Red Hill Iron Ltd
(RHI $1.50) – Speculative Buy, Initiation of Coverage

EUROZ SECURITIES LIMITED

Analyst: Greg Chessell

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Date: 12th September 2014

Investment Case:

Red Hill Iron (RHI) is low risk exposure to the Baosteel led WPIOP. We believe RHI is an opportunity in potential for further consolidation in the Pilbara.

The Baosteel-Aurizon takeover of Aquila Resources (AQA) implied greater certainty into the value in RHI's stake in the Red Hill Iron Ore JV (RHIOJV), which forms a large part of the West Pilbara Iron Ore Project (WPIOP).

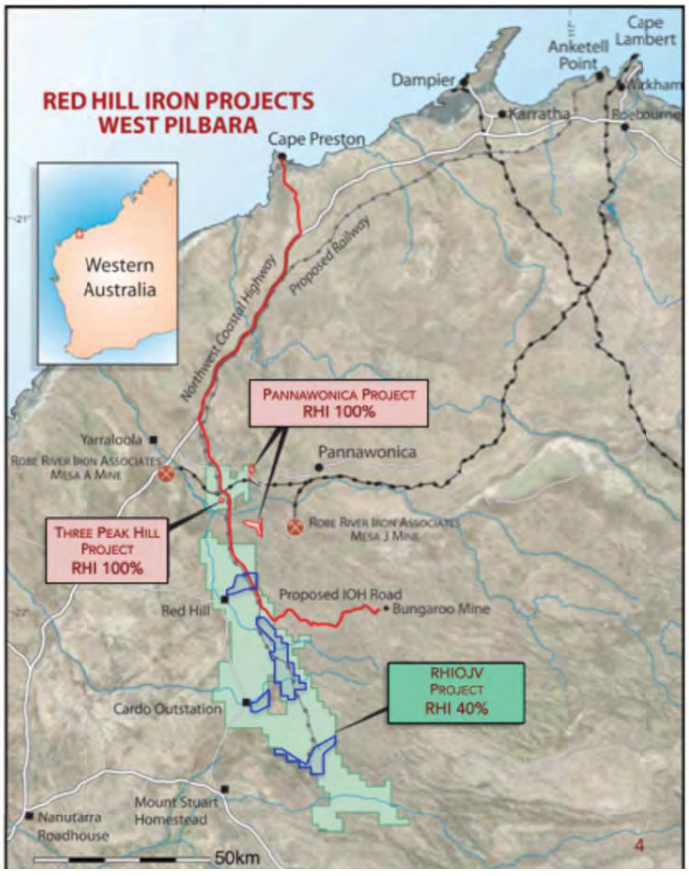
The AQA takeover signalled that the WPIOP has a high likelihood of proceeding, especially given the motive of Baosteel, as a consumer, to see lower iron ore prices in the long run, and its Chinese SOE ownership capable of adequate funding capacity.

RHI has significant leverage on the WPIOP through its well structured JV interest, where RHI is carried to production, and then can elect to retain either a low risk royalty or a higher risk more leveraged equity interest. In either scenario RHI is not obliged to invest capital.

The RHIOJV represents up to 84% of the total WPIOP Ore Reserves and therefore cannot be ignored by the WPIOP partners.

RHI is controlled by well known mining investors Josh Pitt and Neil Tomkinson who have a track record in delivering value for shareholders eg Forrestania Gold and Dalrymple Resources.

We value Red Hill Iron at $4.25/sh.



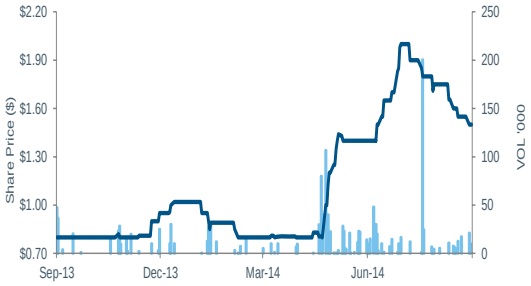
Source: Red Hill Iron announcement

Red Hill Iron	Year end 30 June
Share Price	**1.50 A$/sh**
Issued Capital	
Fully Paid	49.4 m
Options @$0.99	0.5 m
Total Diluted	49.9 m
Market Capital'n	$74 m
Enterprise Value	$73 m
Cash	$1 m
Debt	$- m

Directors	
N Tomkinson	Exec Chair
J Pitt	NE Dir
G Strong	Exec Dir
P Ruttledge	Co Sec

Shareholders	
Wythenshawe & Assoc	27.2%
Baosteel-Aurizon	17.6%
Brisbane Inv	8.2%
Acorn	6.4%
Yandal Inv	4.0%

Share Price Chart



Disclosure

Euroz Securities declares that it is engaged as corporate advisors to Red Hill Iron, and may receive fees for these advisory services.

