

25 June 2009

Coal Sector

Junior Coal: Playing leverage and M&A

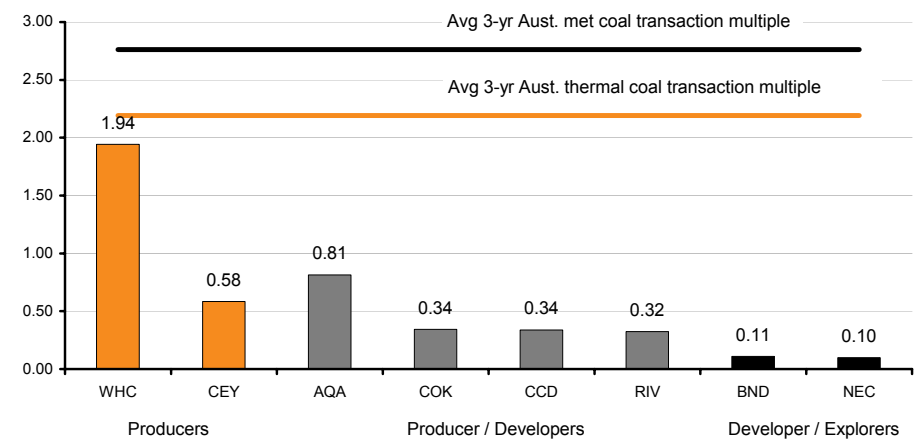
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- Centennial Coal (CEY)
- Aquila Resources (AQA)
- Riversdale (RIV)
- Caledon Resources (CCD)
- Cockatoo Coal (COK)
- Bandanna Energy (BND)
- Northern Energy (NEC)

Despite the late 2008 drop-off in demand, consolidation and strategic investment in the coal sector has continued unabated. Following Yanzhou's bid for FLX, we highlight stocks we believe will attract speculative interest among the Developers.

Current EV / Resource tonne multiples of potential coal targets



Source: Iress, ABN AMRO Morgans, Priced at 25/8/09

The barriers are getting higher for new players

Since the beginning of the mining 'boom,' the barriers to entry for aspiring coal players have become almost insurmountable, driven by rising regulatory hurdles, capital cost inflation, competition for resources and growing constraints on access to debt and capital markets. These barriers are compounded by the need for new rail and port infrastructure (GAPE, Surat Rail, Wiggins et al) to provide a means for many new projects to get product to market. Given this infrastructure will be largely funded by the users, the juniors coal companies need to find strong financial backers, via JV partners, in order for their projects to participate in the export capacity to be delivered by the new railways and ports.

Finding big backers is the key for the juniors – BND, NEC

In this environment, the name of the game for the juniors is in discovering, proving and developing assets to a point where they can attract JV interest from strategic investors/ off takers to help fund development, or to excite potential predators (e.g. Waratah).

Profitable production will help the developers - AQA, RIV, CCD, COK

The producer/developers are at the stage of demonstrating their ability to achieve consistent production that is cashflow positive through the price cycle. This cash won't fully fund these companies' growth projects but it will serve to build market confidence and equity value, helping to attract JV partners and helping to secure debt and equity needed to fund mine and infrastructure. Nonetheless, the market tends also to trade these stocks as asset plays.

How to play the sector for leverage and M&A speculation

In our view we highlight; 1) Whitehaven Coal as a standout takeover candidate among the producers with similarities to FLX in the form of strong production growth, a stake in NCIG and majority owners who we believe are ultimately sellers; 2) Aquila Resources offers excellent exposure to two of our preferred commodities in coking coal and iron ore, albeit more leveraged by asset base than earnings in the near term; and 3) NEC, BND and COK as for providing the most leverage to a recovery in thermal coal markets as well as offering an option on any of their projects moving from concept to reality longer term.

