Research HOLST

Silver Lake Resources (SLR)

Recommendation: Hold (previously: Buy) 13 September 2010

Recommendation downgrade, but outlook remains very promising

- Our recommendation on Silver Lake Resources is downgraded from Buy to Hold due to the rise in the share price to around our current valuation. The share price is now in line with our valuation estimate for SLR of $2.20 to $2.50/share as advised in HOLST's July/August 2010 Portfolio Watch (following the upgrade to the resource inventory at Mount Monger, plus the increasing certainty of a low capital cost Murchison development).
- This is the first downgrade to our recommendation on SLR since we initiated coverage on 23 May 2008. However, our positive view on the outlook for SLR has not changed. The company has a very capable Board (ex-WMC) and management who have delivered on key targets and milestones.
- Our base case valuation is currently $2.40/share assuming a mine life at Mount Monger to the 2017FY and including a valuation for a Murchison Goldfields Operation (note that our earnings estimates, at this stage, exclude a Murchison operation). If we used the current gold forward curve and forward $A/US rates, our base case valuation would increase to ~$3.00/share.
- More significant high grade intersections have been announced (on 7 September 2010) at the Magic deposit at Mount Monger.
- Potential triggers for a higher share price include: further positive drilling results from the Magic deposit; underground drilling results at Mount Monger; and a commitment likely in the next six months to a standalone operation in the Murchison Goldfields.
- SLR had announced, on 29 July 2010, a 70% increase in its Resource Inventory to a total of 2.5 million ounces (Moz) of gold at Mount Monger and the Murchison. The company is on track to deliver on a target Resource Inventory of 4-5Moz by June 2012 (which would justify a higher valuation).

Share price:	$2.34
52 week price range:	$0.74/$2.54
Market capitalisation ($m):	418

Year ending 30 June	2009 Act	2010 Act	2011 Est	2012 Est	2013 Est
Adjusted Profit[1]	10.7	11.8	37.4	61.0	61.3
EPS (fully diluted)[1] (cps)	6.9	6.2	18.4	30.0	30.2
P/E ratio (x)	33.9	37.6	12.7	7.8	7.8
DPS (c)	0.0	0.0	3.0	5.0	5.0
Franking (%)	0	0	0	100	100
Assumptions					
Gold production (koz)	47	60	101	143	143
$A/US	0.746	0.881	0.865	0.820	0.790
Gold price (US$/oz)	896	1105	1103	1025	1000

[1] Excludes a potential Murchison Goldfield Operation

Analyst: Rob Craigie

F W Holst & Co. Pty Ltd ("HOLST") ABN 67 006 545 660 AFSL 247841 A Participant of ASX Group
Telephone: (03) 9282 8111 Facsimile: (03) 9282 8222 Email: holst@holst.com.au Webpage: www.holst.com.au
Address: Level 9, 600 Bourke Street Melbourne Victoria 3000 Postal: PO Box 44 Collins Street West Victoria 8007 Australia

Mount Monger Operations Summary		2009 Act	2010 Act	2011 Est	2012 Est	2013 Est
Daisy-Milano, Daisy East	mt	0.160	0.225	0.280	0.400	0.400
	g/t Au	9.7	8.4	9.5	9.8	9.8
Open Pits - Christmas Flats, Magic, Wombala Dam, etc	mt	0.003	0.115	0.200	0.200	0.200
	g/t Au	0.0	2.4	3.0	3.5	3.5
Total Ore **Hoisted**	mt	0.160	0.340	0.480	0.600	0.600
Recovery		95%	95%	96%	96%	96%
Gold in ore hoisted	**koz**	**49.3**	**66.3**	**100.6**	**142.6**	**142.6**
Gold Production	**koz**	**47.3**	**60.1**	**100.6**	**142.6**	**142.6**
Gold Sales	**koz**	**48.4**	**55.0**	**100.6**	**142.6**	**142.6**
$A/US		0.746	0.881	0.865	0.820	0.790
Gold Price	$US/oz	896	1107	1103	1025	1000
	$A/oz	1200	1257	1275	1250	1266
Cash operating costs	$A/oz	647	597	515	462	466
Cash costs incl mine development	$A/oz	727	825	603	525	528
Total cash costs incl mine development & royalties	**$A/oz**	**780**	**864**	**644**	**565**	**569**