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Valuation:

We value RHI at $4.25/sh.

The basic premise is that RHI's royalty option has a reasonable degree of certainty since the Baosteel-Aurizon takeover of Aquila Resources.

The NPV of a potential royalty stream is $151m risk adjusted. This assumes an iron ore price received of A$70/t FOB, discount rate 7.5% after tax, risk adjusted to 75% for 289mt of RHIOJV Ore Reserves, and 50% for the 86mt Ore Reserve at Kens Bore East, out of a total WPIOP Ore Reserve of 445mt.

Additional small nominal value is assigned to:

- Potential for production and/or ore reserve uplift within the RHIOJV - $20m;
- The option to elect to retain a 20% equity interest - $20m
- The option to market RHI's equity share of production exclusively - $5m;

In context, the Baosteel-Aurizon takeover of Aquila valued AQA's 50% stake in the WPIOP at ~$450m (other asset values were cash ~$500m and other assets ~$450m for total $1.4b). It is worth reinforcing that RHI's interest has Nil capital & funding risk.

RHI's Pannawonica Project is nominally valued at $15m. This is broadly consistent with the $0.35 - $0.50/t of Ore Reserve ascribed by BCI to IOH's Buckland Project at the time the offer was made.

ASSET VALUATION	A$m	A$/sh
Royalty - RHIOJV	126	2.52
Royalty - RHIOJV-KBE	25	0.50
Rsv & Prod'n upside	20	0.40
20% equity opt	20	0.40
Exclusive market opt	5	0.10
Pannawonica	15	0.30
Quarry	1	0.02
Investments	0	0.00
Cash	1	0.01
Total	**212**	**4.25**

Source: Euroz

RHI's valuation sensitivity to assumed iron ore price is relatively low, assuming other variables unchanged.

RED HILL IRON - VALUATION SENSITIVITY	
Iron Ore Price Assumed	**Valuation Outcome**
62% Fe index	
US$115/t	$4.80/sh
US$95/t	$4.25/sh
US$80/t	$3.70/sh

Source: Euroz

In reality the intrinsic value of RHI is more linked to the likelihood of the WPIOP to proceed. We argue Baosteel's motivation for the WPIOP to proceed is less influenced by the iron ore price of the day, but more to do with the existing oligopolistic structure of seaborne iron ore trade.

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Euroz Comments:

WPIOP & Red Hill Iron Ore JV (RHIOJV)

Red Hill Iron is unique and is a relatively low risk exposure to the 30mtpa West Pilbara Iron Ore Project (WPIOP). WPIOP is owned equally by Baosteel-Aurizon and AMCI(IO) through API Mgt Pty Ltd.

Greater certainty on the value of the RHI assets has recently been evident. In our view the Baosteel led takeover of Aquila Resources, completed in July 2014, signalled that the WPIOP is likely to proceed.

Baosteel, a Chinese SOE and a large consumer of iron ore, is motivated not only by the usual project financial return and risk objectives, but also to invest in new iron ore supply to encourage downward price pressure, in our view. Further enabling the development, Baosteel is expected to bring substantial funding capability to the WPIOP.

Red Hill Iron is a meaningful stakeholder in the WPIOP through its interest in the RHIOJV:

- RHIOJV Ore Reserves comprise a 65% of the total WPIOP Ore Reserves, 289mt out of 445mt in total.
- A further 86mt, or 19% of total WPIOP Ore Reserves at Kens Bore East is disputed between RHI and API Mgt. KBE is the subject of a Supreme Court WA action initiated by RHI. It is possible that the new ownership of API Mgt may seek to resolve the matter amicably.

RHI, currently 40% owner of the RHIOJV is carried, and can elect to convert to either a 20% contributing interest; or to a 2% FOB royalty, at any time up until 1st product sales. API Mgt, currently 60% is earning up to 80% of the RHIOJV.

