FROM THE CAPITAL

Standing out in the crowd

Junior coal and iron ore firms did not hitch their wagons to China and are succeeding when others are not

John Robertson

Universal Coal and Cascade Resources are making money from coal and iron ore despite markets treating them with the same disdain as less successful mine developers.

Outside the mining majors, coal and iron ore investments have remained friendless. In industries relying heavily on economies of scale for their competitiveness, small operators have been thought unlikely to have the right stuff. There is a risk in applying this rule that some babies are thrown out with the bathwater.

Since the first quarter of 2011 the Cascade Resources and Universal Coal share prices have both fallen 80-90%. The share-price movement has not been materially different from outcomes across the sector in which the median fall among ASX-listed stocks has been 87%.

Universal Coal was listed in December 2010 to fund and develop coal deposits in South Africa. In the June quarter of 2015 the company reached its targeted 2.8Mt/y run-of-mine production at its Kangala mine in the Witbank coalfield about 65km east of Johannesburg.

The Roodekop prospect, east of the Kangala operating mine and containing shallow defined resources of the same Permian age coal seams mined at Kangala, sits adjacent to the New Clydesdale Colliery where production started in 1949. The mine had been placed on care and maintenance in 2013 enabling Universal to buy it from Exxaro Resources for A$17 million.

The company expects to begin open-pit production at New Clydesdale by the end of 2015 having received government approval for the transfer of mining rights in June. Production will be ramped up from 2Mt/y to 2.8Mt/y with a planned underground development. Another resource at Brakfontein, between Kangala and New Clydesdale, is expected to produce at 1.2Mt/y beginning sometime in 2017.

Cash flow from operations in the June quarter reached A$8.5 million, leaving the company well set to reach $28-30 million a year in the near term before production is pushed higher over the subsequent two or three years.

With a current market value of just $52 million (US$38.5 million), there are strong grounds for expecting a market reappraisal

Universal's South Africa coal operations are low-cost and profitable

of the value proposition as confidence grows about the ability of the company to continue to deliver against its targets. So far, its track record has been among the best available to investors in the sector, reinforcing the likelihood that the company will meet its established targets and set itself for potentially longer-term growth.

One of the potential attractions of Universal Coal for investors is the absence of the China exposure. The company is establishing itself as a low-cost coal producer taking advantage of growing coal-fired power use in South Africa. The company's positioning offers investors a unique opportunity to diversify their portfolios geographically. They are able to retain an exposure to coal sales while bypassing the depressed international thermal and metallurgical coal markets.

The company will be able to take advantage of more buoyant seaborne coal market conditions, should they arise in the future, to rebalance sales between domestic and overseas markets depending on where the best returns are available.

In an industry in which companies have been struggling to source adequate development capital, leaving investors sometimes exposed to prolonged delays and highly dilutive deals, Universal accessed a $55 million funding package in June. The package will give the company what it needs for the New Clydesdale development, as well as enough to refinance the existing project debt used for the Kangala colliery.

Crusader Resources is also tapping into the growth of one of the world's developing economies and, in doing so, offering a way to gain iron ore exposure without a dependence on Chinese steel production.

Crusader also shares the advantage with Universal of operating in a country with a declining exchange rate. Since the beginning of 2014, the South African rand has fallen by 15% against the US dollar. At the same time, the Brazilian real has dropped 26% to blunt the edge of the fall in the US dollar price of iron ore.

Crusader's Posse iron ore mine is 30km east-northeast of Belo Horizonte in Minas Gerais, an established iron ore mining and steel manufacturing region. Crusader experienced some lengthy delays in having the project approved after acquiring it for $3.4 million in 2007. The company only received a full mining licence in January 2013.

Sales have declined in the past year as a consequence of weakening economic conditions, but the company has pushed costs down. It reported unit operating costs of $14.60/t in the March 2015 quarter. In the 12 months ended December 2014, the company reported a gross profit of $6.3 million on sales revenue of $16.9 million.

Crusader will never threaten the market shares of the iron ore majors. As an investment, it will not suit larger investors. It will remain a niche producer of a high quality product for the local market. Interest lies in its revaluation potential as it demonstrates its operational capabilities and capacity to differentiate itself from the pack.

Unfortunately, from a portfolio construction standpoint, Crusader's shift in emphasis toward gold risks blurring this particular investment attribute despite the high quality of its Juruena and Borberema gold deposits in Brazil. A well-reasoned argument for an iron ore investment based on a sound operating approach can be easily derailed by a gold exposure driven by global financial market influences.

Universal Coal and Cascade Resources have shared the fate of many smaller stocks pummelled by capital markets seemingly unimpressed by track records delivering profitable mines. Regrettably for the industry, there is still reluctance on the part of investors and their advisers to seek out companies differentiating themselves from the primary macro trends driving the bulk of the sector.

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