

Caledonia Mining

2016 to see marked increase in profit

2015 for Caledonia featured stable gold production at Blanket, albeit at slightly higher costs due mainly to a reduced average gold grade and additional sustaining capex. Investment accelerated with the implementation of the revised investment plan (RIP), significantly yielding ore production for the first time from below the 750m reduced level (RL) via the completed No. 6 Winze. This level is a key 'watermark' in that the company's longer-term growth hinges on gold production below this depth. Such an important milestone mirrors a management team that is delivering on its 2014 initiated RIP and one that has taken precautionary measures to ensure its successful completion (inter alia, a small gold hedge).

Year end	Revenue (US\$m)	PBT* (US\$m)	EPS* (c)	DPS (c)	P/E (x)	Yield (%)
12/14	53.5	11.0	10.4	6.9	7.9	8.5
12/15	49.0	5.1	8.1	4.8	10.1	5.9
12/16e	60.4	16.0	23.5	4.5	3.5	5.5
12/17e	87.2	36.7	46.6	4.5	1.8	5.5

Note: *PBT and EPS are normalised, excluding amortisation of acquired intangibles, exceptional items and share-based payments. Accounting change to US\$ (previously C\$).

Collar/cap hedge provides certainty over cash flows

In early 2016 Caledonia entered into a small 15koz gold hedge valid until July 2016. There are no forward sales of any of Caledonia's gold production, and the hedge is structured such that the company achieves a minimum price of US\$1,050/oz (termed the collar value) regardless of the gold price being below this, while maintaining full price participation above US\$1,079/oz (the cap value). The maximum cost of the hedge, if the gold price stays above the cap value for the hedge period, is US\$0.435m. This hedge position is described by management as an insurance product used to maintain certainty over cash flows during a key phase of Blanket's expansion, as market volatility continues to dominate.

Zimbabwe support for Blanket

Government support for the RIP has been via a suspension of indigenisation payments (for 2015) and a narrowing of refining costs. With these set against a backdrop of South African political turmoil and adverse mining industry taxation changes elsewhere, Caledonia's total RIP investment of c US\$65m starts to appear a more astute choice than developing elsewhere in Africa and poses the question of whether a narrowing of Zimbabwe risk is now overdue for the company.

Valuation: Underlying RIP assumptions maintained

We adjust our model for Caledonia's FY15 accounts and its US dollar accounting format. On this basis, our DCF valuation of Blanket's cash flows, based on the RIP's production and cost profile, is £1.59 per share, at a 10% discount rate to reflect general equity risk and our gold price assumptions (see pages 6-7). On the same basis but using a flat gold price of US\$1,200/oz, our valuation becomes £1.05. We also note that Caledonia should realise a 190% uplift in earnings in FY16, based on an average gold price of US\$1,224/oz and achieving 50koz of gold production.

FY15 results and outlook

Metals & mining

4 April 2016

Price **57.50p**

Market cap **£30m**

US\$/£:1.42

Net cash (US\$m) at 31 December 2015 10.9

Shares in issue 52.1m

Free float N/A

Code CMCL

Primary exchange TSE

Secondary exchange AIM

Share price performance



% 1m 3m 12m

Abs 22.3 51.3 51.3

Rel (local) 22.3 54.2 64.8

52-week high/low 58.50p 38.00p

Business description

Caledonia Mining mines gold at, and maintains management control over, its main operating asset, the 49%-owned Blanket gold mine in southern Zimbabwe. It is also progressing its understanding of a number of promising satellite projects close to Blanket.

Next events

AGM May 2016

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Production rate making the pace

Caledonia's fully indigenised Blanket gold mine in Zimbabwe is currently absorbing its largest injection of capital since Caledonia bought the mine from Kinross in 2006. Management's RIP, announced in November 2014, sees a rapid increase in earnings and production in 2016 and 2017, with a more sustained increase beyond 2017. In our previous valuation, which used the company's January 2013 investment plan, 2017 was the year of peak production, after which it tailed off significantly in the absence of a further plan to access deeper resources. Caledonia's investment will be underpinned by mining reserves through the major phase of investment (2015 to 2018).

