

HIGHFIELD RESOURCES LIMITED

Scoping Study for Muga By-Product Project

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We say

Price

Target

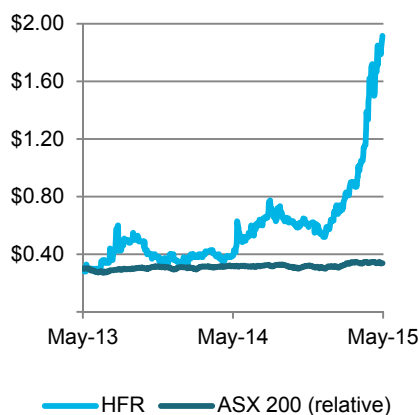
Strategic Target

BUY

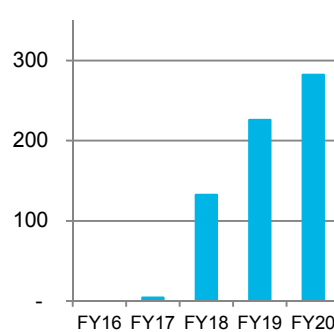
1.92 2.85 6.00

We believe the Scoping Study for Muga's by-product project supports our thesis that Highfield could be a takeover target within 3-6 months. In our view HFR could grow to a \$2-3bn company within ~3 years, or a \$5-6 stock, if it can bring Muga into production and trade on similar multiples to its producing peers. We also believe HFR could have its foot on a **district** of low-capex, high-margin potash production. Highfield is our top pick in the ASX resource space for 2015.

HFR SHARE PRICE (A\$)



MUGA EBITDA (A\$M)



Potash producers typically trade on 8-10x EV/EBITDA

COMPANY DATA

Enterprise value	A\$638m
Diluted market cap**	A\$660m
Diluted shares**	344m
Free float*	51%
12 month price range	0.38-1.94
GICS sector	Materials
* EMR Capital ~20%, Management ~29% (FD)	
** Diluted for 50m performance shares and 43.5m options	

IMPLIED RETURN

Total expected return	48%
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SCOPING STUDY FOR MUGA'S BY-PRODUCTS

The Scoping Study for the by-products from Muga outlined the construction of a conventional crystallisation plant for US\$124m to process the slimes from Muga to produce 135ktpa of granular K62 potash plus 260ktpa of high-purity industrial vacuum salt (NaCl). The key financial outcomes include operating margins of ~65%, an NPV of US\$222m and a compelling post-tax IRR of 33%.

A \$2-3BN COMPANY WITHIN ~3 YEARS?

If Highfield can bring its flagship Muga project into production and trade on similar multiples to its producing peers, we believe the company's EV could grow from the current A\$640m to \$2.4-3bn over the next ~3 years. Importantly, two of the *key* de-risking milestones are due within the next ~6 months, namely permits and funding.

HEIGHTENED RISK OF TAKEOVER IN NEXT 3-6 MONTHS IN OUR VIEW

Now that Highfield has released its DFS for Muga, we believe the company is at an increased risk of takeover, given the *substantial* potential value uplift if it can bring Muga into production, as well as the fact the company has four other pipeline projects in the same basin. We believe the risk of takeover is likely to increase *materially* on receipt of permits for Muga.

SCOPING STUDY FOR MUGA BY-PRODUCTS

On 1 May 2015, HFR released a Scoping Study on to upgrade the by-products produced by Muga. Importantly, the project does *not* add to the initial capital required to develop Muga, but represents a potential project enhancement, which is likely to be funded from a combination of cash flow and potentially funds from end users in the form of offtake finance.

The important point to note here is that ***this project enhancement project for Muga may also be applicable to Highfield's other four pipeline projects***. The Muga by-product project added ~15% to the NPV of the project and we believe a similar uplift in value may be possible for each of Highfield's other four pipeline projects.

- **Processing:** Conventional crystallisation processing
- **Final products:** Granular K62 potash + industrial high-purity vacuum salt (NaCl)

Project Metrics	Scoping Study	Commentary
Initial Capex	€118m / US\$124m	Includes 20% contingency, 24-month construction period
C1 Costs (including sustaining capex)	€66/t / US\$69/t (both products)	Includes 20% contingency No royalties in Spain
Plant Throughput	1.3mtpa	Processing slimes tailings from Muga
Grade	11.5% KCl, 21% NaCl	
Recovery	90% KCl, 95% NaCl	
Production	135ktpa KCl + 260ktpa NaCl	K62 granular potash + High-purity vacuum salt
Initial Mine Life	~24 years	Based on reserves only (for Muga)

