GoldOz FML Briefing
Shandong Proposal - the Business case
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Is the sum greater than the two parts?

The purpose of this report is to examine the Shandong proposal to inject approximately $225M into Focus Minerals Ltd (ASX-FML) in return for the placement of approximately 4.55 billion ordinary shares or 51%. An understanding of the FML assets, the current constraints on the business and the potential benefits of the transaction requires close examination. The question is: "*does this represent a good deal for all shareholders, including the proposed investor*?"

Introduction and discussion

The Shandong Gold Group (SGG) is a 100% owned subsidiary of a large-scale state-owned (Chinese) enterprise (SOE), with a comprehensive industrial chain and substantial gold base. They have a stated aim to grow as a global first-class enterprise with international competitiveness. A match of purpose has been identified; FML has sought a cornerstone investor to support their medium to long term growth plans over an extensive tenement package.

Before I cover what the transaction *is*, it may be useful to clear up a limited view amongst some retail investors who consider this a *takeover*. It is not, the simple definition of 'takeover' is a bid for *all* the shares issued in a public company. The proposal under discussion is for the issue of new shares and no offer has been made for *any* of the existing shares on the current FML register.

Should SGG have wanted to undertake a full take-over it was comfortably within their capacity and ability to launch a takeover bid for 100% of FML. The market capitalization of FML at the time of the negotiations was around A$160M (3.7c). A full 100% takeover, even at a 90% premium (7c) would have cost SGG approximately $300M and yet SGG have offered $225M in return for a controlling 51% stake. Clearly SGG are therefore proposing to invest in the Board, Management, staff and the upside potential not just the company or assets.

This is a very significant capital raising at a premium. Investors may also note there is concern among some about the 51% interest as a majority stake. FML understand these concerns and have pointed out there is no naivety involved in putting forward this proposal. The FML Chairman Don Taig has worked with Chinese interests at this level for over thirty years, coming to a thorough understanding of the culture over this time. One should note that the Law also protects the 49% minority interest in FML (assuming the transaction is approved).

The Corporations Act 2001 regulates company activities in Australia. The Corporations Act and regulations are administered by the Australian Securities and Investments Commission (ASIC). ASIC has issued a considerable number of policies, to help companies, directors and their advisers interpret and comply with the Corporations Act and regulations. Penalties for breaches of the Act or duties defined under common law can result in a jail term for offending directors.

Director duties include avoidance of;

- Improper use of position,
- Conflict of interest and
- Improper use of information.

All Directors are required to;

- Act in good faith and for a proper purpose, and
- To act in the best interests of the company.

Minority shareholders also have the right to;

- Bring legal proceedings in the name of the company (e.g. against Directors) with the courts permission
- To inspect the books with the courts permission, and
- To approve or disapprove any sale of assets of the company to related parties such as majority shareholders or Directors.

The Tax Act does not allow sham transactions; a further safeguard against non-commercial transactions that have potential to benefit a majority shareholder over the interests of smaller shareholders.

Investors should also consider there are similar *risks and protections* in place where there are large investors who are *not* holding a majority stake. A disproportionate influence by a larger investor does not necessarily come from a majority ownership, as seen in relation to concerns re: Fairfax. In this light any major holder has potential to create issues for smaller investors.

Note: The reasons given for the 51% majority in this case were; access to the giant Chinese syndicated loan market and that an investment on this scale would not otherwise be possible (for Chinese Government approvals) at less than 51%.

What is the spirit of the transaction?

It is clear from the amicable approach and agreement reached by the respective Boards of both Parties that SGG wish to invest in the ground position, the FML Board and the FML team as they stand. SGG conducted all negotiations in good faith and true to their word throughout the process.

SGG have made an offer of $225M, equivalent to $99 per Resource ounce at 5c per share in return for 51%. This is at the upper end for this type of transaction. The market capitalization of FML was approximately $160M at the time of the *initial agreement* on the offer and $190M at the time of the announcement. A new floor price value for FML at 5c per share has been set for any further bidding that may arise. This current bid for new shares implies a *current* value, based on the proposed expanded capital of approximately $440M for the new entity at 5c per share.

As stated in the Chairman's letter, SGG have not offered this capital injection, made in return for 51% of FML only to see it fail. The imbedded value in the operations and tenements are expected to be rapidly unlocked with the new capital. The offer implies that SGG can see the potential and agree that FML can implement their Strategic Plan with their assistance and capital.

The strengthened FML entity would have a robust balance sheet, negligible debt (current gearing 4%) and minimal hedging. Clearly SGG see this valuation as a base and that FML have the capability to create value from their ground position and production facilities.

This is a commercial transaction. As such SGG will be expecting capital appreciation during the early stages and a cash return over the medium to longer term. The Chinese appreciate gold and hold a view of the true value of this monetary metal. After all gold is an important part of the Chinese culture and the international banking system. It is apparent that this is a strategic investment and viewed as long term a commercial opportunity for SGG.

The Chinese government is seeking to expand its gold reserves over time; an emerging part of this strategy is their involvement at arm's length via SOE's. This strategy is overt, tactical and commercial when they intentionally involve an SOE. They understand the increasingly important role of gold and wish to participate in the business opportunity; as such the SGG partnership with FML is an attractive avenue to further this aim.

The benefits should be obvious for FML too. Share price appreciation would provide a higher 'book value' on the SGG balance sheet with associated benefits to the corporation. The upside must be apparent to SGG for them to consider this large capital injection into FML. The due diligence will have been extensive and thorough. This level of investment is a strong endorsement of the ground position and also the trust and respect for the FML team, from the Board of Directors down to the Management team.