RHI's total attributable interest in WPIOP Ore Reserves, upon completion of the API Mgt earn-in and subject to the KBE dispute, amounts to 75mt of the total 445mt (ie 20% x (65%+19%) x 445mt).

Red Hill Iron has leverage over API Mgt. RHI's options on its RHIOJV interest cause significant uncertainty, complexity and value leakage for API Mgt. We believe this may cause them to seek to acquire RHI's interests to reduce cost, simplify and expedite development.

The WPIOP Definitive Feasibility Study is currently being revised. Aurizon (AZJ) has recently released an update in which the AMCI(IO) partners, AMCI 51% and POSCO 49% have acceded to the Infrastructure Framework Agreement (IFA) previously contemplated by Baosteel and Aurizon. The IFA has also been amended to include revised milestones. Key milestones include:

- 30 Sep'14 -Development assumptions to be received by AZJ from APIJV;
- 31 Oct'14 - Integrated Project schedule (mine + infrastructure);
- 31 Mar'15 – Infrastructure tariff estimates +/- 25%;
- 31 Oct'15 – Infrastructure tariff estimates +/- 15%;
- 11 Jan'16 - Expiry of exclusivity period.

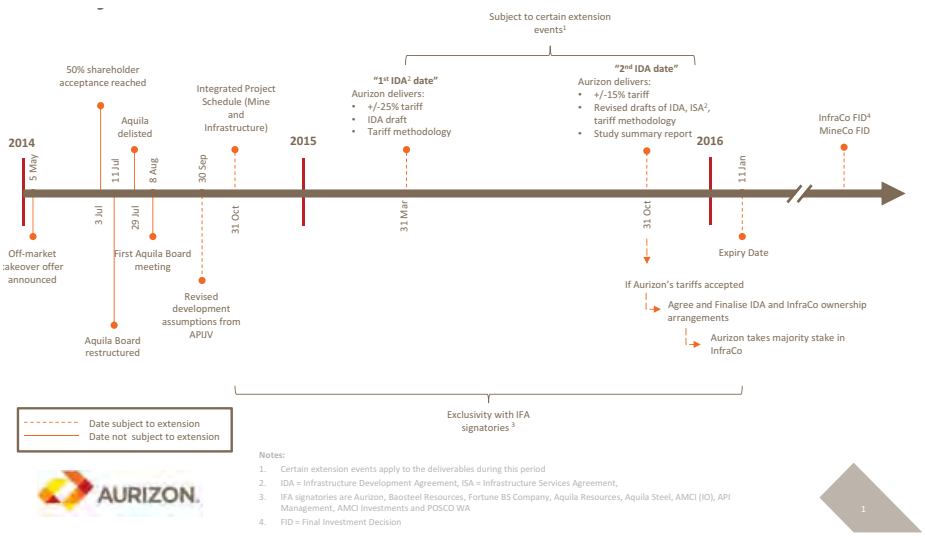
In essence under the IFA, Aurizon has a period of exclusivity until Jan'16 to deliver a commercially attractive and scalable infrastructure solution for Baosteel, POSCO and AMCI, by the applicable milestone dates. If it cannot then Baosteel, POSCO and AMCI have the right to terminate and seek other options to progress the WPIOP. Please refer to following chart.

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Aquila Resources and West Pilbara Infrastructure Project timeline



Source: Aurizon announcement 11 Sep 2014

Our valuation of the royalty, the option with most certainty in our view, is small relative to the size of the investment required by API Mgt (royalty value $235m (unrisked) v's $7.4b project capex). In other words the cost to acquire RHI is small relative to the project scale of investment required, especially in context of the enhanced returns and simplification to be achieved.

RHI's 2% FOB royalty option has a higher value relative to the 20% carried option in a low iron ore price environment, like at present.

The value in the 2% FOB royalty option is a linear relationship with iron ore price received, ie no leverage. Whereas the value in the 20% carried interest is related to project margin, ie leverage to both iron ore price received and total costs.

RHIOJV PRODUCTION SCENARIO		
Prod'n - WPIOP total	mtpa	30
Prod'n - RHIOJV exc KBE	mtpa	19
Prod'n - RHIOJV-KBE	mtpa	6
Iron Ore price ass'd (Fe62%)	US$/t	95
Iron Ore price rec'd (FOB)	A$/t	70
Royalty Cashflow (2%FOB)	$m pa	35

Source: Euroz

The 2% FOB royalty option equates to ~$1.40/t of ore sold from the RHIOJV under our long run iron ore price assumption of US$95/t basis Fe62% index. This amounts to ~US$35m pa, including Kens Bore East and assuming pro-rata production from RHIOJV within the 30mtpa overall WPIOP production rate.