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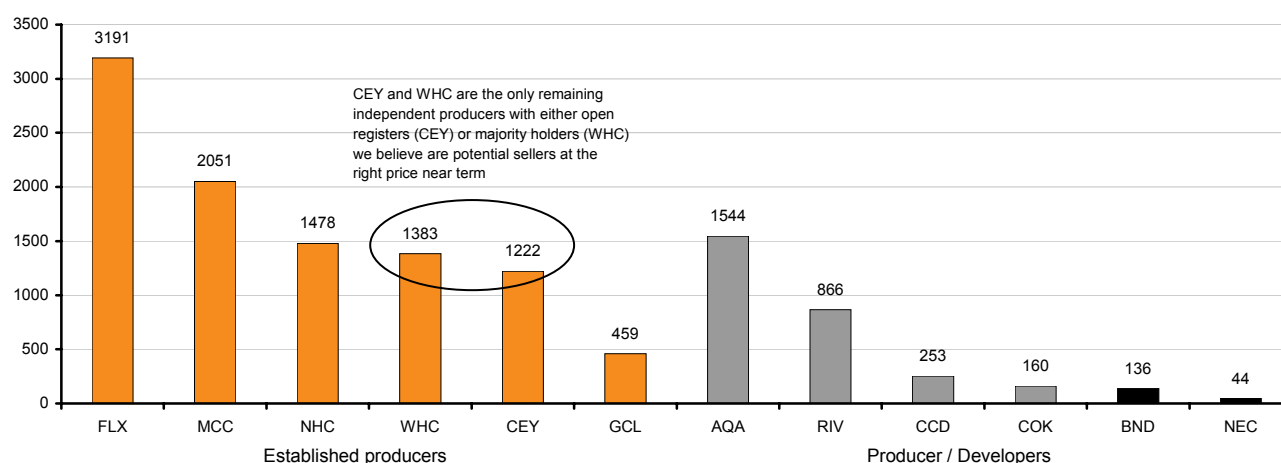
Recent corporate activity

Despite the late 2008 drop-off in coal demand, consolidation and strategic investment in the sector has continued unabated.

- Feb-May 09 – Gloucester Coal / Whitehaven attempt to merge;
- Jun-09 – Noble successfully bids for control of Gloucester at A\$7.00ps securing 87.7%;
- May-09 – Waratah announces MOU with China Metallurgical Group re development of its 30Mtpa, A\$6b Galilee Basin project;
- Aug-09 – Whitehaven sells another 7.5% of Narrabri to a Korean consortium for A\$125m;
- Jun-09 – Gujarat NRE Minerals makes A\$20m bid for WA explorer REY Resources (ongoing)
- AQA, CCD, NEC – Currently soliciting JV interest or possible sale (ongoing); and,
- Aug-09 – Chinese Miner Yanzhou Coal makes agreed A\$3.54b cash bid for Felix (ongoing)

We expect consolidation to continue domestically and strategic interest to accelerate as coal markets continue to improve, funding frees up and security of supply concerns again come to the forefront of the coal customers' thinking. Ongoing Chinese buying of Australian coal, and their acquisition of assets like Felix will only exacerbate these concerns in our view.

Chart 1: Coal Sector Enterprise values (A\$m)



Source: IRESS, Company data, ABN AMRO Morgans

Whitehaven, Centennial next in line?

The mid-cap sector is fast running out of independent producers that are also clean targets.

Whitehaven Coal (WHC) appears to us to be the standout takeover candidate among the established producers. The company produces c3.5Mtpa of export thermal and PCI coal from established mines in the Gunnedah Basin and is developing the Narrabri thermal coal project, targeting exports of 6Mtpa from FY10 via an efficient longwall operation.

WHC has similarities with FLX in that; 1) it is strongly growing export volumes via a flagship project; 2) it has attracted strategic investors as the asset level 3) it holds a strategic (11%) stake in NCIG port infrastructure at Newcastle; and 4) we believe its majority shareholders are sellers at the right price. We are yet to formally cover WHC but value the company at ~A\$4.00ps and would envisage a take-out value well in excess of this level in order to satisfy the majority shareholders.

WHC's Narrabri project has already attracted Japanese, European and Korean investors at the asset level, similar to FLX's Moolarben project

As strategic interest in the coal sector continues, we believe the market will again build corporate premiums into these stocks whether M&A is realised or not.

Centennial Coal (CEY) is another established producer we expect will attract corporate speculation due mainly to its drive to grow export volumes above 5Mtpa and its clean register. See our report 'A potential target? 19/8/09' for our current view on the company.

Working against CEY is the fact their growth in exports is lower and slightly longer dated than for WHC. The fact that the NSW gov't owned power generators rely heavily on CEY for fuel (CEY supplies c46% of NSW's powergen coal) may also be off-putting for potential predators with a preference for more lucrative export production.