Source: Company, Blue Ocean

Project Financials	Scoping Study	Commentary
Potash Price (KCl)	~US\$350/t FOB Vancouver	As per potash industry expert, Integer ¹ .
Salt Price (NaCl)	US\$125/t Pasajés	Allows US\$15-35/t in transport costs
€/US\$ FX	1.05	Spot €/US\$ is 1.12
Post-tax IRR	33%	We estimate a 22% IRR at spot potash of US\$305/t and spot EUR/USD of 1.12
NPV ₁₀	€211m / US\$222m	
EBITDA 1 st full year	€53m / US\$56m	Represents ~65% EBITDA margins

Source: Company, Blue Ocean

¹ Discounted by 5% for sales commissions and a further 5% for potential contract discounts. Assumes no premium pricing for higher-grade K62 product which may ultimately attract premium pricing.

Other Highlights

Process Flow Sheet: Designed by GEA Messo PT, a global engineering firm with over 60 years experience in the design and construction of crystallisation plants and which has designed more than 1,200 crystallisation plants worldwide.

Capex and opex estimated on an owner-operator basis with the exception of transport.

The global salt market is ~300mtpa, ~85% of which is made up by premium industrial salts.

Salt prices for major salt producers in North America and Europe over the long term have averaged US\$140-160/t. The company has assumed a selling price of US\$125/t at Pasajés which allows US\$15-35/t in transport costs to customer. The East Coast of the US is one of the company's target markets given the high prices in the region.

KEY CHANGES TO OUR FORECASTS

The main changes to our forecasts since last publish comprise:

- incorporating the Scoping Study for the Muga by-product project into our forecasts and applying a 60% discount (+A23c)
- adding HFR's fifth project, Izaga, to our valuation (+A5c)
- updating our forecasts for the A\$21.2m cash balance at end March (from A\$25m at end Dec) (-A1c)

These changes result in 10% increase in our price target from \$2.60 to \$2.85.

PRICE TARGET & RATING

Our \$2.85 price target represents an implied return of 48%, and is predominately based on a:

- 40% risk-adjusted NPV for Muga (DFS)
- 60% risk-adjusted NPV for Sierra del Perdon (Scoping Study)
- 60% risk-adjusted NPV for the Muga by-product project (Scoping Study)

STRATEGIC TARGET

To derive our longer-term \$6.00 Strategic Target we assume Highfield successfully brings Muga into production and achieves EBITDA of ~A\$300m (based on current spot prices).

We also assume the stock re-rates as it makes the transition to production and begins to trade in line with other potash producing peers on an EV/EBITDA multiple of ~8-10x.

We see significant upside potential to our Strategic Target if Highfield can bring its four pipeline projects up the development curve and use the cash flow generated from Muga to bring these projects into production.

While there is considerable work required to confirm the viability and economic returns of these projects, **we see potential, longer-term for our Strategic Target to eclipse \$10.00 per share**. We have provided more detail on this thesis in our video presentation published on 15 April 2015, available via the link below².

KEY RISKS

Highfield is exposed to all the normal risks associated with developing and operating mining projects, including permitting, funding and construction risk.

Once in production, the company's revenue will be predominately derived from the sale of potash, and fluctuations in the potash price as well as the EUR/USD exchange rate could impact the company's cash flow, profitability and share price.

Highfield's share price also carry an embedded Spanish sovereign risk as the company's development projects are based in Spain.

² <http://blueoceanequities.com.au/highfield-investment-thesis/>

VALUATION & FINANCIALS

Stock Details

Recommendation:	Buy	Share Price	\$1.92
Target	\$2.85	52 Week High	\$1.94
Risk-Adjusted NAV	\$2.87	52 Week Low	\$0.38
Implied Return	48%		

Enterprise Value	\$638m
Diluted MCap	\$660m
Diluted Shares	344m
Free Float	51%
Avg Daily Value	\$0.4m

Macro Assumptions	FY16E	FY17E	FY18E	FY19E	FY20E
Exchange Rate (€/US\$)	1.09	1.11	1.13	1.16	1.18
Potash Price FOB Van (US\$/t)	305	305	305	305	305

Profit & Loss (A\$m)	FY16E	FY17E	FY18E	FY19E	FY20E
Revenue	-	17	225	380	656
Operating Costs	-	(7)	(85)	(147)	(265)
Operating Profit	-	11	140	233	391
Corporate & Other	(6)	(6)	(6)	(6)	(8)
Exploration Expense	-	(0)	(1)	(1)	(2)
EBITDA	(6)	5	133	226	382
D&A	-	(1)	(12)	(21)	(44)
EBIT	(6)	4	121	205	338
Net Interest Expense	1	(9)	(20)	(28)	(37)
Pre-Tax Profit	(4)	(5)	101	178	300
Tax	-	-	(18)	(44)	(75)
Minorities	-	-	-	-	-
Underlying Profit	(4)	(5)	83	133	225
Significant Items (post tax)	-	-	-	-	-
Reported Profit	(4)	(5)	83	133	225