Focus Minerals has agreed to pay a break fee of $600,000 to SGG under certain circumstances, including an outcome where FML shareholders do not approve the Placement, or if FML directors change their recommendation in respect of the Placement. This scale of investment proposal would normally attract a much larger break fee indicating good will from SGG.

From the FML web site: "The Placement is subject to a number of conditions, including: Shandong Gold obtaining Chinese regulatory approvals; Foreign Investment Review Board ("FIRB") approval (under the Australian Government's foreign investment policy and the Foreign Acquisitions and Takeovers Act 1975 (Cth); Focus shareholder approval for the purpose of section 611 (item 7) of the Corporations Act 2001 (Cth); no material adverse change that has a fundamental and sustained impact occurring in respect of Focus and other customary conditions."

After extensive due diligence including studies by independent geologists SGG have come to the conclusion there is ample scope for significant upside for production, cash generation and growth of Resources on the FML ground position. The investment will be targeted initially to increase Reserves which is one key to a higher share price in the market as confidence is increased. This discovery process will then allow commercial decisions to be made in due course at the corporate level in keeping with appropriate corporate governance guidelines and planning controls. Greater production capacity and economies of scale will follow.

The spirit of the deal from Shandong can be summed up by this comment from the Shandong Gold General Manager, Zhang Dahui who said:

"Shandong Gold is very pleased to be investing in Focus Minerals, and we look forward to sharing our expertise with the Board and senior management to help build Focus into a major Australian gold producer. We have been impressed with the Board, management, assets and operations of Focus, and Focus's plans to become a significant gold mining company. Our investment in Focus will be substantial – this reflects both our confidence in Focus and our resolve to help build and develop Focus, for the benefit of all shareholders. We are a significant gold producer in China and understand the nature of the opportunities that Focus could realise with a serious investment in exploration of its tenements."

Another question the reader may well ask is: "*why did SGG select FML in particular?*"

Background:

FML originally commenced production in late 2009 from one underground mine. Since 2009 FML has grown from approximately 70 staff to around 600 staff and contractors. The Coolgardie gold field has great potential yet it required significant investment after mill refurbishment. The defined deposits had mostly been mined out by previous owners therefore much resource definition was required. Reserve levels have been low since FML started even though Resource levels are robust at over 2.2M ounces. Gold is abundant throughout the field as illustrated by steady Resource growth even after mine depletion.

Historic drilling suggests many high grade deposits are yet to be defined and FML are on track to unlock this value as they gain mastery and scale over the area. Most of the Resources are currently located within a very small area central to the mill. Capital is required to unlock the high grade potential now that base load ore is secured via the open pit system. The 1.2Mt PA Three Mile Hill mill is undersized for the scale of Coolgardie. A mill upgrade has potential to lower cash costs via economy of scale and increased operational efficiencies. This would require significant capital depending on the scale of the upgrade in the order of 2 – 3Mt PA capacity. This becomes a topic of realistic discussion and analysis under the SGG transaction.

Costs throughout the industry have been consistently rising since 2001. For FML 2009 and 2010 were characterised by this phenomenon. FML were unable to contain their costs particularly into 2011 and FY 2012 at Coolgardie. This has slowed, however not stopped progress across FML operations. FML have recently initiated a range of new cost saving measures as they also work through an exploration prioritization process and LOM (Life Of Mine) plan. This enhances their viability and potential moving forward.

In 2011 it was decided to raise approximately $40M to accelerate production and development for the company. Since that time The Mount has been ramped up and the open pits have been developed at Coolgardie as promised. FML also identified an opportunity to expand more dramatically to a second gold field in Laverton. This is a historically rich field that has produced large scale deposits and rich underground mines. Recent discoveries to the north by Regis Resources (Garden Well) and to the south at Red October (Saracen project) further highlight the prospectivity of the area.

Careful planning and execution was required to simultaneously deliver on the outcome promised via the capital raising at Coolgardie and to complete this second deal at Laverton. The desired outcomes have been delivered in an operational sense, the progress on the ground and production turn-around at Laverton has been outstanding. They ramped up mining volumes and ROM stockpiles and have shown signs of stabilized production through higher grades processed at the Barrick Granny Smith Mill (BGSM).

The market has not been sympathetic to the diversion of these funds away from Coolgardie to be spent on the Laverton project. FML do not control their production at this stage in the area, despite the immense upside in the project the value has not yet been recognised as shareholder value. The effect has been negative in this regard.

FML acquired the majority interest (81.57%) in Crescent Gold (CRE) during 2011 and have subsequently renamed the company Focus Minerals (Laverton) Ltd. FML have now delisted this public company and will move towards total ownership. CRE was in a distressed financial state needing substantial input to achieve viable grades of circa 2g/t and volumes approaching 500kt per quarterly campaign. FML had to divert significant capital away from Coolgardie, The Mount and Lake Cowan to achieve this turn-around.

Ore continues to be treated at the Barrick Granny Smith Mill (BGSM) under an ore purchase agreement (OPA) which expires in mid-2013. This OPA creates a cashflow issue as costs are incurred weekly against quarterly income payments. Lost production days at the BGSM have also impacted cashflows as the mining costs had already been expensed as reported in the recently released financial report.

