0kt. The delayed start has also impacted our FY13 production estimates.

Table 1: Kanmantoo Production Changes (Jan 31 year end)

	2012E			2013E			2014E			2015E		
	New	Old	% ch.	New	Old	% ch.	New	Old	% ch.	New	Old	% ch.
Copper (kt metal in conc.)	1.0	2.3	-57.2%	14.8	16.6	-10.7%	18.7	18.7	0.0%	18.7	18.7	0.0%
Gold (koz)	0.4	1.0	-58.3%	6.3	7.0	-10.2%	7.9	7.9	0.4%	7.9	7.9	0.0%

Source: Ord Minnett estimates.

We believe that this delayed start in production is likely to significantly impact the company's cash position. Previously we had estimated cash of \$31.6m as at 31 January 2012 (end of HGO's Financial Year). However, following the delays, we now have cash at that time of \$14.5m, which leaves significantly less room for other delays or cost blowouts. Consequently we will be monitoring HGO's costs and the Kanmantoo ramp up schedule.

Our rescheduling of Kanmantoo production has impacted on FY12 & FY13 earnings significantly, with large changes in percentage terms. However, we note that the FY12 financials are coming off a very low base, with production very late in the financial year.

Our July 2012 price target reduces slightly by 1cps to 41cps. Our Jul-12 PT is a roll forward of our current sum of parts valuation. Our sum of parts valuation is dominated by our discounted cash flow for the Kanmantoo project (WACC 10%).

Table 2: Ord Minnett Earnings Changes

	2012E			2013E			2014E			2015E		
	New	Old	% ch.	New	Old	% ch.	New	Old	% ch.	New	Old	% ch.
Revenue (\$m)	18.5	26.1	-29%	141.3	167.4	15.6%	194.2	193.6	0.3%	187.8	183.7	2.2%
EBITDA (\$m)	-7.7	7.3	-206%	53.5	78.0	31.4%	97.5	96.7	0.8%	88.7	84.6	4.9%
EBIT (\$m)	-15.8	-3.6	338%	35.6	60.5	41.1%	79.0	78.6	0.5%	69.6	65.8	5.8%
NPAT (\$m)	-10.1	-1.9	433%	24.2	41.2	41.3%	56.3	55.5	1.4%	51.5	48.4	6.4%
EPS (AUc/shr.)	-1.3	0.0	na	3.0	4.9	37.6%	7.1	7.2	-1.0%	6.5	6.0	8.1%
NPV (\$/shr.)	0.41	0.42	-3%	0.42	0.46	-9.6%	0.44	0.49	10.2%	0.47	0.51	-7.6%

Source: Ord Minnett estimates.

Risks to our valuation include further delays in the construction and cost escalations, the underperformance of the Kanmantoo ore body and processing plant, as well as higher operational costs.

Potential funding scenarios

By way of comparison, we have undertaken an analysis of the impact on our Jul-12 price target of Hillgrove raising \$20m via either debt and equity. We have examined two scenarios:

- \$20m raising at \$0.195/share (15% discount to the current share price), and
- \$20m increase in debt.

Table 3: Jul-12 Price Target for \$20m Funding Scenarios

	Current Scenario	\$20m Equity Raising	\$20m Debt Increase
Kanmantoo (\$m)	314.2	314.2	314.2
Investments (\$m)	2.0	2.0	2.0
Corporate costs (\$m)	-13.9	-13.9	-13.9
Net cash/(debt) (\$m)	-18.9	0.3	-19.9
Exploration potential (\$m)	40.0	40.0	40.0
Group NPV (\$m)	323.5	342.7	322.5
Shares on Issue (Undiluted)	793.7	793.7	793.7
New Shares	-	102.6	-
Total Shares (Undiluted)	793.7	896.3	793.7
NPV/Share	0.408	0.382	0.406

Source: Ord Minnett estimates.

The analysis demonstrates that whilst the debt funding scenario is slightly more attractive from a dilution perspective, both scenarios are significantly higher than the current share price.

Hedging reduces copper price risk

The company has indicated that to reduce its exposure to potential falling copper prices, it has taken out a hedging program in the form of put options for all copper produced during the ramp up period. These puts have a floor price of \$7,500/t. This compares to a spot copper price of c.\$7,600/t.

HGO also has 50-55% of its copper production hedged at \$8,320/t over the first 40 months of production starting from June 2012.

Downgrade to Accumulate; monitoring cash closely

HGO has been very focused on its 1 November deadline, and the fact that it has now missed this deadline is disappointing. However, delays and cost escalation in mining construction projects is almost expected in the current environment, and it does not change our long term view of the company as being good value at current levels.

