FINANCIAL REVIEW

SE Portfolio

HD **How to build your own BHP**

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Resources It takes time and cash to buy into the **mining** giant, so why not create your very own?

Everyone wants a piece of BHP Billiton. As Australia's biggest miner moves to streamline its **operations** into just five commodities in pursuit of superior returns, its appeal as an investment option grows.

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But getting on the ownership list of the **iron ore** giant will take time – and dollars. So why not build your own BHP, using the **mining** monster's own criteria?

The worm has turned in the **mining** industry. It's no longer about resources in the ground, as was the case during the **mining** boom. Instead, it's all about cash in the claw.

Miners know they have to present projects with economic viability and realistically projected metrics such as rates of return and commitments to paying dividends.

BHP is simplifying its focus into **iron ore**, **copper**, **coal** and petroleum, with potash thrown into the mix, indicating it is viewed as a commodity with strong growth potential.

Smart Investor has put together a portfolio with one stock from each of those commodities, to provide you with a model that parallels BHP's own. Of course, they are not of the same scale BHP will be targeting, but importantly they are leveraged to the same trends.

With returns on capital invested very much in mind, it is necessary to step outside the Pilbara in search of value.

Even after share prices have taken a hit as a result of negative sentiment towards the **iron ore** sector, companies in the Pilbara continue to trade strongly. It is clearly evident that investors are still paying top dollar for exposure to premium Pilbara **ore**.

Outside of Australia, Africa is one of the most prominent hosts of large **iron ore** resources, particularly in the central and western regions.

Two Australian players, Equatorial Resources and Sundance Resources, have **operations** in the central western African region.

Equatorial's Mayoko-Moussondji project is immediately adjacent to the Mayoko-Lekoumou project being developed by Johannesburg-listed Exarro Resources.

Both projects are progressing with a similar stage development, targeting first production this year.

Equatorial has a market capitalisation of $65 **million** and, with zero debt and $45 **million** in cash, has an enterprise value of about $20 **million**.

Smart Investor recently spoke with Equatorial managing director John Welborn, who explained the company's development plan for its wholly owned piece of land in the Mayoko region.

Upfront, he said, the mined product ore grades were well below Pilbara standards, with the JORC mineral resource now standing at 917 million tonnes at 31.4 per cent iron, but including near surface haematite resource of 182 million tonnes at 35.7 per cent iron.

In short, the company will employ a low-cost upgrading technique that will initially produce a 64.1 per cent iron "Mayoko premium fines" product, which should fetch at least $120 per tonne based on conservative estimates.

Infrastructure on the site will need minor upgrades to transport 2 million tonnes per annum to port, but upfront costs are relatively low and the internal rate of return is estimated to be 30 per cent. Based on the current resource and exploration upside, there is scope for a long-life project for Equatorial, with increased annualised production at comparatively low costs.

A strong 2013 production performance from Tiger Resources' Kipoi copper project in the Democratic Republic of Congo, combined with a substantial increase in ore reserves announced by the company in January, has reinvigorated interest in the stock.

But details contained in a definitive feasibility study (DFS) released by Tiger shortly after show the reserves are far more significant.

While the project may not be the next Escondida, it is situated in the heart of a prolific copper-bearing region referred to as the "copper belt".

Consequently, the scope for Tiger to increase its high-grade reserves is substantial and this has the potential to extend the production of premium-priced copper cathode that is sold into export markets.

As a low-cost, high-return asset, it fits the bill in terms of meeting BHP's criteria.

Analysts at Macquarie reviewed their estimates and valuation on Tiger after the group's recent earnings results. The broker has an outperform recommendation on the stock with a 12-month price target of 69¢, implying upside of about 85 per cent to Friday's closing price of 37.5¢.

An anticipated substantial increase in cash flow has prompted Tiger to approve a dividend policy. In recent discussions with Smart Investor, Tiger managing director Brad Marwood expressed a strong commitment to delivering a dividend sooner rather than later, once again meeting the need for material shareholder returns.

As Marwood so simply put it: "The numbers speak for themselves – Kipoi is a world class copper project."

Whitehaven Coal is hard to go past in terms of identifying a pure coal play that would fit BHP's model.

The company has scale, scope for expansion, multiple projects and diversification across coking and thermal coals.

Whitehaven's result for the six months to December reflected solid growth in revenues, margins and earnings, indicating the company is poised to reap the benefits of substantial investment in recent years. The miner's Maules Creek project, the largest in terms of reserves of the company's six operations, is due to start production in March next year.

This is likely to prompt a significant share price re-rating in Whitehaven, given it should come on stream with a production capacity of 6 million tonnes a year, increasing to 13 million tonnes a year.

The mine life of at least 25 years, combined with the quality of product, should provide a higher value semi-soft coking coal account for about half of production. This premium-quality thermal coal can be used in domestic markets or exported overseas.

