Pan African Resources

Roundabouts and swings

South African lockdown begins to ease

Metals & mining

On 23 March, the South African government made the decision to lockdown the country for all but 'essential services' for a period of three weeks, which it later extended to the end of April. Since the lockdown, Pan African's group surface mining operations (which account for the majority of its profitability) have been working at c 70% of normal capacity, while Barberton Mines produced enough from certain high-grade sections of its Fairview operation in order to ensure the required minimum feed for its BIOX® processing plant. While it is very early days as South Africa eases its lockdown protocols and Pan African recalls workers, it has estimated that production for FY20 will be c 176,000oz cf the 185,000oz it estimated prior to the coronavirus crisis (a 4.9% decline). Nevertheless, during the same period, the gold price has risen by 12.4% while the value of the rand has fallen by 23.9% versus the US dollar. For the moment, we are placing our forecasts and valuation for Pan African under review. In Exhibit 3 however, we provide a discussion and scenario analysis of how we believe the current crisis might affect PAF's results to 30 June 2020, given information known to date.

Year end	Revenue (US$m)	PBT* (US$m)	EPS* (c)	DPS (c)	P/E (x)	Yield (%)
06/18	145.8	29.3	1.31	0.00	13.4	N/A
06/19	218.8	37.1	1.64	0.15	10.7	0.9

Note: *PBT and EPS are normalised, excluding amortisation of acquired intangibles and exceptional items. For our previous FY20 and FY21 estimates, please refer to our March update note.

Coronavirus – the South African experience so far

South Africa detected its first novel coronavirus infection on 5 March. Throughout the second and third weeks in March, the disease spread at an exponential rate prior to the government's lockdown. Despite being one of the most infected countries in Africa however (along with Egypt and Algeria) and despite lurid headlines, since the lockdown, South Africa has nevertheless managed to keep the level of officially confirmed cases to a relatively modest 10,015 (at the time of writing and with all of the usual caveats) and the death rate to a relatively modest 1.9% (cf 6.9% globally). As such, there is reasonable evidence that the country has been successful in flattening the curve of infections. In addition, Africa in general has experience in managing pandemics – eg HIV and, more recently, Ebola – although there must also be concern that the rate of infection could increase again as the country enters its colder winter months.

Valuation: Under review

In the aftermath of its interim results, we valued Pan African at 28.28c/share plus the value of c 19.2m underground Witwatersrand ounces, which we estimated could lie anywhere in the range of 0.22–5.24c per share (see our March update note). Given the current economic uncertainty, we place our valuation and our forecasts under review and plan to update them as soon as the situation is known with more certainty. In the meantime, however, on the basis of consensus forecasts, Pan African remains cheaper than its South African- and London-listed gold mining peers on at least 86% of common valuation measurements (Exhibit 5).

12 May 2020

Price	**14.11p**
Market cap	**£315m**

ZAR22.9185/£, ZAR18.4055/US$, US$1.2452/£

Net debt (US$m) at end-December 2019 including US$25.0m to non-financial institutions.	130.7
Shares in issue*	2,234.7m
*Effective 1,928.3m post-consolidation	
Free float	86%
Code	PAF
Primary exchange	AIM/JSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	37.8	15.9	58.4
Rel (local)	36.1	47.7	91.5
52-week high/low		14.9p	9.0p

Business description

Pan African Resources has three major producing precious metals assets in South Africa: Barberton (target output 95koz Au pa), the Barberton Tailings Retreatment Project, or BTRP (20koz), and Elikhulu (55koz), now incorporating the Evander Tailings Retreatment Project, or ETRP (10koz).

Next events

FY20 operational update	July 2020
FY20 results	September 2020
AGM	November 2020
Dividend payment date	December 2020

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Edison profile page

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South African national lockdown

South Africa detected its first new coronavirus infection on 5 March. For the next few weeks, the epidemic followed a typical exponential curve and on 15 March, the country's president, Cyril Ramaphosa, declared a national state of emergency banning visitors from high-risk countries, stopping large gatherings, closing more than half of its land borders and shutting schools. On 23 March, the South African government made the decision to lockdown the country for all but 'essential services'. On 14 April, it extended the lockdown by two weeks, until 30 April. As an adjunct however, from 16 April, it allowed underground mining operations to return to 50% capacity from a position of care & maintenance, albeit observing strict health protocols. Now, as from 1 May, surface operations will be able to return to 100% capacity. Underground mines will still be required to remain at 50% capacity initially, albeit subject to the discretion of the Mining and Energy Minister Gwede Mantashe, who has the authority to sanction production above this level.

