

Highfield Resources^{1,7}

BUY

HFR AU

March 9, 2015

 Last: **A\$0.98**
 ▲ Target: **A\$1.75**

Site visit: Muga and SDP support >2Mtpa potash, price target lifted and cheap at current price

Muga 1Q15 DFS should impress: ~1.1Mtpa

The Muga 2Q14 PFS outlined 860ktpa potash for US\$308m capex, but 2014 drilling lifted M&I resources 52% to 239Mt, leading to submission of a mining application for 800tph or ~1.1Mtpa potash. Lifting the run rate, increasing extraction to 80% with backfill and using the weaker euro lifts 1xNPV10% from US\$538m to US\$960m in our model, with GMPE capex of US\$400m.

Sierra del Perdon (SDP) to hit DCF with 1Q15 scoping: ~1.6Mtpa

We previously modelled 422ktpa potash production for US\$200m capex at SDP. We think there is potential to increase this to >500ktpa but leave our model unchanged. Our key point is that the scoping study should show investors the project is real, and enables basin-wide production of >1.5Mtpa.

Muga drilling now puts 50% expansion on the table: ~2.1Mtpa

With extension drill highlights of 10m @ 14.0% K₂O from 253m, and a lift in extraction, the Muga resource supports a 16yr life even post a +50% expansion. We don't model this, but for example the expansion would lift our NPV from US\$960m to US\$1.1bn, but more importantly sets a clear path to >2Mtpa production by 2020.

Clear M&A target, but more value in build: >3Mtpa potential

Beyond 2.1Mtpa above, Highfield controls the *entire* basin, with Pintano and Vipasca potentially supporting two more mines. EU peers ICL and K+S face declining assets, making Highfield a target in our view, but we see better value in mine build. For example, *lower-margin* peer Intrepid's US\$1.1bn EV is for 910ktpa (metric) sales, implying US\$2.5bn for Highfield at 2.1Mtpa.

Maintain BUY rating, lift PT from A\$0.94/sh to A\$1.75/sh

Seeing the basin-wide potential on site, we think Highfield remains cheap despite the recent rally. We update our Muga NPV from US\$538m to US\$960m, and the SDP NPV from US\$350m to US\$389m on model roll forward and FX. Including the weaker AUD and EUR, we lift our 0.35xNAV8% target from A\$0.94/sh to A\$1.75/sh. We expect this NAV discount to dissipate through DFS and licencing, with 1xNAV10% at spot equal to A\$4.95/sh.

What's Changed	Old	New
Rating	BUY	n.c.
Target	A\$0.94	A\$1.75

Summary

Key asset:	Muga / SDP (Spain)
Potash resource (kt)	456Mt @ 11.2% K ₂ O
Peak Potash Production (kt)	1,498
FD 1xNPV _{10%} (US\$m / A\$/sh)	1290 / 4.93

Share Data

Shares (mm, basic/itm f.d.)	252 / 342
52-week high/low	A\$1.01 / A\$0.35
3M avg daily vol (000)	190
3M avg daily val (000)	A\$157
Mkt cap incl. perf. sh (m)	A\$257
Net cash (debt) (m)	A\$20
FD EV (m)	435
Projected return (%)	70%

FINANCIAL DATA

Year to Jun	2016E	2017E	2018E
Revenue (m)	-	A\$87.7	A\$426
EBITDA (m)	A\$(16.4)	A\$41.2	A\$264
Income (m)	A\$(20.9)	A\$30.4	A\$187
EPS	nm	0.09	0.57
CFPS	nm	0.11	0.62
PER (x)	nm	nm	nm
EV/EBITDA (x)	-	13.8x	2.2x

All amounts in US dollars unless otherwise stated

 Current Chart

 Previous Research

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Muga economics set to improve

There are two key changes to look for in the DFS from the PFS, the mining rate and the mine life.

