

HGO

AUD \$0.240

Spec.

HIGH



UNDERVALUED AUSTRALIAN COPPER PRODUCER

Hillgrove Resources flagship is the Kanmantoo copper project which has recently been commissioned and is in production. Our attraction is in the valuation of the project and the potential upside from further exploration in the region surrounding the mine. Furthermore we are comfortable with being exposed to a supply constrained metal such as copper.



Prices encountered resistance at the 26 cents level, which also coincides with the October 2011 high. A corrective pullback is likely, targeting the technically important 200 day moving average of 23.5 cents in the near term. We would expect prices to lift, once this key support level is tested.

The project's location, 55 kilometres by road from Adelaide's CBD, brings significant inherent operating and capital cost advantages. The mine accesses low cost grid power, treated waste water from the nearby town of Mount Barker, is three kilometres from the main dual carriageway South Eastern Freeway that leads to Adelaide and the exporting port of Port Adelaide only 75 kilometres from the mine. The mine's location in the

Adelaide Hills also helps to attract and retain a high quality workforce who predominantly live within the region.

The potential for further discoveries and growth of the global copper/gold resource at Kanmantoo is high. The deposit appears to remain open along strike and down dip where additional drilling could materially increase the resource inventory. The project's regional exploration prospects range from grass roots to those with significant intercepts and resources, which it is hoped will also add additional resources. Further additions to the mineral resources at depth and along strike of the open pit, if converted to ore reserves, could result in the expansion of the open pit, increases in the mining rate and extension of the mine life. This should all translate into low cost growth for Hillgrove.

The region remains one of the most under explored and prospective base metal provinces in Australia, showing outstanding potential for copper-gold and silver-lead-zinc mineralisation. The diagram illustrates the size of the mining and exploration permits which we believe are highly prospective.



Kanmantoo: The main game

Kanmantoo has a resource of 32mt of copper grading at 0.9%. There is also gold and silver occurring with the copper which they will receive credits for and hence keep operating costs down. It's estimated that the life of mine cash costs will be in the vicinity of US\$1.61 per pound. We estimate a mine life of approximately ten years based on the current resource. Target production when at full ramp-up will be approximately 20,000 tonnes of payable copper per annum.

We know that there are wide zones of copper mineralisation at shallow depths outside of the current optimised pit. The processing plant has significant upside capacity from the planned run-of-mine capacity of 2.4mt per annum to more than 3.5mt per annum with minimal capex of around \$12m. Specifically, at Critchley (south east of the main pit) where these wide zones have been intersected the copper mineralisation remains open along strike to the south and at depth. Part of the drilling campaign is about the conversion of resources to reserves in addition to expanding the current resource.

The ramp-up of Kanmantoo has been successful. It is now three months into ramp-up toward full production at an annual rate of 2.4 million tonnes per annum which is likely by May this year. The operating margin at US\$3.73 for a pound of copper is clearly attractive relative to its stated cash costs of approximately US\$1.61 per pound. The hedge price gives us additional comfort in that it locks in a healthy margin for just over 3 years (we discuss the hedge in greater detail shortly).

Although, the mining grades of this project will not set the world alight, the economics look robust and the plant is clearly designed for this lower grade feed. It appears to us that this will be a large low grade copper operation (0.8% to 1% approx) with the addition of low risk tonnes (via near mine drilling/exploration) in the region surrounding the main pit. The near mine exploration potential will be a continual feature of the Kanmantoo project over the medium-term.



With reference to the weekly chart, prices broke to the upside from the long term downtrend line, which is bullish. A convincing break above the 200 week moving average would signal broader term momentum to favour the upside. Should this bullish case evolve, further gains are likely to be had over the long term.

Hedging & Debt

As with most projects that have some debt funding, there is some hedging. In this case it is 50-55% of the output for 40 months (debt repayment period) at an average price of US\$3.73 per tonne which is equal to the current price at the time of writing. We consider this to be good hedge price given our assumption of US\$ 3.20 per pound for life of mine and our view that the marginal cost of production globally to be in excess of US\$2.50 per pound.

Indonesia

The company has two exploration projects in Indonesia which combined amount to 2,000 sq km of exploration ground. The exploration licence on Sumba Island occurs in a major structural corridor and looks to be highly prospective for copper and gold. The other tenement in West Papua has some historical drilling data undertaken by Normandy. This includes 5,000 metres of surface drilling to a depth of 150 metres. Importantly Hillgrove's follow-up work has identified all the features of classic sub-surface copper porphyry mineralisation.

Drilling at the Birdshead prospect in West Papua is expected to commence in late March, with first drill results likely by the end of June this year. Hillgrove recently gained permitting to drill at Birdshead and is targeting bulk tonnage porphyry copper/gold mineralisation. **Birdshead sits on the same geological trend as world class deposits such as Grasberg and Wafi. The Grasberg mine in West Papua is owned by Freeport-McMoRan. The mine has 106 million tonnes of copper in reserves.** Hence, whilst this acreage does look very promising, we have not included any value for the Indonesian exploration potential in our valuation.

Valuation & Investment thesis

We have been very conservative in our valuation in order to give us plenty of comfort surrounding the economics of the project. As such, we have assumed a A\$3.20 per pound copper price for the life of mine which is approximately 15% below the current spot price. We estimate that Hillgrove will be cash flow positive in April this year and our NPV based valuation is A40 cents post tax. We assume throughput at 2.7mt pa and have NOT included the potential increase to 3.5mt pa in our numbers. In addition, this places no value on the potentially world class Indonesian exploration acreage, it just values production based on the current resource with conservative estimates around grade and recoveries.

We see Hillgrove as a sleep at night stock, given the project has successfully been de-risked. It has navigated through its highest risk exploration and development stages and is now a producer in ramp-up mode to full nameplate capacity. In addition to its emerging status as a copper producer, we see the extension of mine life, upgrade to its resource position, as well as continuing success with the ramp-up as positive near term catalysts for the share price.

We recommend Hillgrove as a buy for all members with a **limit** of 24 cents.

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Snapshot HGO

Hillgrove Resources

Latest Closing Price: \$0.24

Hillgrove Resources Limited (HGO) is developing into a mid tier gold and copper/gold resources group. HGO's flagship development is the Kanmantoo Copper Mines in South Australia and exploration on its greenfield exploration projects in Indonesia.

Market Capitalisation: \$198m

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