Summary Profit / (Loss)[1] - Year end 30 June		2009 Act	2010 Act	2011 Est	2012 Est	2013 Est
Revenue	A$m	58.1	69.1	128.2	178.2	180.5
Mining		-27.6	-28.7	-44.4	-54.5	-55.1
Transport to LGPF		-0.3	-2.6	-3.7	-4.7	-4.7
Milling		-7.5	-8.5	-12.0	-15.0	-15.0
Site Administration		-0.4	-0.6	-0.5	-0.6	-0.5
Operating Surplus		22.3	28.7	67.6	103.4	105.2
Royalties		-1.9	-2.2	-4.1	-5.7	-5.8
Depreciation/Amortisation		-5.2	-7.6	-7.9	-8.4	-9.6
Exploration/evaluation expensed		0.0	0.0	0.0	0.0	0.0
Corporate / Other		-1.8	-2.2	-2.2	-2.2	-2.2
Pre-tax profit		13.4	16.7	53.4	87.2	87.6
Tax expense		-2.9	-4.9	-16.0	-26.2	-26.3
Adjusted Profit		**10.4**	**11.8**	**37.4**	**61.0**	**61.3**

[1] Excludes a likely Murchison Goldfield Operation.

Summary Cash Flow - Year ending 30 June		2009	2010	2011	2012	2013
Operating Surplus	A$m	22.3	28.7	67.6	103.4	105.2
Royalties		-1.9	-2.2	-4.1	-5.7	-5.8
Capital Expenditure		-4.2	-7.7	-12.0	-5.0	-5.0
Exploration, evaluation, mining assets [1]		-5.0	-17.8	-11.7	-6.0	-5.0
Working capital changes, Other		3.7	-5.9	-2.2	-2.2	-2.2
Tax Paid		0.0	0.0	0.0	-15.6	-25.4
Cash Flow before funding		**14.9**	**-4.9**	**37.6**	**69.0**	**61.8**

[1] Includes exploration, evaluation in the Murchison to 30 June 2010.

Production Outlook

SLR's gold production in the 2011FY is likely to be 90–105koz. We estimate 101koz, down a little from an estimated 111koz in our last full SLR report released on 1 June 2010, but still a substantial increase on the actual 60koz for the 2010FY. Production will be skewed to the June 2011 half – around 35-40koz in the first half and 50-70koz in the second half.

There is scope for production from Mount Monger in the 2012FY to be ~150koz. On our assumptions, we estimate 143koz (slightly above our previous estimate of 139koz, 1 June 2010). This estimate is based on: 61koz from Daisy Milano; 60koz from Daisy East; and 22koz from open cuts (Costello, Wombala Dam). There is some chance that we may be over-estimating the underground production and under-estimating potential open-cut production.

SLR is aiming at an initial 50koz in the 2012FY from the Murchison, giving a total potential 2012FY production target of 200koz. **A potential full year contribution of 100koz from the Murchison in the 2013FY gives a conceptual production target for SLR of more than 250koz.**

Valuation

Our base case valuation is currently $2.40/share assuming a mine life at Mount Monger to the 2017FY. If we used the current gold forward curve and forward $A/US rates, our base case valuation would increase to ~$3.00/share.

