Research HOLST

Silver Lake Resources (SLR)

Recommendation: Accumulate (previously: Hold) **16 March 2011**

Recommendation upgrade. Key decisions expected next 3 months.

- Our recommendation on Silver Lake Resources is upgraded from Hold to Accumulate due to the increased share price discount to our base case valuation of $2.46/share.
- Our valuation assumes a mine life at Mount Monger to the 2018FY and a preliminary assessment of a new 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.
- Our earnings estimates now include the development of a standalone operation in the Murchison Goldfields with production commencing in mid 2012FY.
- 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 two months to a new operation in the Murchison.
- SLR had announced (on 19 January 2011) a December 2010 Resource inventory at Mount Monger and the Murchison totalling 3.0 million ounces (Moz) of gold, an increase of 17% from the June 2010 inventory. The company is on track to deliver on a target Resource Inventory of 4-5Moz by June 2012 (which would justify a higher valuation).
- The company has a very capable Board (ex-WMC) and management who have delivered on key targets and milestones.

Share price:	$1.915
52 week price range:	$1.08/$2.69
Market capitalisation ($m):	343

Year ending 30 June	2009 Act	2010 Act	2011 Est	2012 Est	2013 Est
Adjusted Profit[1]	10.7	11.8	28.3	65.7	80.4
EPS (fully diluted)[1] (cps)	6.9	6.2	13.9	32.3	39.6
P/E ratio (x)	27.8	30.8	13.8	5.9	4.8
DPS (c)	0.0	0.0	0.0	5.0	5.0
Franking (%)	0	0	0	100	100
Yield (%)	0.0%	0.0%	0.0%	2.6%	2.6%
Assumptions					
Gold production (koz)	47	60	85	181	233
$A/US	0.746	0.881	0.973	0.985	0.925
Gold price (US$/oz)	896	1105	1341	1285	1170

[1] Includes a potential Murchison Goldfield Operation.

Analyst: Rob Craigie

Operations Summary		2009	2010	2011	2012	2013
		Act	Act	Est	Est	Est
Daisy-Milano, Daisy East	mt	0.160	0.225	0.290	0.400	0.400
	g/t Au	9.7	8.4	8.2	9.5	9.5
Mount Monger Open Pits	mt	0.003	0.115	0.200	0.200	0.200
	g/t Au	0.0	2.4	2.8	3.5	3.5
Murchison					0.450	0.900
					3.2	3.4
Total Ore **Hoisted**	mt	0.160	0.340	0.490	1.050	1.500
Recovery		95%	95%	96%	96%	96%
Gold in ore hoisted	**koz**	**49.3**	**66.3**	**90.7**	**181.5**	**232.7**
Gold Production	**koz**	**47.3**	**60.1**	**84.7**	**181.5**	**232.7**
Gold Sales	**koz**	**48.4**	**55.0**	**84.7**	**181.5**	**232.7**
$A/US		0.746	0.881	0.973	0.985	0.925
Gold Price	$US/oz	896	1105	1341	1285	1170
	$A/oz	1200	1254	1379	1305	1265
Cash operating costs	$A/oz	647	597	579	574	606
Cash costs incl mine development	$A/oz	727	825	677	623	644
Total cash costs incl mine development & royalties	**$A/oz**	**780**	**864**	**718**	**665**	**684**

Summary Profit / (Loss)[1] - Year end 30 June		2009	2010	2011	2012	2013
		Act	Act	Est	Est	Est
Revenue	A$m	58.1	68.9	116.7	236.8	294.4
Mining		-27.6	-28.7	-44.8	-77.6	-99.4
Transport to LGPF		-0.3	-2.6	-3.8	-8.1	-11.6
Milling		-7.5	-8.5	-12.3	-26.3	-37.5
Site Administration		-0.4	-0.6	-0.5	-1.1	-1.4
Operating Surplus		22.3	28.5	55.4	123.7	144.5
Royalties		-1.9	-2.2	-3.7	-7.6	-9.4
Depreciation/Amortisation		-5.2	-7.6	-9.1	-15.1	-15.6
Corporate / Other / Interest		-1.8	-2.2	-2.2	-7.2	-4.7
Pre-tax profit		13.4	16.6	40.4	93.9	114.8
Tax expense		-2.9	-4.9	-12.1	-28.2	-34.5
Adjusted Profit		**10.4**	**11.7**	**28.3**	**65.7**	**80.4**

[1] Includes a likely Murchison Goldfield Operation.

