Iluka's Iron Ore Royalty

Sandon Capital believes Iluka's iron ore royalty over BHP Billiton's Mining Area C (MAC) is worth close to A$2/share in its current form. If and when BHP Billiton decides to proceed with the development of its South Flank iron ore deposit, we believe the royalty could be worth >A$4/share to Iluka shareholders. Iluka has one of the better track records in capital allocation in the global mining industry over the past decade. We believe the company has an opportunity to enhance this track record by demerging the company's iron ore royalty into a separately listed entity where it will be valued more appropriately.

In Sandon's opinion, Iluka's MAC royalty is the best asset in the Australian mining sector and the cheapest. Despite having a book value of only $16.7m, the asset has generated Earnings Before Interest & Tax (EBIT) of almost A$650m for Iluka since Mining Area C first produced iron ore in 2003. The royalty provides direct exposure to the revenues of iron ore production from Mining Area C without the typical risks that are inherent in mining assets. Iluka does not have to concern itself with permitting, exploration, financing, capital expenditure, mine construction, operating costs, mine and equipment repair and maintenance, rehabilitation and all of the other risks that come with the ownership, development, operation and closure of mining operations. Iluka simply collects a royalty cheque from BHP Billiton each quarter that Mining Area C produces iron ore. The major risk for any royalty is counterparty risk, and in the case of BHP Billiton, the MAC royalty counterparty is the world's largest mining company and Mining Area C is one of the lowest cost iron ore mines globally.

Furthermore, the MAC royalty enjoys all of the upside that comes from exploration success and production increases with no additional capital expenditure or operating costs. We expect this attribute to become apparent as BHP Billiton depletes the reserves at its Yandi operations and looks to replace this production from other assets within its iron ore system. We expect replacement production to come from a new deposit at South Flank, which is located ~8kms to the south of the existing Mining Area C operations and sits within ML281SA, the mineral lease to which Iluka's iron ore royalty pertains. The Yandi production that South Flank will replace does not sit within this mineral lease and hence is not subject to the MAC royalty.

Sandon Capital believes the royalty is significantly undervalued whilst it is housed within a mining company and would be more appropriately valued in a separately listed, pure play royalty company. Based on offshore comparables, the royalty today could be worth A$840m-940m. Should BHP Billiton proceed with the development of the South Flank deposit, we believe the royalty could be worth between A$1.7-1.9bn.

In order to properly value the MAC royalty and maintain the integrity of Iluka's balance sheet, we think the company should demerge the royalty via an in-specie distribution to existing shareholders. A focused standalone royalty company, with its own dedicated board and management, would be able to focus on growth opportunities such as adding other royalties or even looking at 'streaming' deals such as those undertaken by North American royalty/streaming companies. The powerful cash flow generation of the royalty could support at least $300m of debt in a standalone entity. Transfer of the debt at the time of the demerger would leave Iluka's balance sheet unencumbered.