The royalty income, if RHI so elects, requires Nil capital investment, has Nil management risk and negligible market risk, and is available from 1st ore sales from the RHIOJV.

RHI's 20% interest in the RHIOJV is carried into production, at which time its share of capital will thereafter be repaid out of 80% of cashflow from the project, and RHI will retain access to 20% of the cashflow. RHI will assume Nil capital risk on its 20% stake, but will be at risk of margin squeeze due to either cost or price pressure.

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RHI's 20% interest is limited to the mine and process plant, and does not extend to the logistics infrastructure assets of the WPIOP. Total capex was last estimated at $7.4b, with infrastructure comprising $6.0b of this. We estimate RHI's attributable share of capex might be $215m upon completion, basis pro-rata RHIOJV ore reserves, including $24m spent to date for its share.

RHI is not required to commit to its preferred option in the RHIOJV until 1st product sales. This allows it effectively a put option on the iron ore price and execution of the project being done cost effectively.

WPIOP financial returns will be driven by maximising volume usage of infrastructure. The project proponents will be motivated to maximise production rate, and to grow the ore reserve inventory from source mines within the WPIOP, such as the RHIOJV, and also from unrelated 3rd parties seeking access to the infrastructure. Obviously growth in mineable inventory and production rate from the RHIOJV will grow RHI's intrinsic value.

RHI can elect to export and market its share of production separately, or co-mingle with the entire WPIOP production. This option causes uncertainty and management issues for the WPIOP. It is important that ore from all sources is blended to maximise the "on-spec" tonnage potential from the entire project resource.

Other interests in the WPIOP worthy of note are:

- AMCI(IO), a 50% owner of API Mgt, is owned 51% by AMCI & 49% by POSCO. The intentions of both shareholders is not clear. We presume AMCI(IO)'s relationship with Baosteel-Aurizon is on better terms than the Aquila and AMCI(IO) relationship that saw the project stalled for 2+ years.
- Cullen Resources (CUL) has a contributing 30% interest in the Mt Stuart JV. This JV hosts some 70mt of WPIOP Ore Reserves, or 16% of total. CUL is a possible corporate target, however less strategically important than RHI because it is contributing its share of funding to the JV, and its share of project inventory is relatively small. Baosteel-Aurizon own 9.7% of CUL and interests associated with Red Hill Iron directors own 17.8% of CUL.
- Helix Resources (HLX) has diluted from a 30% JV interest to an undisclosed royalty interest in the Yalleen JV. We don't see HLX as a corporate target because its interest is a relatively minor portion of the WPIOP, currently with Nil Ore Reserves from a Mineral Resource of 84mt.
- DeBeers is understood to hold a royalty interest (undisclosed) over production from Mt Elvire which also includes the Kens Bore East Ore Reserve of 86mt.

