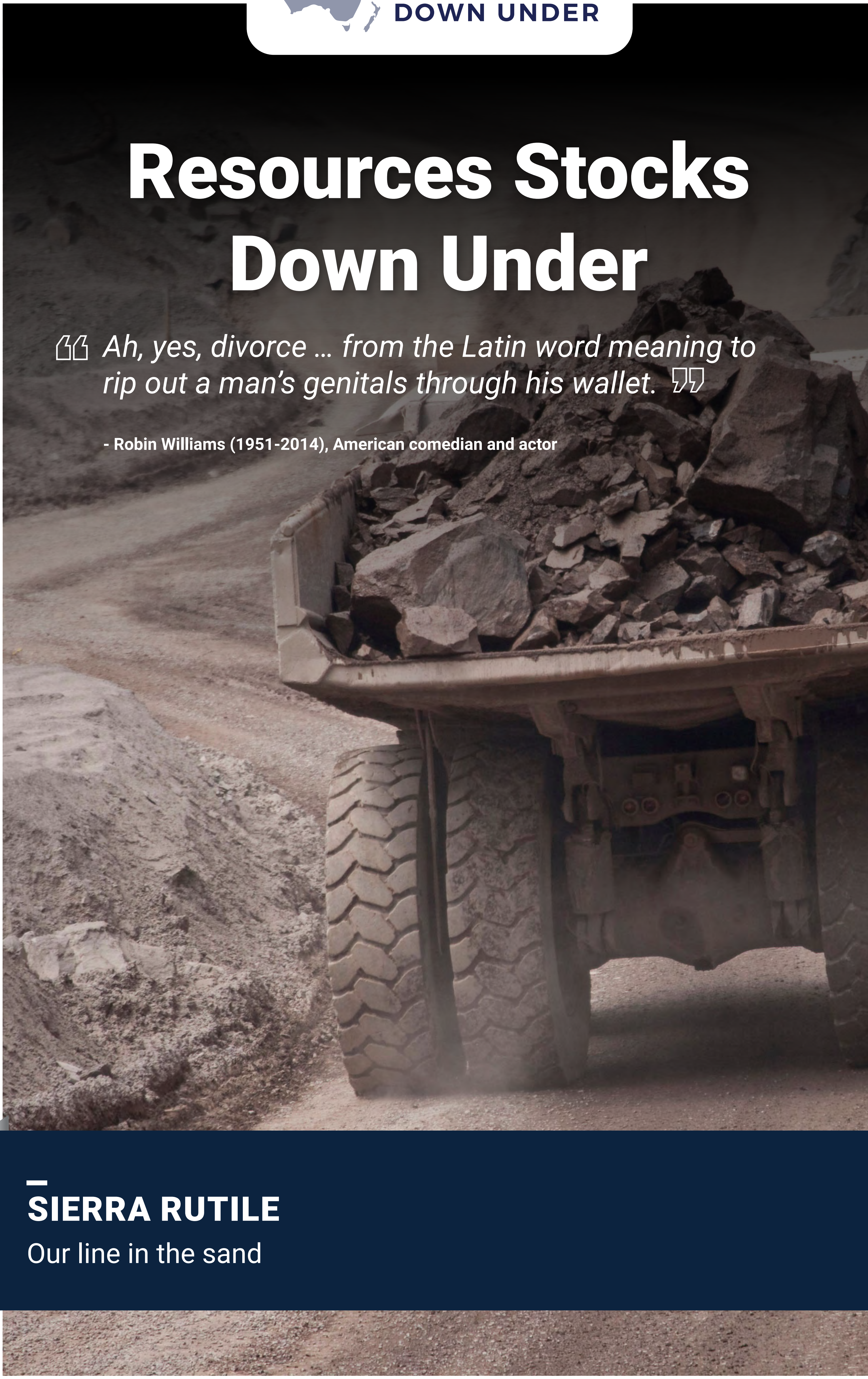
STOCKS DOWN UNDER

11 AUG 2022

Resources Stocks Down Under

Ah, yes, divorce … from the Latin word meaning to rip out a man's genitals through his wallet.

