

Overview

Kingsgate (Sydney: KCN) is an Australian gold mining company with one major asset, the Chatree gold mine in Thailand. Although closed for a number of years due to governmental action, Chatree is set to restart operations this year and will begin to generate substantial cash flow. Despite the imminent change in fortune that is already underway, Kingsgate continues to trade at a significant discount to the underlying value of its Chatree mine.

Kingsgate trades in Australia in AUD (Australian Dollars), but its business is denominated in USD (US Dollars). All numbers in this Position Paper are in USD, except for share price, which is in AUD.

Chatree Mine – The Short Story

The Chatree mine was opened in 2001 and operated successfully for a number of years until the Thai government precipitously shut it down at the end of 2016. Kingsgate sued Thailand over its illegal closure without compensation, litigation that has taken a number of years. The litigation is now winding down to a close, and the Chatree mine is now being reopened. Kingsgate will likely see their first gold revenue in the beginning of 2023 and ramp up further over the year. Chatree is a highly profitable mine, and was even quite profitable at the lower gold prices which were prevalent years ago. At the present higher gold prices, Kingsgate is in position to generate the value of its market cap in just three years of operation.

Chatree Mine – The Long Story

The Chatree mine is the only gold mine in Thailand. It was commissioned in 2001 and operated successfully for a number of years, producing approximately 110,000-140,000 ounces of gold and 750,000-1,000,000 ounces of silver per year. The Chatree mine has a relatively low AISC (All-In Sustaining Cost, a measure of the full cash cost of operating a gold mine, including both mining & processing costs, as well as administration and exploration costs) and was quite profitable over the years.

In May 2014, Thailand underwent a military coup. The new government, headed by General Prayut Chan-o-cha, started creating issues for Kingsgate, with fabricated health, environmental, and legal concerns. Things came to a head in May 2016, when the Thai government announced a policy to cancel all existing gold production and exploration in the country and refused to extend Kingsgate's licenses beyond the end of the year. In December, General Prayut ordered all gold mining in Thailand (which was then, and remains now, solely the Chatree mine) to cease by the end of 2016, using the powers of Section 44 of the newly drafted Thai constitution. (Section 44 gave the head of the military junta, the aforementioned General Prayut, the ability to “legally” order anything “for the sake of the reforms in any field, the promotion of love and harmony amongst the people in the nation, or the prevention, abatement or suppression of any act detrimental to national order or security, royal throne, national economy or public administration, whether the act occurs inside or outside the kingdom”. In other words, Section 44 granted the ruling general broad dictatorial powers.)

Unfortunately for Thailand (but fortunately for Kingsgate), Thailand and Australia are parties to a bilateral trade agreement, known as TAFTA (Thailand-Australia Free Trade Agreement). Among many other provisions, TAFTA requires Thailand to treat Australian companies and investors with “fair and equitable treatment”. TAFTA also provides that all expropriations (including indirect expropriations where the government does not directly take the asset at issue but throws up roadblocks and unreasonable regulations that amount to the taking away of the asset in all but name), must satisfy four conditions: the expropriation



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must be for a public purpose related to the internal needs of Thailand, must be carried out under due process of law, must be non-discriminatory, and must be accompanied by the payment of “prompt, adequate, and effective compensation”.

There was never much question that Thailand was in clear violation of TAFTA. There was no public purpose in closing the mine at all, and even Thailand has since admitted that no actual health or environmental issues were found and that there was no legitimate reason to close the mine. Neither the military coup nor Section 44’s dictatorial powers can be considered “due process”. The ban on gold mines which affected only one company, Kingsgate, is arguably discriminatory. And even if Thailand were entitled to close the mine, it is obligated to provide “prompt, adequate, and effective compensation”, which of course it did not do. As investor-state disputes go, this case was basically open-and-shut in favor of Kingsgate, and no third-party observer seriously considered that the international arbitration tribunal would find in Thailand’s favor.