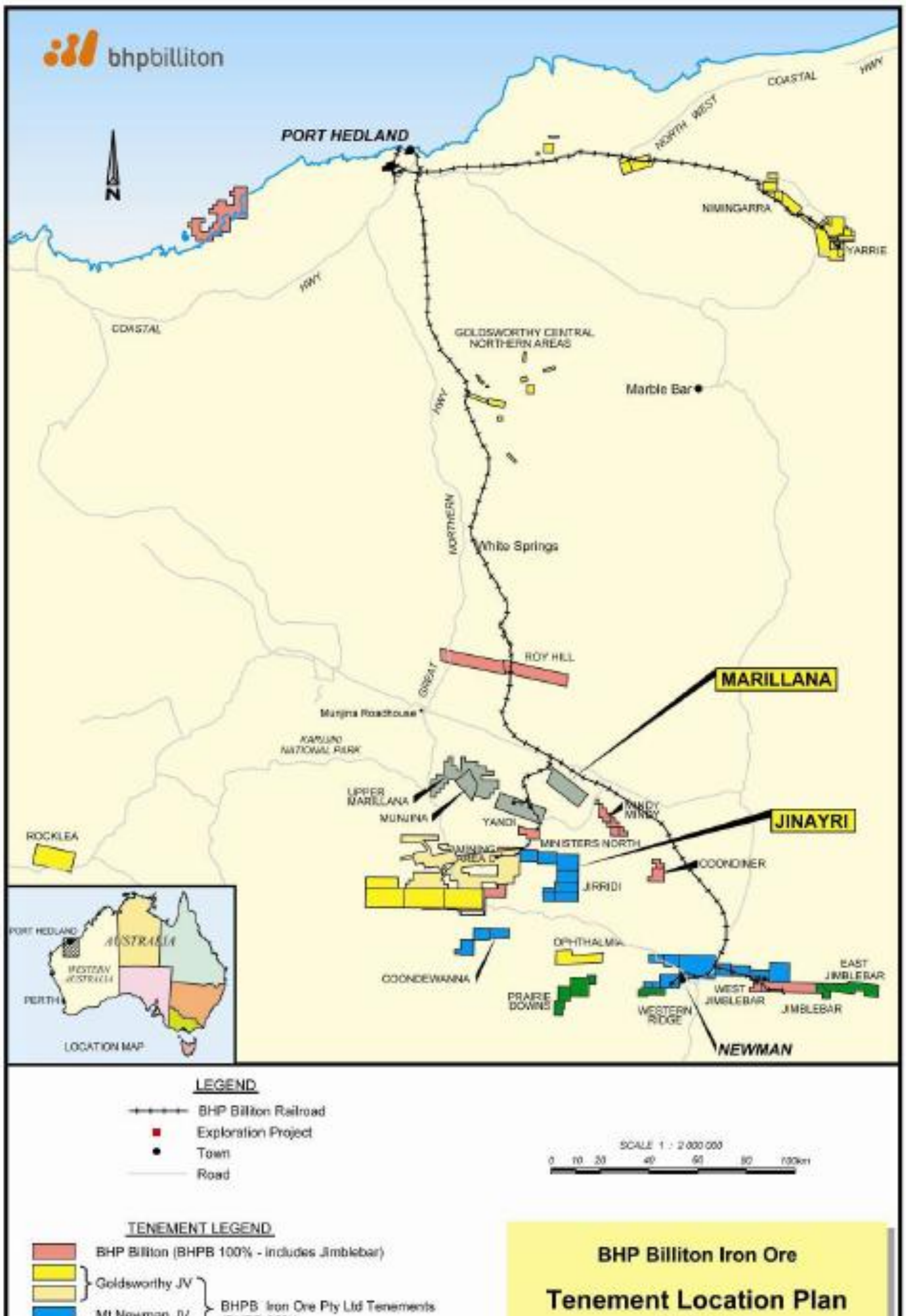
The remaining Iluka mineral sands business would be left with a lowly geared balance sheet that could accommodate the plethora of capital investment opportunities available to the company. For example, production growth at Sierra Rutile (assuming the deal closes), or new production at Cataby and Balranald.

When our estimate of the value of the royalty is combined with the A$500m of excess working capital that currently sits on Iluka's balance sheet, we estimate the implied value of the world leading mineral sands assets is ~A$500m, well below tangible book value (~A$1.4bn) and at a multiple of ~3x current EBITDA.

Background to the Royalty

Iluka has a royalty over iron ore produced from specific tenements in BHP Billiton's Mining Area C province in Western Australia, representing a deferred consideration from sale agreements dating back to 1977. An antecedent company to Iluka, Consolidated Goldfields, originally had a one-third interest in the Mt Goldsworthy Mining Associates Joint Venture. This interest was divested for a consideration of A$29m, which in 1994 was converted into a royalty and capacity payment arrangement. Iluka's right to the royalty is an in-perpetuity right – it is active as long as BHP Billiton produces and sells from this part of its iron ore tenements. Iluka has no exposure to capital and operating costs, nor State or Federal taxation changes.[1]

BHP Billiton Tenement Location Plan



Source: BHP Billiton

Main Components of the Royalty

Iluka's income from the MAC Royalty Area comprises a revenue based royalty and production capacity payment covering the Mining Area C (Mining Lease 281 containing various deposits) and consists of:

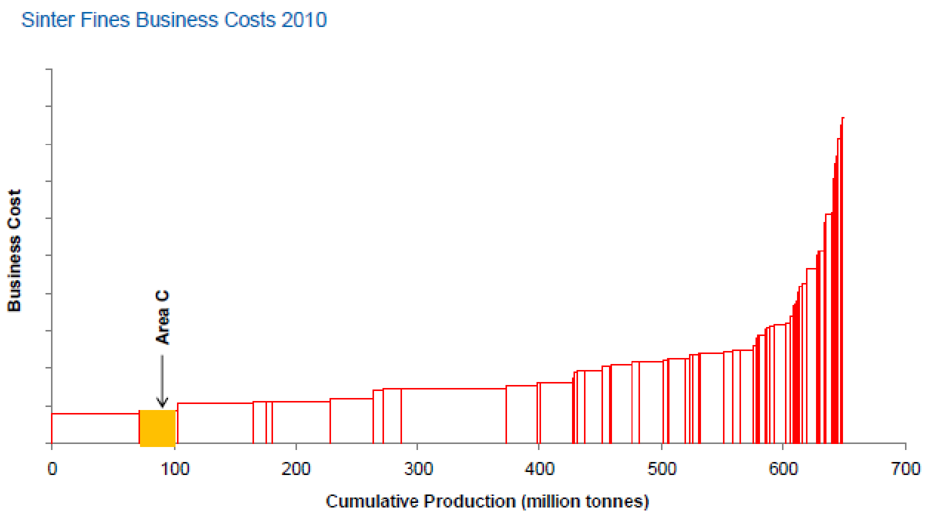
- the greater of:
  - (i) ongoing quarterly royalty payments of 1.232% of sales revenue from the MAC royalty area (less all export duties and export taxes), or
  - (ii) A$0.25 per tonne of all ore produced from the MAC royalty area in that quarter

- when applicable, annual capacity payments of A$1m per million tonne increase in the annual production level from the MAC royalty area during any 12 month period ending 30 June above the previous highest annual production level, paid within 30 days of the relevant amount of production being produced.[2]

Mining Area C Mining & Transport Operations

Mining Area C is located in the Pilbara region of Western Australia, 92kms north-west of the town of Newman. The mine is majority owned (85%) and operated by BHP Billiton, with the minority owners being Mitsui (7%) and ITOCHU (8%). Iron ore produced at Mining Area C is crushed and screened before being transported 360km by the Mt Newman JV-owned rail to Port Hedland where the ore is loaded onto ships at Finucane Island and transported to international markets. According to a CRU cost curve produced in 2010, Mining Area C is close to the lowest cost iron ore mine in the world, which stands the asset in good stead to produce iron ore in any pricing environment.

Global Iron Ore Cost Curve



Source: CRU
CRU utilises a value based costing system which incorporates: raw material costs; royalty payments; conversion costs; realization costs (freight costs and marketing and finance expenses); business costs; corporate and capital costs.

The ore produced at Mining Area C is also of high quality with a product grade of ~61%, low silica and alumina content (~6.5%), and a high proportion (~38%) of premium priced lump in the product mix.[3]

Mining Area C Reserves & Resources

BHP Billiton no longer report reserves and resources by mining hub. The last time this was reported was FY12 and at that point in time, the resource statement showed that the Mt Goldsworthy JV Area C was particularly well endowed with a total resource base of in excess of 5.5bn tonnes, at a grade of 60% and with low impurities. Assuming that half of the resource base will eventually convert to reserves and be mined, Mining Area C has around 55 years of mine life at current production of 50Mtpa, or close to 30 years of mine life at production of 100Mtpa.