Mining rate to lift to 1.1Mtpa per licence application: Highfield declared a mining rate of 800tph (twin 400tph declines) in its 4Q14 mining licence application. Assuming 88% availability, this equates to 6.1Mtpa. We use the diluted 12.3% grade supplied in the recent 1Q15 resource upgrade along with 256Mt inventory (potential for selective mining to lift this in the DFS) and conservatively lower recovery to 84% from 84.6% from the PFS. Reversing mass pull to drive a 60% product **gives steady state production of 1,075kt pa**, a +25% lift from the PFS. Leaving euro input costs flat, but easing the EUR/USD rate from 1.33 to 1.10 (1.08 spot) lowers site cash costs from US\$108/t to US\$93/t – we leave this for now as we expect various other modifications to come into the DFS including lower freight costs now allocation at a closer port has been secured.

GMPe reserve lifts by >80% post 1Q15 JORC upgrade: The PFS outlined 96Mt of material mined, a 60% extraction from a 154Mt resource. The recent M&I of 239Mt (below) and estimated mining inventory of 256Mt, clearly extend this. However, a second key advantage has become apparent – backfill with slurry pipelines is readily achievable given the dip of the resource, and allows two phased mining. We simplistically estimate that a first pass Christmas-tree patterned room and pillar arrangement could remove ~45% of material, followed backfill and mining of the residual pillars for a total extraction close to 80%. As such, even though we conservatively only model 210Mt of reserve, 80% extraction enables 168Mt of removed material, an 80% lift on the PFS.

Figure 1. 2015 resource at Muga and variance to previous

Muga (100%)	Tonnes (Mt)	K ₂ O (%)	KCl (%)	Insolubles (%)	Δ Tonnes (%)	Δ K ₂ O (%)	Δ KCl (%)	Δ Insolubles (%)
Measured	43	11.8	17.5	12.9	144%	4%	-2%	-4%
Indicated	197	11.2	16.7	15.5	41%	-1%	-7%	8%
Total M&I	239	11.3	16.8	15.1	52%	0%	-7%	6%
Inferred	63	12.2	18.7	12.8	-43%	10%	6%	-9%
Total Resource	302	11.5	17.2	14.6	13%	3%	-3%	3%

Source: Highfield, GMP

Maiden Sierra del Perdon (SDP) economics scheduled for 1Q15 scoping study

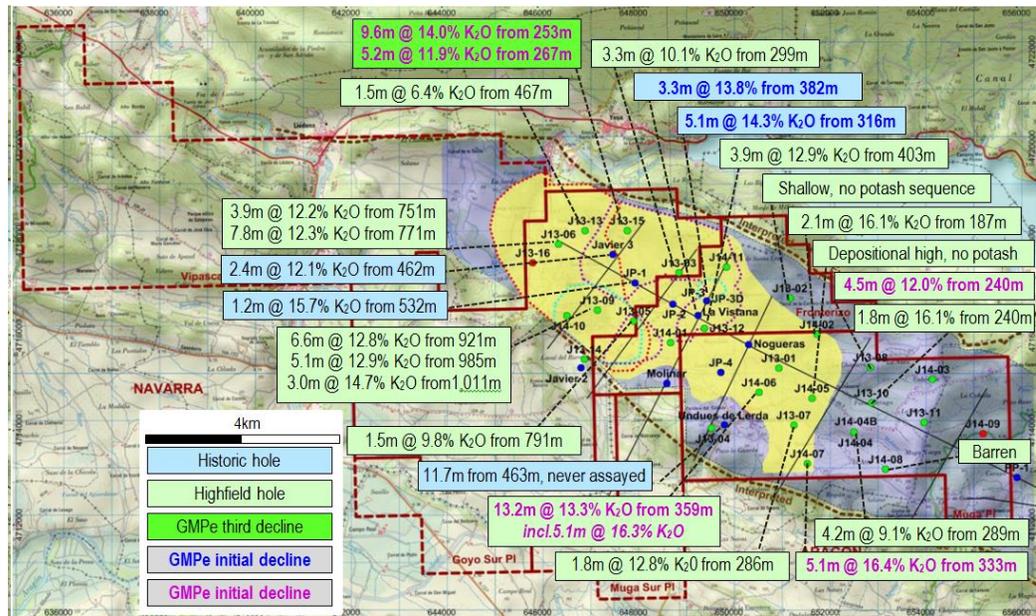
In our opinion many investors give little value to the historic SDP mine as the resource is pre-feasibility study. We think this will change in the coming weeks as the company remains on track to release a scoping study for that asset. We previously modelled 420ktpa from this smaller lower-grade resource (carnallite and sylvinitite) – we see potential for this to lift to >500ktpa, but leave our model as-is until the scoping study is released, simply rolling forward a year to lift the NPV10% from US\$350m to US\$389m. While smaller than Muga, this project is real, readily accessible to mine (another dry basin, with existing underground development), and should have low capex (we currently model US\$200m).

