

K92 Mining

KNT-TSX

 Rating
Outperform

 Price: Jul-27
\$5.64

 Target ↑
\$8.00

 Total Rtn
51%

Phase 3 Expansion PEA; Visibility on >300,000oz/yr AuEq

Bottom Line: We are increasing our target price to \$8.00 from \$6.00 by matching the Phase 3 PEA expansion driven by higher-than-expected grades at lower capital and operating costs than we had been expecting. K92 is self-financed for significant growth to an intermediate gold-copper producer (>300koz/yr AuEq) – this is scarce among junior and even intermediate peers. In our opinion, especially as K92 completes the Phase 2 expansion and advances Phase 3, there will be ongoing market support and revaluation.

Key Points

We are increasing our target price to \$8.00 from \$6.00 as the PEA proposed a higher-grade mine profile at lower unit costs than we had been expecting. Additionally, the Phase 3 expansion appears rather easily financed by the current Phase 2 mine plan eliminating K92's requirement to seek debt or equity financing. We provide the following discussion:

- **The updated Phase 3 PEA exceeded BMO expectations** outlining an average of 258,000oz/yr AuEq over 12 years at a significantly low LOM AISC of US\$362/oz.
- **The new life-of-mine grade averages 10.4g/t AuEq** with visibility on several years averaging 11+g/t.
- **K92 is self-financed for significant growth** to intermediate producer – this is scarce among junior and even intermediate peers.
- Discussions on this morning's conference call suggested additional opportunity to leverage the existing Phase 2 plant after the start-up of the Phase 3 plant when the PEA mine plan assumes it is transitioned to care and maintenance. Management indicated that they are working through trade-off studies for using the Phase 2 mill to treat lower-grade mineralization, not in the PEA mine plan (~4g/t), or could be leveraged to treat Judd or Karempe mineralization quite easily should planned drilling delineate economic mineralization.
- **Looking ahead:** The company is targeting the delivery of a Definitive Feasibility Study (DFS) for Stage 3 in mid-2021, and Q2 financials are expected in August.

Key Changes

Target	Estimates	Q3 / 20E	2020E	2021E
\$8.00↑	Revenue	\$48	\$177	\$226
\$6.00	Previous	\$50	\$185	\$275
	EPS		\$0.40	\$0.47
	Previous		\$0.42	\$0.59
	CFPS	\$0.15	\$0.53	\$0.72
	Previous	\$0.16	\$0.55	\$0.92

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Metals & Mining

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Company Data		in C\$		
Dividend	\$0.00	Shares O/S (mm)	214.7	
Yield	0.0%	Market Cap (mm)	\$1,211	
NAV	\$8.49	P/NAV	0.7x	
BMO Estimates		in \$		
(FY- Dec .)	2019A	2020E	2021E	
Revenue	\$102	\$177↓	\$226↓	
EPS	\$0.25	\$0.40↓	\$0.47↓	
CFPS	\$0.14	\$0.53↓	\$0.72↓	
Gold Prod (koz)	76	101↓	125↓	
AISC (\$/oz)	\$689	\$720↑	\$749↑	
Consensus Estimates		2019A	2020E	2021E
EPS			\$0.41	\$0.57
Valuation		2019A	2020E	2021E
P/E			14.2x	11.9x
P/CFPS			10.7x	7.8x
EV/EBITDA			11.0x	7.4x
QTR. EPS	Q1	Q2	Q3	Q4
2019A	\$0.08	\$0.03	\$(0.01)	\$0.16
2020E	\$0.03a	\$0.13a	\$0.10	\$0.14
2021E	\$0.13	\$0.12	\$0.11	\$0.11

Our Thesis

Kainantu is one of the few single asset companies that has visibility on significant production growth. Kainantu's Phase 3 will deliver growth to >200koz/yr of gold production and graduate to mid-tier producer status by late 2023.

