Southern Cross Equities

28 August 2009

Aquila Resources (AQA)

Landmark deal with Baosteel

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Recommendation

Buy

Price

$7.15

Target (12 months)

$10.55

AQA's unrivalled portfolio of steel making raw materials projects has been recognised by Baosteel, China's largest steel mill. This has culminated in the signing of a strategic alliance to fast track the development of the projects, and a share placement to Baosteel, raising $285.6m. With AQA's project pipeline now significantly de-risked, we have upgraded our price target to $10.55 and maintain our Buy rating.

Expected Return

Capital growth	**48%**
Dividend yield	**0%**
Total expected return	**48%**

Company Data & Ratios

Enterprise value	**$1,583m**
Market cap	**$1,631m**
Issued capital	**249m**
Free float	**50.2%**
12 month price range	**A$1.90-16.43**
GICS sector	**Materials**

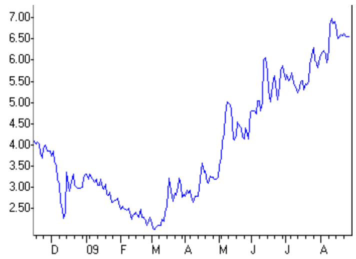
Baosteel picks AQA for its first major offshore investment

AQA and Baosteel have signed two landmark agreements. Firstly, a Memorandum of Strategic Co-operation under which Baosteel will help to secure finance, potentially make direct investments into a number of AQA's projects, have off-take agreements, and assist in marketing product to other PRC customers. Secondly, a Share Subscription Agreement provides for a placement of up to 43.95m shares at $6.50/sh for proceeds of up to $285.6m, and a board seat, to Baosteel.

Funding and off-take risks reduced

Our valuation is $12.66 assuming that all AQA's projects progress in a timely manner. In the past we have set a lower price target to account for the funding and development risks which are high in the early stage projects. However, the support of Baosteel should reduce the risk profile, and as such we have increased our price target to $10.55 from $7.00.

Absolute Price



SOURCE: SOUTHERN CROSS EQUITIES ESTIMATES

Earnings Forecast

Year end June	2008a	2009f	2010f	2011f
NPAT (reported) (A$m)	97.3	-0.3	7.8	54.2
NPAT (adjusted) (A$m)	-40.8	-0.3	7.8	54.2
EPS (adjusted) (cps)	50.1	-0.1	2.6	17.5
EPS growth (%)	na	na	na	na
PER (x)	na	na	na	40.8
P/CFPS (x)	na	na	140.0	44.3
EV/EBITDA (x)	na	411.6	237.6	34.6
Dividend (¢ps)	0.0	0.0	0.0	0.0
Yield (%)	0.0	0.0	0.0	0.0
ROE (%)	48.0	-0.2	1.8	11.1

SOURCE: SOUTHERN CROSS EQUITIES ESTIMATES

The perfect marriage

Aquila needs help to maximise its potential

AQA is at the early stage of a long term growth strategy in coal, iron ore and manganese. It has a portfolio of coal projects in the Bowen Basin, an iron ore project in the Pilbara, and manganese in the Kalahari. There is potential for significant levels of production over time, but risks remain high and include financing, offtake and development.

Baosteel needs security of supply

Baosteel is China's largest steel mill and one of the world's largest steel makers. It is one of the most important companies in the steel industry. Baosteel, like other steel makers is looking for security of supply of its major raw materials, iron ore coal and manganese.

The perfect marriage

It comes as no surprise that AQA and Baosteel can complement each other well, and today's announcement of a Memorandum of Strategic Co-operation and a Share Subscription Agreement should benefit both parties.

