

Special Report 4th December 2010

Strategic Natural Resources (LON: SNRP) – Do the maths!

A coal play in South Africa

Coal can often divide opinions. For those with longer memories, the word usually conjures up images of Arthur Scargill and the Miners strikes which plagued the UK in the 80's.

And again in the UK, with environmental concerns paramount, coal for power generation is steadily being phased out - though more recently, much has been made of promising developments in the area of [carbon capture & sequestration](#).

In the developing world however, where growth in power consumption is ubiquitous, it's a different story. Nuclear power holds the promise of zero emissions and is the favoured solution from a long term planning perspective; but given the timescales required for implementation, it does nothing to alleviate the immediate, (and often chronic) supply constraints.

So the attraction of Coal is in the stop-gap solution it provides; and with [China about to become largest user of coal-derived electricity](#), generating 1.95 trillion kilowatt-hours per year, we can see how in the near and medium term, coal will remain an essential source of energy generation and as such, simply cannot be ignored.

So, vulgar opportunists that we are, we remain firmly focused on these global realities and for us, the demand/supply dynamics form an extremely compelling investment case.

So with a conducive tailwind driving market fundamentals, our next job is to identify the best investment opportunities – the right vehicles - and in the case of stocks, which ones to pick....?

We have had a few interesting thoughts on which stocks consider and when we ran our Coal Slide Rule up against [Strategic Natural Resources](#), we got plenty of the boxes ticked; more than enough to make us wonder just how undervalued this tiddler might actually be!

See what you think; we have put together a few notes here and whilst we urge all investors to do their own research, we think this may just spark some enthusiasm.

Firstly, we are impatient and want to know about the quality of the licences and the exclusivity thereof. Here SNRP have a lead on the market with their [Elitheni Project](#) being the only coal project on the Eastern Cape of Africa and one with 30 years of exclusive mining rights to boot!

The licences are situated within areas hungry for coal supplies and, in the case of export demand, within an acceptable distance of the available ports.

Moreover, three years ago SNRP held just 9,283 hectares of land within their licences and now that has increased to 180,000 hectares - that's 694 square miles in case you wondered – Greater London covers 610 square miles, so by any standards, a huge land holding!

With South Africa, there is always the geopolitical risk to consider, and of course the local operating company [Elitheni Coal \(Pty\) Limited](#), is 74% owned by SNRP and 26% by a Local Black Empowerment Enterprise (BEE) (see the Company's [11th November Announcement](#) noting recent positive developments here), as is standard for companies with foreign investment, so the appropriate structure is in place, in line with local requirements.

In addition to the local operating company, we always like to look at the shareholder register and for SNRP that made us sit up and take notice. On the [AIM Rule 26 page](#) from the company website you will see [Coal of Africa](#) as the leading shareholder with 19.05%, Southern Cape Corridor Power (majority owned by a trust associated with Barry Nel, Director of SNRP) with 14.98% and Credit Suisse holding 14.43% across the Securities and Nominee accounts combined.

Director Jeremy Metcalfe owns 3.1% and Chairman Richard Latham 3.01% and in total some 81.25% of shares are held by those with more than 3% leaving just 18.75% in technical free float from total shares of just 94.1million. In other words a relatively illiquid stock with a robust and 'management inclusive' shareholder register! That said, an additional 10m shares are expected to be issued, in line with the BEE restructuring as referred to in [11th November announcement](#).

So with the territory, licences and ownership matters addressed - what of the Resource?

Well three years ago when they came to market at 30p per share they held a resource of just 15Mt, but now this stands at 150Mt – that's a tenfold increase! And, more importantly, this resource comes from just 3% of the licences, with the remaining 97% yet to be explored.

Doing our first Maths, it is easy to deduce that if the resource found thus far is replicated over the balance of their licences, that could equate to a multi-billion tonne resource.

Of course that is a rather big assumption, but it does give an indication of the potential and scale by which the existing resource can be grown.

The Company, on the other hand, take a slightly more specific approach and have concluded their own 'extrapolation' of the resource, based on evidence from previously accessed informal adits and coal outcrops - indicating a potential in-situ tonnage of 3billion tonnes discounted back for prudence by 50% to 1.5billion tonnes of coal.

If one assumes the coal is there, can they mine it and produce? Well here, once more, we stood up and took notice, because one look at their [gallery pictures](#) should answer that question.

Their 30 year exclusive mining rights mean they certainly should be able to produce. And their target, in the short term is to build to 500,000 tonnes per annum mined and supplied to local industries.

In the medium term, the company is also looking to develop three additional sources of revenue. Namely export markets, power generators and metallurgical supply.

In total, the expected volumes through these sources approximate to around 5million tonnes per annum.

One also has to remember that the project is yielding [Anthracite coal](#), which is lower in sulphur and higher in carbon content, improving the attractiveness of this material to consumers.

The company appears confident that the customers can be secured and it looks like many are already pounding on the door seeking to do deals with Strategic. So it would not be too optimistic to suggest there may be further news soon.

But, even if the customers are there, moving millions of tonnes of coal is no mean feat. Is it feasible?

Well we think it may be looking that way - with the third stage of a detailed feasibility study completed and [announced in October](#).

It seems that Strategic's coal can be exported and also applied to a variety of local uses. In addition, a completed Feasibility Study could also assist them in securing of bank (debt) funding, which could help avoid the dilution issues Investors tend to focus on.

Speaking of funding, how is the company doing for cash? Well they seem to be pretty well funded for the foreseeable future (12 months or so we understand) and, as noted above, as and when they may need additional funding, the company is looks likely to opt for debt based funding rather than equity, thus reducing dilution.

And of course as sales start to flow, there will also be the value of an incoming cash stream to consider. The amount of net cash inflow and profits of course depends on operating costs which are not so easy to judge at this stage.

We don't know what the level of profitability will be, so we thought we would do a little straightforward sensitivity analysis using assumed profits per tonne of \$10, \$20 and \$30.

If the company achieves 500,000 tonnes per annum, that would represent a profit of \$5million per annum (£3.1million), assuming a \$10 profit margin per tonne. And at 1m tonnes this would amount to \$10million profit margin per annum and 5m tonnes would amount to \$50million.

At \$20 per tonne the figures become: 500,000 tonnes - \$10million, 1m tonnes - \$20million and 5m tonnes - \$100million, all per annum.

And at \$30 per tonne the figures upgrade further to: 500,000 tonnes - \$15million, 1m tonnes - \$30million and 5m tonnes \$150million, again all per annum.

No doubt, as the actual revenues, costs and margins become known, along with the future growth rates, the accountants can get out their Price Earning (PE) slide rules and determine a sensible PE ratio for this level of earnings. Also one should remember that Strategic only hold 74% of the project, so any net profit should be adjusted accordingly.

Of course it's not just about earnings, but asset value as well. And as each year goes by, company exploration is expected to materially add to the known resource. How much would or could a billion tonne coal resource be worth?

The reality is that SNRP seems to have just about everything moving in the right direction and, as demonstrated by two parties making an offer for the business last year (details [here](#) and [here](#)); they look to be attracting an increasing array of interest.

So with all this going wouldn't one expect the market to value SNRP quite highly? Well at 18.5p per share, the market capitalisation equates to just under £18m, something that caused us to triple check our calculations!

We believe this may represent something of an outstanding opportunity and entry point and would encourage readers to scrutinise the company and its operations sooner rather than later.

Disclosure: The Authors hold shares in SNRP

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We are building a network of investors who are, like us, on the look out for value propositions and prefer a no nonsense approach to investing in the natural resource sector.

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