K92 Mining - Block Summary Model

Income Statement	2019A	2020E	2021E
Revenue	\$102	\$177	\$226
Operating Costs	48	57	67
SG&A	3	2	2
EBITDA	39	113	154
Depreciation	0	6	9
Tax	(3)	24	44
Adjusted Net Earnings	48	85	103
EPS	\$0.25	\$0.40	\$0.47
Cash Flow Statement	2019A	2020E	2021E
Cash Flow From Operations	27	113	156
Cash Flow From Investments	(44)	(66)	(59)
Cash Flow From Financing	35	(2)	(12)
Free Cash Flow	(17)	47	97
FCF/Share	\$(0.09)	\$0.22	\$0.45
Balance Sheet	2019A	2020E	2021E
Cash & Equivalents	22	66	152
Long-Term Debt	15	0	0
Total Assets	155	261	396
Total Liabilities	30	52	83
Total Shareholders' Equity	125	209	313
Attrib. Production & Cash Costs	2019A	2020E	2021E
Payable Gold (oz)	80,370	105,900	131,290
Payable Silver (oz)	0	0	0
Payable Copper (mmlbs)	431	1,393	2,040
Total Gold Production	76	101	125
Total Gold Eq. Production (koz)	78	105	131
Total Cash Cost (\$/oz)	538	549	525
AISC (\$/oz)	\$689	\$720	\$749
Commodity Price Assumptions	2019A	2020E	2021E
Gold Price (\$/oz)	1,393	1,732	1,768
Copper Price (\$/lb)	2.72	2.60	2.66
Silver Price (\$/oz)	16.20	17.60	18.50
USD:CAD	0.754	0.735	0.747

Source: BMO Capital Markets, Company Reports

New Scenarios

Valuation

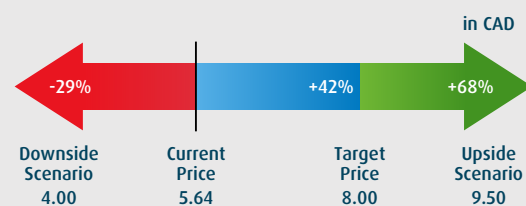
Our valuation is based on using a 1.25x target-setting multiple to our NPV5% estimate in line with small producers in advanced development stages.

Upside Scenario \$9.50

Upside based on adding 3g/t to reflect ongoing exploration success to expand high grade zones.

Downside Scenario \$4.00

Downside based on dropping 5g/t and increasing opex by 25% in next 5 years to reflect excess dilution to higher grades as Phase 2/3 mining rates increase.



Key Catalysts

Ongoing quarterly performance and exploration results; Late July Phase 3 PEA and Kora Resource Update; Completion of Phase 2 end of Q3/20; DFS Mid-2021

Company Description

K92 Mining is a precious metals producer and operates the Kainantu Gold Mine in the Eastern Highlands province of Papua New Guinea with visibility on an expansion to >200,000oz/yr of gold production.



KNT-TSX Research



Glossary



Company Models

Kainantu's Phase 3: An Emerging Intermediate Producer

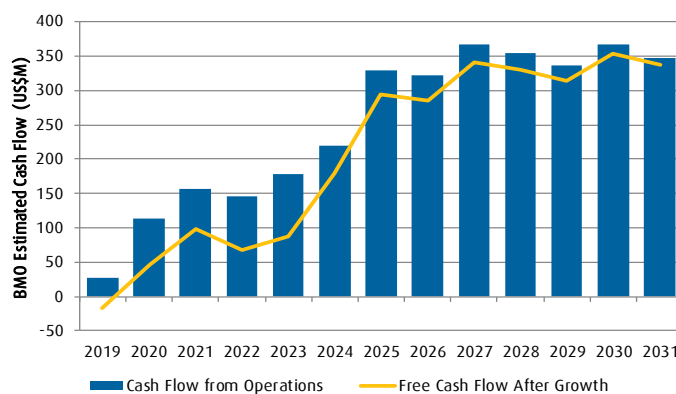
The updated Phase 3 PEA exceeded BMO expectations outlining an average of 258,000oz/yr AuEq over 12 years of mine life at significantly lower AISC compared to the 2018 PEA and 2019 actuals. In our opinion, especially as K92 completes the Phase 2 expansion and advances Phase 3, there will be ongoing market support and revaluation. We discuss our key takeaways below:

Self-financed significant growth to intermediate producer – this is scarce among junior and even intermediate peers.