We still expect HGO to be rerated as it transitions from a developer to a producer. However, we now expect this rerating to be somewhat delayed until the concern about a cash squeeze is removed, and Kanmantoo is generating positive cash flow.

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HGO Summary - January 31 year end (A\$m)

Company Data	
Share Price (A\$)	0.240
52 Week range (A\$)	0.2 - 0.365
Shares on issue (m) (undiluted)	793.7
Shares on Issue (m) (diluted incl ITM options)	793.7
Market Capitalisation (A\$m) (undiluted)	190.5
Market Capitalisation (A\$m) (diluted incl ITM options)	190.5

Substantial Shareholders	
JP Morgan Metals & Concentrates	7.0%
BT Investment Management	6.7%

Profit & Loss (A\$m)	2011A	2012E	2013E	2014E	2015E
Revenue	4.3	18.5	141.3	194.2	187.8
Costs	-31.8	-26.2	-87.8	-96.8	-99.0
EBITDA	-27.5	-7.7	53.5	97.5	88.7
Depreciation & Amortisation	-0.4	-8.1	-17.9	-18.5	-19.1
EBIT	-27.9	-15.8	35.6	79.0	69.6
Other	0.0	0.0	0.0	0.0	0.0
Interest	4.6	0.1	-1.1	1.4	3.9
PBT	-23.3	-15.7	34.6	80.4	73.5
Tax	9.1	5.5	-10.4	-24.1	-22.1
Minorities & other	0.0	0.0	0.0	0.0	0.0
NPAT - reported	-14.2	-10.1	24.2	56.3	51.5
Exceptional items	-0.3	-0.1	0.0	0.0	0.0
NPAT - adjusted	-14.5	-10.2	24.2	56.3	51.5

Shares outstanding (millions)	794	794	794	794	794
EPS - reported	-0.02	-0.01	0.03	0.07	0.06
EPS - adjusted	-0.02	-0.01	0.03	0.07	0.06
DPS	0.0	0.0	0.0	0.0	0.0

Segmented revenue (A\$m)	2011A	2012E	2013E	2014E	2015E
Copper	0.0	6.8	120.7	169.3	166.4
Gold	0.0	1.4	19.2	24.5	22.4
Silver	0.0	0.3	3.7	5.6	4.9

Attributable Production	2011A	2012E	2013E	2014E	2015E
<i>Payable metal</i>					
Copper (kt metal in conc.)	0.0	1.0	14.8	18.7	18.7
Gold (koz)	0.0	0.4	6.3	7.9	7.9
Silver (koz metal in conc.)	0.0	7.9	118.5	149.5	149.5

Cash Costs	2011A	2012E	2013E	2014E	2015E
<i>Ct</i>					
A\$/lb (post credits)	0.0	6.71	1.98	1.66	1.81
US\$/lb (post credits)	0.0	6.99	2.15	1.50	1.59

Resources & Reserves

Kanmantoo

Resources (8/12/2008)

Measured + Indicated	Tonnes	Copper	Gold	Silver
	24.8Mt	0.90%	0.20g/t	3.3g/t
Cont. Metal	226.1kt	152.0koz	2.6Moz	
Inferred	7.4Mt	0.9%	0.20g/t	2.9g/t
Cont. Metal	66.1kt	39.1koz	0.7Moz	
Total Cont. Metal	292.2kt	191.1koz	3.3Moz	

Reserves (4/5/2010)	Tonnes	Copper	Gold	Silver
Proven & Probable	14.8Mt	0.85%	0.17g/t	3.1g/t
Cont. Metal	125.8kt	80.9koz	1.5Moz	

Key Ratios	2011A	2012E	2013E	2014E	2015E
PE Ratio	-13.4	-18.8	7.9	3.4	3.7
EV / EBITDA	-6.9	-20.8	3.1	1.9	2.1
EBITDA / sales margin	-644%	-42%	38%	50%	47%
ROA (EBIT/Assets)	-11%	-6%	12%	23%	18%
ROE (NPAT/Equity)	-8%	-5%	11%	21%	16%
Net debt / net debt + equity	-39%	9%	3%	-15%	-25%
Net interest cover	6.0	152.4	32.9	-57.7	-17.7

Cashflow (A\$m)	2011A	2012E	2013E	2014E	2015E
Cashflow - Operating					
Receipts from customers	3.4	10.3	111.4	187.5	188.9
Payments to suppliers & empl.	29.6	35.6	76.4	96.2	98.6
Interest received	4.7	2.4	-1.1	1.4	3.9
Tax paid	19.2	0.0	-10.4	-24.1	-22.1
Total CFO	-40.7	-23.0	23.5	68.5	72.2