Long Term Strategic Alliance

Reduces financing and off-take risk

AQA and Baosteel have entered into a Memorandum of Strategic Co-operation which provides a foundation for a long-term strategic alliance between the two companies. The key points of this agreement are:

- Support in securing finance for the major capital projects. Baosteel has committed to work with AQA to assist in sourcing low cost financing from Chinese institutions for a number of AQA's larger projects, including the West Pilbara Iron Ore Project.
- Potential direct investment into a number of AQA's projects. Baosteel has the right to exclusive due diligence and exclusive negotiations in the event that AQA proposes seeking or progressing third party investment in a project during the 12 month period to August 2010.
- Potential off-take agreements with Baosteel. AQA and Baosteel have agreed to work towards the establishment of long-term raw material off-take arrangements from these projects, once they are developed and in production.
- Marketing assistance from Baosteel to other PRC customers. AQA and Baosteel will work towards establishing a joint sales arrangement to assist in the distribution of production from these key projects throughout the Peoples' Republic of China.

Placement to Baosteel

To raise $285.6m

The Share Subscription Agreement provides for a placement of up to 43,946,413 shares at $6.50 per share in AQA for total cash proceeds of up to $285.6m. The placement, when completed, will result in Baosteel owning up to 15% of the expanded issued share capital of AQA. Further conditions of the agreement are:

- Board seat to Baosteel. The initial Baosteel nominated director will be Mr Dai Zhihao, a Vice President of Baosteel.
- Subject to usual approvals. The placement is subject to approvals from FIRB, Chinese regulators, and AQA's shareholders.
- Anti-dilution rights. Baosteel can participate in new issues during the period to August 2010.
- A standstill agreement. Baosteel cannot have a relevant interest in more than 19.99% during the period to August 2010.
- A "lock-up" arrangement. Restrains Baosteel from disposing of any shares during the period to August 2010.
- "No-shop" restrictions on Aquila. During the period prior to the completion of the placement.
- $2.85m break fee. In the event that a third party control transaction is publicly announced and recommended by a majority of AQA's directors before the completion of the placement

Baosteel's first major international investment in a public company

For Baosteel, this represents its first major international strategic investment in a public company and is an important transaction in its strategy to secure long-term supply of steel raw materials.

For AQA the funds raised will add to the 30 June cash balance of $73m (net cash $48m) and be used to progress the whole portfolio of projects. The first to be developed should be Eagle Downs.

Aquila proceeds as planned – but faster, and with less risk

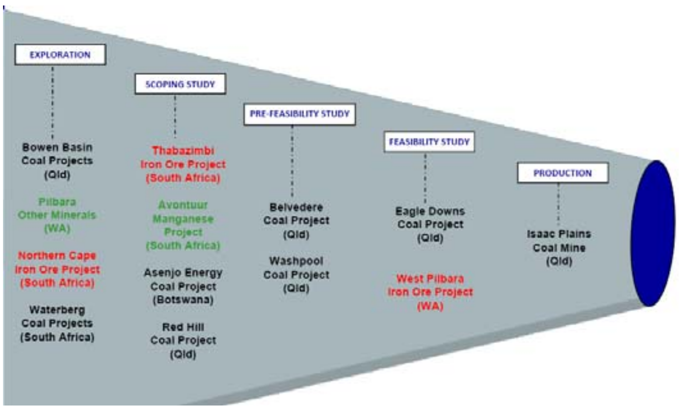
We understand that AQA will proceed with its projects as previously planned, but the support from Baosteel will reduce development risks and expedite some parts of the project process. The next projects on the horizon are:

- West Pilbara Iron Ore Project (WPIOP) (c.40%). AQA has a 50% interest in the API JV which is seeking to develop the WPIOP, with initial production of 30Mtpa through Anketell Point near Cape Lambert. AQA conducted a pre-feasibility study in 2008, and although the study was favourable, it found that total development costs would be A$4.2bn of which A$2.2bn was related to infrastructure, which is difficult to finance for a new player. AQA has been looking for partners to share the infrastructure and lower the costs, which remains part of the strategy. However finance assistance from Baosteel in the form of low cost debt, greatly reduces the risk of this project.