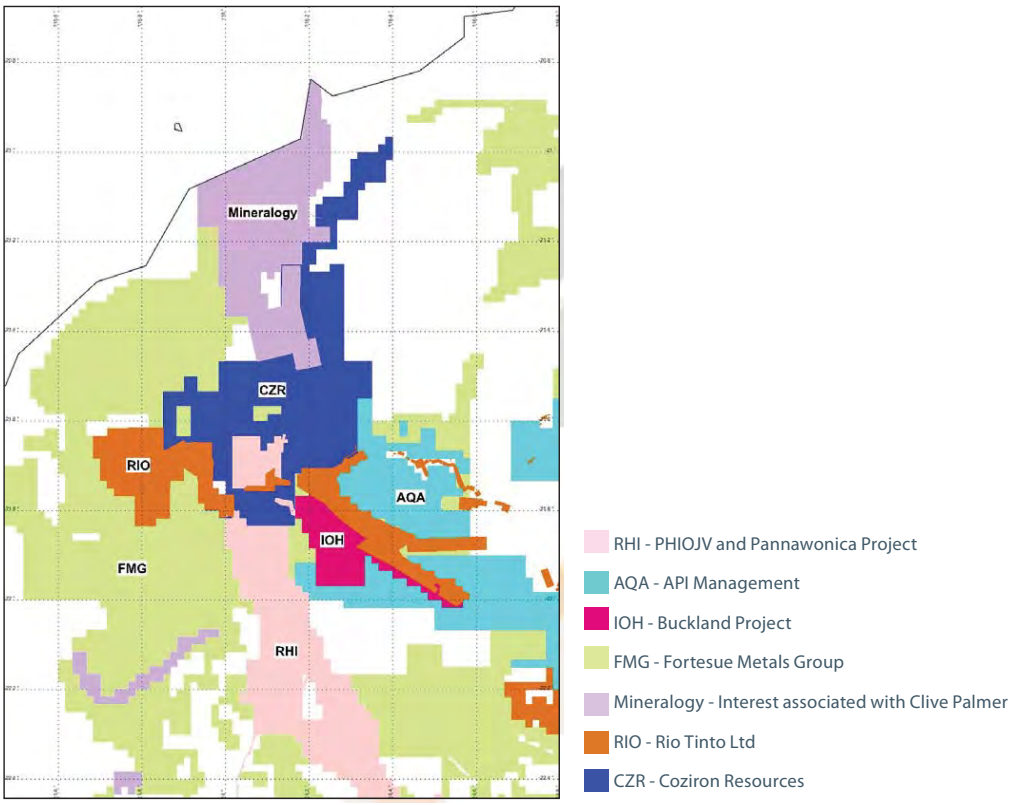
The following map shows major tenement holders in the West Pilbara area.

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Source: Coziron Resources Ltd presentation

Red Hill Iron also owns the nearby Pannawonica Iron Ore Project (100%) which has recently had a pre-feasibility study completed on a 4mtpa development from a 29mt Ore Reserve. While this is low grade it does offer some attractive blending characteristics including low Phos level, good blast furnace performance, and the ore lies above the water table.

RHI's Pannawonica Project has synergy with Iron Ore Holdings' (ASX:IOH) proposed Buckland Project which has a 134mt Ore Reserve, with capex of $744m for an 8mtpa development. RHI will seek to utilise IOH's proposed 200km road and trans-shipping port infrastructure.

Conversely API Mgt will be keen to see production from both projects, Buckland and Pannawonica, utilise its proposed WPIOP rail-port infrastructure to aid capital amortisation. API Mgt already owns a resource at Buckland Hills too, adjacent to IOH's Buckland project, which it has earmarked for WPIOP Stage II.

IOH is currently the subject of scheme of arrangement to merge with BC Iron (ASX:BCI). The value of the Buckland project under the offer from BCI is $50m - $70m in our view, consistent with views publicly expressed by BCI management. This equates to $0.35/t - $0.50/t of ore reserve.

BCI undoubtedly sees the opportunity to commercialise Buckland through access to the proposed WPIOP infrastructure. BCI is unlikely to make the $744m investment in alternative competing infrastructure as proposed by IOH in our view. BCI has a track record of low risk investment to commercialise expediently and to maximise dividend returns. This leads us to think Buckland may eventually be developed through a JV between BCI-IOH and Baosteel. Nevertheless, the BCI-IOH proposed infrastructure remains an option should the iron ore price increase significantly, allowing a greater development risk appetite.

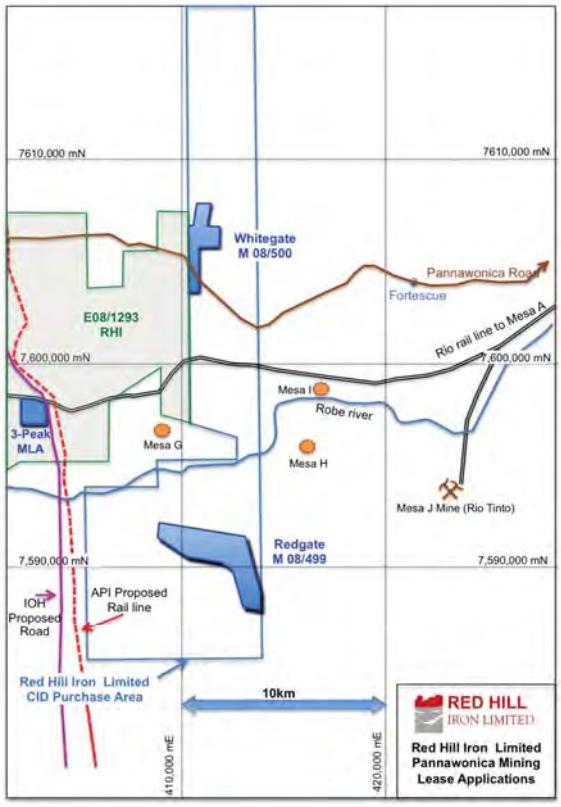
Development of Buckland will increase the likelihood of development of RHI's Pannawonica Project due to its proximity and complementary ore characteristics.