FY15 a staging year as Nov 2014 RIP is implemented

Caledonia increased gold production 3% y-o-y, recovering 42,804ozs from 440,079 tonnes at a gold grade and recovery factor of 3.25g/t Au and 93.0% respectively. While gold production increased slightly, there was a material increase in tonnes hauled to surface and milled during the year. FY14 tonnages mined and milled totalled 390,735, 11% lower than what was achieved during FY15. This is in no small part due to the RIP's implementation and, specifically, the completion of the Tramming Loop in June 2015.

Cash costs – stable y-o-y: on-mine cash costs increased 7.5% from US\$652/oz to US\$701/oz due mainly to a gold grade averaging 3.25g/t Au (compared to 3.55g/t Au in 2014). While FY15 gold production was level with FY14's, the lower gold grade meant higher milled tonnes and therefore cost, while producing relatively fewer ounces.

All-in sustaining costs – sustaining capex increases: increased sustaining capital during the course of FY15 resulted in a y-o-y increase of 7.1% in all-in sustaining costs from US\$969/oz to US\$1,038/oz.

RIP investment higher in 2015, revised down overall on greater cost detail: investment at Blanket increased from US\$6m in 2014 to c \$17m in 2015, although Caledonia has now reduced its 2015-17 forecast capex at Blanket from US\$50m to US\$45m citing cost savings achieved during FY15. This cost saving (achieved during FY15) offsets Caledonia's FY15 stated US\$5m investment into Blanket from its own treasury.

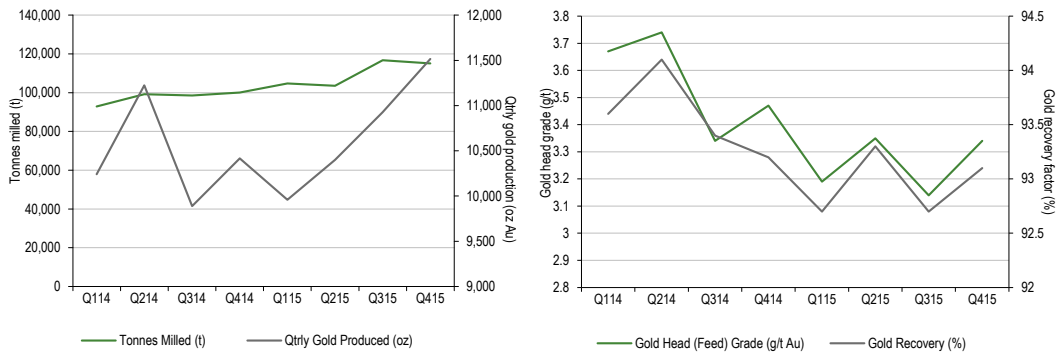
For further detail on Caledonia's FY15 results please refer to pages 7 and 8.

2016 should provide gear change in Au production

The following exhibit gives data for tonnes milled vs quarterly gold production (LHS) and gold head grade vs recovery (RHS). We note the sharp increase in gold production over the period Q2-Q415, which resulted from extra haulage capacity coming on line from the Tramming Loop from end Q215. In addition, we plot grade versus gold recovery, which as expected, move in tandem. The average grade of 3.25g/t matches the planned grade and correlates well with available grade data for the AR Main ore body, from which a portion of FY15's ore production was taken.

Caledonia's FY15 gold production was above its target of 42koz by 2%. As long as the RIP is implemented as planned, its FY16 production target increases 17% to 50koz, which should provide a significant reduction in unit costs (see Exhibit 3).