Market focus turning again to the Juniors / Developers – A snapshot

Table 1: Coal developers – Company basics

Company	MCap (A\$m)	Coal Resources & Type	Description of Assets
Aquila Resources (AQA)	1631	1678Mt of mainly coking coal in QLD	Owns a 50% non-operating stake in the Isaac Plains open cut mine in the Bowen Basin in JV with Vale, ramping up to design capacity of 2.8Mtpa of coking and thermal coal. Owns 50% of the Eagle Downs project in JV with Vale where the feasibility study has confirmed viability a single longwall producing up to 4.6Mtpa of hard coking coal with expansion potential via two longwalls to 8.0Mtpa for A\$977m. Other assets include another +1bt of HCC coal Resources in the Bowen Basin, 649Mt of Iron Ore Resources in the West Pilbara, and Manganese exploration acreage in South Africa.
Riversdale (RIV)	1156	2669Mt of Coking and Thermal coal in Mozambique	Owns and operates the Zululand Anthracite colliery in South Africa producing c700ktpa into domestic and export markets. Developing the Benga Coal Project in Mozambique in JV with Tata Steel. Targeting staged development of up to 10.6Mt of ROM capacity, producing 3.3Mtpa of hard coking + 2Mtpa of export thermal coal by 2014 subject to the expansion of rail, port and river barging infrastructure in Mozambique. Tata acquired 35% of Benga and 40% of the hard coking coal offtake for A\$100m in 2008.
Caledon Resources (CCD)	260	748Mt of mainly Coking coal in QLD	Dual listed with its primary listing on AIM. Operates the historically difficult Cook mine in the Bowen Basin which it acquired for A\$45.6m in August 2006. Cook is targeting production of 450-500kt in 2009 at relatively high costs for CCD to date. Progressing evaluation of the nearby 342Mt Minyango coking coal deposit and is also a member of the WICET consortium of coal companies which is the preferred developer of the A\$4bn Wiggins Island Coal Terminal in Gladstone.
Cockatoo Coal (COK)	180	466Mt of mainly Thermal coal in QLD	Owns a 62.5% stake in and is operator of the Baralaba PCI/thermal mine purchased from Peabody for A\$52.5m in late 2008. Targeting 420kt of production in 2009 with exploration upside at Baralaba North although production costs have been high to date. Developing the 155Mt Woori export thermal coal project in the Surat Basin and is also a member of WICET.
Bandanna Energy (BND)	143	1248Mt of mainly Thermal coal in QLD	BND listed into difficult coal markets in late 2008. Currently undertaking exploration for export quality thermal coal resources in the Bowen Basin where it has already defined 665Mt of JORC Resources across 3 projects. Also hold a large tenement position in the Galilee Basin hosting 982Mt of thermal coal with additional potential to +1.5bt. In JV with AMCI who is funding A\$25m of drilling to earn 50%.
Northern Energy (NEC)	58	441Mt of mainly Thermal coal in QLD including a small coking coal project	Aiming to develop the Colton hard coking coal project near Maryborough targeting 0.5Mtpa of production for export via Bundaberg in the near term – An ML application is planned for the current quarter. Progressing evaluation of the 244Mt Elimatta thermal coal project in the Surat Basin, which also hosts 106Mt of Marketable Reserves. NEC is also evaluating the Yamala thermal coal project near Emerald which hosts 190Mt of thermal coal and is also a member of the WICET consortium.

Source: Company data, ABN AMRO Morgans, Note: Resources are on an attributable basis

How the Juniors / Developers compare

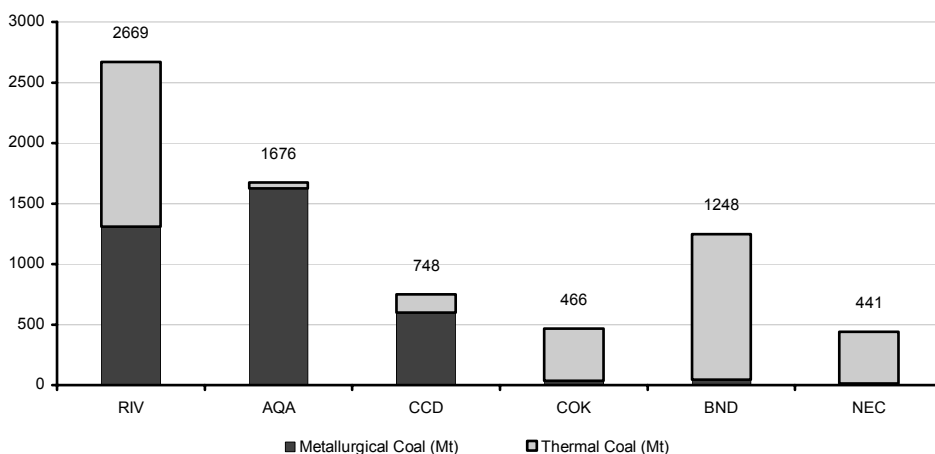
Leverage by resource base & product type

The Resource bases of both Aquila and Riversdale into the billions of tonnes, with large proportions of higher value coking coal, explain these companies' A\$1-2bn Market Caps. We emphasise that the volumes of coal that any of these companies can ultimately get to market is the true driver of long term value. However, large resource bases are seen by speculative investors as ways to leverage exposure to the commodity.

So we would expect both **Aquila** and **Riversdale** to provide the best sentiment driven leverage to strong coking coal markets, while **Northern Energy**, **Bandanna**, and **Cockatoo** provide most upside leverage to thermal.