Muga expansion potentially adds 50% or +0.55Mtpa

After reviewing the 2014 drilling released on Muga, we now take the view that an extension to 1.6Mtpa is readily achievable with a third decline. Firstly, we think this would access material we excluded in our own DCF of 210Mt against the 256Mt estimated as the mining inventory in the

1Q15 JORC upgrade. Secondly is the physical location – below we show the drilling to date, and highlight in blue and purple text our own previously published estimate of broadly where the initial two declines will go.

Figure 2. Drilling results to date including GMPe potential +50% expansion location



Source: Highfield, GMP

Two more mines thereafter offer potential for >3Mtpa

Beyond Muga and SDP we see two other key development assets, Vipasca and Pintano. Vipasca, shown above as the westerly extension of Muga, looks to offer thick potash at similar grades to Muga, albeit dipping more steeply so the south. Similarly, Pintano, which is along strike to the SE from Muga, has an existing resource of 187Mt @ 11.2% K₂O. In both cases the resources are deeper, extending to >900m depth, and would likely benefit from a shaft. Whilst not as immediately attractive as Muga and SDP, on a world-standard, the dry host sequence, existing infrastructure, and market proximity continue to make these some of the best undeveloped resources globally. As such, beyond 2020, we still see material upside. In our opinion, this should manifest itself immediately as a strategic premium for Highfield, who now substantially controls the entire basin in this region of Spain, a truly strategic land position.

Right team to build

We met with two recent senior management appointments Alfredo L. Menendez Diaz and Michael Schlumpberger. Mr Menendez Diaz has been appointed Executive General Manager Construction and has over 30 years' experience including direct responsibility for construction, commissioning and operation of a number of mines in Spain such as the Aguas Tenidas underground copper-lead-zinc mine. Mr Schlumpberger has been appointed Executive General Manager Operations and again has over 30 years mining experience. This includes 21 years in various roles with PotashCorp, with specific experience as the GM of the 8Mtpa underground

Lanigan mine for over 3 years during which time he managed an expansion which increased production 50%. In our experience quality assets attract quality people so today’s appointments validate our view that Muga is a first class potash development asset. With the hire of first rate people with solid Spanish and underground potash development experience we think investors should be confident that Highfield is not only serious about taking Muga into production, but also that it has the skills to execute the project.

Permitting progressing steadily

The company submitted a mining licence application late last year. We went over the incredibly comprehensive document in detail on site, and to date the application appears to be progressing steadily with no objections raised. Public consultations are scheduled to take place mid-year, leaving the company on track for 4Q15 construction start. In our opinion, we see little to no risk of the permit not being granted, with endorsements and support from all impacted regions. This area of Spain is industrialised, and the mine benefits from having no open-pit, no uranium, no cyanide, and a limited tailings footprint given backfill. Bureaucracy and time is of course the critical hurdle – as such, we see every potential for a permit this year, but if a delay is experienced, we wouldn’t expect more than a quarter or two at the most.