The market has remained sceptical on the eventual outcome despite strong operational progress and the reduction of cash costs down to circa $1200 per ounce at Laverton. This is a highly prospective ground position however the cashflow issues and lack of control of their own milling remains a dampener on sentiment. Reversing this situation via refurbishment of the 1.45Mt PA Barnicoat mill becomes a viable discussion for analysis under the SGG proposal.

Time and capital is required to conduct and process exploration and development drilling before this becomes a commercial reality. Cash flow can continue to be generated in the meantime now that the operational turn-around is in progress. This is useful cashflow however the revenue is insufficient to meet ongoing operations in addition to mill refurbishment at this stage.

FML acquired an exciting greenfields exploration project at Lake Cowan generally known as Treasure Island back in late 2010. This project and their promising Nepean nickel project have been constrained by the lack of capital. Lake Cowan has received as much expenditure as FML could spare and this has generated a large anomaly in early stage exploration RAB drilling. Clearly progress has been hampered by lack of capital.

These are potentially company making projects in their own right however significant capital is required to bring them to fruition. Much work and investment is required before the market can value these projects in the FML share price. Further exploration is required; any valuation by the market in the FML share price will be incremental if they continue without additional funding. This effect would be enhanced however if the market considered FML to be capable of bringing either or both of these projects to production. The SGG transaction (again) makes these projects viable topics of conversation and analysis.

Gold has traded in a range mainly within US$1600 to US$1800 over the past 14 months. Gold in AUD terms has mostly traded between A$1540 and A$1700 over that period. FML is leveraged to a rising gold price as margins will benefit strongly in percentage terms. Most of the higher cost producers fit into this category. During the September quarter FML moved to monetize some of their development to consolidate their cash position in order to protect their future viability and provide a financial buffer to continue with their plans.

Current position of FML

FML have been investing almost all available operational cash flows into their forward production and ground position over the past three years. The capital raising in 2011 increased development at Coolgardie and The Mount which de-risked ore supply and production at Three Mile Hill and secured a stronger base. It also funded initial *greenfield* exploration programs at Lake Cowan. Cash generated and raised also funded the CRE take over and subsequent turnaround. This resulted in a doubling of the ground position and resources for FML increasing their upside potential. It also increased their cash requirement to optimise this potential.

A number of factors impacted their income in recent months. Cash costs were significantly higher than budgeted in Coolgardie after a mishap at Tindals underground, underperformance from The Mount and other issues. Gold settled down in USD terms as it consolidated gains of last year, and the AUD remained persistently high. They also lost vital production days at the BGSM (Laverton) over the last two quarters; 20% down in the March quarter and over 10% down last quarter. This delay of income not only causes financial pressures it also slows progress on the organic growth front which is far from ideal. This also depressed the share price in a negative gold sector phase.

The quarterly production campaigns at the BGSM create a cashflow issue. The income from each campaign is received in two stages, at the end of the processing and after gold in circuit calculations and the final tally. Costs however are incurred on a weekly and monthly basis. The income is received in the following quarter and varies in magnitude depending on the gold price at that time in the quarter and the processing days allocated at the BGSM. This has also been financed by FML as part of the turnaround process. CRE were unable to absorb this cost which was a major factor in their predicament when they became a distressed asset after the cyclone.

FML have the ability to bank capital and they are a going concern from all available data, not a distressed asset. The difficulties for FML encountered above have been managed; the effect reversed during the September quarter to some extent as they scaled back progress and monetized development. Cash levels were lower than required however FML do have this flexibility to fall back on when necessary. FML currently carries a gearing ratio of approximately 4%. Cash costs are on the higher side and falling, already having dropped significantly at Laverton. These costs should decrease further due to reduced need for the additional digging fleet at Apollo. Coolgardie has a number of programs designed to reign in cash costs, which should begin to show up in the December quarter.

Despite generating net cashflow from operations of $56M in the 2012 financial year the mine development and exploration expenditure was $67.9M. Clearly FML are not yet at a stage where they can return operational profits to shareholders as dividends. The cash flows are required for securing ore supply to feed the mills, to replace Reserves net of mine depletion and for organic growth. In order to complete the transition to leading gold producer with a higher recognised value the Reserve position and balance sheet must be strengthened.

FML are experiencing growth pains and are managing the process building their team as required. Cash reserves are currently constraining exploration which had to slow late in the last financial year. FML control some potentially world class projects as discussed however the pathway to achieving high returns for shareholders is currently a challenge. They have worked to secure stability and now work to do justice to their ground position for the benefit of shareholders, both existing and if passed, also for SGG.

FML have recently developed a LOM (Life Of Mine) plan which places the 55+ targets identified into context. This detailed list is weighted on importance. They are currently producing from two gold fields; Laverton and Coolgardie. They hold an additional two prospective areas which have the potential to be company makers in their own right; Nepean nickel and Lake Cowan which includes Treasure Island. The Mount is currently supplying ore to the Three Mile Hill mill at Coolgardie however it is situated 85km from the mill and much closer to Lake Cowan.

Achieving market recognition, risks / uncertainties and shareholder returns

Put simply FML have two ways forward, two options;

1. Stay the current course
2. Accelerate exploration, development, production and growth

Option1. This is the stay the current course option open to a shareholder vote under the current proposal from SGG. Shareholders can vote yes or no. This path is the slowest growth option and generally relies on a gradual improvement in the company's fortunes, improved sentiment for the gold stock sector and exploration success. This analyst believes this is likely to occur over time however the pathway to growth and dividends is likely to be significantly delayed. Progress has been muted to date on this path.