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Pannawonica Iron Ore Project - Comments



Source: Red Hill Iron announcements

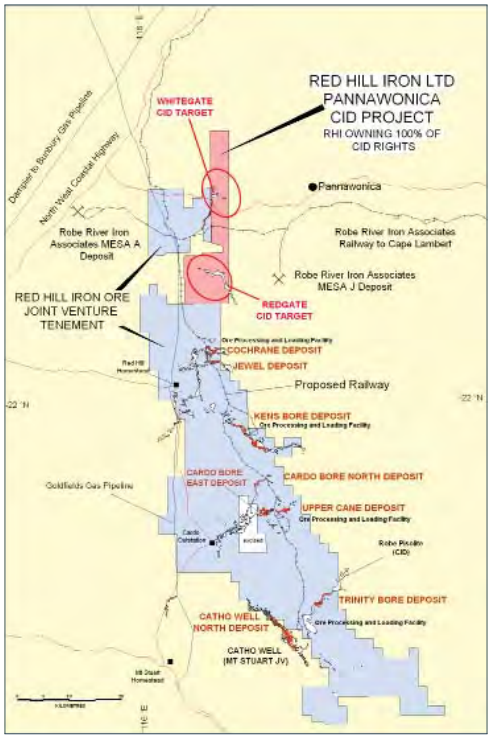
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Project Background:



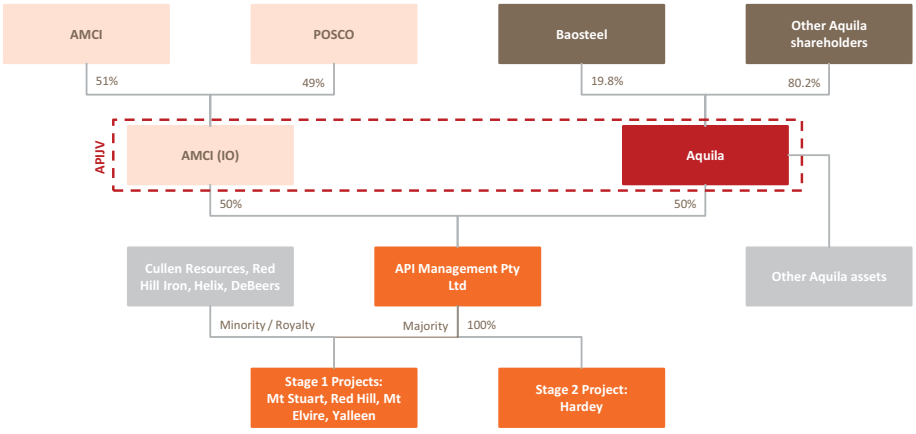
Source: Red Hill Iron Website

West Pilbara Iron Ore Project

Red Hill Iron Ltd (ASX:RHI) holds a 40% interest (potentially reducing to 20% upon 1st sales of iron ore) in the Red Hill Iron Ore JV (RHIOJV). The RHIOJV is the centrepiece of the West Pilbara Iron Ore Project (WPIOP).

The WPIOP is owned by API Mgt Pty Ltd, which is owned equally by Baosteel and Aurizon Ltd (50%) and AMCI(IO) (50%). Baosteel & Aurizon (85/15 respectively) jointly acquired their stake in July 2014 through the takeover of Aquila Resources (ASX:AQA) at $3.40/sh cash.

WPIOP ownership structure



Note: 1. Aquila Resources is now owned Baosteel 85% and Aurizon 15%.
2. Mt Elvire and Yalleen do not currently contribute Ore Reserves to WPIOP stage 1.
Source: Aurizon ASX presentation.