Exhibit 1: Gold/ore production (LHS) and grade/recovery data (RHS) Q114 to Q415

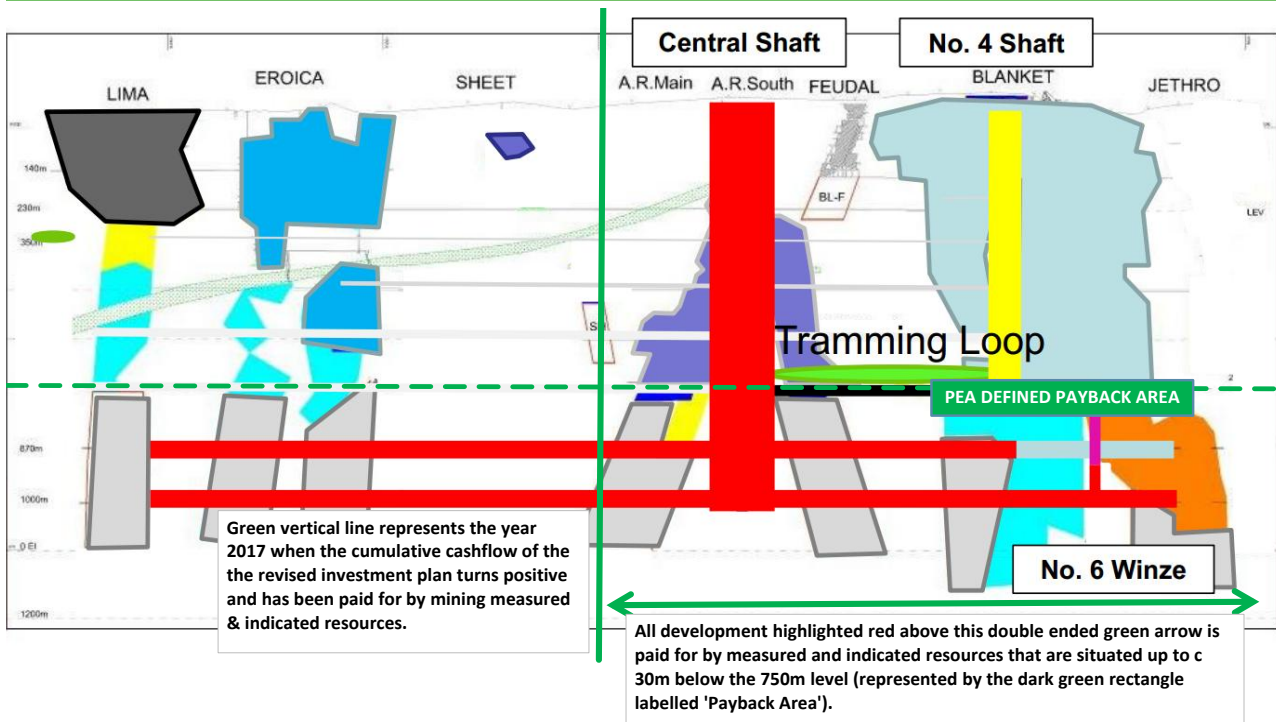


Source: Edison Investment Research

FY16 production schedule to mine higher-grade ore sources

Ore production for FY15 occurred predominantly from the AR Main and AR South ore bodies above the 750m level. Exhibit 2 below, supplied by Caledonia, shows an ore block carrying a gold grade of c 3.25 g/t for AR Main. This corresponds well with the average grade achieved for FY15 of 3.25g/t Au. From grade data given in Exhibit 1, the Eroica ore body (which is the current focus of mining activity, aside from the smaller tonnages being extracted from the Blanket ore body via the No. 6 Winze) shows grades of approximately 3.50g/t Au to 4.50g/t Au, which supports an increase over the average grades seen during the past 12 months. The Blanket gold mine's gold grade is budgeted to increase to 4.0g/t by 2020.

Exhibit 2: Blanket long section showing ore bodies and main RIP developments



Source: Caledonia Mining

The completion of the Tramming Loop in June 2015 has increased underground haulage capacity, on the main Level 22 haulage level at the 750m RL, to Blanket and removes a key bottleneck relating to the ability to transport ore to the main surface transport route via the No. 4 Shaft. Blanket

achieved a 13% uplift in tonnes delivered to the mill following the Tramming Loop's completion. This uplift occurred over the period Q2-Q315, ie the first quarter of production post its completion.

Revised mine plan – de-risked to end 2017 by mining reserves

The 2014 RIP includes a new mine plan for Blanket. The plan indicates declining production from ore reserves, which are largely above 750m, from 42koz in 2015 to only 6koz by 2021, with a corresponding increase in production from inferred mineral resources from 2016 (4-5koz) to 70-75koz by 2021. Note: Caledonia reported two resource upgrades during 2015, which significantly increase the confidence level of its resource base (see page 6 for further detail).