Mineral Resources

As at 30 June 2012

Commodity Deposit [1][2]	Ore Type	Measured Resources						Indicated Resources					
		Mt	%Fe	%P	$\%SiO_2$	$\%Al_2O_3$	%LOI	Mt	%Fe	%P	$\%SiO_2$	$\%Al_2O_3$	%LOI
Iron Ore													
Mt Newman JV	BKM	412	64.1	0.08	3.8	1.9	1.9	1,361	60.9	0.12	5.1	2.5	4.5
	MM	13	61.2	0.07	2.7	1.5	7.6	184	60.2	0.06	3.6	2.4	6.9
Jimblebar [3]	BKM	387	61.4	0.12	4.4	2.7	4.6	570	60.4	0.12	4.9	3.0	5.1
	MM	108	61.0	0.08	3.8	2.1	6.1	188	59.8	0.08	4.2	2.5	6.9
Mt Goldsworthy JV Northern [4]	NIM	27	60.7	0.06	9.0	1.3	2.4	99	61.6	0.06	8.0	1.1	1.7
Mt Goldsworthy JV Area C	BKM	135	61.8	0.14	3.1	2.3	5.6	579	59.2	0.14	5.8	2.8	6.1
	MM	209	62.2	0.06	3.1	1.7	5.7	315	60.7	0.06	4.3	2.0	6.4
Yandi JV	BKM	–	–	–	–	–	–	–	–	–	–	–	–
	CID	1,033	56.2	0.05	6.2	1.9	10.9	394	56.4	0.04	6.7	1.8	10.5
BHP Billiton Iron Ore Exploration [5]	BKM	–	–	–	–	–	–	–	–	–	–	–	–
	MM	–	–	–	–	–	–	–	–	–	–	–	–
		Mt	%Fe	%Pc				Mt	%Fe	%Pc			
Samarco JV [6]	ROM	3,041	39.5	0.05				3,011	37.1	0.05			

Mineral Resources

As at 30 June 2012

Commodity Deposit [1][2]	Ore Type	Inferred Resources						Total Resources						BHP Billiton Interest %
		Mt	%Fe	%P	$\%SiO_2$	$\%Al_2O_3$	%LOI	Mt	%Fe	%P	$\%SiO_2$	$\%Al_2O_3$	%LOI	
Iron Ore														
Mt Newman JV	BKM	1,380	59.2	0.13	5.3	2.9	6.1	3,152	60.6	0.12	5.0	2.6	4.9	85
	MM	1,060	59.3	0.08	4.4	2.5	7.3	1,257	59.4	0.07	4.2	2.5	7.3	
Jimblebar [3]	BKM	1,200	59.9	0.13	5.0	3.2	5.4	2,157	60.3	0.13	4.9	3.1	5.2	100
	MM	190	58.6	0.08	5.2	2.8	7.4	485	59.6	0.08	4.5	2.5	6.9	
Mt Goldsworthy JV Northern [4]	NIM	60	60.2	0.06	10.2	1.3	1.9	187	61.0	0.06	8.8	1.2	1.9	85
Mt Goldsworthy JV Area C	BKM	1,560	59.4	0.12	5.8	2.7	5.8	2,274	59.5	0.13	5.7	2.7	5.9	85
	MM	2,770	59.8	0.06	4.6	2.1	7.2	3,294	60.0	0.06	4.5	2.1	7.0	
Yandi JV	BKM	2,500	59.0	0.15	5.0	2.3	7.3	2,500	59.0	0.15	5.0	2.3	7.3	85
	CID	1,040	55.0	0.06	6.5	2.9	11.0	2,467	55.7	0.05	6.4	2.3	10.9	
BHP Billiton Iron Ore Exploration [5]	BKM	2,460	59.1	0.15	4.4	2.8	7.4	2,460	59.1	0.15	4.4	2.8	7.4	100
	MM	370	59.6	0.06	4.8	2.5	6.0	370	59.6	0.06	4.8	2.5	6.0	
		Mt	%Fe	%Pc				Mt	%Fe	%Pc				
Samarco JV [6]	ROM	2,019	36.0	0.05				8,071	37.7	0.05				50

Source: BHP Billiton

Development of South Flank

According to recent commentary in the press from BHP Billiton, the company's production from Yandi will need to be replaced by production from another source in the medium term:

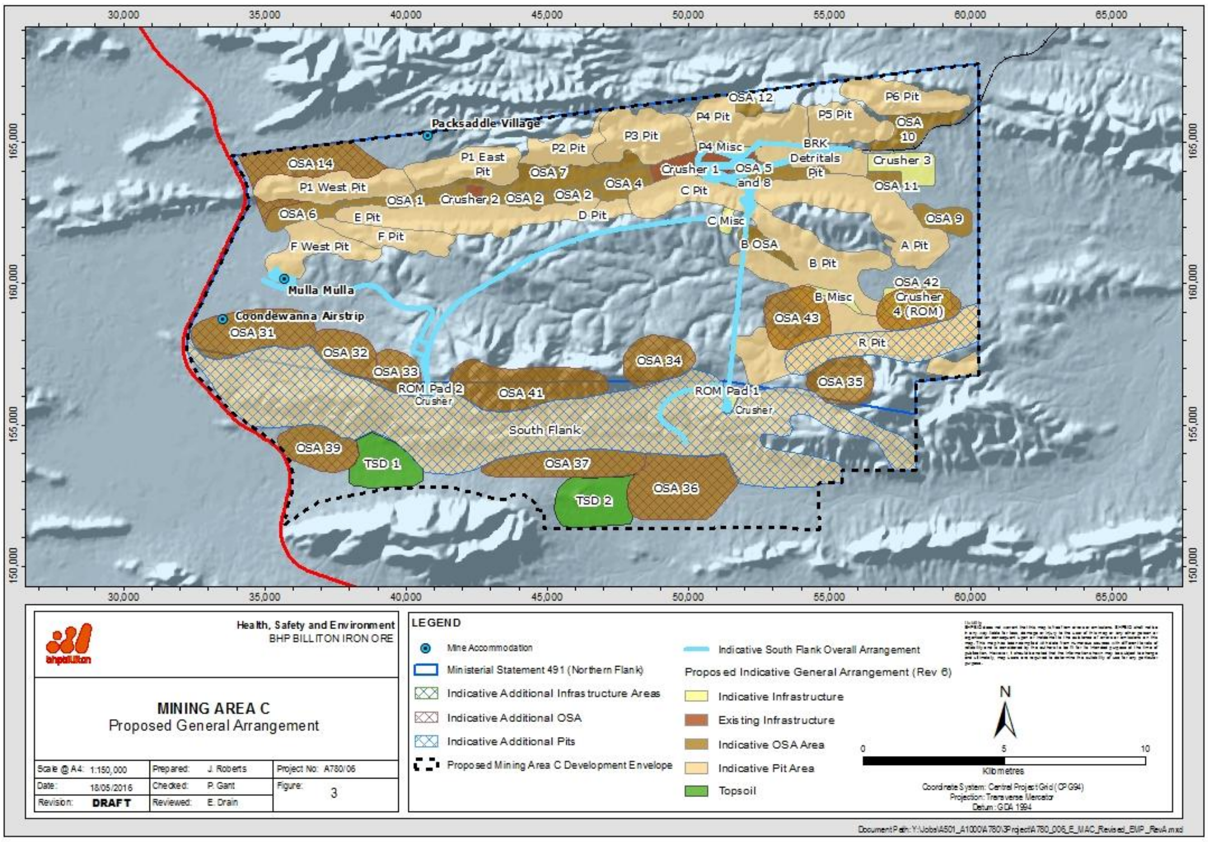
"We are currently studying a number of options to sustain our supply chain capacity for the future, and the South Flank deposit is one option under consideration. At the current rate of production, the resource supporting Yandi's 80mtpa operation will need to be sustained from other ore sources at some stage over the next five to ten years."[4]

Whilst this comment was quite vague regarding the development of South Flank, a "Mining Area C Revised Proposal" submitted to the EPA in May 2016 was more explicit:

"The revised Proposal includes the development of a new satellite ore body at Southern Flank, which is located approximately 8 km to the south of the existing approved Mining Area C operations... Conventional open pit mining methods will continue to extract ore from the existing approved Mining Area C deposits and