Cashflow - Investing					
Purchase of PP&E	-35.5	-112.0	-4.0	-4.0	-4.0
Proceeds Sales	10.6	0.4	0.0	0.0	0.0
Projects & Investments	-3.2	-0.2	0.0	0.0	0.0
Exploration & evaluation	-15.1	-5.8	-11.5	-11.5	-5.8
Total CFI	-43.1	-117.6	-15.5	-15.5	-9.8

Cashflow - Financing					
Proceeds from issue of shares	79.1	6.2	0.9	0.0	0.0
Payment of share issue costs	-5.3	0.0	0.0	0.0	0.0
Proceeds from issue of debt	0.0	31.0	0.0	0.0	0.0
Repayments of debt	2.5	0.0	5.0	20.0	5.0
Dividends Paid	0.0	0.0	0.0	0.0	0.0
Total CFF	71.3	37.2	-4.1	-20.0	-5.0

Change in cash					
Opening cash & equivalents	130.4	117.9	14.5	18.4	51.5
FX	0.0	0.0	0.0	0.0	0.0
Closing cash	117.9	14.5	18.4	51.5	108.9

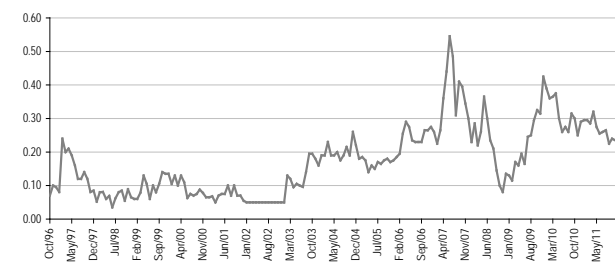
Balance Sheet (A\$m)	2011A	2012E	2013E	2014E	2015E
Cash and cash equivalents	117.9	14.5	18.4	51.5	108.9
Trade and other receivables	1.9	3.4	33.3	40.0	38.9
Inventories	0.1	0.6	0.6	0.6	0.6
Other	3.8	2.0	2.0	2.0	2.0
Total current assets	123.7	20.5	54.4	94.1	150.4
Total non-current assets	129.8	247.8	245.4	242.4	233.0
Total assets	253.5	268.3	299.7	336.5	383.5
Trade and other payables	8.7	6.4	17.7	18.2	18.7
Other current liabilities	0.3	0.9	0.9	0.9	0.9
Total current liabilities	8.9	7.3	18.6	19.1	19.6
Interest bearing liabilities	0.0	30.0	25.0	5.0	0.0
Other non-current liabilities	1.1	-3.5	-3.5	-3.5	-3.5
Total non-current liabilities	59.7	70.2	65.2	45.2	40.2
Total liabilities	68.6	77.5	83.8	64.3	59.8
Net assets	184.8	190.8	215.9	272.2	323.7
Share capital	178.3	184.5	185.5	185.5	185.5
Retained earnings	43.2	33.0	57.2	113.5	165.0
Minorities	0.3	0.2	0.2	0.2	0.2
Other	-37.0	-26.9	-26.9	-26.9	-26.9
Total equity	184.8	190.8	215.9	272.2	323.7
Net cash/(debt)	117.9	-15.5	-6.6	46.5	108.9
Total debt	0.0	-30.0	-25.0	-5.0	0.0

Valuation	Jul-11		Jul-12	
	A\$m	cps	A\$m	cps
Kanmantoo	258.7	33	314.2	40
Investments	2.0	0	2.0	0
Corporate costs	-22.5	-3	-13.9	-2
Net cash/(debt)	44.6	6	-18.9	-2
Exploration potential	40.0	5	40.0	5
Total	322.9	41	323.5	41
Shares on issue (m)	793.7		793.7	

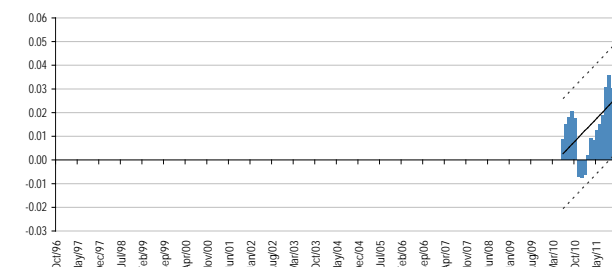
Price Assumptions	2011A	2012E	2013E	2014E	2015E
AS/US\$ FX rate	0.88	0.99	1.06	1.00	0.89
Copper (US\$/t)	7,601	8,759	8,750	8,750	8,500
Gold (US\$/oz)	1,233	1,598	1,677	1,391	1,242
Silver (US\$/oz)	20.40	36.26	33.98	33.70	29.10