Summary Cash Flow - Year ending 30 June		2009	2010	2011	2012	2013
Operating Surplus	A$m	22.3	28.5	55.4	123.7	144.5
Royalties		-1.9	-2.2	-3.7	-7.6	-9.4
Capital Expenditure		-4.2	-7.7	-15.0	-55.0	-5.0
Exploration, evaluation, mining assets [1]		-5.0	-17.8	-17.7	-6.0	-5.0
Working capital changes, Other		3.7	-5.9	-2.2	-7.2	-4.7
Tax Paid		0.0	0.0	0.0	-11.6	-29.0
Cash Flow before funding		**14.9**	**-5.0**	**16.8**	**36.3**	**91.4**

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

First Half Mine Production

At Mount Monger, Daisy Milano mine production for the 2010 December half was 25,711 oz at an average grade of 7.5 g/t gold. Lower grade stoping panels were completed during the period (levels north of the dolerite dyke) and extraction of the higher grade zones to the south has commenced.

Decline development at the end of the period was 40 metres from the 31 level crosscut. The ventilation shaft (cost: $5m) is progressing to plan, with the 520 metre deep pilot hole being completed *[refer to Figure 2]*. The project is on schedule to be completed in the June 2011 quarter.

Daisy East underground mine production was 7,508 oz at an average grade of 6.0 g/t Au. Ore driving during the period yielded lower grades as expected. Ore development will be the primary source of Daisy East production for the coming period until the ventilation shaft is constructed. Post completion of the ventilation shaft, waste development will have exposed 120koz of gold in stoping blocks. **Extraction from the stoping blocks will allow high grade production to ramp up in the September quarter (first quarter of the 2012FY).**

The **Costello open pit** commenced in October 2010 and produced 62,074 tonnes of ore at 1.8 g/t Au for 3,591 oz. The pit is performing to expectations and will be completed in the March 2011 quarter.

Gold production at the company's 600ktpa Lakewood Gold Processing Facility (LGPF) was constrained due to limited ore stockpiles during the period. This position has now changed with rising mine production. Indeed, production is now mill constrained. **A decision on a Stage 2 plant upgrade will be made shortly (depending on the mine plan). Options include a 800ktpa to 1mtpa mill, part of the recently acquired plant.**

Production Outlook

SLR recently confirmed its guidance of gold in ore production for the 2011FY of 90-105koz. We have reduced our <u>gold in ore</u> production estimate to 91koz and 2011FY gold production and sales to 85koz.

SLR is aiming at an initial 50koz in the 2012FY from the **Murchison**, giving a SLR total potential 2012FY gold in ore 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 $2.46/share assuming a mine life at Mount Monger to the 2018FY and a preliminary assessment of a Murchison operation. We assume a $50m initial development cost in the Murchison is debt funded (although an equity raising is an option). If we used the current gold forward curve and forward $A/US rates, our base case valuation for SLR 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 31 December 2010, SLR had net cash of $21m. The company has no hedging.

Base Case Valuation [1]	A$m	NPV/share
Mount Monger Gold Mine [2]	362	1.78
Net Cash & Bullion	21	0.11
Capitalised corporate costs	-8	-0.04
Future value of option exercise	7	0.03
Valuation excl Murchison	**382**	**1.88**
Murchison Goldfield	117	0.58
Base Case Valuation	499	2.46

1 Based on 178.8m fully paid ordinary shares and 24.4m options.
2 Based on mine life to end of 2018FY.

Interim Result

SLR reported a profit of $6.0m for the December half, based on gold sales of 29,796 oz sold at an average realised price of A$1,363/oz.

HOLST estimates excluding Murchison

Whilst we expect the development of a standalone operation in the Murchison to proceed, we show our estimated earnings excluding this development in the following table.

