STOCKS DOWN UNDER

18 FEBRUARY 2021

Resources Stocks Down Under

"Before agriculture was invented, land was not a resource. Before oil drilling and nuclear fission were invented, petroleum and uranium were not resources."

- Robert Zubrin (b. 1952), Aerospace engineer and author

HIGHFIELD RESOURCES

Key ingredients for success

VRX SILICA

Profitable footprints in the sand

PEEL MINING

The spokes are filling out around the hub

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Stocks Down Under rating: ★★★

ASX: HFR
Market cap: A$ 208M

52-week range: A$0.24 / A$0.78
Share price: A$ 0.63

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Market cap: A$ 164M

52-week range: A$0.045 / A$0.43
Share price: A$ 0.325

Perth-based VRX Silica had a good end to 2020. The stock went from 9.9 cents per share on 8 September 2020 to reach 40 cents per share by 6 January 2021. The market has begun to figure out what VRX realised three years ago – that there's a looming global shortage of quality silica sand. And VRX has three silica sand projects in Western Australia where the economics are very favourable.

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Share price chart

Source: Tradingview

Almost ready to go

Highfield Resources believes its flagship Muga Potash Project's location gives it the best possible avenue into the European potash markets. Muga, which is situated 50 km south-east of Pamplona – the one with the bulls – covers about 60 square kilometres of predominantly shallow sylvinite rock, containing a mixture of sylvite (potassium chloride) and halite (sodium chloride) found in potash ore. The company's plan is to produce muriate of potash, or MOP, muriate being an archaic term for chloride, which is a common ingredient in fertiliser. And it plans to produce sodium chloride as a by-product.

Since receiving environmental approval in June 2019, Highfield and its Spanish subsidiary, Geoalcali, have conducted mine and treatment plant design improvements despite only inching forward with mining concession and construction permits. While Muga is a low-risk conventional underground room and pillar operation (the norm for potash mining), the shallowness of the mineralisation, at 350 metres and above, means the company has managed to reduce its overall construction and operating costs, making Muga one of the lowest cost potash projects. Highfield is currently working with Endeavour Financial to secure debt financing. Assuming that white whale will be harpooned, permitting will be the only remaining obstacle.

The mine is expected to start production in two Phases with 500,000 tonnes of MOP in the first with an extra 500,000 tonnes in the second, leading to 1 million tonnes of MOP and a further 1 million tonnes of salt by-product annually. On top of these plans, Highfield is pursuing permits for further exploration in tenement areas in the Aragon and Navarre regions, including the nearby Vipasca prospect as a possible extension to Muga, and improve upon the current indicated mineral resource of 108 million tonnes at 10.2% potassium oxide. Because of Muga's comparatively low-cost curve, the project has a Net Present Value of €1.97bn (at an 8% discount rate), an Internal Rate of Return of 25% and an EBITDA of €310m at full production.

A sound market – if you can stay in it

Outside of northern Spain's vibrant agricultural industry, which is well-known for its food and wine, Highfield has good reason to be excited about Europe's growing potash market where production has been cut and prices remain high. As a leading potash contender in Spain, Muga's location gives the company a logistical advantage in terms of existing port infrastructure and export options, but that doesn't mean entry into the market will be guaranteed.

Even with demand for potash increasing over 25% during the last decade to support crop production and population growth, there is a perception out there that this market is challenging for juniors like Highfield to enter. Witness how the majors controlled supply in 2020 with the shutdowns of Germany's 600,000 tonne Sigmundshall and the UK's 500,000-tonne Boulby potash mines as well as further cuts in Spain at the Iberpotash mine. Maybe a newcomer like BHP, with its Jansen project in Canada, can get in, but not Highfield goes this line of thought. We're not so sure.

The thing about tightly controlled markets is that the controllers like them, but not the customers. Currently, around three-quarters of the world's potash comes from just three countries – Canada, Russia and China. With the latter two sources coming with certain downsides as far as international trade politics are concerned, Highfield believes its sales and marketing strategy to provide salt and fertiliser to customers in Europe as well as in growth areas South America and Africa, is viable. More importantly, the short-term production cuts we noted above don't reflect the long-term outlook for the potash market, which is expected to grow 2.5-3% per annum into the foreseeable future.

