

Equities

8 May 2012 | 12 pages

African Rainbow Minerals (ARIJ.J)

Attractive iron ore exposure at a discount price

Company Update

Buy	1
Price (07 May 12)	R176.00
Target price	R220.00
Expected share price return	25.0%
Expected dividend yield	3.4%
Expected total return	28.4%
Market Cap	R37,720M
	US\$4,817M

Price Performance

(RIC: ARIJ.J, BB: ARI SJ)



Johann Pretorius

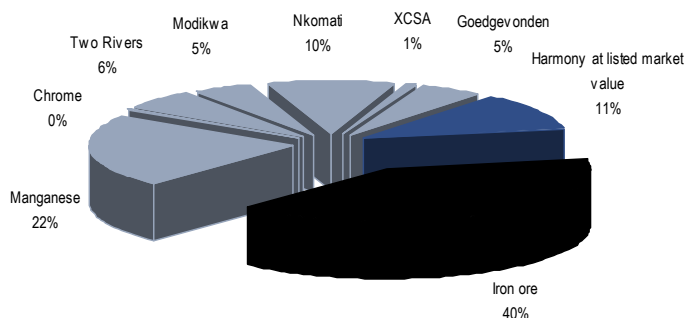
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- **ARM seems to offer a lot for free...** — ARM's value could be justified by the implied value of its iron ore division alone if one applies Kumba's valuation per iron ore tonne. This means you get ARM's manganese, platinum, nickel and coal assets (Figure 1) effectively for free at its current share price on our estimates. We value ARM's other divisions at R21bn, which is around 55% of its current market cap.
- **...applying Kumba's EV/production tonne** — We calculate Kumba's enterprise value (EV) per 2015 production tonne at US\$572. Applying this multiple to African Rainbow Minerals' projected 2015 attributable iron ore production of 8Mt, we calculate ARM's iron ore division's EV at R35.8bn. This is more than ARM's entire market value (excluding its stake in Harmony) of R34.5bn.
- **ARM even cheaper on EV/iron ore reserve tonne** — ARM (excluding Harmony) trades at an EV per reserve tonne of USD22.5, which is a 41% discount to Kumba's USD38 even if no value is given to ARM's other divisions.
- **BUY ARM** — ARM's high quality iron ore asset seems to be trading on a very attractive relative valuation. We like ARM's long-life, low-cost assets, near-term iron ore growth prospects, and strong balance sheet. Our one-year target price of R220 offers 28% one-year total return potential and we maintain our Buy recommendation.
- **Sell Kumba** — Apart from our view of falling iron ore prices we are concerned about the following: 1) Kumba is more expensive than peers on relative valuations 2) more cost pressure than peers due to increasing mining complexity at Sishen, 3) Kumba has a shorter reserve life (about 23 years) than major peers. 4) Limited reserves could mean the end of its strong growth profile beyond Kolomela, which is currently ramping up. 5) Limited reserves also mean that Kumba may be forced into an acquisition, which poses capital allocation risk. Our target price is R430.

Figure 1. Contribution to ARM's DCF derived enterprise value (R44 233m)