Year end 30 June	2011 Est	2012 Est	2013 Est
Adjusted Profit	28.3	59.9	56.5
EPS (diluted) (cps)	13.9	29.5	27.8
P/E ratio (x)	13.8	6.5	6.9
Assumptions			
Gold produced (koz)	85	137	138
$A/US	0.973	0.985	0.925
Gold (US$/oz)	1341	1285	1170

Figure 1 - Mount Monger Location Plan

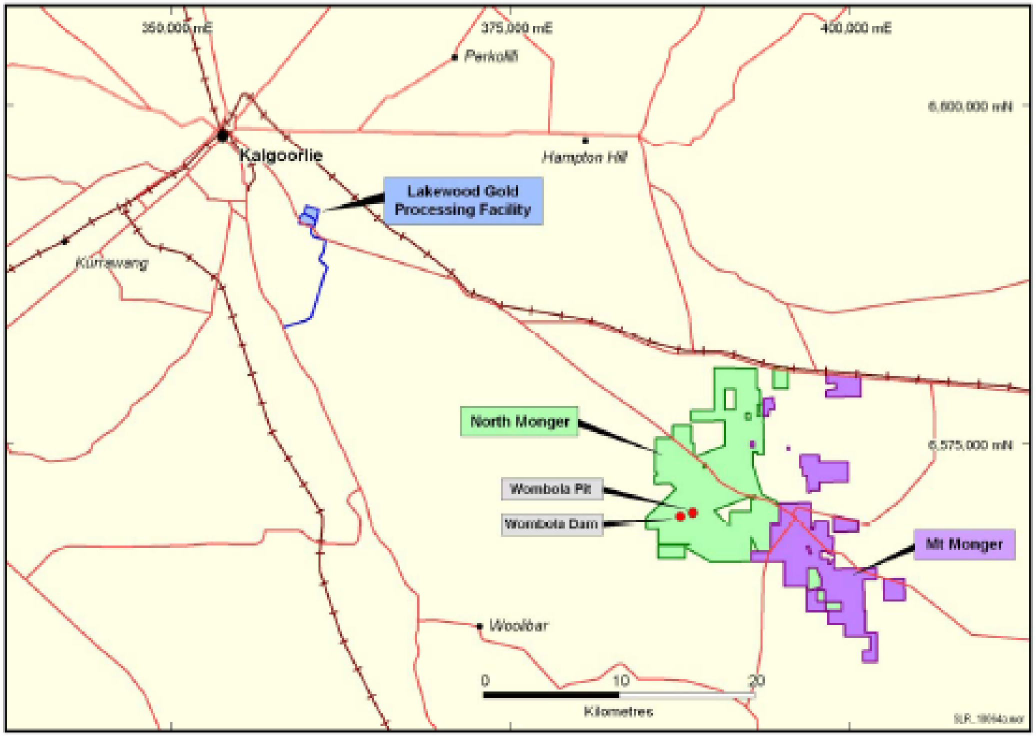


Figure 2 – Schematic View of Daisy Deeps Showing Ore Structures

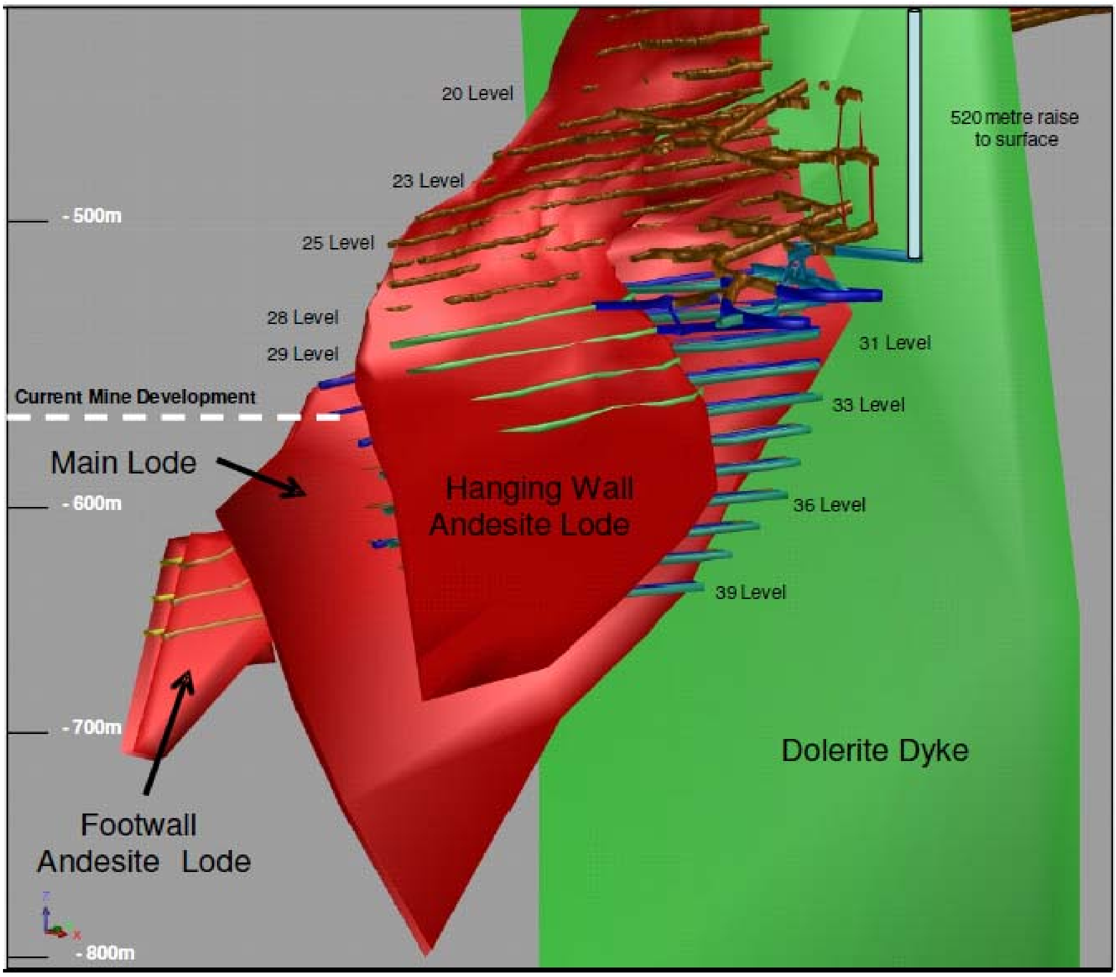
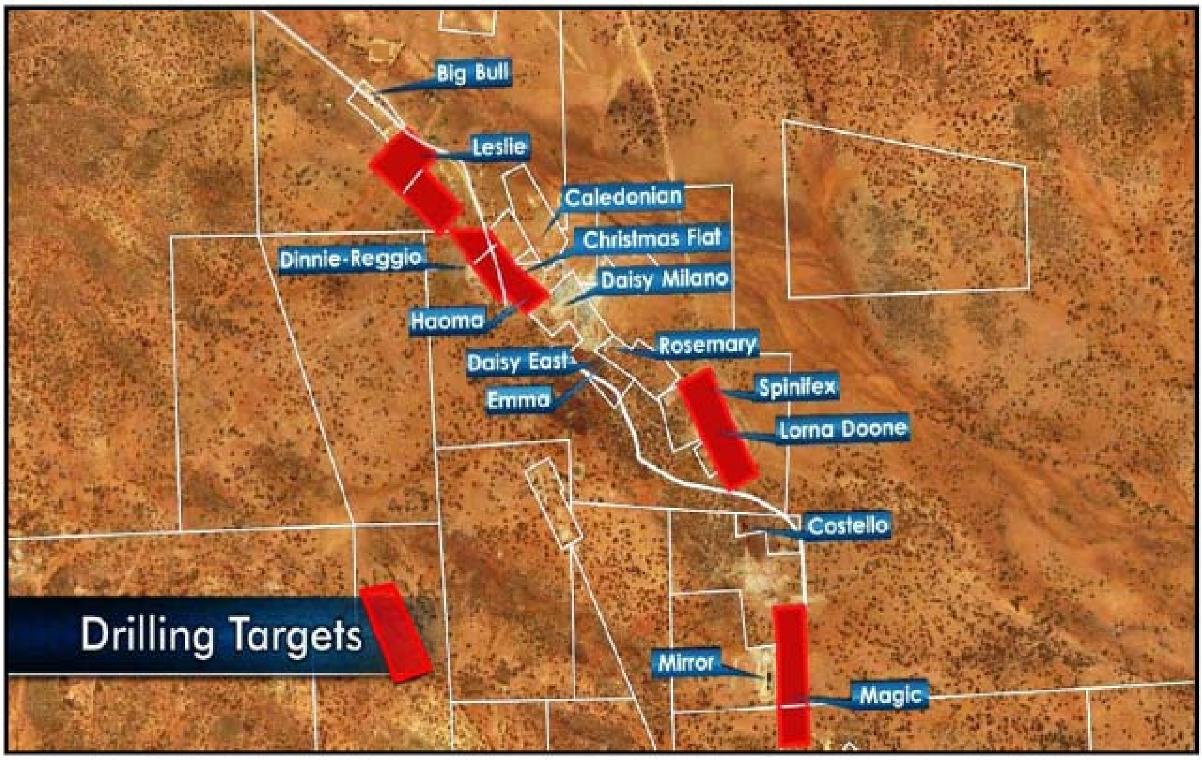