As far as Pan African is concerned, during the lockdown, 'essential services' included security, pumping and ventilation activities, metallurgical plant maintenance, inspection of underground workings, management and monitoring of tailings deposition facilities, waste management and water treatment facilities and other health and safety related services. As part of essential services, the group undertook to conduct limited surface re-mining and processing activities at its Elikhulu Tailings Retreatment Plant and at its Barberton Tailings Retreatment Plant. As a result, during the lockdown, Pan African's group surface mining operations operated at c 70% of normal capacity, while Barberton Mines resumed limited operations at certain high grade sections of its Fairview operation in order to ensure the required minimum feed for its BIOX processing plant. Of the group's total staff and contractor complement, only 26% (excluding security staff) were involved in essential services.

The South African Department of Mineral Resources & Energy approved all of the group's activities, subject to compliance with, and adherence to, all relevant laws and regulations.

As soon as the lockdown was announced, Pan African suspended its production guidance (previously 185,000oz) for the year. Now the lockdown has eased from a level 5 alert to level 4 and with the phased recall of permitted employees, PAF has provided the following output indications for its assets for the financial year to 30 June 2020, assuming that surface operations produce at or close to capacity for the remainder of the year and underground operations produce at 50% of capacity. These are contrasted with our last-published forecasts and our updated forecasts, in the light of PAF's indications:

Exhibit 1: Edison FY20 production analysis vs last published and prior official guidance

Production asset	Prior guidance (oz)	Updated guidance (oz)	Change in guidance (oz)	Updated Edison forecast (oz)	Last published Edison forecast* (oz)	Change (%)
BTRP	20,000	21,000	+1,000	21,000	20,619	+1.8
Elikhulu & ETRP infrastructure	65,000	59,000	-6,000	58,992	65,199	-9.5
Barberton underground	80,000	64,000	-16,000	64,904	77,737	-16.5
Evander underground & 8 Shaft pillar	20,000	31,000	+11,000	31,000	27,053	+14.6
Total	**185,000**	**175,000**	**-10,000**	**175,896**	**190,608**	**-7.7**

Source: Pan African Resources, Edison Investment Research. Note: Totals may not add up owing to rounding. *See our last note, Pan African Resources: H120 confirms FY20 forecasts, published on 2 March 2020.

Note the small discrepancy of 1,000oz (0.6%) between PAF's FY20 guidance of 176,000oz and its output indications by asset of 175,000oz (which we deem immaterial).

Mitigating effects and gold price update

Notwithstanding the shortfall of 14,712oz gold in our post-coronavirus scenario relative to our last published production forecast, there are certain mitigating circumstances in the case of Pan African that prevent the full effect of this flowing through into the company's financial statements:

- The gold price has risen by 12.4% in US dollar terms since the start of the year and is now in excess of both our prior CY20 forecast and our prior H220 forecast for PAF (see below).
- The rand has weakened materially, from ZAR19.2691/£ and ZAR14.8592/US$ at the time of our last note on 2 March to ZAR22.9185/£ and ZAR18.4055/US$ at the time of writing – declines of 18.9% and 23.9%, respectively – thereby increasing the rand price of gold or (depending upon interpretation) decreasing local costs in US dollar terms (PAF's reporting currency).
- It has the infrastructure available to isolate and screen its workforce (see COVID-19, below).
- Whereas up to two months' worth of FY20 production from underground operations at Barberton and Evander could yet be lost as a result of the lockdown restrictions, production at Pan African's surface facilities (which accounted for 62.1% of EBITDA in H120) should only be reduced by c 5% in H220 relative to our prior expectations and previous company guidance.

Gold price

Our longer-term gold price forecasts were set out in our recent report, Portents of economic weakness: Gold – doves in the ascendant, published on 14 August 2019, and are summarised in the table below:

Exhibit 2: Edison gold price forecasts (August 2019)*

Calendar year	CY20	CY21	CY22	CY23
Real gold price forecast (US$/oz)	1,572	1,395	1,387	1,350

Source: Edison Investment Research. Note: *See *Portents of economic weakness: Gold – doves in the ascendant*, published on 14 August 2019.