Maules Creek will be Whitehaven's growth engine over the next three years as production doubles from an anticipated 10.7 million tonnes in 2014 to 21 million tonnes in 2017.

In the interim, output from the company's Narrabri project, which accounts for about half of production, should increase in 2014-15 and remain at a steady state production rate of nearly 6 million tonnes per annum.

While predominantly producing lower priced thermal coal, the Narrabri project provided the cash flow and stability which has been extremely beneficial while Whitehaven has been developing Maules Creek.

Whitehaven has definitely been a casualty of negative sentiment towards the coal sector, but unless you are a long-term bear on the coal industry, this may be an opportune time to pick up the stock as a real spike in production and related kick in earnings should occur between 2016 and 2017.

However, analysts are tipping the stock to begin dividend payments in 2014-15, and with most of its low-cost projects having mine lives in excess of 20 years, the company looks an excellent value proposition.

Having invested heavily in large-scale, long-term projects over recent years, Santos is poised to reap the benefits over the short term, but its accelerated growth profile doesn't appear to be factored into its share price.

It is a good time to consider Santos given that the execution risk on a number of the company's major projects is diminishing, and the forward earnings upside is drawing closer.

Furthermore, the strategic value of the group's Moomba assets have strengthened due to increasing gas prices, a trend expected to continue.

Santos's Cooper Basin assets have the potential to fuel the east coast of Australia for decades by tapping into both conventional and unconventional underground reservoirs.

The company's exploration outlook appears just as promising, with a strong prospect of continued success at existing projects as well as making further progress in the Browse Basin.

Based on Macquarie forecasts, Santos's profit growth should be outstanding over the next three years, but particularly strong in 2014 and 2015.

During this period Santos's net profit should grow to nearly $1.2 billion, representing an increase of about 140 per cent compared with its 2013 performance.

On a price-earnings multiple to growth (PEG) basis, Santos represents compelling value.

Looking beyond 2015, as cash flow increases substantially, dividends should also increase, making the company an attractive yield play.

BHP's $US40 billion takeover offer for Potash Corporation of Saskatchewan back in 2010 brought the commodity into the spotlight, but in a sense was also its undoing.

What transpired shortly after the failed takeover bid was a flood of potash "wannabes" that trashed the commodity's name and basically turned cash into fertiliser, potash's core byproduct.

One of the best aspects of potash is its easy-to-understand applications. The main byproduct is sodium chloride, which is sold simply as salt.

However, the most lucrative end market is the agricultural industry, as potash makes up a substantial element of 95 per cent of fertilisers.

This is where the big industry players expect demand to outstrip supply in coming years, effectively driving up prices and supporting BHP's belief that it belongs in a portfolio of growth commodities.

Unlike many failed projects of the past, Highfield Resources' potash assets in Spain look like the real deal.

Experienced resources investors at EMR Capital have a substantial position in the company, with a stake of 29.5 per cent, and expect big things from Highfield.

This is shown through EMR's decision to retain its stake rather than take a profit at a significant premium to their entry price.

EMR managing director Jason Chang brings plenty to the table in the way of global corporate experience, particularly across Asia and China.

A man with a strong understanding of these markets, Chang told Smart Investor he was very positive on the macro outlook for potash as demand for fertilisers accelerates across China, India and Brazil.

He is of the view China will continue to make strategic potash acquisitions along with the likes of BHP and Rio Tinto.

There appears to be consensus among brokers that Highfield will be one of the lowest-cost producers on the basis of current modelling, and analysts at Canaccord expect the company to be in production by 2016-17, generating a net profit of $33.6 million in that year.

Canaccord cited the coming results of the pre-feasibility study being undertaken at Highfield's Javier project, which management noted should be released in May, as a likely near-term share price catalyst.

Also, an upgraded JORC-compliant measured and indicated resource estimate should be released in April.

This could be extremely significant in terms of the Javier project, as Highfield is of the view it should enhance the resource estimate and extend the mine-life projections.

Highfield also owns the Sierra del Perdon project, a 100 square kilometre tenement in northern Spain containing two former operating mines that produced close to 10 million tonnes of potash between 1972 and 1997.

Sierra del Perdon is particularly valuable given that depths from surface to potash mineralisation start at less than 300 metres. While slightly shallower than Javier, both assets are substantially nearer the surface than most of its peers and this is expected to be a key factor in reducing development and production costs.

Analysts at Canaccord have a 12-month target price of 69¢ on Highfield, derived from a sum of the parts net asset valuation which also assumes a diluted share capital structure.

The target price fully takes into account options and performance shares and provides an accurate valuation, albeit more conservative than some other analysts.

For example, UK broker Numis Securities increased its 12-month share price target on Highfield from $1.50 to $2 in January.

It is also much more bullish on forward earnings estimates, suggesting there could be some scope for further upside for Highfield.

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