- Doubling production capacity:** The new mine plan shows visibility on a gradual but quick ramp-up to 1mmtpa in Phase 3 by late 2023 compared to 400tpa in Phase 2. Stage 2 expansion commissioning is currently underway toward the planned +120koz/yr AuEq that will be maintained through 2023 when Phase 3 ramps up.
- Kainantu is higher grade at higher throughputs:** The new life-of-mine gold grade is 8.8g/t, only a slight decrease from the 9.0g/t in the previous 2018 PEA and above our assumed grade of 7.9g/t. Average copper grade of 1.0% is a modest decrease from the previous PEA but tends to increase over the life of the mine with throughput. Overall, the new mine plan holds Kainantu in the upper end of high-grade mines globally with visibility on several years averaging 10+g/t. Notably, exploration continues to expand the high-grade zone – 7 rigs are currently turning and expanding to 10 by year-end.
- Lower operating costs/tonne:** The net result of mining at higher throughputs is lower-than-expected unit costs averaging US\$93.6/t LOM and US\$88.8/t post Phase 3 expansion.
- Capital and sustaining costs:** The Phase 3 capex of US\$125M and US\$28M/yr is lower than the our previously modelled \$300M and likely manageable for the company to fund internally from Kainantu Phase 2 cash flows. **Exhibit 1 highlights the FCF drawdown in 2021-2023 as \$125M of capex is invested in the Phase 3 expansion.**
- Significant leverage to gold price:** The updated PEA boasts an after-tax NPV_{5%} of US\$1.5 billion at US\$1,500/oz gold, increasing to an after-tax NPV_{5%} of US\$2.0 billion at US\$1,900 per ounce gold.
- Phase 3 already underway:** The company is targeting the delivery of a Definitive Feasibility Study (DFS) for Stage 3 in mid-2021. Currently, the new twin incline is underway, and four diamond drill rigs are operational underground focused on upgrading the resource for the DFS and expanding the known resource to the south and at depth. Surface drilling is ramping up as well with three drills now active and five drill rigs expected by year-end.

Phase 3 development shows visibility on 1mmtpa averaging >300koz/yr AuEq.

Exhibit 1: Kainantu Is Well Positioned to Self-Fund Phase 3



Source: BMO Capital Markets

Valuation Assumptions

Exhibit 2: BMO Assumption Comparison

We are increasing target price to \$8.00 from \$6.00.

		2018 PEA (Stage 2)	BMO Previous	2020 PEA (Phase 3)	BMO Updated
Modeled Inventory					
Ounces	koz	1,400	2,800	2,642	2,800
Copper tonnes	kt	64	158	88	158
Average Au Head Grade	g/t	9.0	7.9	8.8	8.9
Average Cu Head Grade	%	1.3%	0.7%	1.0%	0.9%
Average Throughput	ktpa	400	820	816	847
LOM AuEq Production	oz/yr	120,000	230,000	258,000	230,000
LOM Gold Production	oz/yr	108,000	210,000	220,000	210,000
Average Gold Recovery	%	95%	94%	95%	94%
Expansion Capex	US\$m	\$15	\$300	\$125	\$150
Production Start	year	-	Q1 2024	Q4 2023	Q4 2023
LOM Unit Cost	US\$/t	\$163	\$158	\$94	\$106
AISC	US\$/oz	\$695	\$685	\$362	\$359
Mine Life	years	13.0	13.0	12.0	13.0
Sustaining Capex	US\$m	\$164	\$388	341	\$366