Until the beginning of the current calendar year, the forecasts above provided the basis of our valuation and earnings estimates for Pan African. In common with our normal practice however, once the current calendar year began, our forecasts for PAF evolved to be based on the year-to-date average and current spot price of gold. Compared with our earlier forecast of US$1,565/oz in H220, to date the gold price has averaged US$1,611/oz during the period and is currently trading at US$1,702/oz, implying an average price of US$1,636/oz for H220 (an increase of 4.5% vs our previous estimate).

Debt service and covenant compliance guarantees

Pan African has two forms of relatively modest hedging contracts currently in place solely for the purposes of guaranteeing debt serviceability and covenant compliance. The first is a gold loan of 20,000oz that locks in a gold price of approximately US$1,325/oz (ZAR784,076/kg at current forex rates), representing approximately 11% of the group's possible production for the 2020 financial year. The second is a series of zero cost collar contracts over 50,460oz gold in H220 that cap the likely gold price received by Pan African at ZAR836,000/kg (c US$1,413/oz at current forex rates), but also floor it at ZAR655,000/kg (c US$1,107/oz). Of these, contracts of only 21,820oz are reported to remain outstanding for the final two months of Pan African's FY20 (ie May and June), at a floor price of ZAR683,226/kg (US$1,155/oz at current forex rates) and a ceiling price of ZAR847,109/kg (1,4332/oz at current forex rates).

Credit approval has been obtained from Rand Merchant Bank to defer the last three tranches of the existing gold loan's redemption (5,000oz in total) until the first quarter of the group's FY21 financial year (ie Q3 CY20). Although this will therefore still result in a notional loss for PAF in H220 of, we estimate, US$1.9m, approximately 18% of it will now be ‘unrealised’ and will therefore not affect cash flows.

Given our current gold price expectations (see Exhibit 2) however, we do now expect the remaining call options written at ZAR847,109/kg to be exercised in H220, which will result in a ‘loss’ from realised hedges of, we estimate, US$11.2m, which we typically include in ‘other income/(expenses)’ in our forecasts (NB Pan African reported ZAR29m, or US$2.0m, in realised hedging losses in H120).

Potential effect on FY20 financial performance

Given that the situation is so fluid, and the full impact of the coronavirus outbreak on the economy and the company’s performance is currently unclear, for the moment, Edison has decided to place its forecasts for Pan African and its valuation under review. However, the following table provides an initial indication of the effects of the five-week production hiatus plus recent gold price and forex changes on a number of measures of profitability (note that all other assumptions including cost implications remain, to all intents and purposes, unchanged).

Exhibit 3: COVID-19 potential effects on PAF FY20 profitability

	Edison last published FY20 forecasts*	Edison last published FY20 forecast adjusted for gold price and forex changes as well as production
Profit after tax (US$000s)	55,022	47,254
EPS (US cents per share)	2.85	2.45
HEPS (c)	2.84	2.44
Normalised HEPS (c)	3.02	3.15
DPS (c)	0.86	0.72

Source: Edison Investment Research. Note: HEPS = headline earnings per share (company adjusted basis). *See our last note, Pan African Resources: *H120 confirms FY20 forecasts*, published on 2 March 2020

In particular, readers should note the potential increase in normalised headline earnings per share (HEPS) once gold price and forex changes are taken into account compared with the more general decline in profitability, as measured by profit after tax and EPS and HEPS. This apparent anomaly reflects the inclusion of both PAF’s realised and unrealised losses as a result of its debt service and covenant compliance guarantees.

Self-evidently, it is not yet completely clear under what terms the lockdown may be lifted. In the meantime, however, the scenarios in Exhibit 3, above, compare with a consensus EPS forecast of 2.52c/share, within a range 2.01–3.04c/share (source: Refinitiv, 11 May 2020).

Our last published valuation of PAF’s existing four producing assets only was 22.43c/share, based on the present value of our estimate of the maximum potential stream of dividends payable to shareholders over the life of mining operations using a 10% discount rate and not taking into account any of the above factors (see Pan African Resources: *H120 confirms FY20 forecasts*, published on 2 March 2020).