Sensitivity Analysis	+10%	0	-10%	+10%	-10%
% change in NPV:	cps	cps	cps	%	%
AUD	35	41	48	-14%	17%
Copper	46	41	36	13%	-13%
Gold	42	41	40	3%	-3%
Silver	46	41	45	12%	11%

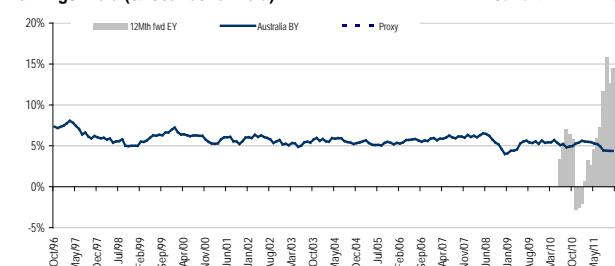
Local Share Price Current: **0.24**



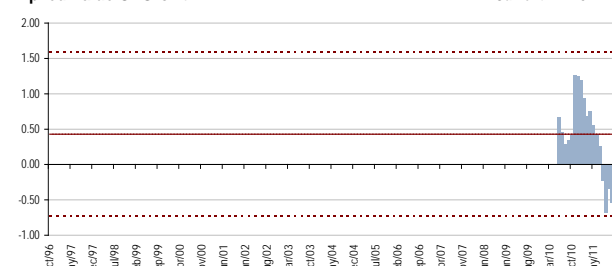
12 Mth Forward EPS Current: **0.03**



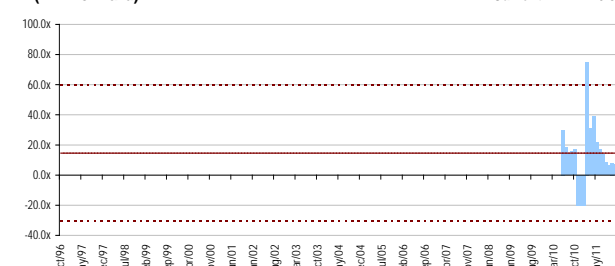
Earnings Yield (& local bond Yield) Current: **14%**



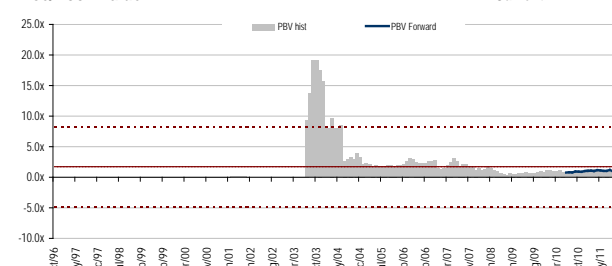
Implied Value Of Growth* Current: **-54.42%**