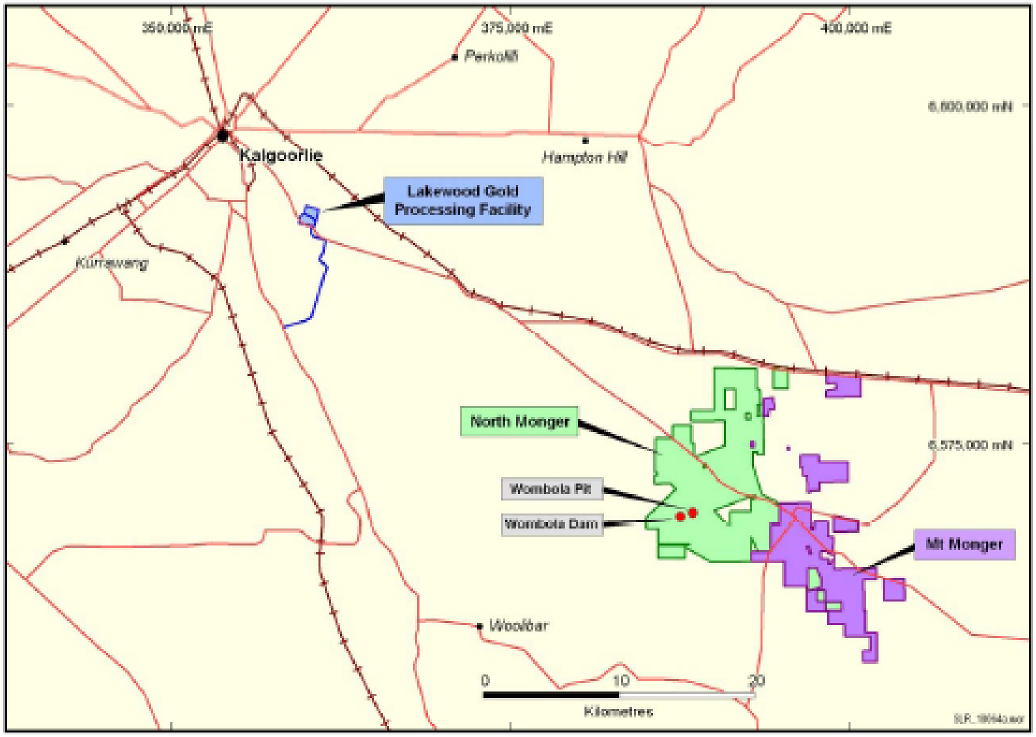
Our estimated Mount Monger mine life has been increased following the upgraded resource inventory (based on 80% resource to reserve conversion) and the reasonable certainty of further resource extensions.

At 30 June 2010, SLR had net cash of $29m and net cash and bullion of $36m. The company has no hedging.

Base Case Valuation [1]	A$m	NPV/share
Mount Monger Gold Mine [2]	355	1.75
Net Cash & Bullion	36	0.18
Capitalised corporate costs	-8	-0.04
Future value of option exercise	5	0.03
Valuation excl Murchison	**388**	**1.91**
Murchison Goldfield	100	0.49
Base Case Valuation	**488**	**2.40**

1 Based on 178.8m fully paid ordinary shares and 24.4m options.
2 Based on mine life to end of 2017FY.

Figure 1 – Mount Monger Location Plan



2.5Moz Resource Inventory

SLR had announced (on 29 July 2010) a 70% increase in its high grade gold JORC Resource Inventory to a total of 2.5Moz of gold at Mount Monger and the Murchison. Of the 1Moz increase in its resource inventory, Mount Monger contributed 691koz.

The company is <u>on track</u> to deliver its target of 4-5Moz of gold within two years.

An increased Mount Monger mine life reduces annual amortisation charges.

In our research note on SLR (released on 1 June 2010) <u>we had highlighted three potential share price triggers</u>, the **<u>first</u>** being "a significant estimated resource upgrade for Mount Monger is scheduled to be released in July". **SLR's announcement is <u>better than expected</u>. Key highlights are:**

- **At Mount Monger,** a total resource of 3.6mt at 9.4 g/t gold (1.1Moz) including: a 142% increase in the resource at Daisy Milano to 624koz *[refer to Figure 2]*; a maiden resource estimate at Daisy East of 143koz at 38.7 g/t gold; and a 152koz resource at the Magic Deposit (includes an 11m intersection at 59.4g/t).
- **In the Murchison,** a total resource of 13.7mt at 3.0 g/t gold (1.3Moz).

Further encouraging results are expected from ongoing drilling programmes as many of these resources are not closed out. A total of 70 drill holes (or ~9,000m of drilling) completed during the June quarter, with some holes now partially assayed (but not yet released to the ASX), are **<u>NOT INCLUDED in the new resource inventory</u>**. A further resource upgrade will be announced <u>in January 2011</u> to include:

- <u>Expanded resources at Magic and Daisy East (at Mount Monger).</u> Drilling and development is confirming that the width of the Daisy East orebody on the 9 level is typically 3-5m (ie not a narrow vein orebody);
- <u>Maiden resources for Lena South, Leviticus and Numbers on the Moyagee tenements in the Murchison.</u> (The resource inventory at Moyagee was unchanged from the 2009 estimate due to insufficient drilling at this stage to justify an updated inferred estimate.)