Figure 3 – Mount Monger Drilling Targets



3Moz Resource Inventory

SLR had announced (on 19 January 2011) a December 2010 Resource inventory totalling 20.8 million tonnes at 4.4 g/t Au for 3.0 million ounces, an increase of 17% from the June 2010 inventory. The December 2010 resource inventory is calculated after allowing for the previous six months mining depletion of 36,800 ounces. Highlights of the recent Resource inventory include:

Mount Monger:

- Total resource of 4.7mt at 8.7 g/t Au for 1.3Moz;
- Maiden resource at Haoma totalling 65,600 ounces at 18.7 g/t Au;
- 81% increase in resource at Magic to 276,300 ounces.

Murchison:

- Total resource of 15.5mt at 3.0 g/t Au for 1.5Moz;
- 92% increase in resource at Tuckabianna West to 287,200 ounces;
- Maiden resource at Numbers totalling 21,640 ounces.

Further encouraging results are expected from ongoing drilling programmes throughout the year, particularly at the Magic, Haoma and Tuckabianna West deposits.

Current Exploration Plans

Silver Lake is targeting to increase its gold resource base from 3.0 million ounces to 5 million ounces within two years. The objective of the $18m exploration programme (115km of drilling) that commenced in November 2009 is unchanged. **Progress to date suggests that the company is on track to realise its target.**

Over the next six months, **surface exploration in the Mount Monger region** will be targeting the thick high grade zones at the **Magic deposit** *[refer to Figure 3]* and extensions to the **Wombola Dam deposit**, while underground exploration will mainly target the Haoma deposit which remains open along strike, to the south and at depth.

Magic deposit, Mount Monger

The Magic deposit remains a key focus area for SLR. An ongoing drilling program is required to better understand and delineate the mineralised potential (December 2010 resource estimate for Magic: 276koz of contained gold). Based on the latest drilling results, the mineralisation is both porphyry and shear hosted with high grade cross linking structures, open to the south and at depth.

Significant high grade intersections at the Magic deposit have included: 8.3 metres at 44.4 g/t gold and 4.2 metres at 42.6 g/t gold located 100-200m west of the thick high grade mineralisation previously reported on 25 May 2010 (11m at 59.4g/t gold).

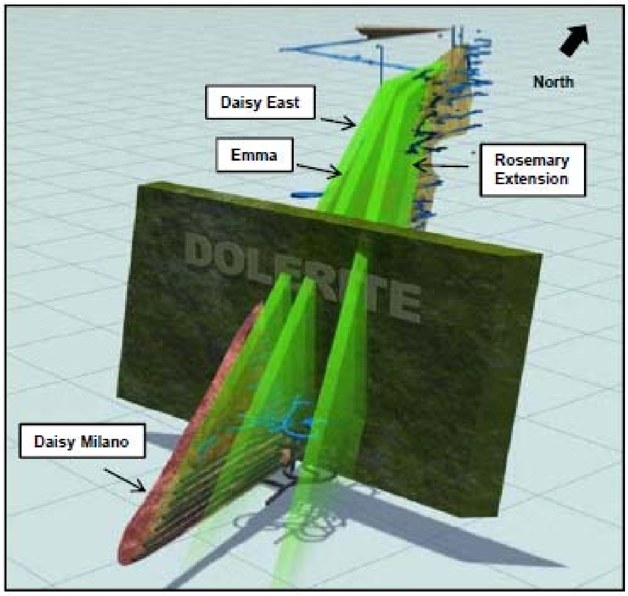
Daisy Deeps

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

Over the next six months, the surface drilling programme in the **Murchison** will mainly be targeting depth and strike extensions at the Tuckabianna West and Caustons Main deposits, to validate the underground mining potential of these deposits. Infill drilling is currently in progress at the Lena deposit to validate the underground mining potential, while extensional drilling is planned for the Lena South and Leviticus prospects to allow calculations for a maiden resource for each area.

The exploration plan has comprised a total of 60,000m of RC and diamond drilling (50-450m deep holes).

The market is probably assigning a modest value for SLR's assets in the Murchison.