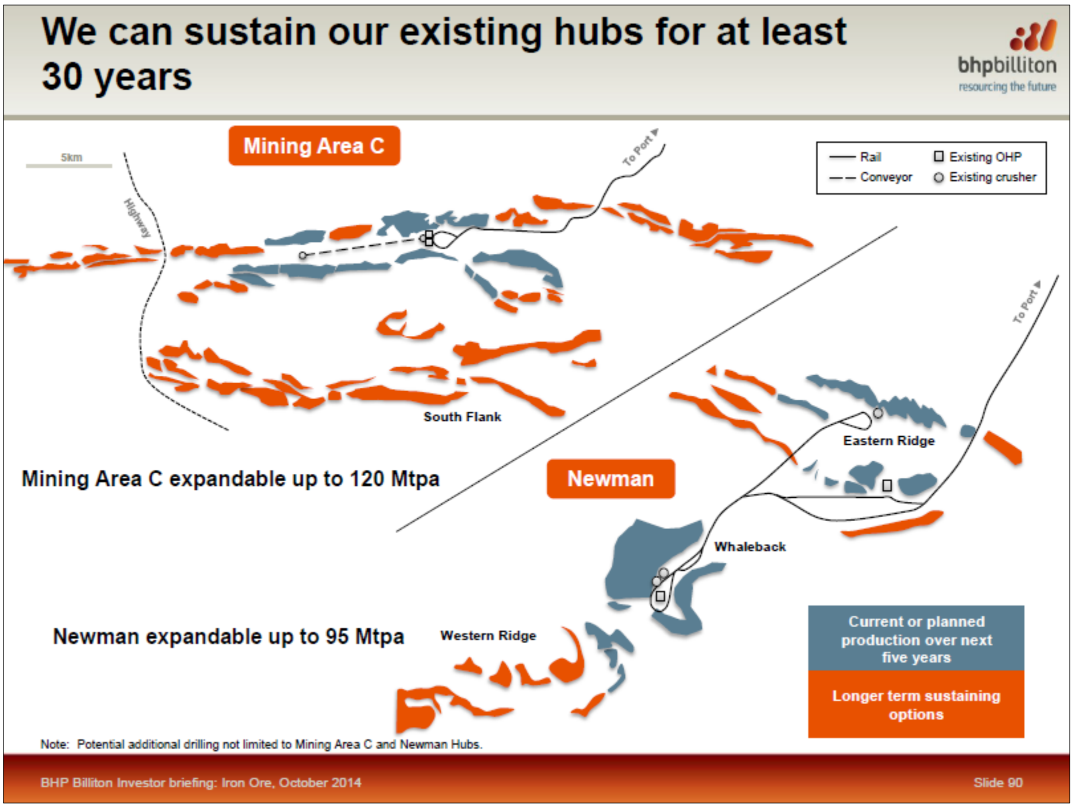
the proposed Southern Flank deposits. Overland conveyors will transport ore from the Southern Flank deposits to existing processing facilities at Mining Area C…The timing for development of the Southern Flank deposits will be designed as a sustaining tonnes option to coincide with the rate of resource depletion at other BHP Billiton Iron Ore existing operations in the Pilbara region. Mining commenced at Mining Area C (initially at C Deposit) in 2003. Taking into consideration the existing approved and proposed new deposits at Southern Flank, this new Revised Proposal provides sufficient resource to continue operations well into the future (~ another 30 years)."[5]

The same EPA proposal also highlighted the proposed mine layout for South Flank:



Source: BHP Billiton

Whilst it has not been confirmed by BHP Billiton, we believe that the South Flank satellite ore body will be developed some time in the next 5-10 years. A presentation by BHP Billiton in October 2014 also highlights that South Flank was then at the top of its priority list for development projects. The presentation was released when BHP Billiton had more ambitious production plans, however we believe the comments that Mining Area C is *'expandable to 120Mtpa'* and *'We can sustain our existing hubs for at least 30 years'* give a high degree of confidence that South Flank will be developed and will be a material increase to the production that Iluka's MAC royalty currently pertains to.