Figure 2 – Long Section of Daisy Milano & Daisy Deeps Indicating Gram Metre Contours

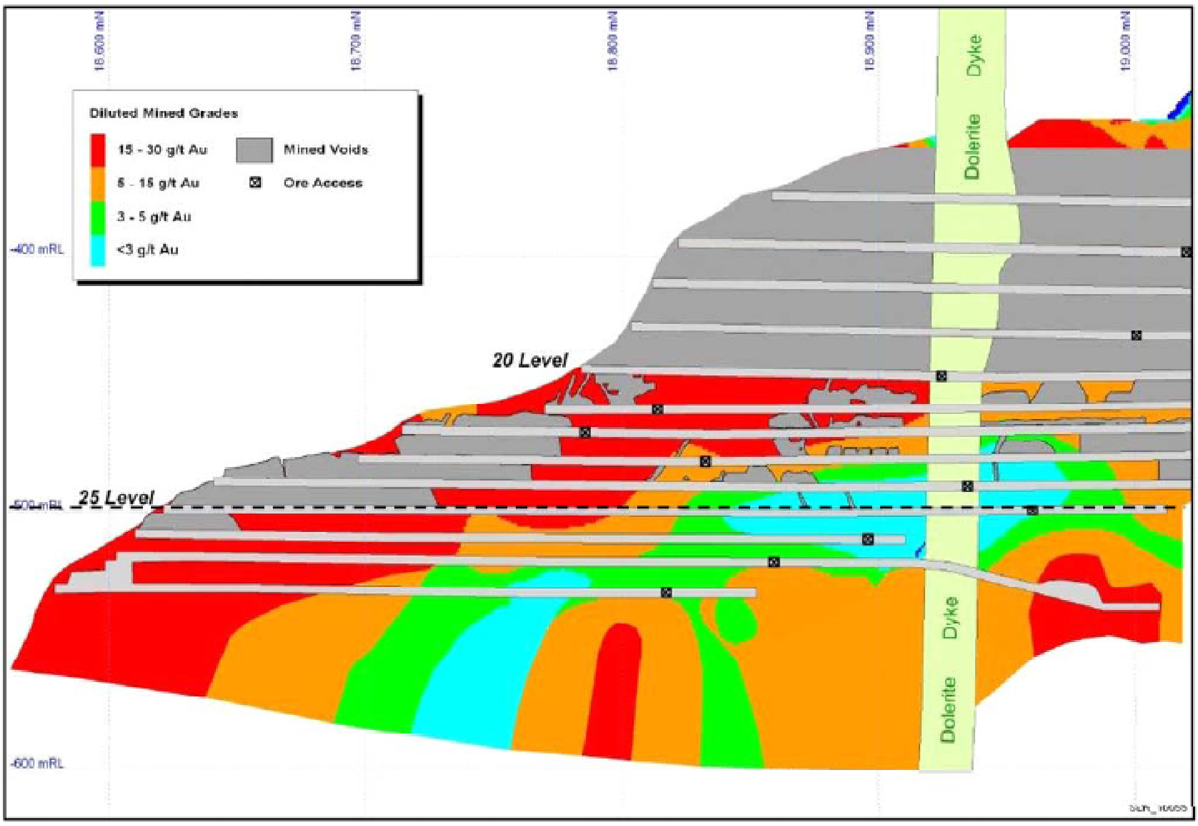
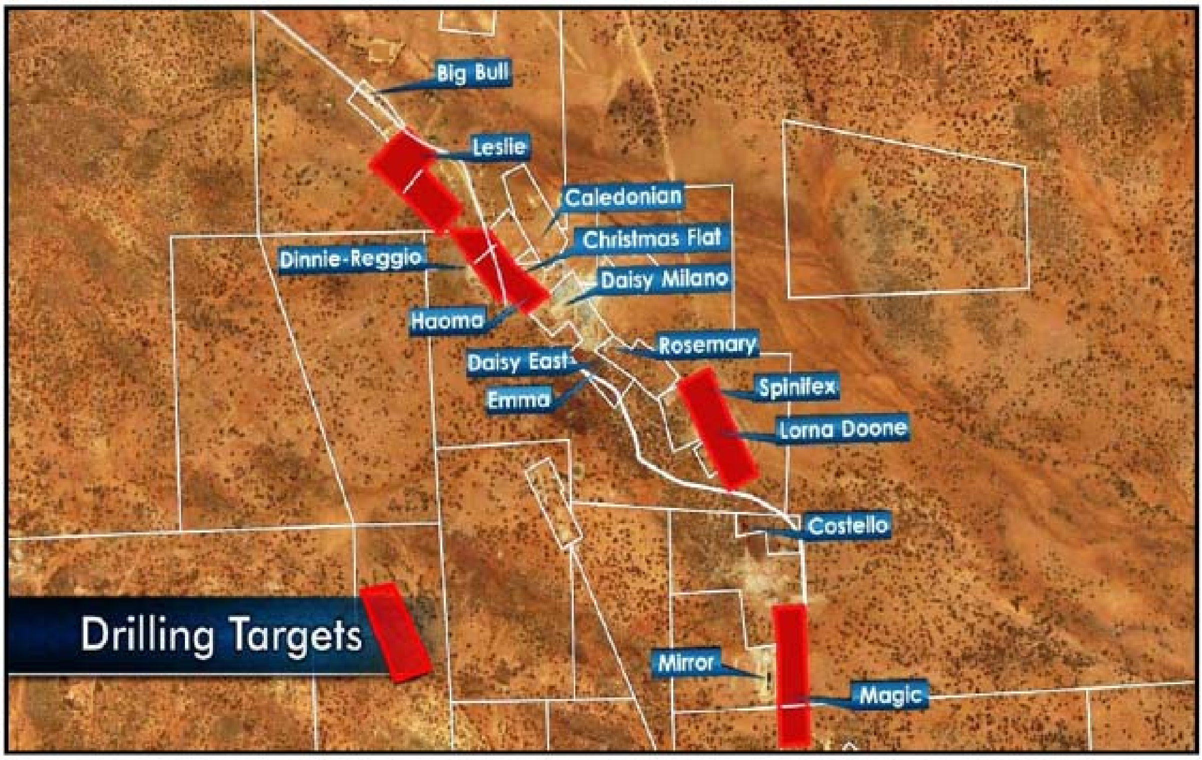


