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BY THE SOUTHERN CROSS EQUITIES TEAM AS EDITED BY CHARLIE AITKEN | [PRINT THIS EDITION](#)

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Aquila Resources (AQA); enter the dragon

Over the last 12 months, we have written on emerging, iron ore, coking coal and manganese producer, Aquila Resources (AQA), a number of times and recently upgraded our price target to A\$10.55 per share. The catalyst for the upgrade from \$7 per share was the announcement of a strategic cooperation agreement with Baosteel which will see Baosteel take a 14.9% stake at \$6.50 per share. Last week we hosted Chairman, Tony Poli, in Sydney and Melbourne and will be hosting him in London next week, so it is an opportune time for us to update with our latest thinking on the company.

Firstly, the best way to describe the Baosteel investment at this point in time is just that, an investment. The 14.9% placement at \$6.50 per share is subject to FIRB and NDRC approvals and with it will come one seat on the AQA board, but at this stage that is as far as it stretches. For now, there are no agreements around off-take and certainly no change in control issues, (the board currently speak for 51% and are going to 40%), which should make FIRB approvals fairly straight forward. What there is however, is a strategic cooperation agreement that sees Baosteel receive a first right to invest directly into AQA's projects and in an understanding that the two companies will pursue off take and funding deals together. From our perspective this gives greater certainty to the development ambitions of AQA's pipeline of projects and in particular the key risk of funding. The change in risk assessment is the reason for the upgrade to our price target.

Over the next 12 months AQA has a number of strategic initiatives underway that may see the company emerge in a strong capital position and potentially with an increased stake in the West Pilbara Iron Ore Project.

The process is dynamic, and the company has proved itself a good asset trader so this is how we believe the maths may work as AQA work to deal themselves into the strongest position to develop their projects with the minimal amount of dilution and without blowing out the debt to equity ratio.

- AQA currently has ~A\$100m in cash and liquids.
- The Baosteel investment is worth A\$285m.
- Vale have an option to acquire AQA's interest in the Belvedere Coking Coal Project that starts in December this year and expires in June 2010. The feasibility study is due in February next year, so that may prove the catalyst for an exercise of the option. The size of the resource is massive at 3.86bn tonnes, which puts the resource attributable to AQA at nearly 1bt, so even at 50c/t would put the price tag at \$500m. Note that transactions have happened recently at up to \$6/t. We would put a strong probability on Vale exercising the option given their desires on coking coal.
- Aquila are looking at the possibility of a sell down of up to 23% of the Avontuur Manganese Project which may realise up to A\$100m, (company's estimate).
- And finally, AQA are also investigating the potential to sell down of up to 40% of the Washpool Coal project that also may realise in the order of A\$100m, (company's estimate), if successful.

So from that, Aquila has the potential to go from A\$100m in cash and liquids to in the order of A\$1bn by this time next year – all going according to plan!

Against that the company has the potential to buy AMCI out of the West Pilbara Iron Ore project, (if the press is to be believed) and clearly this may prove attractive at the right price. There is development capex associated with each of the projects as well as cashflow from the Isaac Plains Coal Mine, in the order of A\$40m. So balancing funding requirements, with cashflow and potential asset sales is a balancing act that is occupying Tony Poli's mind. Given his past track record we are happy to back him through that process and particularly with Baosteel now arriving and providing support and financial muscle to the process.

In terms of what Aquila are working towards, assuming no change in interest, **the projects have the potential to support an equity share of production of at least 14mt of iron ore (note it is shaping up that AQA could have another 5mt of iron ore production from bedded iron formations); 5mt of coal production and 740,000t of manganese production** and a path is clearly set to achieve this. AQA's estimated share of capex is estimated at A\$3,065m, which with all projects in production is estimated to result in EBITDA of approximately A\$990m per annum.

The economics are clearly attractive and AQA has the potential to emerge as a major mining house within three to four years. Importantly each of the projects that Aquila are involved in are long in life and generally low in cost, ie, "world class", and hence the attraction of Baosteel, (it is the first direct investment by Baosteel into any company anywhere in the world). The key now lies in execution and with competition for scarce labour and contracting resources hotting up, AQA are conscious of starting to resource projects now. In the case of the key Pilbara Iron Ore project they have engaged Worley parsons who were the key contractor to FMG in bringing on their project.

Our price target for AQA is A\$10.55 per share, recommendation Buy.

Go Australia.

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