Nevertheless, the arbitration process takes time. As the process wound down and the date for the arbitration’s ruling approached, Thailand became increasingly amenable to negotiation, so as to avoid the potential \$750 million+ award expected to be handed down by the arbitration tribunal. Thailand took specific steps which credibly signal its sincerity in negotiation. Thailand has reversed its previous stance on Chatree’s operation, has allowed Kingsgate to process and sell the remaining gold sludge on hand from 2016, has approved long-standing exploration requests over vast areas of land surrounding the mine (land which is already known to contain further veins of gold), and has re-granted Kingsgate the necessary mining and processing licenses. Thailand has even granted Kingsgate’s long-standing request to expand the mine on the northwest (i.e., the Quartz lease) to fully optimize the mine from more productive and accessible ore. Politically, Thailand has fully reversed its position, and now states that Chatree is a model mine with no health or environmental concerns, and that the mine closure was never meant to be permanent, etc., etc.

Even after Thailand began to seriously negotiate with Kingsgate, the settlement talks have dragged on and deadlines have been extended, which has weighed down on the stock. Nevertheless, although not all aspects of the settlement have been ironed out yet, at this point in time the Chatree mine has no further legal obstacle to reopen and become fully operational. Kingsgate is lining up the necessary financing (about \$30 million) to refurbish and restart the mine, and they project first gold pour to occur before the end of the year. Kingsgate intends to start with refurbishing Plant 2 (the more modern plant) and processing more accessible ore and stockpile, and will then use the proceeds from the initial operations to refurbish Plant 1 as well; we expect that by the end of 2023, the Chatree mine will be back up to full capacity.

Although it would be nice to see Thailand pay Kingsgate compensation for the multi-year illegal closure as well as the costs incurred in maintaining and then restarting the mine, it is apparent that Thailand is not willing to offer cash compensation under any circumstances. Indeed, it would seem to be very difficult politically for the ruling party to offer this. Instead, we expect Thailand to offer concessions in terms of royalty rates, tax abatements, and expanded exploration rights. Negotiations are held behind closed doors, with Kingsgate necessarily providing almost no details, so it is unclear what precisely (if anything) Kingsgate will receive in exchange for the multi-year closure. In the meantime, the arbitration panel is holding their award (on mutual request of both parties) as the parties work on a final settlement. At present, the arbitration panel has agreed to hold their decision until December 31, 2022, although that can be extended again if necessary. By having the award in its back pocket, Kingsgate retains the necessary leverage to force Thailand to a settlement that is at least as good as the expected monetary award, which Thailand desperately wants to avoid.



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The key to understanding the settlement dynamics is the price of gold. Gold has shot up significantly from 2016 to now, from about \$1,200 an ounce to above \$1,900 an ounce. This makes keeping the mine and operating it more attractive than simply taking a hefty monetary award from the arbitration panel.

Chatree Timeline

- November 2001 Chatree mine commissioned
- December 2011 Chatree Plant 2 commissioned, close to tripling processing throughput
 - May 2014 Thai military coup
- January 2015 Mine closed for 44 days amid (false) allegations of elevated levels of arsenic and manganese in surrounding population
 - May 2016 Thailand announces policy to cancel all gold operations and exploration in Thailand as of end of 2016; renews Kingsgate licenses only to YE 2016
- December 2016 Using dictatorial powers of Section 44, Thai military leader shuts down all gold mine production and exploration by end of year
 - April 2017 Kingsgate commences TAFTA proceedings, beginning with formal consultation period
 - October 2017 Kingsgate sues Zurich consortium of political risk insurers to make good on their political risk policy
- November 2017 Kingsgate sues Thailand under TAFTA
 - March 2018 Tribunal hearings scheduled for November 2019 in Hong Kong
 - March 2019 Kingsgate settles insurance claims for \$58.5 million
- November 2019 Due to unrest in Hong Kong, tribunal hearings rescheduled to February 2020 in Singapore
 - February 2020 Tribunal hearings completed over ten days
- September 2020 Thailand allows Kingsgate to process and sell gold sludge left from cleaning tanks and machinery in 2016, netting Kingsgate ~\$10 million; shares rise 9%
- November 2020 Thailand approves 44 SPLs (Special Prospecting Licenses), totaling 400,000 rai (=~150,000 acres) for Kingsgate exploration, an increase of >130x in permitted exploration area; shares rise 15%
- September 2021 Tribunal ready to issue decision; Kingsgate and Thailand jointly request to hold decision until end of October as negotiations enter final stages; shares shoot up 44% on announcement and commence sharp run-up
 - October 2021 Tribunal continuing to hold decision until end of January 2022; Kingsgate expects to receive approval for Quartz lease (important orebody extension of present mine pit) and restart Chatree in a staged bootstrap manner; has begun exploration activities on 22 of