  At the same time, FMG has also struck a deal for financing from Chinese partners, and is looking to expand as quickly as possible. While FMG's near term focus is on its Chichester Ranges production and export route through Port Hedland, longer term it may require another transport route for its Western Pilbara deposits around Solomon, and Anketell Point would be suitable in our view. It is possible that all the stars are beginning to align for the WPIOP.

- Eagle Downs (50%). Isaac Plains (in production), Eagle Downs and Belvedere are all progressing in partnership with Vale. The feasibility study results on Eagle Downs were released this month and showed favourable economics for a 4-8Mtpa coking coal project. Initial capex is expected to be c.$1bn, with $500m being AQA's share. The money raised through the placement, plus debt funding, should support the sanction of this project within 12 months.
- Avontuur (74%) The size, grade, and commercial potential of the initial resource are consistent with other producing mines in Australia and South Africa. Drilling and scoping study work is continuing and infrastructure solutions should be available by 2012.
- Washpool (100%) Potential to produce up to 4Mpta ROM hard coking coal. Will use the new Wiggins Island port at Gladstone which should be available from 2013.
- Thabazimbi (74%) Potential to export 1-3Mtpa from South Africa.

Figure 1 - Project Pipeline



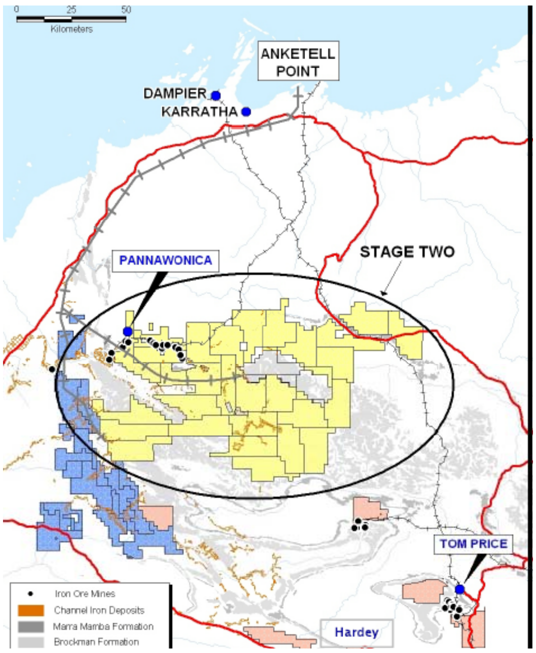
SOURCE: COMPANY DATA

Figure 2 - Potential Production

	PROJECT	ATTRIBUTABLE
IRON ORE		
- West Pilbara Iron Ore	30.0 Mtpa	12.0 Mtpa
- Thabazimbi * (South Africa)	2.5 Mtpa	1.9 Mtpa
	32.5 Mtpa	**13.9 Mtpa**
COAL (Queensland)		
- Isaac Plains	2.8 Mtpa	1.4 Mtpa
- Eagle Downs	7.0 Mtpa	3.5 Mtpa
- Washpool *	1.6 Mtpa	1.6 Mtpa
	11.4 Mtpa	**6.5 Mtpa**
MANGANESE (South Africa)		
- Avontuur *	**1.0 Mtpa**	**0.74 Mtpa**