Chart 1 breaks down each company's defined coal Resources into higher value coking coal versus lower value thermal coal.

Chart 2: Total JORC Coal Resources of the emerging Developers / Juniors (Mt)



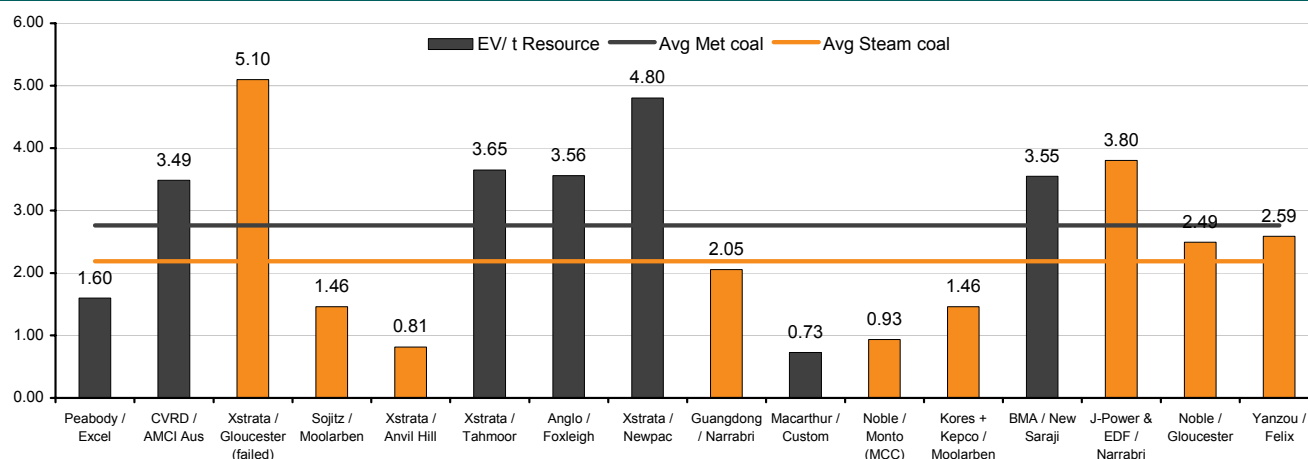
Source: Company data, ABN AMRO Morgans - Note: Resources are on an attributable basis

EV per tonne of resources

We fully acknowledge the limitations in using EV/ tonne of Resource metrics when analysing companies in production. However the metrics are useful in comparing projects and companies against the market and against recent transactions.

Chart 3 shows a 3-year history of transactions for Australian coal assets on an A\$ Enterprise Value per Resource tonne of attributable resource basis.

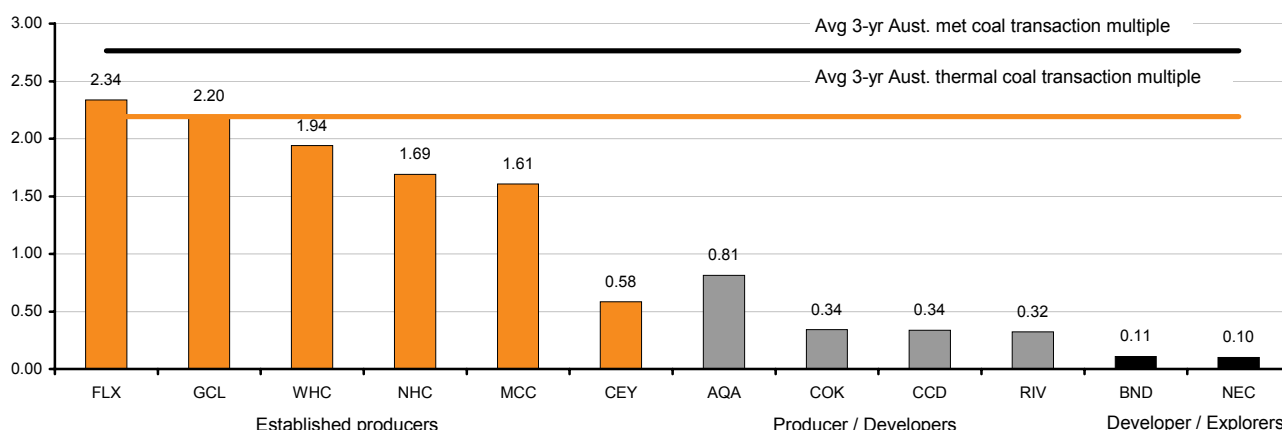
Chart 3: EV per Resource tonne of recent Australian coal market transactions (A\$/t)



Source: Company data, ABN AMRO Morgans Note: Resources are on an attributable basis

Chart 4 ranks current EV/ tonne multiples of the sector against the average transaction multiples.