Shareholders also need to consider risk. Contingencies must be in place. The likely direction of the gold price may dictate hedging policy, however speculation is not a valid part of corporate governance. A strong equity market cannot be relied on either in this deleveraging economic environment. Capital markets are distorted with excessive government borrowing crowding out other borrowers. Credit markets are a significant risk at this point in time. FML cannot just assume they will be able to borrow capital if required under these conditions.

The diverse political and economic differences between member states in Europe and the "Target 2" capital flows have created treacherous conditions. Target 2 is the inter-country banking mechanism that balances funds held by member central banks in the Euro Zone. This has become a systemic risk because cross border claims are now extreme. If one member country leaves the Euro or the Euro breaks up then even the German tax payers could face huge losses. To put a scale on this one economist has estimated that the greater percentage of €1 Trillion or around 25% of German GDP could be lost by Germany should Greece, Ireland, Portugal, Spain and Italy leave the Euro. This has global ramifications.

A rising gold price may be popularly considered a 'given' however it is not prudent to factor this development as part of any financial plan. Financial plans require certainties, as do development programs. The Board are highly competent and would not put the shareholder equity or capital at risk on an assumption about a *projected* future that may or may not occur. Corporate governance practices are clear about risk management frameworks and managing day to day operations within budgetary controls. For example fiscal responsibility dictates that open pit design is based on a much lower gold price to allow for unexpected fluctuations. Pit shells were designed at $1400 per ounce as appropriate in Coolgardie. Please note this is sound industry practice.

FML would greatly benefit from control of milling at Laverton as this would eliminate the cashflow issue described in paragraph 3 on the previous page. Clearly capital can accelerate refurbishment of the Barnicoat mill in Laverton at a cost of circa $50M or be invested any number of ways to extract value for investors. The current operational cashflows would not allow this to occur in the near to mid-term.

Coolgardie would greatly benefit from a larger more efficient mill to bring down cash costs and increase production. This expansion, while highly beneficial on several levels, would not be in any short term plans under the current revenue base. Even with gold at $1800 levels the company will be busy drilling;

- mines in operation, to replace Resource depletion,
- development areas, to replace or compliment current ore sources,
- exploration at Lake Cowan or
- exploration at prospective high grade areas across greater Coolgardie and Laverton

There is no problem funding this activity from cashflows at this point in time, provided *the rate* does not exceed operational profit levels. The track record of the Board and Management demonstrates that adverse events over the past 12 months have been handled and this provides confidence going forward.

Nickel has created some interest in the market lately. The Nepean nickel project is highly prospective, currently a dormant asset for FML. Finding capital for drilling which is required for the market to assess the value on a stand-alone basis or as part of the FML Group will require a capital investment. A sale price at this stage would not represent a viable return for shareholders. Funding this will not be on the radar at this stage due to capital constraints and higher priorities elsewhere in the portfolio of tenements.

Option 2 Part A and Part B

This option has been split into two categories. FML have taken steps in the past to move from explorer to the large employer and mid-tier producer they are today. The method (Part A) has been two pronged; re-invest generated operational profits, and raise capital via the brokers and share placement programs (SPP's). The SPP have been required to provide existing shareholders with an opportunity to participate at the same price as the capital raisings. Part B is the consideration of the SGG offer.

Part A

A capital raising is typically transacted at a discount to the recent share price, if greater than 15% of issued capital a shareholder meeting and approval is required. There are three considerations here; firstly the discount issue which depresses the share price, secondly the progress of growth is incremental, and thirdly there is a cost to the company in cash and management time which would be better spent on other activities.

The cost aspect is significant; broker commissions, company meetings and administration, key staff and Board time and energy used in the process all have a negative impact at each and every time interval that such an activity is undertaken. Shareholders tend to be disadvantaged due to the time consumed by each raising. This tends to depress or mute the share price over time, especially if repeated. The prospect of an impending capital raising is enough to stall investment, thus liquidity is denied impacting negatively on the share price.

Investors should consider that a stock overhang can also be created in the process; sometimes large and to detrimental effect. This situation occurs when a Fund takes a short term position for short term profit and can end up caught with insufficient liquidity in the stock to exit their position. Any forced selling in cases like this will result in a protracted down-trend in the share price. A large investor in CRE was in this position and converted to FML shares as part of the CRE takeover. The position was originally understood to have been a long term holding however conditions for the investor changed; hence they had to exit. This certainly had a detrimental effect on the FML share price as they exited during the recent down trend in the sector exacerbating the effect.

These capital raisings are not usually considered long term by the Funds. They are in no way comparable to a cornerstone investor who takes a very large long-term position lasting a decade or more. This benefit is exactly what FML are trying to achieve with the SGG offer.

The *smaller* capital raising pathway was previously necessary for FML to buy out the Canadians and later to refurbish the Three Mile Hill mill. Ambitious growth plans and rising industry costs necessitated the capital raising in 2011, which resulted in a positive outcome in terms of assets, Resources, production and ground position. The potential benefit of incremental capital raisings for future expansion is that a reduced dilution *may* be possible. Future expansions that would benefit the company include; the refurbishment of Barnicoat, expansion at Three Mile Hill, increased Reserve drilling, accelerated drilling and development of Lake Cowan or Nepean.