We visited the proposed site of the plant and declines (below) – the area is largely unpopulated, and is also not visible from the important Camino trail. This compares very well against a plethora of quarries in the region, which are largely major eyesores given the propensity to mine into hillsides.

Figure 3. Site physiography near proposed plant / decline



Source: GMP

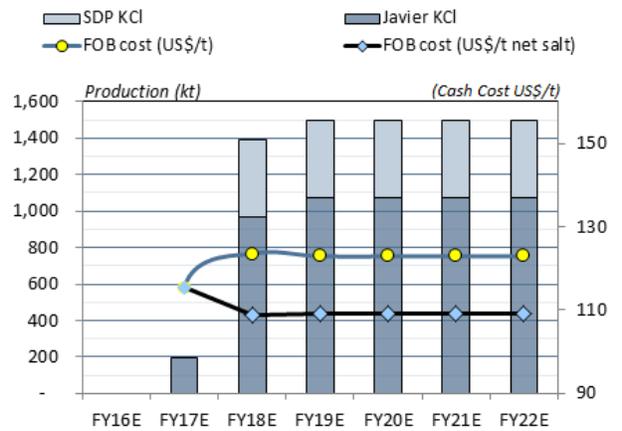
Catalysts

- 1Q15: Muga DFS
- 1Q15: SDP maiden JORC from historic data
- 2Q15: SDP scoping study

Highfield Resources (HFR AU)	Share price	A\$1.02/sh			
Analyst: Brock Salier	Market cap	A\$257m			
Year to December					
Ratio analysis	FY16E	FY17E	FY18E	FY19E	FY20E
Average shares outstanding (m)	252	252	252	252	252
EPS (US\$/sh)	(6.4)	9.3	56.8	62.1	61.3
CFO PS before wkg cap (US\$/sh)	(6.1)	10.6	61.8	68.1	67.5
FCF PS before wkg cap (US\$/sh)	(63.8)	(68.7)	14.3	26.9	64.3
Dividend (US\$/sh)	-	-	-	-	21.3
PER (x)	-	8.4x	1.4x	1.3x	1.3x
EV/EBITDA (x)	-	7.8x	1.2x	1.1x	1.1x
P/CFO (x)	-	7.3x	1.3x	1.1x	1.2x
P/FCF (x)	-	nm	5.5x	2.9x	1.2x
Income statement (yr to Dec)					
FY13A	FY14E	FY15E	FY16E	FY17E	
Revenue (A\$m)	-	-	-	-	87.7
Cost of sales (A\$m)	-	-	-	-	(30.0)
Finance income (costs) (A\$m)	0.2	0.2	(10.7)	(4.5)	(7.0)
D&A (A\$m)	(0.0)	-	-	-	(3.8)
Gross profit (A\$m)	0.1	0.2	(10.7)	(4.5)	46.9
Central SG&A (A\$m)	(1.6)	(15.6)	(15.6)	(15.6)	(15.6)
Share based payments (A\$m)	(2.0)	(1.5)	(0.8)	(0.8)	(0.8)
FX (A\$m)	0.0	0.2	0.0	-	-
Impairment / depreciation (A\$m)	-	(0.7)	-	-	-
Income Tax (A\$m)	-	-	-	-	-
Net attributed profit (A\$m)	(3.5)	(17.4)	(27.2)	(20.9)	30.4
Cash flow (yr to Dec)					
FY13A	FY14E	FY15E	FY16E	FY17E	
Revenue less cost of sales (A\$m)	-	-	-	-	57.7
SG&A + finance income (A\$m)	(1.5)	(5.4)	(15.5)	(20.1)	(22.6)
Tax and other (A\$m)	0.0	-	-	-	-
Change in working cap (A\$m)	-	-	27.4	28.7	(65.2)
CFO (A\$m)	(1.5)	(5.4)	11.9	8.6	(30.2)
Purchase of PP&E (A\$m)	(0.0)	(0.1)	(43.1)	(215.4)	(195.8)
Exploration and other (A\$m)	(1.0)	(6.7)	(10.0)	(3.0)	-
CFI (A\$m)	(1.0)	(6.8)	(53.1)	(218.4)	(195.8)
Net share proceeds (A\$m)	5.1	14.0	207.2	-	-
Debt proceeds (repayment) (A\$m)	-	-	195.8	-	-
CFF (A\$m)	5.1	14.0	403.0	-	-
Net change in cash (A\$m)	2.6	5.5	361.8	(209.8)	(226.0)
Balance sheet (yr to Dec)					
FY13A	FY14E	FY15E	FY16E	FY17E	
PP&E (A\$m)	0.1	0.1	43.2	258.6	450.6
Exploration and other (A\$m)	24.2	39.7	49.8	52.8	52.8
Total non-current assets (A\$m)	24.3	39.8	93.0	311.4	503.4
Cash (A\$m)	6.2	11.6	373.4	163.6	(62.4)
Inventory and AR (A\$m)	0.2	1.4	0.8	0.8	44.6
Total current assets (A\$m)	6.4	13.0	374.2	164.3	(17.8)
Total non-current liabilities (A\$m)	-	-	-	-	-
AP, tax and provision (A\$m)	0.3	2.0	28.7	57.4	36.1
Debt (US\$m)	-	-	195.8	195.8	195.8
Current liabilities (A\$m)	0.3	2.0	224.5	253.3	231.9
NET ASSETS (A\$m)	30	51	243	222	254
Issued capital (A\$m)	21.0	34.8	253.7	254.5	255.3
Accum'd profits & other (A\$m)	9.4	16.1	(11.1)	(32.0)	(1.6)
TOTAL EQUITY (A\$m)	30	51	243	222	254