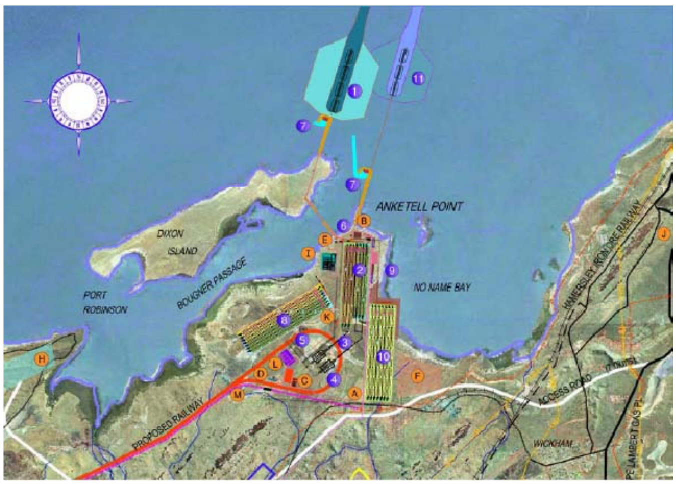
SOURCE: COMPANY DATA

Figure 3 – Anketell Point and proposed rail line



SOURCE: COMPANY DATA

Figure 4 – Anketell Point



SOURCE: COMPANY DATA

Valuation and Price Target

Valuation increased to $12.66

Since our last report we have made some changes to our valuation having updated to reflect:

- The Q4 report
- Eagle Downs feasibility study results
- Our updated iron ore and coal price forecasts
- The impact of the Baosteel placement

As a result our valuation has increased from $11.29 to $12.66.

Given that the majority of AQA's projects are at the scoping or feasibility stage, in the past we have risk weighted each project to take account of development and funding risks to derive our price target. These risks have now been significantly reduced through the strategic alliance and placement with Baosteel and as a result we have reviewed these weightings. Specifically:

- West Pilbara Iron Ore – 75% from 25%. The project does still rely on other Pilbara players sharing the infrastructure. FMG may be interested and also has financial backing, but relying on others remains a risk.
- Eagle Downs - 100% from 75%. Port capacity through Abbot Point should be available from 2012/13 and Vale is supportive of the project.
- Belvedere - 100% from 75%. We expect Vale to exercise its option in the 6 month period from 31 December. Recent M&A in the coal sector, and rising spot prices should support our valuation.
- Washpool and Avontuur – 75% from 50%. The high ash nature of the Washpool coal still needs to be resolved, potentially by blending with coal from another mine.

Price target raised to $10.55 as risks reduced

We have upgraded our price target to $10.55 from $7.00, and maintain a Buy rating.

Figure 5 – Valuation and Price Target

	$M	$/sh	Weight	$/sh risked
AQUILA RESOURCES				
Iron Ore				
West Pilbara	303	0.98	75%	0.73
Thabazimbi	319	1.03	25%	0.26
Coal				
Isaac Plains	419	1.35	100%	1.35
Eagle Downs	978	3.16	100%	3.16
Belvedere	389	1.26	100%	1.26
Washpool	328	1.06	75%	0.79
Manganese				
Avontuur	715	2.69	75%	2.02
Other				
Corporate	-121	-0.39	100%	-0.39
Investments	29	0.09	100%	0.09
Options	8	0.02	100%	0.02
Cash	334	1.08	100%	1.08
Exploration	100	0.32	50%	0.16
Total	3802	12.66		10.55
INCREMENTAL UPSIDE				
West Pilbara 45Mt	496	1.60	0%	0.00
Total	4298	14.26		10.55

SOURCE: COMPANY DATA

Aquila Resources

Company Description

AQA is an Australian based developer of bulk commodity projects (coal, iron ore, manganese). The Isaac Plains coal mine (AQA share 1.4Mtpa) is currently ramping up, and attributable coal production should grow to 6.5Mpta by 2013 through the development of the Eagle Downs and Washpool projects, all in the Bowen Basin, Queensland. AQA's 50/50 partner in Isaac Plains and Eagle Downs is Vale. AQA has a 50% interest in the API JV which is seeking to develop the West Pilbara Iron Ore Project (WPIOP), with initial production of 30Mtpa of CID product through Anketell Point near Cape Lambert. The Avontuur manganese project could produce 1Mtpa. The project pipeline enables a steep production curve to globally significant scale.