Figure 3 – Mount Monger Drilling Targets



Current Exploration Plans

The objective of the $18m exploration programme (115km of drilling) that commenced in November 2009 **is to increase SLR's global resource base to 5Moz within two years. Progress to date suggests that the company is on track to realise this target.**

Mount Monger – Surface drilling targets

The surface drilling programmes are targeting extensions of known deposits, particularly at the Magic deposit *[refer to Figure 3]*. In addition the exploration programme is targeting three independent zones at Mount Monger; Big Bull to Dinnie Reggio, Fifty Grand to Caledonian and Lucky Strike to Lorna Doone.

The exploration plan comprises a total of 55,000m of RC and diamond drilling (50-450m deep holes) over the next two years.

Magic deposit, Mount Monger

SLR has announced (on 7 September 2010) **more significant high grade intersections at the Magic deposit at Mount Monger.** These are outside the current resource boundaries and include: 8.3 metres at 44.4 g/t gold and 4.2 metres at 42.6 g/t gold and located 100-200m west of the thick high grade mineralisation previously reported on 25 May 2010 (11m at 59.4g/t gold). **This is a key focus area for SLR.** An ongoing drilling program is required to better understand and delineate the mineralised potential (June 2010 resource estimate for Magic: 152koz of contained gold). Based on the latest drilling results, it is currently interpreted that the mineralisation is stacked in multiple layers to the west that remain open to the south and at depth.