Stock rating:	BUY	Implied return:	70%
Target price:	A\$1.75/sh	Market P/NAV:	0.21x

Year to December					
Commodity price	FY16E	FY17E	FY18E	FY19E	FY17E
Potash (US\$/t FOB Vanc.)	-	325	325	325	325
Potash (US\$/t CIF NW Eur)	-	380	380	380	380
Other data					
Basic shares (m)	252.0		12M high:	A\$1.01/sh	
Fully diluted shares (m)	341.5		12M low:	A\$0.35/sh	
Resource / Reserve Total					
Resource (M&I + Inf)	489.3Mt @ 11.4% K2O / 17.4% KCl				
Reserves (P&P)	-				
Production (100% basis)					
FY16E	FY17E	FY18E	FY19E	FY20E	
Javier production (kt)	-	199	968	1,075	1,075
SDP production (kt)	-	-	422	422	422
Total prod'n (kt)	-	199	1,390	1,498	1,498
FOB costs (US\$/t)	-	93	93	93	93
FOB costs (US\$/t ex salt)	-	115	109	109	109



Estimate share valuation					
	US\$m	NAVx	US\$m	A\$/sh	
Javier	960	0.35	336	1.28	
SDP	389	0.35	136.2	0.52	
Pintano	-	-	-	-	
Cash	19.8	0.35	7	0.03	
Cash from options	20.4	0.35	7	0.03	
Debt	-	0.35	-	-	
SG&A and central costs	(99)	0.35	(34)	(0.13)	
Valuation (fully diluted)	1,290	-	452	1.73	
Valuation sensitivities (A\$/sh) to potash price (US\$/t FOB Vancouver)					
To discount rate	US\$275	US\$300	US\$325	US\$350	US\$375
12% discount	0.90	1.13	1.35	1.57	1.79
10% discount	1.19	1.46	1.73	2.00	2.26
8% discount	1.58	1.91	2.24	2.57	2.90
To NAVx @ 8%	US\$275	US\$300	US\$325	US\$350	US\$375
0.25xNAV	0.85	1.04	1.23	1.43	1.62
0.35xNAV	1.19	1.46	1.73	2.00	2.26
0.45xNAV	1.53	1.87	2.22	2.57	2.91

Source: GMP estimates

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