- Robin Williams (1951-2014), American comedian and actor



SIERRA RUTILE

Our line in the sand

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Stocks Down Under rating: ★★

ASX: SRX
Market cap: A$140M

52-week range: A$0.24 / A$0.65
Share price: A$0.33

So far this year we've given little attention to the mineral sands sector, but Iluka's demerger of its Sierra Leone business has brought it to our attention once again. Six years after Iluka acquired the assets, it has spun them out into a new company, called Sierra Rutile. Iluka spun it out as it wanted to focus on its Eneabba rare earths development in Western Australia. But a report by Deloitte found it would be for the good of the Sierra Leone assets too, as funding would likely be easier to obtain as a separate company. And a new deposit at the project promises to extend its life into the late 2030s.

Share price chart

Source: Tradingview

Meet rutile

As the company's name suggests, Sierra Rutile's specialty is rutile, a mineral sand used as a titanium dioxide feedstock for industrial purposes - paint pigments and welding being two examples. Rutile is the purest, highest-grade natural form of titanium dioxide. Despite rutile's importance to industrial activity, rutile prices can still fluctuate because the amount of cash directed to such projects shifts in conjunction with economic conditions.

2021 was a solid year for rutile due to the rebound in industrial activity following pandemic restrictions in 2020. At the end of 2021, Iluka was selling rutile for an average price of US$1,350 per tonne. In 2022, rutile prices have grown again, with the average price being US$1,506/t, levels it has barely touched in the last decade. Iluka has also reported strong orders for the second half of 2022 despite rising interest rates and COVID-19 restrictions in China which have tightened supply.

Sierra Rutile runs the Sembehun Project, which consists of an existing mineral sands operation and a potential new project 30km away. Sembehun represents one of the world's largest natural rutile deposits and there have been operations in this area since the mid-1960s. The Area 1 mine, where activity has occurred, has delivered a mineral resource estimate of 205m tonnes at 1.04% for 2.1m tonnes of rutile. It also has ore reserves of 38m tonnes at 1.42% for 541,000 tonnes of rutile.

Giving the project a new lease on life

Sierra Rutile wants to extend the life of the whole project and thinks there is more rutile at two particular prospects – Pejebu and Ndendemoia. It has completed a preliminary feasibility study with a definitive feasibility study underway and expected to be completed next year, after which a Final Investment Decision will be made. This could see production begin in 2024 and the PFS forecasted a 13-year mine life with annual production of 176,000 tonnes of rutile along with 98,000 tonnes of ilmenite and 13,000 tonnes of zircon. It has a NPV of US$318m and a 24% post-tax Internal Rate of Return.

As with all companies at this stage, the challenge is getting the project off the ground. It will need capital (~$337m according to Deloitte) and it also needs to ensure that lawmakers will let operations begin. With the lack of Australian resources companies having exposure to Sierra Leone, we can understand investor scepticism here. But the West African country is a stable democracy with a strong mining sector, enabled by the existing regulatory framework.

Is it worth the risk?

As we noted last week, spin-off resources companies have not performed well in recent times. Can Sierra Rutile be an exemption? Spoiler alert: We don't think so, here's why.

In its favour is its multiples. Sierra Rutile has a market capitalisation of $157m and an EV of $240.4m considering its $83.4m in debt. It has just one asset and underlying EBITDA of just US$20.5m (A$29.3m) giving it an EV/EBITDA ratio of 8.2x - we normally prefer to use forward multiples, but we have to use trailing multiples as no consensus estimates exist.

Considering this doesn't take account of future revenues from the project from the next stage of development, this is a reasonable multiple, in our view. The company has not given EBITDA guidance, but it has given production guidance – for FY22 it is expecting 144kt of rutile, up 12% from the year before.

But the company is at the mercy of rutile prices and is more difficult to track and predict than other commodities. Sierra Rutile is evidently being cautious in making financial forecasts as a result. And as we know too well, even if a business' fundamentals, industry and competitive advantages are strong, investors can overlook or disregard it if they cannot understand particular aspects of it or if there are too many risks outside the company's control. We think Sierra Rutile will have difficulty selling the story of rutile as a commodity considering what we have outlined above and because there is a lack of investor experience in Australia with Sierra Leone as a mining jurisdiction. Therefore, it's wo stars from us.

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