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- the 44 SPLs; shares drop 13% on announcement as beginning of 30% slide
- January 2022 Chatree mining leases reinstated, including new approval for Quartz mining lease; metallurgical processing license reinstated; recruitment agency appointed to restaff mine personnel
- February 2022 Tribunal continuing to hold decision until end of 2022, as negotiations continue on small number of remaining issues; no obstacle to mine reopening remaining as preparations for restart underway; shares slide 11%, going on to drop more than half from their recent highs
- March 2022 Kingsgate announces preliminary funding agreement with Taurus for mine refurbishment; expects first drawdown in April; expects 4-6 months from commencement of refurbishment until mine operations begin; expects first gold pour as soon as end of year; shares shoot up 27% on announcement

Valuation

At the recent price of \$1.80 AUD (Australian Dollars), Kingsgate has been trading at a market cap of approximately \$300 million USD (US Dollars). Kingsgate presently has no debt, but is borrowing ~\$30 million to refurbish the plant in preparation for the coming reopening. In addition, upon successful resolution of the litigation with Thailand, Kingsgate will have to pay back all monies fronted by their insurance company, ~\$60 million.

For this, we get Chatree. Chatree has the proven ability to produce ~125,000 ounces of gold and ~850,000 ounces of silver a year. At the present prices of gold and silver (\$1,900 an ounce and \$25 an ounce, respectively), this amounts to ~\$260 million revenue a year. From this, we must deduct expenses. Before closure, cash costs amounted to approximately \$800 an ounce, or about \$100 million total. Interest on the \$30 million loan and \$60 million insurance payout adds up to under \$5 million a year. Depletion adds another \$30 million in cost. (Investors should take note that for mining companies and the like, the stated depletion in the financial statements needs to be ignored and replaced with depletion based on the investor's projected cost basis. In our situation, although the Chatree assets were written down in 2016 and there is therefore no depletion in the official financials to speak of, we are depleting the \$300 million of equity over ten years, \$30 million a year. This is overly conservative, as we expect to have many more years of mine life ahead.)

The final piece is royalties and taxes. Both royalties and taxes are probably under negotiation for the final settlement, particularly as Thailand's sliding royalty scheme, introduced in 2007, is an outlier in global markets and itself quite possibly another violation of TAFTA. We are going to assume a worst-case scenario where there are no concessions from Thailand on royalties or taxes. This would amount to \$223 an ounce in royalties (assuming a gold price of \$1,900) for a total of \$30 million, and another \$20 million in taxes.

Putting everything together, we reach a projected net income of \$75 million a year, and more than \$100 million of cashflow. In other words, Kingsgate, which is trading at ~\$300 million right now can be expected to generate a third of its market cap in just one year of full production! We believe this to be a conservative estimate. Firstly, we believe there is potentially significant upside to these numbers with a possible



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agreement for reduced royalties and taxes. Secondly, the more productive and accessible ore from the Quartz lease expansion to the mining pit (and, potentially, other approved exploration areas) is likely to both increase revenue as well as decrease mining expense compared to the above estimates. All in all, we believe the stock is at a very attractive valuation, with the potential to double or triple in short time as the mine comes online and starts producing.