Option 2 Part A delivers the desired and increased outcomes for growth and shareholder returns at lower risk than "stay the current course". However this pathway (Option 2 Part A) unfortunately delivers <u>limited optionality</u> over the various projects and deposits under FML control. The revenue base could be increased incrementally over time to compliment staged capital raisings; that is *if* the gold price rises. This is not guaranteed. Will capital markets offer funds when required? This is not guaranteed either during these debt market conditions.

A risk is that further capital raisings would be required to achieve each of the large expansionary moves that FML potentially have across their projects. These raisings may or may not come at a more opportune time; this cannot be guaranteed either way. As FML grows into the mining house it aspires to be, the dilution effect *may or may not* be contained under this scenario. Certainly there is higher risk which *could* have an adverse impact.

The same capital market risk discussed under Option 1 applies to this pathway to growth to a lesser degree however the risk is *not* eliminated. This report discusses the immediate business case; as such a significantly higher gold price *cannot* be factored. I note that higher gold prices would impact earnings and that over time the growth would therefore accelerate under this option i*f* this eventuates. I must also acknowledge a significant risk; that external or internal events could have an adverse impact on the company at any time, and this has the potential to undo the planned use of any future smaller capital raising. Such a large adverse impact would be managed with increased certainty under Option 2 Part B as discussed below.

Part B "*does this represent a good deal for all shareholders, including the proposed investor*?"

The projects and potential discussed under this option may also be considered *probable* under the other options. The risk and time frames to achieve the outcomes would vary substantially however. This is at the crux of the decision process facing current investors. The company progress and reduction of waste, in terms of market time and management resources is minimised under this option. In other words; to secure the funding and balance sheet strength required for sustainable growth across the entire portfolio of projects in one go.

The other factor worthy of consideration is operational risk. The ability of FML to weather various adverse events and conditions is considerably strengthened by a robust balance sheet. Option 2 Part A would also provide a limited buffer against operational or market risk, however the funds would be diverted from the expansion intended under adverse conditions negating any benefit for the loss of market time and management energy. This is exactly what happened after CRE completed its last capital raising before the cyclone impacted them with disastrous consequences. As such the SGG proposal represents an increased certainty for shareholders.

This option is based on acceptance of the SGG proposal by the shareholders of FML. On a legal basis the door must remain open for a superior offer during the offer period. As no such proposal is on the table at this time I am unable to discuss the merits or risks inherent in such a deal.

The discussion below is at arm's length; therefore it could be considered that the same outcomes would be achieved with a superior financial offer. I caution that this would not necessarily be the case and that the individual merits of a counter offer would need to be assessed on the basis of the other Party to the transaction and or any [potential] associated benefits or risks.

SGG have offered $225M at 5c per share for 51%. This level of investment from a State Owned Enterprise (SOE) is not possible without the 51% threshold. This transaction opens the door to cheap capital via the Chinese banks that finance enterprise via syndicated loans. This is a very attractive benefit for existing shareholders, especially given the crowding out effect in the debt markets discussed earlier in this report. There may come a time where it is beneficial to take on some debt to maintain balance sheet strength and flexibility provided robust margins are in place at the time. This decreases dilution risk long term for shareholders.

SGG are also manufacturers of mining equipment and understand the mining of similar gold fields containing multiple deposits. They have a stated aim to diversify their metal production profile beyond gold.

SGG are a highly respected Group run with the purpose and aims of any commercial enterprise. Make no mistake this is a commercial transaction undertaken with the aim of making a profit. As such it is in their interests to see the share price to rise well north of the 5c level of the offer. The aim of a well-run business is to achieve capital growth which increases the book value via share price appreciation and expansion.

The other clear aim is to earn a return on investment in the form of dividends. As such SGG will be a powerful ally for the current shareholder base of FML who will retain 49% of the new capital structure if they decide to retain ownership of their shares. The Chairman's letter indicates dividends are on the agenda however not before their time. The commercial reality is that time and investment in resources and capacity are required to grow the revenue base first. The market will recognise this value in the share price.

This section also covers the question: "*why did SGG select FML in particular?*" The simple answer is that FML are growing into a mining house. The situation described herein also caused FML to be on offer at a *discount to potential* at this time. The capacity of the Board of Directors, the track record of the company to date, the tenements secured and the potential all point to a mining house in the making. The team build has attracted first class individuals who share this vision and have willingly accepted the associated challenges. The long term vision of FML has found a match whereby a cornerstone investor with a similar investment time horizon has been enticed to conduct due diligence and present this proposal.

The share registry and liquidity are worthy of comment. The capital structure would increase to approximately 8.8B shares under this proposal. The irony is that liquidity may actually reduce although not to any detrimental degree. The SGG 51% will not be traded and as such will not affect liquidity. This accomplishes capital raising without a discount at issue, with a zero brokerage fee and no additional shares added to the pool of liquidity.

A fully funded FML with a cornerstone investor of this magnitude and status may attract other longer term investors further reducing shares exposed to the market. This proposal would also have the potential to increase operational profits through efficiencies and infrastructure that would otherwise not be possible.

Shareholders will own 49% of a much larger company at a higher share price if the market supports FML. Support is considered far more likely due to the lowered risk, growing Reserves, increasing production and higher profitability of the new FML. The additional project upside possible from Nepean and Lake Cowan are also significant value drivers for a company with sufficient balance sheet strength to realize the potential.

What does the SGG deal deliver?

