

Territory Resources

Buy TTY around \$1.19

Iron ore production firmly on track

[Fat Mining 113](#), 20 Feb, 2008
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SYMBOL DEFINITIONS			
 DIVERSIFIED RESOURCES	 HIGH RISK	 MARKET CAP	\$303m
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We had the opportunity to meet recently with two of Territory Resources' senior executives for an update on the company's iron ore production activities. Encouragingly, iron ore production at the company's Frances Creek mine in the Northern Territory is continuing to exceed budgeted levels, whilst planning is continuing for an eventual doubling in output. Meanwhile, an aggressive drilling programme is continuing to deliver the tonnage to underpin the proposed expansion and extension to mine life.

"Territory Resources remains our stand-out iron ore favourite."

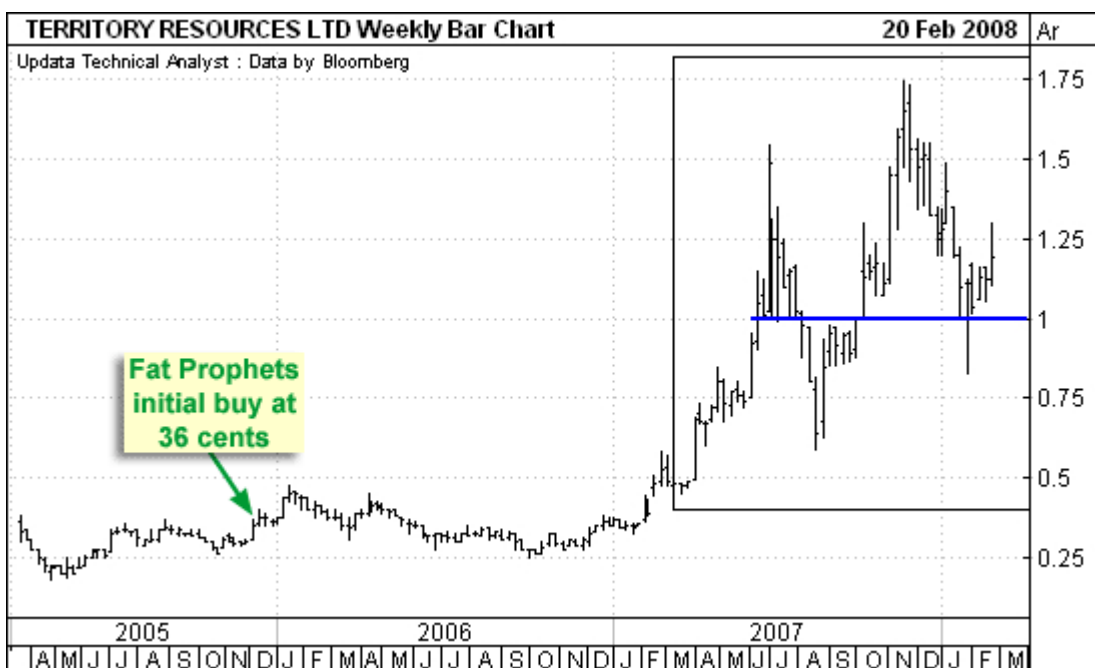
Fat Prophets initially recommended buying Territory Resources at 36 cents in December 2005 (Fat Mining 6). Our last review of the stock was during November in Fat Mining 99.



Since reaching a new all time high of \$1.74 in November, there has been a notable correction in the share price. However, recent gains signal that the outlook for territory remains positive.

Encouragingly, downward momentum has slowed over the past month, and a period of consolidation has developed above \$1. Furthermore, prices have recently lifted higher from this range, which in our opinion signals the early stages of a revival of longer-term upward momentum.

As evident on the weekly chart, despite volatility along the way, an upward trend has emerged over the past year. In our opinion, this trend will likely continue in the coming months, with new highs above \$1.74 achievable in time.



We had the opportunity to meet recently in Sydney with Territory Resources' Chairman, Michael Kiernan, and CEO Allan Quadrio. In our discussion they outlined their vision of building upon and expanding the company's existing Frances Creek iron ore business and provided an update on the company's production progress, which is most encouraging.

At the same time though, the board is actively looking to diversify the company's production and earnings base away from purely iron ore to become a fully diversified carbon steel and other commodity company. Effectively, Mr Kiernan is trying to replicate the business model that he successfully implemented whilst at the helm of Consolidate Minerals.

Whilst we won't focus on these other opportunities here, they include investments in mid-tier mineral sands producer, Matilda Minerals (MAL) and emerging vanadium producer, Windimurra Vanadium (WVL).