Chart 4: EV per Resource tonne of ASX listed coal companies vs recent transactions (A\$/t)



Source: Company data, ABN AMRO Morgans – Note: Calculations apply Resources on an attributable basis, AQA’s iron ore resources have been converted to equivalent coal tonnes at a ratio of 3:1 Iron ore: Coal, equivalent to usage ratio.

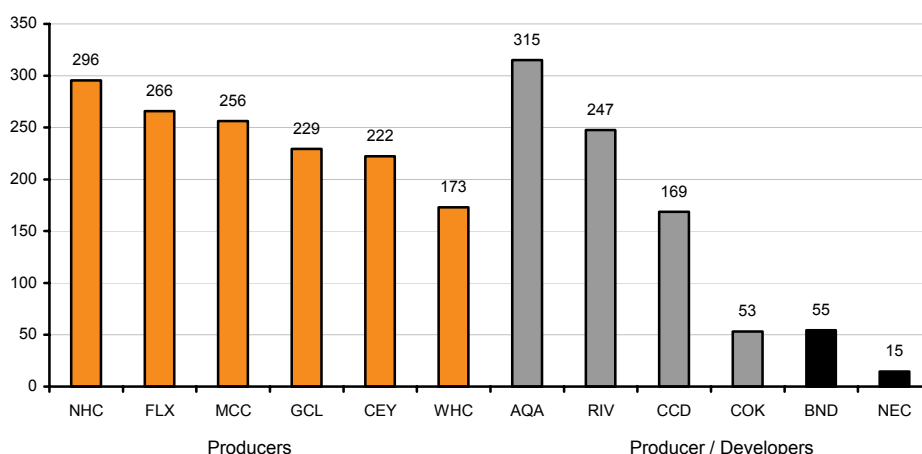
Among the established producers, both **Felix Resources** and **Gloucester Coal** are or were recently subject to takeover offer. **Centennial** is an outlier on this measure by virtue of its very large resource base which is somewhat captive to the domestic markets. Domestic pricing is locked in until at least 2012 when contracts roll off and prices are up for re-negotiation.

At the speculative end, **Northern Energy (NEC)** and **Bandanna Energy (BND)** rate in orders of magnitude below their Producer/Developer peers which is to be expected with these companies still some way from production. We would argue the current market caps of these companies (A\$58m and A\$143m respectively) imply an ‘option value’ of either of these companies taking any of their projects from concept to reality. In that scenario the upside for each is orders of magnitude higher than current levels.

Leverage by aspirational production targets (EV / production tonne)

Ranking the developers on an EV per forecast tonne of production basis is the most subjective of the measures we’re looking at in this exercise. For each company, we have estimated an ultimate attributable production rate assuming all the companies 5-year timeframe projects come to fruition. For the developers, we’ve also assumed each will have to sell down exposure to each asset in the order of 50-70% to facilitate project funding. Note we’re drawing some long bows here, given that some projects remain in the exploration stage.

Chart 4: EV per forecast production tonne on a 5-year basis (A\$/Mtpa)



Source: Company data, ABN AMRO Morgans - Note: Production is on an attributable basis

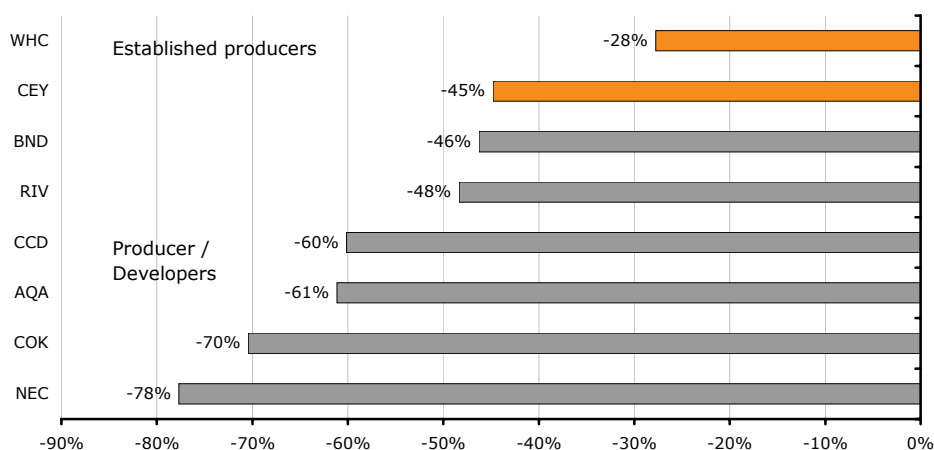
Aquila looks like the most expensive outlier on this metric however we must emphasise that our calculations exclude any value ascribed to AQA's 649Mt of Iron Ore, Manganese and exploration assets.