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Key details of the WPIOP are:

Prefeasibility Study delivered May 2008;

Definitive Feasibility Study delivered June 2010, with key outcomes:

- Production rate 30mtpa;
- Ore Reserve: "Stage I" 445mt (JORC P&P);
  - Incl. RHIOJV 289mt, KBE 86mt, Mt Stuart JV 70mt
- Mineral Resources: 2,233mt (JORC M+I+I);
  - Incl. RHIOJV 472mt, Mt Stuart JV 98mt, KBE undisclosed, other prospects 1663mt.
- Simultaneous mining of 8 CID deposits 30km to 85km SW of Pannawonica, with W:O ratio 1.1:1, predominantly above water table;
- Product: West Pilbara Fines: 57.2% Fe, 3.4% Al_2O_3, SiO_2 5.6%, P 0.07%, LOI 8.5%;
- Heavy Haul railway from central processing facility to port 280km;
- Deepwater port at Anketell Pt, with train unloader, stockpiles, blending and shiploading facilities;
- Channel 20km long to allow capesize class of 250kdwt fully laden;
- Port, initial capacity up to 115mtpa, capacity expandable to 350mtpa.

Cost Update delivered October 2012 (effective July 2012):

WPIOP Costs	
Capital Expenditure, base case	
Port	$2.5b
Rail	$2.1b
Mine	$1.0b
Management	$0.3b
Contingency	$0.7b
Owners Cost	$0.8b
Total Project Cost	**$7.4b**
Operating costs $24.20/dmt, FOB, pre-royalty.	

Source: Euroz

An optimisation study determined that outsourcing of infrastructure and services could eliminate $2.4b of capex, with a consequential increase in operating costs by $15/dmt, relative to the base case.

Approvals: Key umbrella approvals, WA State Environmental Protection Act and Federal Environmental Protection and Biodiversity Act approvals have been obtained following a thorough EIS by API Mgt. Secondary approvals are expected to be received when required.

A Pre-feasibility Study into a Stage II development of the Hardy Iron Ore Project was completed in May 2011. It contemplated production rate of 10mtpa at operating costs of $22/t FOB, pre-royalty, and capex of $1.6b capex. The key feature includes 150km of new rail to connect with Stage I rail.

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WPIOP - Mineral Resources and Ore Reserves

Mineral Resources	ownership	mt	Fe	SiO2	Al2O3	P	LOI
			%	%	%	%	%
Mt Elvire (CID)	API 100%	1264	55.7	7.1	3.5	0.07	9.1
RHIOJV	API 60%, RHI 40%	472	56.6	6.0	3.8	0.07	8.6
Mt Stuart JV	API 70%, CUL 30%	98	55.0	7.1	3.2	0.04	10.3
Yalleen	API 100%	84	57.2	5.3	3.8	0.06	8.6
Mt Elvire (DID)	API 100%	101	54.4	11.9	3.6	0.08	5.8
Hardey (BID)	API 100%	151	60.8	4.0	2.4	0.13	5.9
Innawalley	API 100%	63	58.8	3.9	4.6	0.16	6.4
Project Total		2233					
Ore Reserves	**ownership**	**mt**	**Fe**	**SiO2**	**Al2O3**	**P**	**LOI**
			%	%	%	%	%
RHIOJV incl KBE	API 60%, RHI 40%	375	57.5	5.5	3.5	0.08	
Mt Stuart JV	API 70%, CUL 30%	70	54.8	7.2	3.2	0.04	
Project Total		445	57.1	5.8	3.4	0.07	8.6

notes:

RHIOJV - RHI 40% reducing to 20% upon 1st ore sales (API Mgt 60% to 80%).

RHIOJV - Kens Bore East disputed, comprises 86mt of total 375mt in Ore Reserve.

Mt Stuart JV - API 70%, CUL 30% contributing

Ore Reserves attributable - Total 445mt, split AQA 175mt, AMCI(IO) 175mt, RHI 75mt, CUL 21mt.

Source: Euroz, Aquila Resources, Red Hill Iron

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Pannawonica Iron Ore Project Background

RHI recently completed a Pre-Feasibility Study on its 100% owned CID Ore Reserves that comprise the Pannawonica Iron Ore Project.

The deposits lie within 10km of RIO's Mesa A railway and API Mgt's proposed railway and IOH's proposed haul road.

The study envisages production of 4mtpa with Continuous Miners, processed through a crush & screen plant, and hauled a distance of 123km on road to a new port to be established at Cape Preston East, over a life of 8 years.