The SGG deal and long term partnership delivers financial certainty, stable long term growth and guaranteed momentum to the company and shareholders. A coordinated exploration approach across the key project areas is also required upfront in order to discover the optimum way forward. This first step is both logical and practical. This deal will enable an orderly plan to develop for the conversion of exploration success into production, higher earnings and shareholder wealth. Implementation will be swift and assured with sufficient capital and access to debt markets as required.

These are not empty words they are provided to convey the commercial reality. FML could spend $10M on exploration at Nepean and a similar amount at Lake Cowan only to see restrictions in their own ability to unlock the value of each project. One must examine this as a severe limitation when significant capital is also required to bring Coolgardie to its potential through economy of scale and to take control of Laverton production.

This is about balance sheet strength. It provides sufficient capital to fund the various expansions which will deliver a substantially higher revenue base. It also provides the certainty to plan the expansion in an orderly manner, apply for permissions and purchase long lead items and continue drilling without losing momentum. The sum of the current FML and the proposed SGG deal is far greater than what is possible from organic growth or any smaller capital raising.

The in-depth detail of the project potential is beyond the scope of this report and will certainly be worth increased attention should the deal proceed. This is operational, in particular regard to production and resource definition which is highly likely to deliver much higher Resource and Reserves. Some theoretical probabilities do need to be discussed at this point as they provide an indication of the greater potential.

For example; expansion of processing at Coolgardie would ensure significantly higher production with similar staffing levels creating a large cost saving. The drilling can proceed simultaneously to add higher grade ounces to support and compliment the mill feed. This would in turn create additional income via a higher head grade with a large uplift in tonnage and ounces produced. Add the savings together and we can see higher grades, lowered milling costs, greater throughput, increased ounces produced and a leveraged profit opportunity. The cost to achieve this is significant and would not be possible without balance sheet strength; however the potential reward is immense. Coolgardie becomes a highly profitable production centre. Strong operational cashflow translates directly into profits and a higher share price.

The FML ground position is a key to the SGG interest and upside potential. Gold deposits are found in districts along structural corridors in host rocks of varying types. The science is well understood. Sulphide nickel deposits are also well understood. FML geologists are first class; they have highly successful track records. They have the ability to turn the proposed exploration spend into success across the tenements.

On the exploration side we have Jeff Ion in Laverton who discovered Sunrise Dam and knows the district extremely well. Chuck McCormick knows Coolgardie like the back of his own hand after over 30 years in the district. Dean Goodwin and Phung Nguyen worked for WMC on the salt lakes at St Ives and unlocked methodology to explore for and locate deposits in this type of setting. They are both well qualified to unlock the world class potential of the Lake Cowan gold camp.

Phung is working at Greater Coolgardie for FML, in close association with Chuck McCormick. Under the expanded programs the SGG capital delivers one would expect this team can build on the Resource and Reserve position of the company. This will result in a strengthened mine plan over time and just as importantly the necessary Reserve position by which the investment community can re-rate the value of FML.

There are 4 main areas to expand, develop or explore at this stage in the FML project portfolio. These areas are;

- Coolgardie,
- Laverton,
- Nepean and
- Lake Cowan which should also include The Mount due to its close proximity to the latter project.

The pathway to optimize these projects will depend on exploration success. A coherent plan can only be presented once sufficient drilling has been completed. This step must be completed first. The delivery of this step is a function necessary for optimum delivery of shareholder returns; only a fully funded approach is capable of a co-ordinated uplift in performance across the projects. The scale of the projects justifies the amount of capital involved in the deal. This capital will be supplemented with operational cash flows to help preserve the strengthened balance sheet and advance the company.

The thrust will be on three fronts;

- Mine drilling must continue the resource upgrades within the current ore sources, in order to maintain cashflows production must continue.
- Production drilling will step out ahead at an increased pace in order to strengthen and further develop the Life of Mine plan already announced.
- Exploration drilling will now increase on a number of fronts.

This is a capital intensive stage that would not be possible under either of the first 2 options and this will set the stage for tangible and optimised growth for FML. FML have a Strategic Plan that will involve steps to create staged revenue growth and shareholder value. This is the primary consideration for investors; shareholder value. The SGG deal provides the best way forward on all fronts or the Board would not be presenting this to the shareholders.

Laverton is not currently valued in the FML market capitalization at $190M. The Three Mile Hill mill alone would cost in excess of $100M to replace. The 2.2M ounce in situ resource in Coolgardie is valued at circa $40 per ounce, hardly robust for a producer. This is because FML are continually spending operational profits back on the activities above. Growth and progress is slow however this will clearly change with a strong balance sheet.

Laverton will see drilling to shore up higher grade deposits to support a renewed operation. This may see refurbishment of Barnicoat at 1.45Mt PA or expansion to 2Mt PA. The cost would be the order of $25M to re-start the mill and circa $50M to expand and refurbish. FML may also continue toll treating at the BGSM or, should they prove enough ounces a dual supply scenario is possible with Laverton treating up to 4Mt PA. Taking control of Barnicoat removes the cash flow issue to a large degree. Delineation of high grade deposits will lower costs further and increase production levels generating higher earnings.

Nepean has very similar stratigraphy to the world class Flying Fox nickel deposit. Nepean is potentially a company maker that could be worth upwards of 10c per share based on the new capital structure. The scale is yet to be proven at this stage however this could be an underestimation. This is not a technical report however the above is worth mentioning and can be justified. The scale is immense running over 30+km of nickel horizon. Historical production of this sulphide deposit was high grade and boasted 2g/t PGE's (platinum + palladium) and cobalt. This is currently a dormant project and is not factored into the current share price.