Again the developers in **Northern Energy, Bandanna Energy and Cockatoo Coal** would appear to offer the most upside, subject to their projects moving through the evaluation, feasibility, funding, infrastructure and construction phases to become realities.

Leverage by historical share price performance

On a simple comparison of current prices versus where these stocks peaked at the height of the 2008 run in coal markets, we see most leverage on offer in **Northern Energy, Cockatoo Coal, Aquila** and **Caledon**. We also note that Bandanna has a limited trading history, essentially listing into a severe coal market downturn in September 2008.

Chart 5: Total JORC Coal Resources of the emerging Developers / Juniors

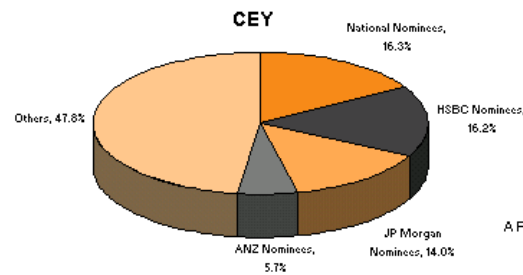


Source: IRESS, Company data, ABN AMRO Morgans

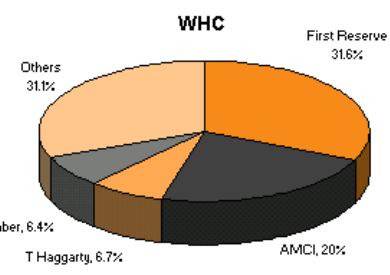
Ownership structures

Chart 6: Ownership breakdowns

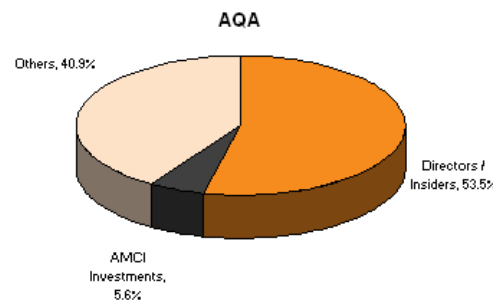
CEY has the most open register of the established producers



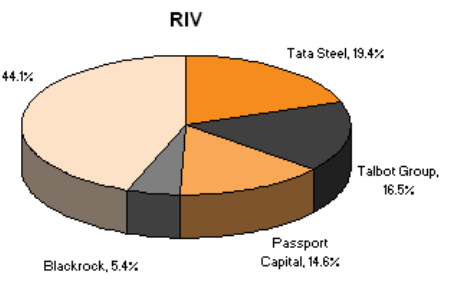
NEC has the most 'open' register of the juniors / developers with only the Directors standing in the way of a potential predator with a modest holding.



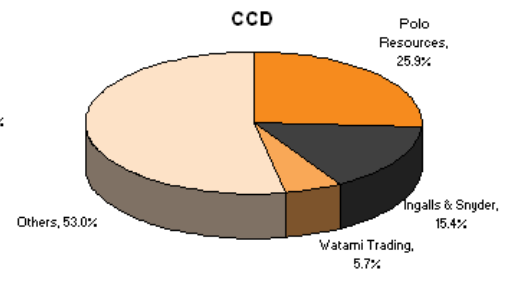
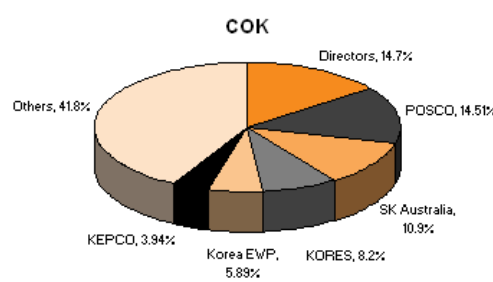
WHC, AQA and BND are majority owned and effectively controlled by Directors / Insiders.



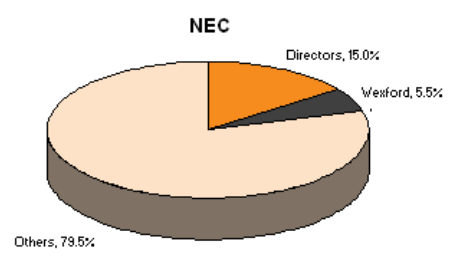
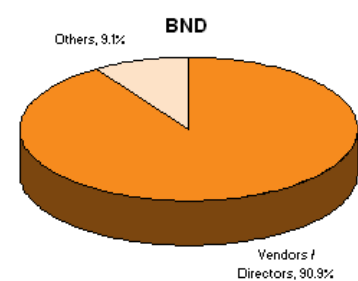
BND's register appears in need of a re-structure to introduce greater liquidity



The intentions of the potential predator (Polo) on CCD's register aren't clear. The group has an effective blocking stake and apparent control of the company's destiny in the event of a takeover or sale



Both RIV and COK's registers are occupied by strategic investors or offtakers. RIV would appear the cleaner takeover target given the varying backgrounds of COK's strategic holders.