Investment Strategy

The portfolio of iron ore, coking coal and manganese is a powerful combination as the current supply base for these steelmaking raw materials is highly concentrated. This makes AQA's assets attractive to consumers looking for independent off-take agreements or acquisitions.

The large portfolio of tenements creates the flexibility to choose higher priority targets to fast track, and potentially divest lower priority assets as a source of funding.

We rate AQA a Buy as it offers a strong growth profile, independent exposure to steelmaking raw materials, potential internal funding options through divestments, and M&A potential. The growth potential should be supported by strong news flow over the next 12 months.

Valuation

Our DCF valuation is $12.66 , however to account for development risk, we have risk weighted each project, and derived a price target of $10.55.

Risks

The majority of projects are at an early stage therefore we see the development risk as high. Isaac Plains is the only source of production and cashflow currently. Other projects are in the concept to feasibility stage and higher production and related cashflows are several years away. Risks include resource definition, securing off-take agreements, access to infrastructure, and financing.

The agreements with Baosteel have greatly reduced the financing and off-take risks, however other risks specific to each deposit, and access to shared infrastructure remain.

Aquila Resources
as at 28 August 2009

Recommendation	Buy
Price	$7.15
Target (12 months)	$10.55

Table 1 - Financial summary

Aquila (AQA)		Share price:	$	7.15
As at	28/08/2009	Market Cap:	$	2,214

PROFIT AND LOSS					
Y/e June 30	2007a	2008a	2009f	2010f	2011f
Sales revenue	15	47	101	131	264
EBITDA	-18	-36	5	8	91
Depreciation	0	0	-5	-7	-15
EBIT	-18	-36	1	1	76
Net Interest Expense	4	9	-3	10	1
Pre-tax profit	-17	-27	-2	11	77
Tax	5	-14	1	-3	-23
Net Profit	-13	-41	0	8	54
Adjustments	0	0	0	0	0
SCEQ adj profit	-13	-41	0	8	54
One-off items	0	138	0	0	0
Reported net profit	-13	97	0	8	54

VALUATION DATA					
Y/e June 30	2007a	2008a	2009f	2010f	2011f
Net profit adj ($m)	-13	-41	0	8	54
EPS (c)	-7	50	0	3	18
EPS growth (%)	na	na	na	na	na
P/E ratio (x)	na	na	na	na	41
CFPS (c)	na	na	na	5	16
Price/CF (x)	na	na	na	140	44
DPS (c)	0	0	0	0	0
Yield (%)	0	0	0	0	0
Franking (%)	0	0	0	0	0
EV/EBITDA	na	na	412	238	35
EBITDA margin (%)	na	na	5	6	35

Valuation per share:	12.66
A$ Target price (12 mth):	10.55
Total Return (including yield)	48%

PROFITABILITY RATIOS					
Y/e June 30	2007a	2008a	2009f	2010f	2011f
EBITDA/sales (%)	na	na	5	6	35
EBIT/sales (%)	na	na	1	1	29
Return on assets (%)	-11	33	0	2	3
Return on equity (%)	-16	48	0	2	11
Return on funds empl'd (%)	-20	166	0	8	4
Dividend cover (x)	0	0	0	0	0
Effective tax rate (%)	27	-50	81	30	30

CASHFLOW					
Y/e June 30	2007a	2008a	2009f	2010f	2011f
Receipts from customers	10	51	94	126	247
Payments to suppliers	-30	-82	-88	-115	-165
Net interest	0	4	8	10	1
Tax paid	2	0	-43	-3	-23
Other	14	0	-3	-2	-11
Operating cashflow	-4	-27	-33	15	50
Capex	-18	-20	-28	-35	-1329
Investments	0	0	0	0	0
Asset sales	7	175	0	0	0
Other	-9	0	-22	0	0
Investing cashflow	-20	156	-50	-35	-1329
Change in borrowings	5	-5	-3	0	1000
Equity raised	0	1	2	0	8
Dividends paid	0	0	0	0	0
Other	0	0	3	286	0
Financing cashflow	5	-4	2	286	1008
Net change in cash	-18	125	-81	266	-271
Cash at end of period	34	159	73	339	68