Chuck McCormick and Dean Goodwin both have relevant experience and wish to prove the concept to the market and unlock the value for shareholders. Proof is one issue however to convert exploration success into shareholder value the market has to be able to measure future earnings as a minimum. The SGG deal provides not only the capital to fund the exploration it also indicates to the market that they could control production via a concentrator on site. This would enable FML to ship to an off-take partner in China. This would maximise profits for FML and ensure a low cost robust project outcome.

Smelting in the area is controlled by BHP at Kambalda under processing agreements. A large percentage of the nickel production is retained as payment and by-products are also retained by BHP. A concentrator is expensive to build however nowhere near as capital intensive as a smelter. The smelting would conceivably be carried out in China under this scenario. The large dilution effect under the SGG proposal is adequately compensated by this project alone.

Hypothetical snap shot - simplified

Valuation is extremely difficult longer term and will depend on exploration success, the sentiment on equities in general, sentiment on gold stocks and the price of gold. To provide one model seems appropriate and by no means is indicative of any guaranteed outcome. We can make some assumptions however as we know the production possibilities, probable costs on expanded production and potential of Coolgardie and Laverton.

Coolgardie

Base load and high grade underground deposits should be able to provide a head grade at Coolgardie in the order of 3.4g/t at a rate of 2Mt PA (2 million tonne per annum) and a recovery of 93% for approximately 200,000 ounces per annum. The mill upgrade would cost circa $50 - 60M. Resource drilling over the preceding time should cost in the order of $14 – 18M. Development work would also be required upfront (partially) and on an ongoing basis. The benefit of the investment would be significant however as improved economies of scale, efficiencies and higher head grade should reduce cash costs down to approximately $800 - $900 per ounce.

Ore sources are likely to come from extensions of Dreadnought and high grade from repetitions at Tindals. Likely sources also include underground from Dreadnought, Patricia Jean and Jolly Brittain. The western trend, the area to the north of Three Mile Hill and the southern area will be extensively explored to bring them into the mine plan for the medium to longer term.

The expanded budget will allow a drilling and a JORC compliance program sufficient to meet the ongoing and future needs of the mill. Defining this will result in a lift in overall Reserves and Resources sufficient to provide certainty to the market for valuation purposes. To be specific the rise in Reserves and more robust cost base would translate to a much higher share price. Higher grade surprises are highly likely and would provide a robust buffer to this illustrative cost and production model over time.

Just as an example we can use a gold price in AUD at $1800 for the 2015 financial year to provide time for studies, mill upgrades and deposit delineation. I am going to estimate a group administration, promotion, legal, and miscellaneous spend of approximately $200 per ounce.

This example results in capital input of $90 - 100M ahead of the income lift, some of which can be generated from operational profits over the next two years. Coolgardie has proven these grades exist and higher however I am allowing for lower grade blending.

Total cost will need to factor ongoing development, exploration, maintenance, taxation, depreciation and so on which could run as high as $100M PA across the whole group (Laverton, Coolgardie and Nepean) which is factored at the final calculation. Leaving this final figure aside Coolgardie should produce at $1100 per ounce ($900 cash cost + $200 additional costs) providing $700 per ounce x 200,000 ounces for an implied gross margin of $140M PA. The operational gross margin is $180M in this example.

Laverton

Laverton is capable of a similar throughput (2Mt PA) at Barnicoat and at the BGSM with sufficient exploration and development powered by a robust balance sheet. Laverton is a higher cost-fly in fly-out operation whereas Coolgardie has a live in work force.

The Euro trend at Laverton is BIF (Banded Iron Formation) and quite capable of supporting 3.5g/t ore supply to Barnicoat supplemented with some higher grade underground ore and lower grade material blended at site. Laverton is capable of supplying the two mills comfortably. Barnicoat would require in the order of $50M for completion and expansion. Again the exploration, JORC compliance work and development costs are significant however achievable under the SGG proposal.

A dual production approach would provide flexibility however it may prove more efficient in the end to expand Barnicoat to 3Mt PA. This model requires a flexible approach because Barrick own and control the BGSM, this is not under FML control.

Expansion of Barnicoat to 3Mt PA would require a larger capital input up front however there would be some significant benefits. Total control of all processing and cost management issues would be more favourable. On the other hand processing at BGSM can delay capital outlay enabling higher input for Nepean and or Lake Cowan.

The uncertainties on the optimum way forward are unavoidable at this stage yet one thing is for certain; the SGG capital provides optionality, so does access to cheap capital via the Chinese debt markets which have a proven appetite for gold.

Apart from the Euro trend ore sources are likely to be Craigiemore, the Burtville system (very large), the Chatterbox trend which has exciting potential and to the north the Lancefield trend. This is by no means exhaustive. Only an extremely well-funded FML would have the ability to tackle this opportunity on a scale that can do it justice. Only the SGG deal (or superior offer) can enable FML to deliver a road map; designed after a major exploration program.

Moving back to a potential earning model; assuming cash costs for Barnicoat at $1,000 per ounce on a 3.4g/t and 93% recoveries for 200,000 ounces PA and $1,100 for the BGSM on 1.9g/t and varying toll treatment days provided for 100,000 ounces PA we reach 300,000 ounces from Laverton and the target 500,000 ounce PA FML production.

Assuming the $200 per ounce in addition to these cash costs at Laverton we could see a gross margin of $120M from Barnicoat and $50M from BGSM under this model.