Source: BHP Billiton

Royalty Production & Financial Characteristics

Since production commenced in 2003, Mining Area C has produced over 450Mdmt of iron ore for cumulative EBIT to Iluka of almost A$650m. This is despite having a book value of only $16.7m at 30 June 2016. With little to no further capital required, we expect the MAC royalty to continue to generate large amounts of free cash flow in its current state and significantly more if and when the South Flank deposit moves into production.

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	1H16
Sales (Mdmt)	20.5	20.3	23.2	36.8	40.3	43.3	44.6	47.4	52.5	53.4	53.5	25.4
Royalty income (A$m)	11.5	16.1	17.9	50.8	42.6	71.3	87.1	69.7	84.3	65.8	48.2	21.0
Capacity payments (A$m)	12.0	3.0	2.0	6.0	8.0	5.0	1.0	3.0	4.0	1.0	3.0	0.0
EBIT (A$m)	23.5	19.1	19.9	56.8	50.6	76.3	88.1	72.7	88.3	66.8	61.6*	21.0
Assets (A$m)	13.1	13.2	13.7	20.8	15.8	27.7	25.6	21.8	27.0	18.2	15.3	16.7
Return on Assets (%)**	46%	126%	101%	102%	191%	224%	193%	241%	233%	229%	257%	176%

* includes $10.4m receipt upon modifications to MAC royalty agreement

** After tax, assuming a 30% tax rate

Source: Iluka, Sandon Capital analysis

Valuation of the Royalty

Currently, there are no listed royalty companies in Australia of meaningful size. However, the North American markets have a number of listed commodity royalty companies that provide a good basis for valuing the MAC royalty. We also see the North American royalty companies as the template for what Iluka's MAC royalty could become if it was spun out into a separately listed entity and provided the means to grow.

The table below highlights the valuation multiples that the North American royalty companies are currently trading on:

	Mkt Cap	EV	EV / EBITDA			EV / EBIT			P/E			Div Yield
	US$m	US$m	CY15	CY16	CY17	CY15	CY16	CY17	CY15	CY16	CY17	%
United States												
Franco-Nevada	10,508	10,282	30.9	21.4	19.3	88.6	49.3	38.0	109.8	64.3	52.5	1.5%
Silver Wheaton	8,304	8,886	20.8	14.7	11.8	39.0	29.3	18.8	35.5	29.2	19.9	1.1%
Royal Gold	4,658	5,199	22.8	17.6	14.4	46.8	36.8	28.2	66.9	47.8	34.0	1.3%
Canada												
Labrador Iron Ore Royalty	843	834	15.2	10.7	10.1	16.3	11.2	10.6	20.8	17.9	18.4	5.6%
Sandstorm Gold	579	636	28.7	18.2	18.0	nmf	42.9	44.5	-46.5	108.7	63.9	0.0%
Osisko Gold Royalties	1,045	764	54.1	23.0	19.8	56.3	33.2	29.4	41.2	41.4	37.6	1.2%

Source: Bloomberg, Sandon Capital analysis. Data as at 28 November 2016

The closest company in form and substance to Iluka's MAC royalty is Labrador Iron Ore Royalty Corporation (LIF), listed in Canada. It holds a 15.1% equity interest in Iron Ore Company of Canada (IOC) and receives a 7% gross overriding royalty and a 10 cent per tonne commission on all iron ore products produced, sold and shipped by IOC. The major difference to Iluka's MAC royalty is that MAC is close to the lowest cost producer of iron ore in the world, whilst IOC is a high cost producer that is barely profitable at current iron ore prices. According to Rio Tinto, the 58.7% majority owner of IOC, the business generated a loss of US$9m in 1H16 following net earnings of only US$12m in CY15. Whilst the business appears to be cash flow positive (EBITDA – capex), we question whether the 30+ years of reserves will actually be mined if iron ore prices remain at low levels. Furthermore, given Rio Tinto's now aborted attempts to sell its stake in IOC, we believe counterparty risk for this asset will be elevated in the future if Rio Tinto does happen to sell. Given BHP Billiton's majority ownership of Mining Area C and the low production cost of the asset, there are no questions surrounding its viability at bottom of the cycle prices and for this reason we think Iluka's MAC royalty should be valued at a material premium to Labrador Iron Ore Royalty Corporation.