Source: BMO Capital Markets, K92 Mining

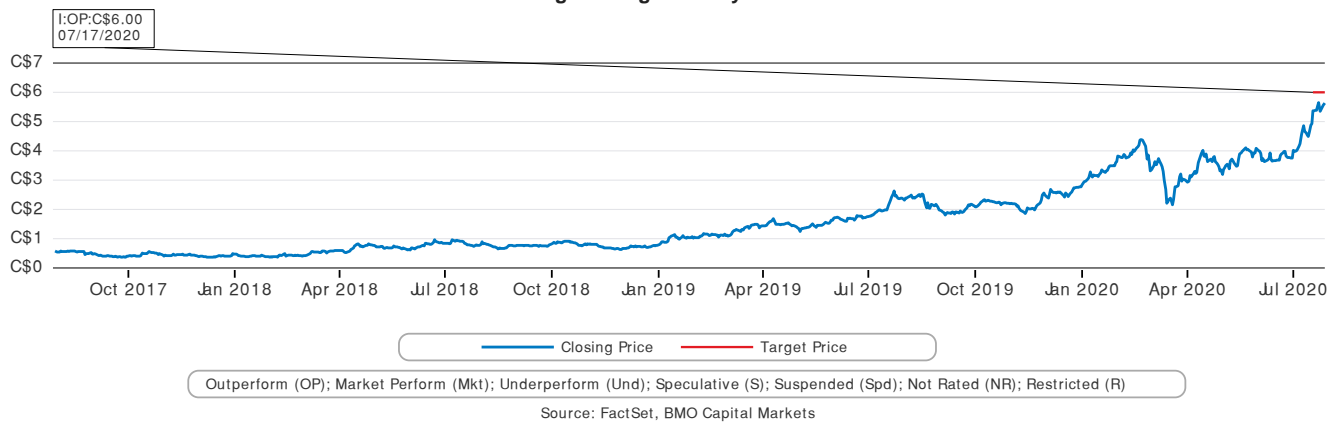
De-risking through development and delivery of the feasibility in 2021 leaves room for multiple expansion.

We are increasing our target price to \$8.00 from \$6.00 by matching the Phase 3 PEA expansion profile. The PEA proposed a higher grade mine profile, at lower unit costs than we had been expecting, which drives the increase in our NAV. Additionally the Phase 3 expansion appears rather easily financed by the current Phase 2 mine plan eliminating K92's requirement to seek debt or equity financings. We provide the following discussion:

- Mining Plan:** We have modelled the PEA mining sequence in terms of ore, waste, and grades for the Phase 3 mine plan. The slight difference is due to extending production to 13 years to reflect a portion of our expectation of future exploration success at Kainantu.
- Unit Costs:** Unit costs are provided as an average of \$94/t life of mine compared to our estimate of \$158. This requires a significant shift to 80% long hole mining (Avoca and modified Avoca) that K92 will have to build a track record with from currently mining almost exclusively with much higher cost cut and fill. We will also be looking to the 43-101 to be filed shortly to better model the profile of unit costs during Phase 3 expansion and during ramp-up. We have conservatively transitioned our unit costs assumptions from current levels to those presented in the Phase 3 PEA – these average out about 13% higher than the company.
- Capital and Sustaining Costs:** Expansion capex at \$125M in the PEA is significantly lower than our assumptions because of a relatively simple Phase 3 plant that leverages the existing infrastructure around the Phase 2 plant. We would also note that some items such as the power and mine infrastructure may have been partially shifted to sustaining capital. Even with this shift the Phase 3 sustaining of \$341M was below our previous estimate of \$388M. We have conservatively modelled slightly higher capex at \$150M.

We are reducing our target setting multiple to 1.0x from 1.25x as the PEA converts the upside that we were previously reflecting in our premium multiple into stronger model assumptions. In our opinion, our target setting multiple still reflects both timeline and operational risks of K92's Phase 2 and 3 expansions as well as perceived jurisdictional risks. De-risking through development and delivery of the feasibility in 2021 leaves room for multiple expansion.

K92 Mining Rating History as of 07/27/2020



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Methodology and Risks to Target Price/Valuation for K92 Mining (KNT-TSX)

Methodology: Our valuation is based on using a 1.0x target-setting multiple to our NPV5% estimate in line with small producers in advanced development stages.

Risks: Resource and operational risk is low to moderate with Kainantu having a fairly new but strong track record of mining. Financing risk is low to moderate with Phase 3 expansions requiring a significant investment for development compared to its current cash flows. As Kainantu delivers growth to a much larger scale of mine, risks to fiscal terms and or license renewal challenges could increase – in our opinion, this applies to any jurisdiction.

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Rating category	BMO rating	BMOCM US Universe*	BMOCM US IB Clients**	BMOCM US IB Clients***	BMOCM Universe****	BMOCM IB Clients*****	StarMine Universe~
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