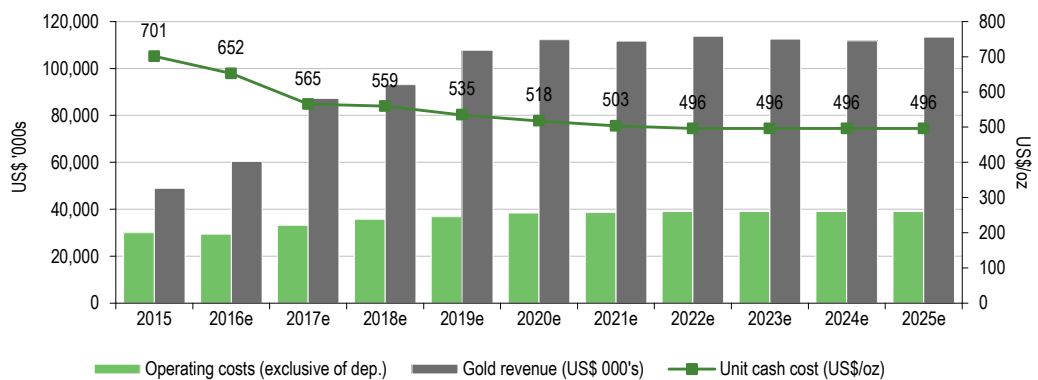
The most important point to take from the RIP is that the majority of capital expenditure will be spent during the 2015-17 period, now totalling US\$45m (cf US\$50m previously). During this time, 97% of planned gold production will come from the mining and processing of the indicated and measured category of mineral resources (according to the 1 December 2014 PEA), with only 3% from inferred mineral resources. However, the 2015 resource upgrades, and subsequent resource upgrades, will reduce the dependence on mining the lower-confidence resources.

The period 2015 to mid-2018 will see the Central Shaft completed which will be the final major infrastructure component completed as part of the RIP. In addition, an extension to the new No. 6 Winze will take place, as well as half the lateral development (comprising two haulage drives) needed to access the Lima and Eroica inferred resources located in the north-western half of the mine. The Tramming Loop was the first component of the RIP to be completed, in June 2015.

The remaining RIP capex of US\$20m from 2018-21 will be invested alongside production from mineral resources, which will be converted into ore reserves below the 750m level.

Our forecast mine operating cash cost estimates, based on production and costs arising from the implementation of the RIP, are given in Exhibit 3 below.

Exhibit 3: Forecast RIP revenue, operating cost and unit costs FY15 to FY25e



Source: Edison Investment Research

Blanket capital projects summary

The following sections provide a summary of the key expansion projects currently underway and the impact each will have. Two of the three main development projects (the Tramming Loop and No. 6 Winze) are completed. The Central Shaft is on track for completion in mid-2018. The Level 22 extension is another development project currently underway.

No. 6 Winze – first gold mined from below 750m level

In our opinion, the completion of the No. 6 Winze is arguably the most important element of the RIP that has been completed so far, and potentially the most important part of its implementation. This is due to:

- the No. 6 Winze has for the first time allowed physical (and not drilling) access to levels below the 750m RL. The depth of the winze provides a full 180m of vertical access below the 750m RL;
- first ore production from below the 750m RL and the opening up of development and ore drives provides first and foremost ore, but also a rich source of first-hand geological information with which to confirm the current understanding of Blanket's ore bodies below this level. This is a critical path component of the company's RIP. The identification of resources and reserves below the 750m RL is understood to be one of the highest risk elements in the RIP's implementation;
- an extension to the above point is that access below the 750m RL provides easier access to develop drill positions projecting out into either the foot walls or hanging walls of Blanket's ore bodies. Completion of new drill positions and the subsequent drilling from these positions will materially de-risk the understanding for future resource and reserve upgrades and both de-risk and potentially increase our valuation beyond 2017;
- the No. 6 Winze access will allow for development of two main haulage drives spanning all of Blanket's main ore bodies below the 750m RL, both of which will ultimately provide haulage ways to the Central Shaft on its completion; and
- ore production from the No. 6 Winze, as of March 2016, is currently at a rate of 10tpd and the company expects this to climb progressively towards a planned capacity of 500tpd by mid-2017. This is in line with the RIP's implementation schedule and is the main driver for the projected increases in production in 2016 and 2017.