Group

Total gross margin under this example would be $310M PA ($50M + $120M + $140M). The much larger mills would be capable of delivering much improved economies of scale.

A two year delivery time at this scale is possible with the SGG balance sheet strength as the development and mill upgrades would be capital intensive however within the limits of this sort of funding. Assuming FML can deliver an EBITDA of circa $210M as per this example and the market was conservative delivering a P:E of 10; FML could be valued at approximately $2B market capitalization or a share price in the order of 22.5c per share based on the expanded capital structure. If we add success at Nepean, and recognition of the market and the potential grows to 32.5c per share.

FML would not have the capacity to develop these projects to anywhere near this degree with smaller staggered capital raisings. Any progress along this potential would also be much slower. The mill upgrades alone would cost in the order of $120 - 140M. Preliminary drilling to rapidly define sufficient ore supply and the development pre-strip and decline development costs will be high, certainly north of $100M. The work required at Nepean to bring about this type of outcome would require a concentrator and further investment, certainly capital intensive.

Robust earnings may allow a level of gearing to maintain cash at higher levels, thus ensuring a robust balance sheet is protected. This will evolve under the watchful eye of the Board of Directors including SGG. SGG will be a powerful shareholder watching over shareholder return which will keep FML focused on delivery of shareholder ROI (Return on Investment).

Cash flows over the next two years leading up to this outcome would also ensure the balance sheet was maintained at a healthy level.

Work needs to continue at Lake Cowan before any estimate might be tackled. This has the potential to attract the world's attention and take FML to a higher status. This example is for illustration purposes only however it serves to show the potential upside with the SGG option. The gold price may well be higher and more buoyant levels of market valuation may be possible on a re-rating of FML with robust cashflows and margins combined with substantial growth.

The outcome may be somewhat muted on a lower gold price in which case the lowered cash costs would provide a more robust valuation than otherwise possible. Two years may also be over optimistic; however these outcomes are (factually) not within the scope without this level of funding. **This SGG delivers tangible outcomes far sooner for shareholders.**

This example is over simplified and does not make allowance for risk and project delays. Only expanded exploration and Reserve definition can create a robust market valuation as these are considered bankable ounces. This can deliver renewed market interest and a higher share price as the company builds greater capacity to produce ahead of the projected uplift in revenue. The development may be staged, priorities changed based on exploration success, the key is optionality and financial freedom to pursue organic growth.

Lake Cowan / Treasure Island

Lake Cowan sits directly on the richest mineral system in Australia called the Boulder Lefroy Fault (BLF). I have it on good authority that the larger gold companies around the world are watching this project. It is too early for them to make any sort of move yet however their casual (at this stage) interest is well founded.

The similarities to the 17M ounce St Ives gold camp to the north are striking. The stratigraphy (rock types), structural complexity and proximity to the BLF are only part of the picture. Early drilling has defined a significant anomaly at 4km long (open) 3 km to the east of Treasure Island. Treasure Island has strong gold showings on outcrops and may yet be proven to have the same source or be part of the same system. The drilling has centred in the granophyric zones (chemical trap for gold bearing fluids) on a large dilation jog. A dilation jog is a change in the orientation of the fault compared to the larger regional trend. This creates a fractured host rock setting capable of receiving gold bearing fluids along one side of the fault.

This system has the setting, regional geology, host rocks, chemical characteristics and pathfinder elements all present to indicate this has the potential to yield a world class discovery. The early exploration work is well advanced to be able to make this claim however the host rocks have yet to be drilled, which is why the majors and investors are sitting back at present. Discovery of large (10M ounce +) deposits are rare in this day and age. FML could have been a takeover target without the SGG deal securing ownership and the ability to develop and exploit this gold camp for the benefit of shareholders. There is no doubt that an early hostile takeover of FML would have yielded a far lower return for shareholders. FML have also been limited by capital to accelerate drilling and any development activities should this potential be realized.

Summary

This SGG proposal provides the necessary capital to advance the FML projects. FML becomes a vastly larger company in a shortened time frame. The resultant impact on shareholders is that they own 49% of a far larger company. This is an asset rich company with immense potential. There are several ways forward, the least effective can be considered to be continuing on with limited capital. The most effective is to secure a position of power with a balance sheet to match the opportunity and demonstrated ability of FML. The SGG capital achieves this while it also adds considerable ability and flexibility. Risk is diminished more significantly with the SGG proposal than any other option, assuming a larger bid does not eventuate.

The SGG proposal delivers the most rapid pathway to growth and realization of shareholder value based on the assets of the company. The business case is obvious, invest wisely, expand production, control cash flows in Laverton, reduce costs and develop Nepean, potentially Lake Cowan as well. This will need to be planned and staged in accordance with good corporate governance.

The Chinese need to build their gold reserves. They are heavily exposed to two currencies required for international trade, the Euro and the USD. A hedge is clearly needed; they want more gold and are now moving to buy equity into gold mines around the world in addition to their bullion purchases. The Chinese government buys bullion and the SOE's and private companies are investing in production. This is a significant positive for gold producers.

FML have been presented with this substantial offer from SGG. The bid is commercial and SGG have so far shown an honourable and genuine approach and intention. Conclusions can only be reached by the respective individual shareholders in this company. GoldOz does not seek to offer conclusions in this regard and suggests readers seek the advice of licenced advisers before they make their own investment decisions based on their own individual circumstances. Shareholders should seek advice from a competent financial advisor.

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Disclosure
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