The other, predominantly precious metal, royalty / streaming companies in North America trade on CY17 EV/EBIT multiples in excess of 25x. We do not expect Iluka's MAC royalty to trade on these multiples given the North American royalty / streaming companies have multi asset royalties across a number of commodities in differing geographies. However we do believe a multiple somewhere between LIF and the other precious metal royalty / streaming companies is appropriate, this being in the order of 16-18x EV/EBIT.

Assuming Mining Area C produces 55Mtpa of iron ore, an iron ore benchmark price of $55/t and an A$/US$ of 0.75, Iluka's MAC royalty generates EBIT of A$52.3m. Applying a 16-18x multiple on this earnings stream yields an enterprise value of A$840-940m. Should South Flank be developed and effectively double the production at Mining Area C, then Iluka's MAC royalty could be worth A$1.7-1.9bn as a standalone entity. When our estimate of the value of the royalty is combined with the A$500m of excess working capital that currently sits on Iluka's balance sheet, we estimate the implied value of the world leading mineral sands assets is ~A$500m, well below tangible book value (~A$1.4bn) and at a multiple of ~3x current EBITDA.

Conclusion

The first reference we have been able to find regarding Iluka's MAC royalty was in the Independent Expert Report for the Merger by Scheme of Arrangement between RGC Limited and Westralian Sands Limited – the merged company later changed its name to Iluka – where it was valued by Grant Samuel at A$10-14m in September 1998.[6] Through the development of Mining Area C into one of the world's largest and lowest cost iron ore deposits and the significant increase in iron ore prices over the past 15-20 years, the value of the royalty has increased exponentially. We believe the royalty will become even more valuable if and when BHP Billiton develops the South Flank deposit.

It is our belief that this royalty is materially undervalued whilst it is housed within a mining company. It appears that the company also shares this view given its comments in a briefing paper on the royalty:

"Iluka believes the royalty is often undervalued by the investment community, given a majority of analysts typically apply an operating company weighted average cost of capital to discount the cash flow stream, whereas the risk characteristics of this revenue stream (in terms of capital, operating cost, counter party risk) are lower than that for a typical mining company and should be afforded an appropriate, lower discount rate. International market earnings and cash flow multiples routinely afforded listed royalty companies would support this view."[7]

Iluka has one of the better track records in capital allocation in the global mining industry over the past decade. We believe the company has an opportunity to enhance this track record by demerging the company's iron ore royalty into a separately listed entity where it will be valued more appropriately.

In order to properly value the MAC royalty and maintain the integrity of Iluka's balance sheet, we think the company should demerge the royalty via an in-specie distribution to existing shareholders. A focused standalone royalty company, with its own dedicated board and management, would be able to focus on growth opportunities such as adding other royalties or even looking at 'streaming' deals such as those undertaken by North America royalty/streaming companies. The powerful cash flow generation of the royalty could support at least $300m of debt in a standalone entity. Transfer of the debt at the time of the demerger would leave Iluka's balance sheet unencumbered.

The remaining Iluka mineral sands business would be left with a lowly geared balance sheet that could accommodate the plethora of capital investment opportunities available to the company. For example, production growth at Sierra Rutile (assuming the deal closes), or new production at Cataby and Balranald.

Footnotes

1. Iluka's Mining Area C Iron Ore Royalty briefing paper, July 2010
2. Iluka's Mining Area C Iron Ore Royalty briefing paper, July 2010
3. BHP Billiton Iron Ore briefing and Western Australia Iron Ore site tour, October 2014
4. The West Australian, 9 June 2016
5. https://consultation.epa.wa.gov.au/seven-day-comment-on-referrals/mining-area-c-revised-proposal
6. Information Memorandum in relation to a Merger by Scheme of Arrangement between RGC Limited and Westralian Sands Limited, November 1998
7. Iluka's Mining Area C Iron Ore Royalty briefing paper, July 2010

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