Risks

The main risk is the possibility of the settlement with Thailand falling through. We do not think this is likely, as Thailand has made many credible indications that they are eager to settle, including permitting the processing and sale of Kingsgate's gold sludge, relicensing the mine and processing plant, adding the coveted Quartz license to expand the mine to important orebody, as well as very significantly expanding Kingsgate's exploration licenses. Thai government officials have also made public pronouncements on official record and in media appearances praising Kingsgate, its health and environmental record, its community involvement, potential job creation, etc. There is also significant political pressure in Thailand to avoid an adverse ruling from the arbitration tribunal, which would cost Thailand a significant sum for no gain and would cause the ruling government to lose face. Thailand appears highly motivated to come to a win-win agreement with Kingsgate, although Thailand is also focused on not paying any actual cash, or giving any concessions that could be characterized as a "sweet deal", due to internal politics.

More importantly, Kingsgate always has the arbitration award to fall back on. The proceedings were all confidential, but this was always a rather open-and-shut case from a legal standpoint, and Thailand appears quite convinced that they will lose (hence their recent conciliatory attitude). Media reports in Thailand peg the amount sued for as \$750 million, plus interest. If forced to go this route, Kingsgate would have to enforce the ruling by collecting from Thailand's assets, but this has proven possible in past cases where Thailand has lost similar arbitrations. We don't expect this scenario to materialize, but it definitely lowers risk significantly to have this option as a backstop, besides the obvious advantages to Kingsgate's negotiating position.

Another risk to consider is a drop in the price of gold. A key part of what makes it so attractive for Kingsgate to negotiate the reopening of the mine instead of simply taking the arbitration award is the sharp increase in the price of gold since Chatree's 2016 closing, from approximately \$1,200 an ounce then to above \$1,900 an ounce now. Nevertheless, Chatree was always quite profitable, even at lower gold prices. Even if gold prices were to drop back to \$1,200 an ounce, a drop of almost 40% from present prices, we still estimate Kingsgate to have positive cashflow of ~\$50 million a year. Even at this sharply reduced profitability, Kingsgate is attractively priced at a \$300 million USD market cap. In today's inflationary environment, we expect gold prices to be more likely to rise further than to drop.

Catalysts

Investing in undervalued asset plays often raises the question of which catalysts on the horizon can trigger a re-rating. In Kingsgate's case, this is not a concern, as the most obvious catalyst will be the mine returning to full production and the profits rolling in. At that point, we expect the company will be valued as a run-of-the-mill gold producer, rather than an obscure litigation play.

Nevertheless, we do believe that there are many milestones along the road that can trigger an advance in Kingsgate shares. This is especially so as we have seen much (in our opinion, unwarranted) volatility in



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Kingsgate shares around news items, even ones that did not contain much new information for people who were paying attention. The potential milestones include: announcing finalization and drawdown of the refurbishment loan, an updated report on resources and reserves based on current gold prices, selling of their Nueva Esperanza asset (a potential silver mine they own in Chile and are looking to sell), announcement of preliminary expanded exploration results, announcement of restart date, announcement of royalty and tax rates, announcement of final settlement with Thailand, first gold pour, first income showing up on financials, first solid guidance, etc.

Summary

Kingsgate is at the cusp of restarting a highly profitable gold mine and is valued at only 3x the yearly expected cashflow. We believe that this is a highly undervalued business which will experience a substantial resetting of market valuation as the mine comes back online. We are literally getting a \$1 billion+ mine for just \$300 million.

Focus Capital Management initiated its position in Kingsgate in December 2021, at an average entry price of \$1.76 AUD a share. Kingsgate has shown substantial volatility due to newsflow, or lack thereof, and we stand ready to purchase even more shares if a substantial unwarranted price drop presents itself.