Cash Flow (A\$m)	FY16E	FY17E	FY18E	FY19E	FY20E
Operating Cashflow	(6)	5	134	227	383
Tax	-	-	(5)	(32)	(62)
Net Interest	1	(9)	(20)	(28)	(37)
Net Operating Cash Flow	(4)	(4)	109	168	284
Exploration	-	(1)	(3)	(3)	(5)
Capex	(176)	(181)	(188)	(318)	(285)
Acquisitions / Disposals	-	-	-	-	-
Other	-	-	-	-	-
Net Investing Cash Flow	(176)	(182)	(191)	(321)	(289)
Equity Issue	165	6	9	10	-
Borrowing / Repayments	61	189	14	154	15
Dividends	-	-	-	-	-
Other	-	-	-	-	-
Net Financing Cash Flow	227	195	23	164	15
Change in Cash Position	46	10	(58)	11	9
FX Adjustments	-	-	-	-	-
Cash Balance	64	75	19	30	39

Balance Sheet (A\$m)	FY16E	FY17E	FY18E	FY19E	FY20E
Cash & Cash Equivalents	64	75	19	30	39
Other Current Assets	2	3	3	3	3
PP&E	176	360	544	857	1,118
Exploration & Development	51	52	56	59	64
Other Non Current Assets	0	0	0	0	0
Total Assets	293	491	621	949	1,224
Debt	61	252	272	434	459
Other Liabilities	1	1	14	27	41
Net Assets	230	238	335	488	725

Ratio Analysis		FY16E	FY17E	FY18E	FY19E	FY20E
Diluted Shares	m	389	389	389	389	389
EPS - Diluted	Ac	(1.2)	(1.3)	21.4	34.5	57.9
P/E	x	n.m.	n.m.	9.0x	5.6x	3.3x
CFPS - Diluted	Ac	(1.2)	(1.0)	28.3	43.5	72.9
P/CF	x	n.m.	n.m.	6.8x	4.4x	2.6x
FCF - Diluted	Ac	(46.7)	(45.4)	(15.8)	(32.3)	8.1
P/FCF	x	n.m.	n.m.	n.m.	n.m.	23.7x

Dividends	Ac	-	-	-	-	-
Dividend Yield	%	-	-	-	-	-
Payout Ratio	%	-	-	-	-	-
Franking	%	-	-	-	-	-

Enterprise Value	A\$m	657	836	913	1,063	1,079
EV/EBITDA	x	(113.9x)	177.4x	6.9x	4.7x	2.8x
ROE	%	(2%)	(2%)	25%	27%	31%
ROA	%	(2%)	(1%)	13%	14%	18%
Net Debt / (Cash)	€m	(2)	177	253	403	419
Gearing (ND/(ND+E))	%	(1%)	43%	43%	45%	37%
Gearing (ND/E)	%	(1%)	74%	75%	83%	58%

	P&P Reserves		M&I Resources		Inferred		
	mt	% K ₂ O	mt K ₂ O	mt	% K ₂ O	mt K ₂ O	
Muga	146.0	13.2	19.3	239	11.3	27	8
Sierra del Perdon	-	-	-	42	10.7	4	4
Vipasca	-	-	-	-	-	-	-
Pintano	-	-	-	-	-	-	21

M+I+I (mt K₂O): 64.3

Earnings Sensitivity			FY17E	FY18E	FY17E	FY18E
		A\$m	A\$m	%	%	
Potash Price	US\$/t +10%	5	18	19%	18%	
Exchange Rate	€/US\$ -10%	4	11	12%	11%	

Valuation	Discount	Stake	€m	A\$m	A\$/sh
Muga	40%	100%	504	721	2.10
Muga by-product project	60%	100%	55	78	0.23
Sierra del Perdon	60%	100%	93	132	0.39
Vipasca	80%	100%	22	32	0.09
Pintano	80%	100%	13	18	0.05
Izaga	80%	100%	13	18	0.05
Exploration			35	50	0.15
Corporate & Other			(60)	(85)	(0.25)
Debt			-	-	-
Cash			15	21	0.06 P/NAV
Net Asset Value			690	986	2.87 0.67x