Central Shaft – progressing as planned, completion mid-2018

The Central Shaft is the most important and most costly element of the RIP. It will be sunk to an eventual depth of 1,080m below surface, with a planned completion date of mid-2018. The pre-sink to a depth of 90m below surface is complete and the equipment for the main sinking phase is onsite and being set up for use. The Central Shaft, on completion, will form the main haulage route to surface and is centrally located in relation to Blanket's ore bodies, providing greater flexibility over ore mining, improved operating efficiency and potentially supplying a more homogenised grade to the mill via the blending of multiple ore streams.

Level 22 Haulage way

This haulage way will eventually link up all of Blanket's ore bodies at the 750m RL (RL is short-hand for Reduced Level – a term denoting the level below a specified mine datum). Level 22 is currently the most important haulage route at the Blanket mine. This is the oldest of Blanket's active capital development projects due to its development taking place alongside normal ore mining activities. As such, development has, on occasion, been suspended periodically to prioritise ore haulage to the mill. While a critical infrastructure component in the long run and crucial for deeper-level exploration activities (ie drilling), its eventual completion has always been secondary to ore extraction and the other three capital projects (Tramming Loop, Central Shaft and No. 6 Winze), and haulage elsewhere in the mine. The Level 22 extension had 450m to go at end September 2015. However, with the Tramming Loop now completed, more regular development on this capital project can take place as a key haulage bottleneck around the No 4. Shaft has now been removed.

FY15 resource additions, upgrades & reserve estimate

Caledonia has a policy by which it resists adding to its resource base material below a cut-off or 'pay-limit' grade of 2.11g/t Au and using a US\$1,200/oz for resource estimation. This cut-off grade increases to 2.30g/t and uses a lower gold price of US\$1,100/oz to determine the reserve grade.

Exhibit 4: Blanket total mineral resources as at 31 December 2015

Mineral resource category	Tonnes (metric)	Grade Au (g/t)	Gold (oz)
Measured resources	1,412,100	3.91	177,700
Indicated resources	3,334,800	4.30	460,700
Total measured and indicated	4,746,900	4.18	638,400
Inferred resources	2,591,000	5.03	419,000

Source: Caledonia Mining

In May 2015, Caledonia converted 491kt tonnes of inferred resource material to the indicated category and added a further 47kt of new indicated resource. In December 2015, a further 222kt of new Indicated resource was added, 255kt of inferred material was upgraded to the indicated category and 283kt of new inferred material was added to the resource. All these additions are included in the resource estimate shown in Exhibit 4. With a freeing up of haulage capacity around the No. 4 Shaft and investment in new drilling machines, exploration drilling (ie the 22 Level Haulage way) has now been accelerated.

Exhibit 5: Blanket total ore reserves as at 31 December 2015

Mineral reserve category	Tonnes (metric)	Grade Au (g/t)	Gold (oz)
Proven reserves	717,700	3.41	78,640
Probable reserves	1,912,200	3.56	218,860
Total proven and probable reserves	2,629,900	3.52	297,500

Source: Caledonia Mining

Valuation

Our previous £1.38 per share valuation was based on a conversion from our Canadian dollar value (C\$2.74), using a C\$/£ forex rate of 2.01, 2015 ytd production values, with future forecasts underpinned by the RIP, as detailed throughout this note. We maintain our production forecasts as per the RIP and have now brought our model in line with Caledonia's new US dollar reporting format.

On this basis, our valuation becomes US\$2.24 or £1.59, 15% higher, in sterling terms, than our previous valuation primarily due to current sterling weakness against the US dollar, but also due to moving our valuation forward one year to FY16. This mirrors previous sterling valuation increases due to the pound's strength against the Canadian dollar.

Caledonia's current share price of c £0.57 implies a discount rate of 29% to our base case valuation of £1.59 using our in-house gold price assumptions and a 10% discount rate. Running our valuation at a spot gold price of US\$1,200/oz results in a valuation of £1.05 and narrows the implied discount rate to 22%.