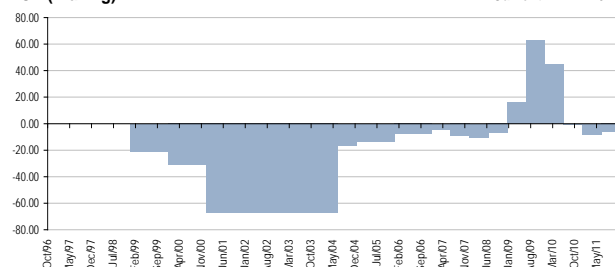
PE (1Yr Forward) Current: **6.9x**



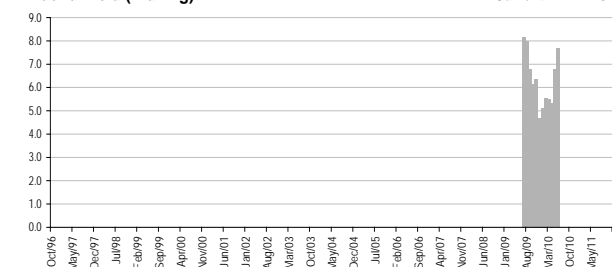
Price/Book Value Current: **1.0x**



ROE (Trailing) Current: **-6.25**



Dividend Yield (Trailing) Current: **0.00**



Summary

Hillgrove Resources Ltd.		SEDOL		6426150		As Of: 4-Nov-11					
AUSTRALIA						Local Price: 0.24					
Materials						EPS: 0.03					
	Latest	Min	Max	Median	Average	2 S.D.+	2 S.D. -	% to Min	% to Max	% to Med	% to Avg
12mth Forward PE	6.91x	-20.00	75.00	14.90	14.57	59.61	-30.47	-390%	986%	116%	111%
P/BV (Trailing)	0.96x	-0.02	19.06	0.86	1.73	8.24	-4.79	-102%	1893%	-10%	80%
Dividend Yield (Trailing)	0.00	0.00	8.16	0.00	0.46	3.80	-2.88				
ROE (Trailing)	-6.25	-67.43	62.73	-13.54	-21.52	46.90	-89.93	-979%	1104%	-117%	-244%
Implied Value of Growth	-54.4%	-0.68	1.27	0.44	0.43	1.59	-0.73	-26%	334%	182%	179%

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Please contact your Ord Minnett Adviser for further information on our document.

Guide to Ord Minnett Recommendations

Our recommendations are based on the total return of a stock – nominal dividend yield plus capital appreciation – and have a 12-month time horizon.

SPECULATIVE BUY	We expect the stock's total return (nominal yield plus capital depreciation) to exceed 20% over 12 months. The investment may have a strong capital appreciation but also has high degree of risk and there is a significant risk of capital loss.
BUY	The stock is undervalued and we expect it to exceed the total return by 15% over the next 12 months..
ACCUMULATE	We expect a total return of between 5% and 15%. Investors should consider adding to holdings or taking a position in the stock on share price weakness.
HOLD	We expect the stock to return between 0% and 5%, and believe the stock is fairly priced.
LIGHTEN	We expect the stock to return less than 0% and possibly as much as 15%. Investors should consider decreasing their holdings.
SELL	We expect the total return to lose 15% or more.
RISK ASSESSMENT	Classified as High, Medium or Low, denotes the relative assessment of an individual stock's risk based on an appraisal of its disclosed financial information, volatility, nature of its operations and other relevant quantitative and qualitative criteria.

Ord Minnett Limited
 ABN 86 002 733 048
 ASX Market Participant
 AFS Licence Number 237121

Head Office
 Level 8
 NAB House
 255 George Street
 Sydney NSW 2000
 Australia
 Tel: (61-2) 8216 6300
 Fax: (61-2) 8216 6311

Ord Minnett Branches

Adelaide
 Level 11
 13 Grenfell Street
 Adelaide SA 5000
 Tel: (08) 8203 2500
 Fax: (08) 8203 2525

Gold Coast
 Level 7, 50 Appel Street
 Surfers Paradise QLD 4217
 Tel: (07) 5557 3333
 Fax: (07) 5557 3377

Coffs Harbour
 Suite 4
 21 Park Avenue
 Coffs Harbour NSW 2450
 Tel: (02) 6652 7900
 Fax: (02) 6652 5716

Melbourne
 Level 23
 120 Collins Street
 Melbourne VIC 3000
 Tel: (03) 9608 4111
 Fax: (03) 9608 4142

Tamworth
 Suite 3
 344-346 Peel Street
 Tamworth NSW 2340
 Tel: (02) 6761 3333
 Fax: (02) 6761 3104

Brisbane
 Level 31
 10 Eagle St
 Brisbane QLD 4000
 Tel: (07) 3214 5555
 Fax: (07) 3221 5550

Caloundra, Sunshine Coast
 79-81 Bulcock Street
 Caloundra QLD 4551
 Tel: (07) 5491 3100
 Fax: (07) 5491 3222

Mackay
 45 Gordon Street
 Mackay QLD 4740
 Tel: (07) 4969 4888
 Fax: (07) 4969 4800

Newcastle
 41-45 Newcomen Street
 Newcastle NSW 2300
 Tel: (02) 4910 2400
 Fax: (02) 4910 2424

Wollongong
 3/55 Kembla Street
 Cnr Market and
 Kembla Streets
 Wollongong NSW 2520
 Tel: (02) 4226 1688
 Fax: (02) 4226 1604

Buderim
 Sunshine Coast
 84 Burnett Street
 Buderim QLD 4556
 Tel: (07) 5430 4444
 Fax: (07) 5430 4400

Canberra
 101 Northbourne Avenue
 Canberra ACT 2600
 Tel: (02) 6206 1700
 Fax: (02) 6206 1720

Sydney
 Level 8, NAB House
 255 George Street
 Sydney NSW 2000
 Tel: (02) 8216 6300
 Fax: (02) 8216 6311

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