Source: Reuters, Company Data, ABN AMRO Morgans

Funding, milestones and potential catalysts

Table 2: Cash, funding and Corporate Status

Company	Cash & Funding as at June 30	Recent & upcoming milestones / catalysts
Aquila Resources (AQA)	~A\$103m in cash & liquid investments, A\$12.5m in debt	<p>Oct-08 – Abandons proposed demerger of exploration assets due to market volatility</p> <p>Late-2008 – Rumoured sale process for the company concludes without resolution</p> <p>Nov-2008 – Added to ASX200 Index</p> <p>Jun-09 – Cooperation Agreement signed with FMG to study the JV potential for development of Anketell Point, WA. DFS ongoing.</p> <p>Aug-09 – Completes Eagle Downs feasibility study</p> <p>Aug-09 – Confirms it is engaged in discussions in relation to potential investment at both the Asset and Corporate level, including partial sale of coal & manganese projects</p> <p>Catalysts – Possible conclusion of assets sales near term, JV approval of Eagle Downs, Progress at West Pilbara & Belvedere</p>
Riversdale (RIV)	<p>~A\$290m in cash and no debt.</p> <p>In FY09 the Zululand Anthracite Colliery generated operating cashflow of ~A\$19m (up from A\$9m).</p>	<p>Apr-09 - Receives the Benga Mining Contract with a 25 year Mining Concession from the Minister of Mineral Resources.</p> <p>Jul-09 – Benga feasibility study completed for review by Tata</p> <p>Catalyst – JV approval of Benga, Govt approval of EIA study due by end CY09, Progress on feasibility of large scale barging capacity on the Zambezi River</p>
Caledon Resources (CDN.LN, CCD)	~A\$44m in cash as at Dec 30, £18m in outstanding convertible loan notes, 8.5% coupon, maturing July 2010.	<p>Dec-08 – Completed production cutbacks subject to market conditions</p> <p>Jan-09 – Announces informal discussions with “a number” of parties regarding a potential takeover or sale of assets, with no guarantee of a conclusion.</p> <p>Catalyst – Ongoing M&A speculation, Conclusion of company or asset sale process, Stabilisation of low cost production at Cook.</p>
Cockatoo Coal (COK)	<p>~A\$20m in cash (post SPP), no debt.</p> <p>Nov-08 - Issued A\$25m in new equity to SK Australia at 70.6cps + marketing JV</p> <p>Jan-09 - Issued A\$10m in new equity to major shareholders EWP and KORES (A\$5m each) at 50.6 cents.</p> <p>Aug-09 – Raised A\$10.8m via an SPP at 33cps</p>	<p>2007-2009 – Several strategic investors (POSCO, KEPCO, SK Australia, KORES) enter the register at above market prices.</p> <p>Nov-08 – Acquires Peabody's 62.5% controlling interest in the 300ktpa Baralaba open-cut PCI/ thermal coal mine for A\$52.5m.</p> <p>Aug-09 – Currently ramping up production at Baralaba to above FY10 targeted rates of c420kt while undertaking resource drilling along strike toward Baralaba North.</p> <p>Catalyst – Consistent production at lower costs at Baralaba, Expansion of Resources + mine life at Baralaba – we anticipate a Resource upgrade by end CY09</p>
Bandanna Energy (BND)	~A\$6.5m in cash, no debt.	<p>Sep-09 – Bandanna backdoor lists onto the ASX at 80cps, raising A\$10m.</p> <p>May-09 – MCC exits Dingo West JV allowing BDN to re-engage third parties</p> <p>Aug-09 – Currently drilling to expand defined Resources at Springsure Creek, Arcturus, Arcadia. AMCI progressing drilling at Alpha in the Galilee under the JV terms.</p> <p>Catalyst – Ongoing expansion of Resources + evaluation, Improving profile of Galilee Basin potential ala Hancock/ Waratah, Potential attraction of JV interest at either the asset or corporate level and/or an improvement in liquidity.</p>
Northern Energy (NEC)	<p>~A\$14m in cash (post raising), no debt.</p> <p>Jun-09 - Raising A\$12m via an underwritten placement and SPP at 35cps</p>	<p>Late 2008 – Called for JV interest in the proposed 500ktpa Colton (Maryborough) open-cut coking coal mine.</p> <p>Nov-08 – Called for strategic investors in the proposed Elimatta Thermal open-cut Coal Project, Surat Basin, including potential operators.</p> <p>Catalyst – Attraction of JV interest in key projects, Ongoing evaluation of Elimatta and progression of Colton towards development.</p>