Our valuation is based on the following gold price assumptions:

Exhibit 6: Gold price assumptions used in base case valuation

Year	2016e	2017e	2018e	2019e	2020e	2021e	2022e	2023e	2024e
US\$/oz	1,224	1,347	1,408	1,483	1,467	1,409	1,404	1,389	1,379
Silver price (US\$/oz)	16.11	17.73	18.53	19.51	19.30	18.54	18.47	18.28	18.15

Source: Edison Investment Research

Sensitivities

Zimbabwean country risk still dominates equity valuations, regardless of underlying asset quality or financial performance. However, Caledonia has had its indigenisation transaction agreed for over three years without amendment. In fact the only amendment to the deal has been driven by Caledonia through its intention to reinvest all of Blanket's free cash flow to modernise and safeguard Blanket's future growth and production. Caledonia's large c US\$65m+ investment has also received the government's support by dint of it agreeing to the suspension of Blanket's facilitation loan repayments until Blanket resumes dividend payments (expected before end-2016), which will allow its indigenous shareholders to resume facilitation loan repayments to Caledonia.

The following quantitative sensitivities are specific to our base case valuation:

Exhibit 7: Sensitivity to changes in the gold price (held flat over LOM)						
Gold price (US\$/oz)	1,000	1,100	1,200	1,300	1,400	1,500
NPV per share (£)	0.43	0.75	1.03	1.32	1.61	1.90

Source: Edison Investment Research

Exhibit 8: Sensitivity to changes in discount rate						
Sensitivity to discount rate used	0	5	10	15	20	32
NPV per share (£)	2.83	2.1	1.59	1.21	0.94	0.5

Source: Edison Investment Research

FY16 to see continued investment, cash flow neutral

Caledonia has changed its reporting currency from Canadian to US dollars. In doing so, it has removed a distortion from its accounts over its operating cost base as Blanket operates in a US-dollarized Zimbabwe. This provides a far more consistent approach to demonstrating Blanket's underlying performance. A separate decision with regard to the change in reporting currency was to re-domicile the company to Jersey. The re-domicile, which became effective on 21 March 2016, also removes a withholding tax burden for non-Canadian domiciled shareholders.

Blanket's Q415 revenue was US\$15.8m from the sale of 11,515oz of gold (a 5.4% q-o-q increase) at an average realised gold price of US\$1,180/oz (Q315: US\$1,106/oz). After production costs, royalty payments and depreciation, Caledonia achieved a fourth quarter gross profit of US\$3.8m, a 39% increase over Q315's gross profit of US\$2.7m. The material increase is largely due to the change to US dollar accounting and the current strength of the US dollar. In terms of annual results, Caledonia produced 42,804oz gold, a 2.5% increase over FY14's gold production of 41,771ozs. FY15's production was hampered by a persistently lower grade from the AR Main and AR South ore bodies, with the average grade for FY15 being 3.25g/t Au. After production costs (US\$30.0m), royalty payments (US\$2.5m) and depreciation (US\$3.3m), Blanket returned a gross profit for the year of US\$13.2m. Administrative and other central costs totalled US\$7.6m (including c US\$1m of non-recurring expenditures), which were largely offset by a US\$2.9m net forex gain, to produce an operating profit of US\$8.5m. After net finance costs of US\$0.5m and tax of US\$2.4m, NPAT for FY15 was US\$5.6m (FY14: US\$5.9m).

2015 operating cash flow was US\$8.3m, while outflows of US\$20.5m included US\$16.6m capex (reflecting the RIP implementation). End-December net cash was US\$10.9m. In terms of the RIP implementation FY16 marks the year of peak investment by Caledonia, with US\$14m in capex being sunk into the Blanket mine. This then reduces to US\$15.4m in FY17, US\$9.1m in FY18 and US\$5.4m in FY19 and remains at a similar level for the remainder of the current mine life. We therefore estimate Caledonia will finish FY16 with net cash (after dividends) of US\$10.5m, which will increase to US\$24.3 in FY17 as Blanket's production ramps up towards 65koz of gold production.

We maintain our previous dividend assumption for FY16 totalling six Canadian cents per share, paid in quarterly instalments. Note that UK residents will effectively see an increase of approximately one-third over the FY14 dividend received as a direct result of removing withholding tax payments. This is equivalent to 4.6c in US dollar terms using a forex rate of 0.76 US\$/C\$. We will take a view on a potential FY17 dividend payment mid-2016 when six months of gold price data and operational results provide greater clarity over end year financial forecasts. For now, we assume an FY17 dividend at the same level as FY16's. We also introduce our forecasts for 2018, which point to a doubling in net cash by year end to US\$48m.