Including its other potential growth projects (ie the Fairview sub-vertical shaft project and Egoli) and assets (ie the residual Evander underground resource and its shareholding in MC Mining), our last published valuation of the entire portfolio of PAF assets was as follows (see our note, Pan African Resources: *H120 confirms FY20 forecasts*, published on 2 March 2020):

Exhibit 4: PAF last published absolute valuation summary

Project	Valuation (cents/share)
Existing producing assets (including Evander 8 Shaft pillar project)	22.43
Egoli	4.67
Fairview Sub-Vertical Shaft Project	0.63
Royal Sheba (resource-based valuation)	0.40
MC Mining shares	0.15
FY19 dividend	0.00
Sub-total	**28.28**
EGM underground resource	0.22–5.24
Total	**28.50–33.52**

Source: Edison Investment Research

Relative peer group valuation

On the basis of consensus forecasts, PAF remains cheaper than its South Africa- and London-listed gold mining peers on at least 86% of common valuation measures (26 out of 30 individual measures in the table below) over the next two years:

Exhibit 5: Comparative valuation of PAF with South African and London peers

	EV/EBITDA (x)		P/E (x)		Yield (%)	
	Year 1	Year 2	Year 1	Year 2	Year 1	Year 2
AngloGold Ashanti	6.1	5.2	12.9	10.1	0.8	1.0
Gold Fields	5.1	4.5	17.0	10.1	1.9	2.8
Sibanye	2.4	2.5	3.9	4.1	7.5	7.1
Harmony	5.3	3.7	12.3	7.7	0.7	0.9
Centamin	7.2	4.8	30.5	14.5	4.4	4.3
Average (excluding PAF)	**5.2**	**4.1**	**15.3**	**9.3**	**3.1**	**3.2**
PAF (consensus)	3.7	2.9	5.1	3.4	6.3	9.2

Source: Edison Investment Research, Refinitiv. Note: Priced at 11 May 2020.

Dividend

At the time of its H120 results, PAF reiterated its dividend policy of having a target dividend pay-out ratio of 40% of net cash generated by operating activities, after allowing for the effect of sustaining capital on cash flow, contractual debt repayments and one-off items. After sustaining the costs related to the Evander underground closure in FY18, the Pan African board elected not to recommend a final dividend for that year. However, it stated that recommencing distributions to shareholders was a priority for the future.

This was achieved one year later, when the board recommended a final dividend of ZAR50m, or approximately US$3.4m for FY19, which it described as a 'signal' of its intent to resume more meaningful distributions to shareholders in the future. While our preliminary analysis suggests that the loss of production in H220 as a result of COVID-19 could result in a c 16% decline in pre-financing cash flows (all other things being equal), we nevertheless expect them to remain positive with the consequent possibility of a dividend pay-out to shareholders for FY20 (see Exhibit 3), albeit this will obviously depend on a number of factors relating to the evolution of coronavirus pandemic and its effect on South Africa in general and Pan African in particular.

Financials

Including its liabilities to non-financial institutions, PAF had net debt of US$130.7m on its balance sheet as at 31 December 2019, compared to US$132.5m as at 30 June 2019. As such, net debt equated to a gearing (net debt/equity) ratio of 64.8% as at end-H120 (cf 72.2% as at end-FY19 and

86.7% as at H119 (restated)) and a leverage (net debt/(net debt + equity)) ratio of 39.3% (cf 41.9% as at FY19 and 46.4% as at H119 (restated)).

Excluding non-financial institutions, Pan African had net debt of US$105.7m as at end-December cf US$128.4m as at end-June 2019.

Now that the most intense phase of capex relating to Elikhulu has been completed, at the time of our last note we expected group capex to more than halve, from ZAR802.0m in FY19 to ZAR352.2m in FY20 (NB capex has already more than halved from ZAR585.9m in H119 to ZAR211.5m in H120). Probably only around ZAR66.5m of this FY20 total may be deferred. Nevertheless, all other things being equal, we would expect the company to remain cash-flow positive in FY20, notwithstanding the development of the Evander 8 Shaft Pillar project.

At the time of its updated guidance (11 May), Pan African confirmed it had been 'cashflow positive' during the period of the lockdown. Assuming the prevailing gold price in rand terms of c ZAR1m/kg is maintained for the remainder of its financial year, PAF expects 'to reduce its senior interest-bearing debt (including the outstanding gold loan balance), net of projected available cash, to approximately ZAR1.3bn (US$70m)…from ZAR1.8bn (US$129m) at 30 June 2019'.

Debt is principally financed via a ZAR0.7bn (US$38.0m at current forex rates) term loan facility plus a similar-sized revolving credit facility (RCF) and a ZAR121.5m general banking facility. As at 31 December 2019, approximately ZAR424.5m (US$23.1m at current forex rates) remained available to Pan African under its banking agreements.