See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

ARIJ.J: Fiscal year end 30-Jun						Price: R176.00; TP: R220.00; Market Cap: R37,720m; Recomm: Buy					
Profit & Loss (Rm)	2010	2011	2012E	2013E	2014E	Valuation ratios	2010	2011	2012E	2013E	2014E
Sales revenue	11,028	14,897	16,856	18,545	21,150	PE (x)	22.1	11.3	11.1	10.5	8.3
Cost of sales	-7,842	-9,414	-11,154	-12,600	-14,025	PB (x)	2.1	1.8	1.6	1.4	1.3
Gross profit	3,186	5,483	5,703	5,945	7,124	EV/EBITDA (x)	8.2	5.0	4.7	4.2	3.3
Gross Margin (%)	28.9	36.8	33.8	32.1	33.7	FCF yield (%)	0.3	3.2	1.7	7.4	9.3
EBITDA	3,978	6,390	6,672	7,348	8,743	Dividend yield (%)	1.1	2.6	3.4	4.0	4.5
EBITDA Margin (%)	36.1	42.9	39.6	39.6	41.3	Payout ratio (%)	25	29	38	42	38
Depreciation	-1,002	-1,125	-1,197	-1,640	-1,865	ROE (%)	11.0	16.7	15.1	14.4	16.5
Amortisation	-2	-2	-2	-2	-2	Cashflow (Rm)	2010	2011	2012E	2013E	2014E
EBIT	2,974	5,263	5,473	5,706	6,876	EBITDA	3,978	6,390	6,672	7,348	8,743
EBIT Margin (%)	27.0	35.3	32.5	30.8	32.5	Working capital	-659	-399	-646	-484	-674
Net interest	17	0	40	15	91	Other	-239	-1,118	-1,398	-1,371	-1,434
Associates	-51	-135	-171	-190	-20	Operating cashflow	3,079	4,873	4,628	5,494	6,635
Non-op/Except	97	-11	2	0	0	Capex	-2,958	-3,682	-3,995	-2,669	-3,091
Pre-tax profit	3,037	5,117	5,344	5,531	6,947	Net acq/disposals	0	0	0	0	0
Tax	-1,009	-1,671	-1,768	-1,656	-2,020	Other	130	56	158	78	133
Extraord./Min.Int./Pref.div.	-162	-194	-160	-247	-318	Investing cashflow	-2,828	-3,627	-3,837	-2,591	-2,958
Reported net profit	1,866	3,252	3,415	3,627	4,608	Dividends paid	-371	-425	-959	-1,283	-1,496
Net Margin (%)	16.9	21.8	20.3	19.6	21.8	Financing cashflow	-784	-357	-1,940	-1,466	-1,700
Core NPAT	1,714	3,319	3,405	3,627	4,608	Net change in cash	-534	877	-1,149	1,437	1,977
Per share data	2010	2011	2012E	2013E	2014E	FCF ex acquisns & explorn	121	1,191	633	2,825	3,545
Reported EPS (R)	8.69	15.20	15.85	16.77	21.31	Segmental Revenue (RM)	2010	2011	2012E	2013E	2014E
Core EPS (R)	7.98	15.52	15.81	16.77	21.31	Two Rivers	2,099	2,274	2,354	2,646	2,925
DPS (R)	2.00	4.50	6.00	7.00	8.00	Modikwa	1,057	1,081	1,229	1,466	1,620
CFPS (R)	14.34	22.79	21.49	25.41	30.68	Nkomati	1,224	1,499	1,592	2,282	2,788
FCFPS (R)	0.56	5.57	2.94	13.06	16.39	Iron ore	2,518	5,171	6,877	6,975	7,052
BVPS (R)	83.69	99.27	112.72	123.69	138.26	Manganese	3,213	3,233	3,084	3,197	3,672
Wtd avg ord shares (m)	212	213	213	214	214	Chrome	704	1,134	948	867	827
Wtd avg diluted shares (m)	215	214	215	216	216	XCSA	1,253	1,273	1,428	1,656	2,070
Growth rates	2010	2011	2012E	2013E	2014E	Goedgevonden	212	505	773	834	1,003
Sales revenue (%)	9.3	35.1	13.2	10.0	14.0	Goedgevonden	212	505	773	834	1,003
EBIT (%)	-19.8	77.0	4.0	4.3	20.5	TEAL and exploration	1	0	0	277	1,263
Core NPAT (%)	-26.0	93.6	2.6	6.5	27.1	Corporate and other	0	0	0	0	0
Core EPS (%)	-26.0	94.4	1.9	6.1	27.1	Less: Equity accounted	-1,253	-1,273	-1,428	-1,656	-2,070
Balance Sheet (Rm)	2010	2011	2012E	2013E	2014E	Sales - total segments	11,028	14,897	16,856	18,545	21,150
Cash & cash equiv.	3,039	3,668	2,519	3,957	5,934	Segmental EBIT (RM)	2010	2011	2012E	2013E	2014E
Accounts receivables	3,077	3,299	3,789	4,429	5,120	Two Rivers	579	622	505	782	993
Inventory	1,982	2,292	2,518	2,665	2,943	Modikwa	215	180	203	339	442
Net fixed & other tangibles	13,300	15,575	17,999	18,638	19,448	Nkomati	287	148	-245	251	600
Goodwill & intangibles	212	202	200	208	216	Iron ore	1,027	3,243	3,954	3,409	3,290
Financial & other assets	6,623	7,273	7,556	7,638	7,726	Manganese	1,147	1,145	872	618	732
Total assets	28,233	32,309	34,582	37,535	41,387	Chrome	-120	-158	-4	-99	-155
Accounts payable	2,315	2,448	2,518	2,821	3,116	XCSA	30	-53	-106	-196	40
Short-term debt	764	732	963	995	1,052	Goedgevonden	54	122	217	318	424
Long-term debt	2,582	2,337	963	995	1,052	TEAL and exploration	-119	-151	-50	108	570
Provisions & other liab	4,043	4,677	4,888	5,129	5,459	Corporate and other	-96	112	20	-20	-20
Total liabilities	9,704	10,194	9,332	9,940	10,679	Less: Equity accounted	-30	53	106	196	-40
Shareholders' equity	17,765	21,157	24,095	26,440	29,553	EBIT - total segments	2,974	5,263	5,473	5,706	6,876
Minority interests	764	958	1,155	1,155	1,155						
Total equity	18,529	22,115	25,250	27,595	30,708						
Net debt	307	-599	-594	-1,967	-3,830						
Net debt to equity (%)	1.7	-2.7	-2.4	-7.1	-12.5						

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 For definitions of the items in this table, please click [here](#).