Source: IRESS, Company data, Blue Ocean estimates

OPERATIONAL ASSUMPTIONS & FCF BY MINE

Operational Summary						
		FY16E	FY17E	FY18E	FY19E	FY20E
Muga (excl by-products)						
Tonnes Processed	mt	-	0.2	3.0	5.0	6.3
Head Grade (K60)	% KCl	-	21.3%	21.3%	21.3%	21.3%
Recovery	%	-	83%	83%	83%	83%
Potash Production (K60)	kt KCl	-	42	528	890	1,112
All-in Sustaining Cost	€/t	-	151	126	121	120
AISC Margin	%	-	47%	55%	56%	55%
Sierra del Perdon						
Tonnes Processed	mt	-	-	-	-	2.5
Head Grade (K60)	% KCl	-	-	-	-	20.0%
Recovery	%	-	-	-	-	83%
Potash Production (K60)	kt KCl	-	-	-	-	416
All-in Sustaining Cost	€/t	-	-	-	-	137
AISC Margin	%	-	-	-	-	49%
Vipasca						
Tonnes Processed	mt	-	-	-	-	-
Head Grade (K60)	% KCl	-	-	-	-	-
Recovery	%	-	-	-	-	-
Potash Production (K60)	kt KCl	-	-	-	-	-
All-in Sustaining Cost	€/t	-	-	-	-	-
AISC Margin	%	-	-	-	-	-
Pintano						
Tonnes Processed	mt	-	-	-	-	-
Head Grade (K60)	% KCl	-	-	-	-	-
Recovery	%	-	-	-	-	-
Potash Production (K60)	kt KCl	-	-	-	-	-
All-in Sustaining Cost	€/t	-	-	-	-	-
AISC Margin	%	-	-	-	-	-
Group Summary						
		FY16E	FY17E	FY18E	FY19E	FY20E
Potash Production (K60)	kt KCl	-	42	528	890	1,528
All-in Sustaining Cost	€/t	-	151	126	121	125

Macro Assumptions						
		FY16E	FY17E	FY18E	FY19E	FY20E
Exchange Rate	€/US\$	1.09	1.11	1.13	1.16	1.18
Potash Price FOB Van	US\$/t	305	305	305	305	305
Net Potash Price*	US\$/t	317	317	317	317	317
Realised Potash Price	€/t	290	286	280	274	269

FCF Contribution						
	US\$m	FY16E	FY17E	FY18E	FY19E	FY20E
Muga (excl by-products)						
Revenue		-	13	168	282	353
Operating Costs		-	5	63	109	139
Sustaining Capex		-	0	5	9	12
Sustaining Exploration		-	1	2	2	2
Corp Overheads		4	4	5	5	5
All-in Sustaining Margin		(4)	3	92	157	195
Growth Capex		133	135	84	22	-
Sierra del Perdon						
Revenue		-	-	-	-	132
Operating Costs		-	-	-	-	57
Sustaining Capex		-	-	-	-	8
Sustaining Exploration		-	-	-	-	1
Corp Overheads		-	-	-	-	1
All-in Sustaining Margin		-	-	-	-	64
Growth Capex		-	-	50	205	-
Vipasca						
Revenue		-	-	-	-	-
Operating Costs		-	-	-	-	-
Sustaining Capex		-	-	-	-	-
Sustaining Exploration		-	-	-	-	-
Corp Overheads		-	-	-	-	-
All-in Sustaining Margin		-	-	-	-	-
Growth Capex		-	-	-	-	191
Pintano						
Revenue		-	-	-	-	-
Operating Costs		-	-	-	-	-
Sustaining Capex		-	-	-	-	-
Sustaining Exploration		-	-	-	-	-
Corp Overheads		-	-	-	-	-
All-in Sustaining Margin		-	-	-	-	-
Growth Capex		-	-	-	-	-
Group Summary						
	US\$m	FY16E	FY17E	FY18E	FY19E	FY20E
Revenue		-	13	168	282	485
All-in Sustaining Cost		4	10	75	125	225
All-in Sustaining Margin		(4)	3	92	157	260
Growth Capex		133	135	134	227	191
Growth Exploration		-	-	-	-	-
All-in Margin		(138)	(133)	(42)	(70)	69
Corporate						
	US\$m	FY16E	FY17E	FY18E	FY19E	FY20E
Cash Tax		-	-	4	24	46
Other Items		-	-	-	-	-
FCF pre Debt Service		(138)	(133)	(46)	(93)	23
Net Interest on Debt		(1)	7	15	20	28
Debt Drawdown / (Repayment)		47	142	10	115	11
FCF post Debt Service		(90)	3	(50)	1	6
New Equity/Dividends						
	US\$m	FY16E	FY17E	FY18E	FY19E	FY20E
Proceeds from Shares/Options		125	5	7	7	-
Dividends Paid		-	-	-	-	-
Change in Cash		35	7	(43)	8	6
Cash Balance		48	56	14	22	29

Source: Company data, Blue Ocean estimates

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