We firmly believe this to be an extremely sound business strategy, but we are surprised that Territory is the only iron ore aspirant looking to diversify its earnings base. We have previously aired our concerns about the vast majority of Australia's iron ore aspirants and their prospects for success.

Michael Kiernan has implemented a growth strategy aimed at leveraging off Territory's recently commissioned Frances Creek iron ore project in the Northern Territory. The beauty of Frances Creek is two-fold.

Firstly, Frances Creek gives the company a huge and extremely valuable head start on the chasing pack of iron ore aspirants, most of which are still years and hundreds of millions of dollars in financing away from production; and secondly, the project was developed on a shoestring budget compared with most of its iron ore peers.

The key of course is Frances Creek's proximity to existing infrastructure, which differentiates the project from most of Territory's colleagues, which are isolated and require huge capital expenditure. Territory will maximize its operating margins, as Frances Creek is located just 190km of Darwin and within close proximity of road, rail and port facilities.

We believe earnings diversification away from a sole reliance on iron ore will be crucial, given the plethora of pure iron ore players set to hit the market over the next five years. Most of these new players will have heavy debt burdens and their operations will be very sensitive to fluctuations in iron ore prices.

Whilst iron ore prices have been rising strongly for six years now, margins historically have never been this strong. The current situation can therefore present a highly distorted picture. As we have previously highlighted, iron ore is historically a relatively low margin business, which is why it is classified as a bulk

commodity.

The major producers that currently supply 80% of the world's iron ore trade, comprising CVRD, Rio Tinto and BHP Billiton, will remain in a position of strength in our view. They have the capacity to wear future price reductions in a trade-off for volume with Asian steel producers, which could put severe pressure on the operating margins of new iron ore players that have massive debt burdens to repay.

The key to profitability and longer-term survival in the industry is the ability to minimise costs and remain dynamic. This is the big advantage that Territory Resources has over all of its smaller iron ore peers.

Territory firstly has current production that allows it to take full advantage of the window of opportunity in iron ore that presents itself right now, and secondly, it is looking to build other income streams to reduce its exposure to iron ore alone. This is visionary stuff and what company building is all about.

For newer Members that may be unaware, the Frances Creek project area had a successful history of iron ore production and export right up until 1974, when damage associated with Cyclone Tracy and lower prices closed the mine.



A change in circumstances over the past 30 years has made the revival of Frances Creek possible, the most important being the Alice Springs to Darwin railway line, which allows transportation of the ore to the port of Darwin for export. Other important factors are new Darwin port facilities and much better market conditions driven by China.

Frances Creek produces a mixture of both lump and fine ore through a simple crush and screening process, currently at a rate of 1.5 million tonnes per annum (tpa). This currently gives Frances Creek a project life of just over three years based on current reserves and six-and-a-half-years based on current resources.

As we have previously stated though, this is a base-case situation, with the company aiming firmly to double iron

ore output to 3.0 million tpa and expand mine life out to ten years. This is immensely achievable in our view as Frances Creek hosts a 35km strike length that is highly prospective for additional iron ore deposits. Recent exploration results support our view.

During the December 2007 quarter, iron ore production continued to exceed budgeted levels, with a total of four shipments (two fine and two lump) exported, which was one shipment above forecast.

The mine is continuing with planning and production to ramp up production towards an annualised target of 3.0 million tpa, whilst an aggressive drilling programme is importantly continuing to deliver the tonnage to underpin an extension to Frances Creek mine life.

The simple mathematics tells the story. Conservative annual production of 1.5 million tonnes at a conservative operating margin of around A\$30 per tonne will generate net cash flow of A\$45 million annually. If we double that to 3.0 million tonnes, net cash flow leaps to \$90 million a year. Territory is therefore trading on a price-earnings multiple of under seven times, which falls to just over three times at the higher production rate.

Finally, a word on iron ore prices, with three of Asia's biggest steel producers this week agreeing to price

rises of between 65% and 71% for ore supplied by Brazil's CVRD. BHP Billiton and Rio Tinto are believed to be holding out for an even larger price rise, due to the lower cost to Asian buyers of shipping their ore from Australia. This is the sixth straight year of price increases.

Territory Resources continues to represent what we consider to be an outstanding resource play. We must admit that outside of Territory, our long-standing favourite, we find it very hard to find value in the iron ore sector.

We remain sceptical about the high development costs associated with most of the aspiring producers that will be hitting the market over the coming years and their 100% exposure to the iron ore price. Most will have heavy debt burdens and their operations will be very sensitive to iron ore pricing.

Territory Resources will remain firmly held within the Fat Prophets Mining & Resources portfolio. However, for Members with no current exposure we recommend the stock as a Buy around \$1.19.

Disclosure: Interests associated with Fat Prophets declare a holding in Territory Resources.

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