Exhibit 9: Financial summary

	US\$'000s	2014	2015	2016e	2017e	2018e
Year end 31 December		IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS						
Revenue		53,513	48,977	60,350	87,208	93,082
Cost of Sales		(34,970)	(35,796)	(38,530)	(44,415)	(47,734)
Gross Profit		18,543	13,181	21,820	42,793	45,349
EBITDA		14,721	8,967	19,541	40,291	42,613
Operating Profit (before amort. and except.)		11,181	5,645	15,730	36,480	38,802
Intangible Amortisation		0	0	0	0	0
Exceptionals		887	2,850	0	0	0
Operating Profit		12,068	8,495	15,730	36,480	38,802
Net Interest		(140)	(535)	251	212	487
Profit Before Tax (norm)		11,041	5,110	15,982	36,691	39,289
Profit Before Tax (FRS 3)		11,928	7,960	15,982	36,691	39,289
Tax		(5,982)	(2,370)	(1,366)	(7,531)	(10,516)
Profit After Tax (norm)		5,059	2,740	14,615	29,160	28,773
Profit After Tax (FRS 3)		5,946	5,590	14,615	29,160	28,773
Minority interests		(1,511)	(811)	(2,367)	(4,814)	(5,204)
Net income (norm)		5,420	4,220	12,248	24,346	23,569
Net income (FRS3)		4,435	4,779	12,248	24,346	23,569
Average Number of Shares Outstanding (m)		52.1	52.1	52.1	52.1	52.1
EPS - normalised (c)		10.4	8.1	23.5	46.7	45.2
EPS - normalised and fully diluted (c)		10.4	8.1	23.5	46.7	45.3
EPS - (IFRS) (c)		8.4	8.9	23.5	46.7	45.2
Dividend per share (c)		6.9	4.8	4.5	4.5	0.0
Gross Margin (%)		34.7	26.9	36.2	49.1	48.7
EBITDA Margin (%)		27.5	18.3	32.4	46.2	45.8
Operating Margin (before GW and except.) (%)		20.9	11.5	26.1	41.8	41.7
BALANCE SHEET						
Fixed Assets		34,736	49,276	59,265	69,953	74,342
Intangible Assets		0	0	0	0	0
Tangible Assets		34,736	49,276	59,265	69,953	74,342
Investments		0	0	0	0	0
Indigenisation receivable		0	0	0	0	0
Current Assets		31,743	23,562	20,069	36,505	61,096
Stocks		6,512	6,091	3,853	4,316	4,627
Debtors		1,850	4,236	4,960	7,168	7,651
Cash		23,082	12,568	10,589	24,354	48,152
Other		299	667	667	667	667
Current Liabilities		(4,972)	(8,397)	(2,622)	(5,123)	(9,185)
Creditors		(4,972)	(6,709)	(2,622)	(5,123)	(9,185)
Short term borrowings		0	(1,688)	0	0	0
Long Term Liabilities		(11,164)	(14,080)	(14,080)	(14,080)	(14,080)
Long term borrowings		0	0	0	0	0
Other long term liabilities		(11,164)	(14,080)	(14,080)	(14,080)	(14,080)
Net Assets		50,343	50,361	62,632	87,255	112,174
Minority interests		(693)	(1,504)	(3,491)	(7,925)	(13,129)
Shareholder equity		49,650	48,857	59,141	79,330	99,044
CASH FLOW						
Operating Cash Flow		15,477	8,331	16,968	37,929	42,027
Net Interest		0	0	251	212	487
Tax		(4,526)	(1,462)	(1,366)	(7,531)	(10,516)
Capex		(6,150)	(16,567)	(13,800)	(14,500)	(8,200)
Acquisitions/disposals		0	0	0	0	0
Management Fees		0	0	0	0	0
Dividends		(3,620)	(2,504)	(2,344)	(2,344)	0
Net Cash Flow		1,181	(12,202)	(291)	13,766	23,797
Opening net debt/(cash)		(21,892)	(23,082)	(10,880)	(10,589)	(24,354)
HP finance leases initiated		0	0	0	0	0
Other		9	0	0	0	0
Closing net debt/(cash)		(23,082)	(10,880)	(10,589)	(24,354)	(48,152)

Source: Company accounts and Edison Investment Research

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