Always look on the bright side

With the expectation that construction permits and mining concessions will be granted early this year, Highfield can at least concentrate on the upside growth potential at Muga and the surrounding Vipasca, Sierra del Perrdon and Pintanos tenements in the Ebro Basin to build on Muga's current 27-year mine life. And although it's a pipedream now, the company has pointed out the possibility of a sulphate of potash (SOP) project at the Port of Bilbao, which has the bonus of fetching a higher price (over US$50 per tonne) even though SOP is costlier to produce.

As Muga has half the CAPEX of other producers (like BHP with Jansen) and the advantage of premium prices in Europe either way, Highfield's bullish desire to become one of Australia's primary potash producers might see the company going in that direction, but for now, we can't see further than three stars until the permitting issues are overcome.

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If you want to learn about an increasingly scarce commodity where fortunes are going to be made in the future, get hold of a 2018 book called The World in a Grain, written by the Los Angeles-based journalist Vince Beiser. The increasingly scarce commodity Beiser writes about is sand. That's right, the stuff that abounds on any beach or desert. It turns out that modern economic life needs a lot of sand and the world is running out of the right kinds of sand. One ASX-listed company set to benefit from the looming worldwide shortage is VRX Silica.

Not all sands are equal

Did you know that the city of Dubai, which is surrounded by sand, has to import construction sand from Australia? Desert sand grains, you see, are too round for construction purposes. There's regular sand, and then there's the economically necessary stuff, the most important of which is silica sand. Unlike beach sand, silica sand is mostly quartz and requires a grade of at least 95.5% SiO_2, that is, silicon dioxide, to make glass and preferably having less than 0.06% iron oxide content. If a sand deposit is silica sand, then it's valuable because that's the kind of sand needed in construction materials and glassmaking, ceramic finishes, paints, solar panel coatings, and 5G telecommunications equipment and a great many other products. And, as you'll learn from

Beiser's excellent and well-balanced reportage, there's not nearly enough of that kind of sand, given the rising demand and the closing off or exhaustion of traditional sources. VRX estimates that in the Asia-Pacific region alone, there's been a supply deficit of silica sand for years now, which means that pricing can only go in one direction in the future.

VRX could see this Global Sand Crisis coming back in 2017 when it first applied for the tenements that became its Arrowsmith Silica Sand Projects. VRX has two silica sand deposits at Arrowsmith, which are not far from Dongara in WA's Mid-West region, 270 km north of Perth. VRX subsequently added two more WA silica sand projects. The one located at Muchea, just 50 km north of Perth, was picked up in 2018. If the name Muchea sounds familiar to you, it might be because that was where NASA located a tracking station in the early 1960s for its 'Right Stuff' Mercury Project…but we digress. VRX's third WA silica sands project, at Boyatup in the south of the state, was picked up in early 2019. By that stage VRX had a cool 1.056 billion tonnes of silica sand in a combined JORC compliant Resource, grading an exceptionally high 99.6%-99.9% SiO_2, with low iron impurities. And every one of these projects was close to gas and rail lines.

Not a complicated business

Silica sand mining is a straightforward business. You just shovel sand through screens to ensure the right particle size and then separate the good stuff with spirals and magnets. The procedures are clean and chemical-free. That's why VRX believes that its margins will be economical. Before 2019 was out, VRX had Bankable Feasibility Studies in hand for both the Arrowsmith Projects and Muchea, with great numbers.

When you combine the projects, they have a post-tax NPV at a 10% discount rate of A$728m, for just $87m in aggregate capital expenditure. Encouragingly, VRX's feasibility work had identified a low-cost 'starter' option in Arrowsmith North that would require just A$28m to commission, but when the projects are up and running, they will have mine lives in excess of 25 years and up to 100 years. In late 2019 VRX believed that within a year it could be in construction mode at Arrowsmith. Obviously, the advent of COVID-19 delayed that somewhat, but the near-term nature of the opportunity meant that VRX stock could start to re-rate almost as soon as the market crash we saw in February-March 2020 was over.

2020: a year of progress

VRX continues to remain close to its goal of having its first producing silica sand mine. After having secured Native Title agreements for both Arrowsmith and Muchea, it has all the Mining Leases in place and is now working towards obtaining all the necessary environmental permits. While VRX will have to raise some capital, keep in mind that the business plan is sober. VRX isn't going after lower-margin construction sand as its first priority, but will instead target glassmakers and metal casters, since both represent high-growth industries with a strong need for high-grade silica sand, particularly in Asia. Discussions with potential offtake partners are ongoing.