The project has a CID Mineral Resource of 62.5mt grading 53.4% iron, from which an Ore Reserve of 29.3mt grading 54% iron with 4.8% alumina, 8.1% silica and 0.05% phosphorous. Some 17.6mt of the Ore Reserve occurs at Redgate and 11.7mt at Whitegate deposits.

Pannawonica Iron Ore Project - Mineral Resources and Ore Reserves

Mineral Resources	ownership	mt	Fe	SiO2	Al2O3	P	LOI
			%	%	%	%	%
Redgate	RHI 100%	48	53.3	8.9	5.2	0.05	9.0
Whitegate	RHI 100%	15	54.0	8.2	4.5	0.04	9.3
Project Total		62	53.4	8.7	5.1	0.05	9.0
Ore Reserves	**ownership**	**mt**	**Fe**	**SiO2**	**Al2O3**	**P**	**LOI**
			%	%	%	%	%
Redgate	RHI 100%	18	54.0	8.2	5.0	0.05	
Whitegate	RHI 100%	12	54.1	8.2	4.5	0.04	
Project Total		29	54.0	8.2	4.8	0.05	

Source: Red Hill Iron annoucement

The iron grade is lower than most such ores currently being mined in the Pilbara however the reserves have the benefit of being dry with a water table well below the planned base of mining and the life-of-mine stripping ratio is low at 1.4:1. The Ore Reserve has relatively high levels of alumina and silica but the phosphorous level and the level of the other deleterious minerals are low.

Metallurgical testwork on the CID ore from both Redgate and Whitegate concluded that Pannawonica ore was acceptable feed for blending in standard Chinese sinter plants at a 15% of feed rate and that the physical characteristics of the ore enhanced sinter yield and quality with improved Reducibility at 900^{O}C and better low temperature Reduction Degradation properties at 500^{O}C.

A native title agreement has been reached with the relevant claimant group. Mining leases have been granted over both deposits and also a nearby hard rock quarry.

Capital costs are estimated at $55m, which assumes 3rd party infrastructure access and contract service providers. Operating costs are estimated at $46/t FOB, pre-royalty.

The Three Peaks proposed quarry is a rare source of outcropping hard porphyry rock in the local vicinity. This will be useful as railway ballast and road base aggregate.

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Corporate

Red Hill Iron Ltd's largest shareholder block is Josh Pitt and Neil Tomkinson, as to 27.2%.

Pitt and Tomkinson have a track record of delivering value for shareholders. Both were directors of Forrestania Gold and Dalrymple Resources which were acquired by LionOre in seperate transactions.

RHI 1st listed on the ASX in Feb'06 with 33.3m shares on issue after raising $4m at $0.20/sh. RHI has issued just 16m new shares since then, raising a further $21m.

Other substantial shareholders are Baosteel-Aurizon at 17.6% (through the Aquila takeover), Brisbane Inv 8.2%, Acorn Capital 6.4% and Yandal Inv. 4.0%.

Top 20 Shareholders

		as at 14th September 2014	
	Shareholders	**Shares (m)**	**%**
1	Perth Capital Pty Ltd	8.16	16.53
2	Penoir Pty Ltd	6.74	13.63
3	Elohpool Pty Ltd	5.19	10.50
4	HSBC Custody Nominees Australia Ltd	2.03	4.11
5	Brisbane Investments II Ltd	2.03	4.10
6	Brisbane Investments II Ltd	2.03	4.10
7	Yandal Investments Pty Ltd	2.00	4.05
8	Zero Nominees Pty Ltd	1.35	2.72
9	Timothy Boddington	1.33	2.70
10	Aquila Resources Ltd	1.29	2.60
11	Australian Mineral Investors Pty Ltd	1.17	2.36
12	Flexiplan Management Pty Ltd	1.09	2.20
13	HSBC Custody Nominees Australia Ltd	0.99	2.01
14	National Nominees Limited	0.89	1.80
15	Maxigold Holdings Pty Ltd	0.87	1.76
16	BT X Pty Ltd	0.66	1.33
17	JP Morgan Nominees Australia	0.62	1.25
18	UBS Wealth Management Aust. Nominees	0.60	1.21
19	Rupert Clarke & Co Pty Ltd	0.57	1.16
20	Strong Investment Pty Ltd	0.51	1.02
	Total	**40.23**	**81.14**

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