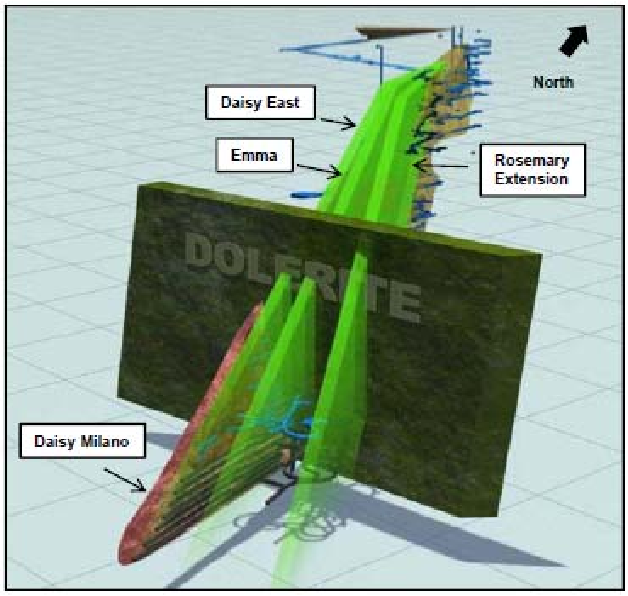
Daisy Deeps

Daisy Deeps is the area within the Daisy Milano mineralised system below 500 vertical metres from the surface. The underground drilling programme is designed to firm up the mineralisation down to 800 vertical metres below the surface which could significantly increase the resource and projected mine life *[refer to Figure 4]*.

Daisy East (and Emma, Rosemary Extension)

The structures contain typical Daisy Milano style narrow vein mineralisation with sericite pyrite alteration and with some intercepts containing visible gold *[refer to Figure 4]*.

Figure 4 - Schematic View of Eastern Lodes



Murchison Goldfields

The exploration programme aims to significantly increase resources at the Tuckabianna, Comet and Moyagee projects *[refer to Figure 5]* located in the Murchison Goldfields which currently have a combined resource of 13.7mt at 3.0 g/t gold (1.3Moz gold). The exploration plan comprises a total of 60,000m of RC and diamond drilling (50-450m deep holes).

The market is probably assigning modest value for SLR's assets in the Murchison. We note the company has previously described the Lena project at Moyagee (current inferred resources: 820koz at 8.5g/t gold or 224koz contained gold) in the Murchison as "a world class exploration project". **Whilst this may be arguable at this stage, we would expect considerable exploration news flow over the next six months on a number of drill targets.**

The recent purchase of a milling circuit (in good condition and readily relocatable) for only $3m – comprising a 250tph crushing circuit, a grinding circuit with 3 ball mills and a 7 stage CIL circuit with a plant capacity up to 2.5mtpa – **further demonstrates SLR's focus on low cost capital options**.

The milling circuit can be configured to the expected 1.2mtpa base load production profile in the Murchison. Following the recent resource upgrade at our Mount Monger Operations, the remaining infrastructure may be located there.

The parameters for a Murchison development are likely to be released shortly, but we expect 100kozpa, moderate/high cash costs and a capital cost of ~$50m (funded from cash, cash flow).

A final commitment to a standalone operation in the Murchison (exploration target: 3Moz) is likely within six months following the completion of a definitive feasibility study.

Mount Monger - Background

Silver Lake's Mount Monger Operation comprises the Daisy Milano underground mine and the Christmas Flat open pit located 50 km SE of Kalgoorlie. Gold ore from Mount Monger is transported to Silver Lake's LGPF located 5km SE of Kalgoorlie and 45km from the Daisy Milano mine.

Silver Lake poured the first gold at its LGPF in April 2008 after commencing operations at Daisy Milano in December 2007. SLR had acquired Perilya's gold assets (including the Daisy Milano mine and most of the Mount Monger Goldfield) in August 2007 in a deal ($7.5m cash, $6m in SLR shares and a minor royalty) which has increasingly appeared highly favourable to SLR.

SLR had separately purchased (30 November 2007) and refurbished the Lakewood Gold Processing Facility (cost: $2.4m; plus $4.6m included installation of a gravity circuit). The replacement cost would now be >$25m, plus extended delays for mill delivery.