VRX investors had a good 2020, but we see more upside from here. The current market capitalisation is still discounting the BFS valuations by a significant amount. The company is funded for the time being, with $7m raised at 18 cents per share in November 2020. And while project financing remains a risk, we reckon any potential financier will be all ears once they read Beiser's book or see articles with headlines like 'The world is running out of sand, and you need to care' (Andy Altman, CNET, 3 December 2020). Four stars.

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Share price chart

Source: Tradingview

Discover and rediscover

While Cobar's 150-year mining history might have been established through gold, Cobar's long-forgotten nickname of 'Copper City' might come back now that the resource potential and copper price start to pick up again. The Basin, which is rich in base metals, has seen the rise of exploration ever since the first Great Cobar Mine in the late 1800s and the inevitable fall. While the region has suffered a few losses (including the closure of Ashanti Gold's CSA mine in 1999), new technology is proving beneficial in re-opening closed mines and expanding reserves.

Peel has an expanding list of base metal projects within the southern Cobar Basin, NSW, having established a promising list of copper-gold projects over the last ten years of operation, including Wagga Tank/Southern Nights, Wirlong, Mallee Bull and May Day. Wagga Tank/Southern Nights, Peel's flagship, lies 130 km south of Cobar and hosts two main ore bodies and a prospective corridor in between which Peel believes it could increase the scope of the 4.95 million tonne project down the track. Wagga Tank/Southern Nights are already known to host a major mineralised system, with extension drilling continuing to reveal massive copper-gold (and zinc-silver-lead) mineralisation over a 2 km strike zone.

75 km south of Cobar proper, the Wirlong deposit is also yielding helpful results, with December's diamond drilling intersecting high-grade copper mineralisation over depths of 10, 15 and 25 metres. Wirlong is pre-resource, meaning it only has a maiden resource estimate (MRE) of 1.128 million tonnes, but the good news was enough to hike the share price up to 27 cents at the end of December.

Are we a developer yet?

While Peel has spent much of a 10-year stretch drilling and expanding its prospects and has more resource upgrades in the works, the 'Holy Grail' for the company is to have five producing copper mines in the neighbourhood of Cobar. The current strategy is "hub and spokes', with the spokes producing the ore and a centralised 'hub' processing it.

Although the company's primary target is copper generation, the abundance of gold is a significant bonus, particularly at Mallee Bull and May Day, which Peel has finally acquired for $17m from former joint venture partner CBH Mining. While Mallee Bull is one of the highest-grade copper deposits in the country with 6.67 million tonnes at 2.6% copper, May Day is a gold-dominant resource and significant addition of gold exposure to Peel's asset base. Though it leaves the company without joint venture support, Mallee Bull's acquisition finally signifies Peel's independence as an explorer, which can stand on its own.

Peel has built a large greenfield position of about 1,950 square km and a dominant position in the Cobar area, but that hasn't stopped the company from adding potential sites to its exploration list, with recent acquisitions including the Siegals, Mt Allen and Double Peak prospects, all of which will undergo drill testing over the next year.

Helpfully for Peel, all the copper excitement has reached the NSW government's ears, which is funding the company's initial reserve drilling program through the New Frontiers Drilling program to the tune of $200,000. Though it's a drop in the ocean compared to what the company has spent to get to its current position, Peel will be reimbursed 50% of its direct-in-ground costs when drilling is completed.

It's only the beginning, folks

As the company ended the September quarter with a cash position of $24m, Peel hopes that exploration at the 'new' prospects will be a significant add-on to its existing projects, which, taken together, is referred to as the South Cobar Project by Peel. Now consolidated, the funds will enable the company to establish a critical mass of 12-15 million tonnes of quality mineral resources to support a centralised processing plant over the next two years.

For the next 12-24 months, investors can expect a complete run-through of Peel's resources as it strives to meet that 'critical mass', starting with a Prefeasibility study at Wirlong and resource upgrades at Mallee Bull, Wagga Tank/Southern Nights and May Day. Because Peel's hub and spoke model is realistically in the early stages, the company still has a few milling considerations, including the flexibility to process all ore styles given the polymetallic nature of its projects (silver being a valuable by-product for a start) to reduce future costs. Though that journey has barely begun, we regard Peel as a solid four-star copper miner with the potential to become a copper producer the region needs.

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Pitt Street Research Pty Ltd is founded on more than 40 years of combined experience researching companies in a range of different sectors.