Source: Company data, ABN AMRO Morgans

Conclusions / Investment views

- **Whitehaven Coal (WHC)** appears to us to be the standout takeover candidate in the sector.
- **Centennial Coal (CEY)** is also likely to draw corporate interest due mainly to its 5Mtpa of exports and its open register.
- **Aquila Resources** – Offers the best leverage of the group to two of our most preferred commodities – coking coal and iron ore – thanks to its large resource base and growing production profile in JV with Vale. We have also ignored the obvious value in AQA's Iron Ore and manganese assets in the metrics presented in this report. The company also appears to be 'For Sale' at the right price for the majority holders.
- **Riversdale** – Offers very good leverage to the strong coking coal thematic via its large resource position in Mozambique, the majority of which remains unexplored. Has a positive operating cashflow, has attracted strategic investors and appears to have a potential predator on the register in the form of Tata Steel. African risk and the resolution of infrastructure challenges in Mozambique should form part of the investment view.
- **Caledon Resources** – As a high cost marginal producer, earnings are highly leveraged to achieved coal prices. Reacted quickly in scaling down production at the Cook mine in Dec-08 in response to softer demand. FY09 production targets now look achievable and we await the 1H results to gauge cost performance. Has been engaged in a potential company sale process since Jan-09.
- **Cockatoo Coal** – Has an opportunity to build market confidence in its ability to mine Baralaba profitably, which would also deliver an advantage in participating in the planned Surat Basin infrastructure. Currently defining coal resources in between the Baralaba Mine and the Baralaba North where the coal seams are expected to be continuous. We expect an upgrade to Resources and Baralaba mine life by end CY09. COK has excellent industry links, with a track record of introducing strategic investors onto the register at a premium to market.
- **Bandanna Energy** – Is executing its exploration program, growing export thermal Resources on Bowen Basin projects. Is free to deal with counterparties on Dingo West and AMCI is funding ongoing drilling in the Galilee where 982Mt has been defined. Should benefit from improving thermal coal market sentiment and from the profile that Waratah and Hancock are bringing to the Galilee. Would benefit from introduction of a strategic partner and improved liquidity. Can move substantially on low volumes and on sector news.
- **Northern Energy** – Coming off the lowest base in terms of market cap, NEC offers the best upside leverage to an improvement in thermal coal market sentiment and to positive newsflow from its projects. Has a real opportunity for early cashflow from the Colton Project where we also expect Resource upside in the near term. Investment case would appear to rely heavily on NEC's ability to attract one or more strategic partners at the asset level. Also has the most open register of the juniors.

Risks

Note that we do not currently formally cover WHC, AQA, RIV, COK, BND or NEC. Each is subject to specific operational, development, industry and macro level risks such as fluctuations in investor risk appetite, coal prices and currency. We recommend investors consult their advisor for more details.

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For listed property trusts (LPTs) the recommendation is based upon the target price plus the dividend yield, ie total return. A Buy implies a total return of 10% or more; a Hold 5-10%; and a Sell less than 5%.

Absolute performance, short-term (trading) recommendation: The Trading Buy/Sell recommendation implies upside/downside of 3% or more. The trading recommendation time horizon is 0-60 days.

Each stock has been assigned a Volatility Rating to assist in assessing the risk of the security. The rating measures the volatility of the security's daily closing price data over the previous year relative to other stocks included in either the S&P/ASX200 Index (large caps) or the Small Ordinaries Index (small caps) of which it is a member. This rating is a quantitative (objective) measure provided as an additional resource and is independent of the qualitative research process undertaken by our research analysts.

A rating of Low indicates very little movement in price over the previous year (Coefficient of Variation < 4 for small caps or < 5 for large caps). A Moderate rating implies average price movement over the previous year (Coefficient of Variation of 9 - 21 for small caps or 7.25 - 15 for large caps). A High rating implies significant price movement over the past year (Coefficient of Variation greater than 25 for small caps or 35 for large caps).

REGULATORY DISCLOSURES

Mentioned Companies: WHC, CEY, RIV, BDN, AQA, CCD, COK, NEC, MCC, FLX, GCL, NHC.

ABN AMRO Morgans Limited was the Lead Manager and Underwriter to the Bandanna Energy Limited public offer in September 2008 and received fees in this regard. ABN AMRO Morgans Limited was a participating broker to the Macarthur Coal Limited share placement in June 2009 and received fees in this regard. An analyst or a member of any analyst's household who participated in the preparation of this report has a shareholding/financial interest in this company: HZN, PNA, RIO, MCC, NCM.

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