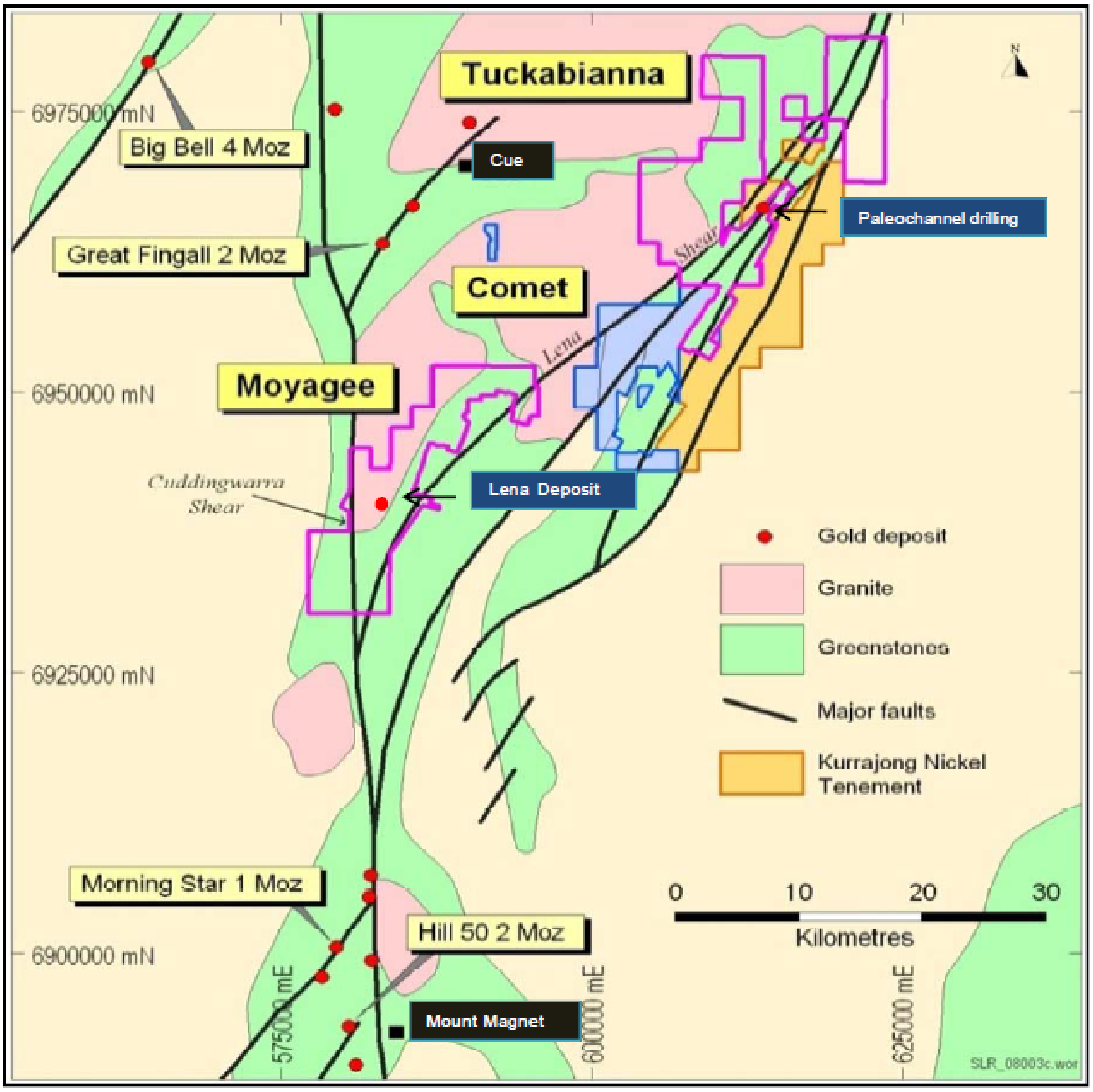
SLR has access to a very large drilling data base for the Mount Monger Goldfield, yet only 3% of drillholes extend deeper than 100m. A due diligence report (AngloGold, 2003) had indicated a potential gold inventory of 2.0 to 4.5Moz.

Lakewood Gold Processing Facility (LGPF)

SLR had completed a Stage 1 expansion of the LGPF in February 2010 by the addition of two CIL tanks, a pre-leach thickener and an upgrade to cyclones (estimated capital cost: ~$4m). The plant can now process 400ktpa of hard rock or up to 600ktpa of blended rock.

A Stage 2 expansion will include a regrind mill, an additional gravity circuit, electrical upgrade and additional tailings storage (estimated capital cost: ~$4.5m). This expansion would take mill capacity to 600ktpa.

Figure 5 – Murchison Goldfield – Location Plan



Source: Silver Lake Resources

F W Holst & Co. Pty Ltd