LIQUIDITY AND LEVERAGE RATIOS					
Y/e June 30	2007a	2008a	2009f	2010f	2011f
Net debt/(cash) ($m)	-14	-144	-61	-327	944
Net debt/equity (%)	-18	-71	-40	-76	193
Net interest cover (x)	17	4	0	0	-62
Current ratio (x)	2	4	3	8	2
Inventory turnover	0	0	13	12	8
Inventory/sales	0	17	5	8	8

INTERIMS					
Y/e June 30 ($m)	2007a	2008a	2009f	2010f	2011f
Sales revenue	2	19	56	63	128
EBITDA	-5	-15	4	5	41
Depreciation	0	0	-2	-4	-8
Amortisation	0	0	0	0	0
EBIT	-5	-15	2	1	34
Other income (expense)	0	0	0	0	0
Net interest	3	1	8	2	8
Pre tax profit	-4	-14	-3	3	42
Tax	1	-38	2	-1	-13
Net Profit	-3	-52	-1	2	29
Adjustments	0	0	0	0	0
SCEQ adj profit	-3	-52	-1	2	29
One-off items	0	138	0	0	0
Reported net profit	-3	86	-1	2	29

BALANCE SHEET					
Y/e June 30	2007a	2008a	2009f	2010f	2011f
Cash	34	159	73	339	68
Receivables	9	12	11	17	34
Inventories	4	5	8	11	21
Investments	0	0	0	0	0
Other	30	70	20	0	0
Current assets	76	246	112	367	124
PPE	31	39	72	100	1413
Investments	0	0	0	0	0
Intangibles	3	0	0	0	0
Other	1	6	15	15	15
Non-current assets	37	47	92	120	1434
Total assets	113	293	205	487	1557
Payables	10	15	17	26	34
Debt	20	15	12	12	1012
Provisions	1	1	1	1	1
Other	4	59	19	19	19
Total liabilities	36	90	51	59	1067
Shareholders' equity	78	203	154	428	490
Minorities	0	0	0	0	0
Total shareholders funds	78	203	154	428	490
Total funds employed	64	59	93	101	1434
W/A diluted shares on issue	169	194	249	293	310

SEGMENTALS					
Base Case Production	2007a	2008a	2009f	2010f	2011f
Iron Ore					
West Pilbara (Mt)	0.0	0.0	0.0	0.0	0.0
Thabazimbi (Mt) (74%)	0.0	0.0	0.0	0.0	1.9
Coal					
Isaac Plains (50%)	0.2	0.6	0.7	1.2	1.4
Eagle Downs (50%)	0.0	0.0	0.0	0.0	0.0
Belvedere (24.5%)	0.0	0.0	0.0	0.0	0.0

ASSUMPTIONS					
Y/e June 30	2007a	2008a	2009f	2010f	2011f
A$	0.79	0.89	0.75	0.80	0.75
Iron Ore Lump (US¢/%Fe)	95	127	179	112	116
Iron Ore Fine (US¢/%Fe)	74	96	133	97	99
HCC (US$/t)	105	147	257	132	143
PCI (US$/t)	65	111	199	91	99
Thermal (US$/t)	50	74	118	72	89

SOURCE: SOUTHERN CROSS EQUITIES ESTIMATES

Recommendation structure

Spec Buy: Expect >30% total return on a 12 month view but carries significantly higher risk than its sector

Buy: Expect >15% total return on a 12 month view

Accumulate: Expect total return between 0% and +15% on a 12 month view

Reduce: Expect -15% and 0% total return on a 12 month view

Sell: Expect <-15% total return on a 12 month view

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Southern Cross Equities Ltd and its associates hold 29,000 shares in AQA as at the date of this report. This position is subject to change without notice.