Principal on the Elikhulu facility is payable in equal instalments until maturity in June 2024, while the RCF has been restructured to extend its maturity from mid-2020 previously to at least beyond mid-2024 currently. The group's RCF debt covenants and their actual recorded levels within recent history are as follows:

Exhibit 6: PAF group debt covenants

Measurement	Constraint	H120	FY19 (actual)	H119 (actual)	FY18* (actual)	H118 (actual)	FY17 (restated)
Net debt:equity	Must be less than 1:1	0.6	0.71	0.85	0.78	0.19	0.02
Net debt:EBITDA	Must be less than 2.5:1 falling to 1.5:1 by Dec 22	1.6	2.2	3.24	3.73	2.25	0.08
Interest cover ratio	Must be greater than 4 times rising to 5.1 times by Dec 22	5.8	4.1	3.64	4.61	4.62	19.32
Debt service cover ratio	Must be greater than 1.3:1	3.0	1.4	2.85	3.84	1.85	9.11

Source: Pan African Resources. Note: *Subsequently restated.

Notwithstanding Edison's post-coronavirus scenario analysis for FY20, Pan African's liquidity position remains 'robust'. As stated previously, credit approval has been obtained from Rand Merchant Bank to defer the last three tranches of the existing gold loan's redemption (5,000oz in total) until the first quarter of the group's FY21 financial year (ie Q3 CY20). In addition, the group's banking consortium has confirmed its support for the company, 'should further liquidity be required'.

COVID-19

As well as complying with South Africa's lockdown requirements, further measures undertaken by Pan African to reduce the risk of contractor and employee contamination include:

- Where possible, staff members are housed in dedicated, restricted-access housing facilities for the duration of the lockdown.
- Continuous screening and monitoring, including thermal temperature monitoring, of staff members, for COVID-19 symptoms is provided.
- Medical support is on standby.
- Rigorous social distancing and sterilisation/hygiene protocols are in place.

Recognising the economic and social hardship that will result from the lockdown, PAF has also said that it will embark on a series of support programmes in addition to its existing initiatives. These have included food hampers and hygiene products for employees and specific communities and the distribution of potable water to affected communities in Barberton by the mine's water tankers in collaboration with the local municipality for the duration of the lockdown.

Exhibit 7: Financial summary

US$'000s	2018	2019
Year end 30 June	IFRS	IFRS
PROFIT & LOSS		
Revenue	145,829	218,818
Cost of sales	(107,140)	(152,980)
Gross profit	38,689	65,838
EBITDA	38,131	65,484
Operating profit (before GW and except.)	31,506	49,256
Intangible amortisation	0	0
Exceptionals	(16,521)	10,596
Other	0	0
Operating profit	14,985	59,852
Net interest	(2,222)	(12,192)
Profit before tax (norm)	29,284	37,064
Profit before tax (FRS 3)	12,763	47,660
Tax	2,826	(8,174)
Profit after tax (norm)	32,110	28,890
Profit after tax (FRS 3)	15,589	39,486
Average number of shares outstanding (m)	1,809.7	1,928.3
EPS - normalised (c)	1.31	1.64
EPS - FRS 3 (c)	0.87	2.05
Dividend per share (c)	0.00	0.15
Gross margin (%)	26.5	30.1
EBITDA margin (%)	26.1	29.9
Operating margin (before GW and except.) (%)	21.6	22.5
BALANCE SHEET		
Fixed assets	315,279	361,529
Intangible assets	56,899	49,372
Tangible assets	254,247	305,355
Investments	4,134	6,802
Current assets	29,009	31,601
Stocks	4,310	6,323
Debtors	22,577	18,048
Cash	922	5,341
Current liabilities	(44,395)	(63,855)
Creditors	(37,577)	(37,316)
Short-term borrowings	(6,817)	(26,539)
Long-term liabilities	(152,906)	(145,693)
Long-term borrowings	(114,065)	(111,345)
Other long-term liabilities	(38,841)	(34,348)
Net assets	146,988	183,582
CASH FLOW		
Operating cash flow	5,345	59,822
Net Interest	(6,076)	(14,685)
Tax	(1,634)	(4,497)
Capex	(127,279)	(52,261)
Acquisitions/disposals	6,319	466
Financing	11,944	(0)
Dividends	(11,030)	(2,933)
Net cash flow	(122,411)	(14,088)
Opening net debt/(cash)	9,083	119,960
Exchange rate movements	(619)	537
Other	12,152	969
Closing net debt/(cash)	119,960	132,542

Source: Company sources, Edison Investment Research. Note: For our previous FY20 and FY21 estimates, please refer to our March update note.

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