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 Mount Monger, 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

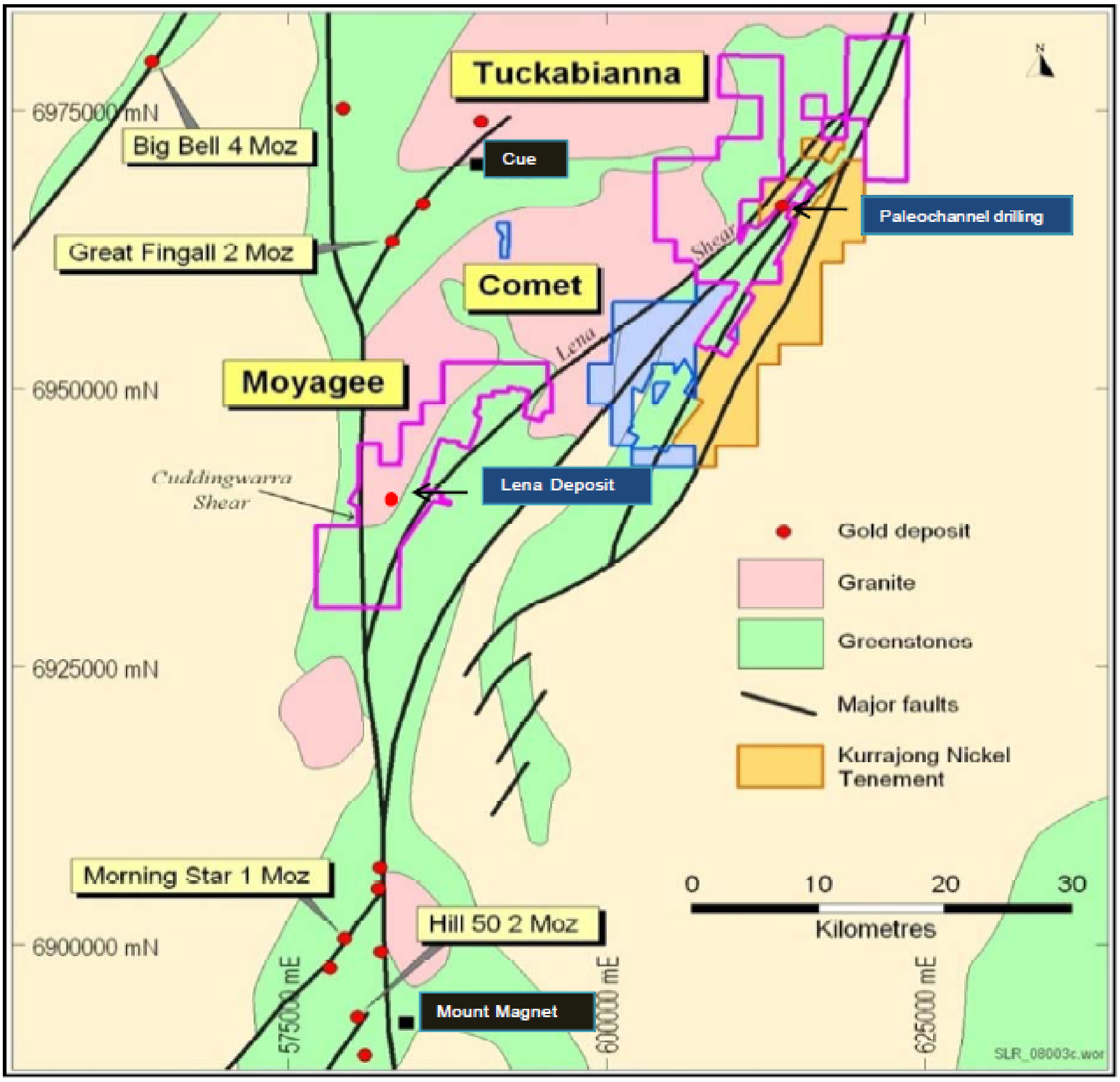
Silver Lake's Mount Monger Operation comprises the Daisy Milano and Daisy East underground mines and the Costello open pit located 50 km SE of Kalgoorlie. Mount Monger has additional multi mine potential underpinned by emerging open pit production from the Magic, Wombola Dam and Wombola Pit deposits. Furthermore the extensions of the Rosemary and Haoma lodes show potential as near term production sources.

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 probably be >$30m.

Figure 5 – Murchison Goldfield – Location Plan



Source: Silver Lake Resources

F W Holst & Co. Pty Ltd

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