Are ARM's other divisions really worthless?

ARM's Khumani iron ore mine is next to Kumba's Sishen. We believe that the mines produce a similar product at a comparable cash operating cost.

We calculate Kumba's enterprise value (EV) per 2015 production tonne at US\$572.

Figure 2. Calculation of Kumba's EV per 2015 production tonne*

Kumba's enterprise value (Rm)	228,242
Divided by Kumba's 2015 iron ore sales (Kt)	51,000
Kumba's EV / 2015 production tonne (rand)	4,475
USD/ZAR exchange rate	7.82
Kumba's EV / 2015 production tonne (US\$)	572

* Priced as at 7 May 2012

Source: I-Net, CIRA

Applying this value per tonne to African Rainbow Minerals' projected 2015 attributable production of 8Mt, we calculate ARM's iron ore division's EV at R35.8bn.

Figure 3. Implied valuation of ARM's iron ore division at Kumba's valuation multiples*

ARI's 2015 iron ore production (Kt)	8,000
Multiplied by Kumba's EV/ 2015 production tonne	572
Implied valuation of ARI iron ore (USDm)	4,578
USD/ZAR exchange rate	7.82
Implied valuation of ARI iron ore (Rm)	35,803

* Priced as at 7 May 2012

Source: I-Net, CIRA

This is more than ARM's market value (excluding its stake in Harmony) of R34.6bn.

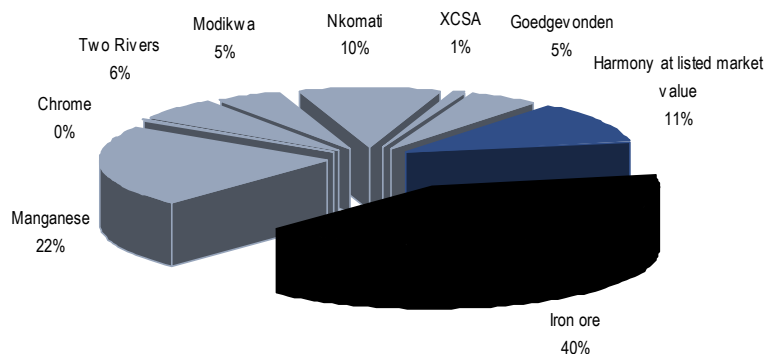
Figure 4. ARM's enterprise value excluding its 14.8% investment in Harmony

ARM's market capitalisation (Rm)	38,080
Plus minorities at book value	958
Plus net debt as at Dec. 2011	237
Less investment in Harmony at market value	-4,722
ARI enterprise value excluding Harmony (Rm)	34,553

Source: I-Net, Company reports, CIRA

This means you get ARM's manganese, platinum, nickel and coal assets effectively for free at its current share price on our estimates. We value ARM's other divisions at R21bn, which is around 55% of its current market cap.

Figure 5. Contribution to ARM's enterprise value (R44 233m)



Source: Citi Investment Research and Analysis

Figure 6. ARM's sum-of-the-parts valuation using DCF valuations

	DCF fair value (ZARm)	Minority interest (ZARm)	Fair value (ZARm)	Fair value per share (ZAR)
Iron ore	16,564	0	16,564	77
Manganese	9,299	0	9,299	43
Chrome	31	0	31	0
ARM Ferrous	25,895	0	25,895	120
Two Rivers (effective interest = 55%)	4,461	2,007	2,454	11
Modikwa	1,995	0	1,995	9
Nkomati	4,205	0	4,205	19
XCSA (effective interest = 20.2%)	-299	0	-299	-1
Goedgevonden (effective interest = 26%)	2,106	0	2,106	10
Copper and exploration	1,679	0	1,679	8
Harmony at listed market value			4,722	22
Corporate and other	-73	0	-73	-0
Enterprise value	39,970	2,007	42,685	197
Other Investments			0	0
Net debt as at 30 June 2011			599	3
Equity value			43,284	200
Number of shares (millions)			216	
DCF fair value per share as at 7-5-2012 (Rand)			200	

Source: Company Reports and CIRA Estimates

Our one-year target price for ARM reflects the company's fair value one year out. We roll fair value forward using cost of equity and subtract expected dividends over the period.

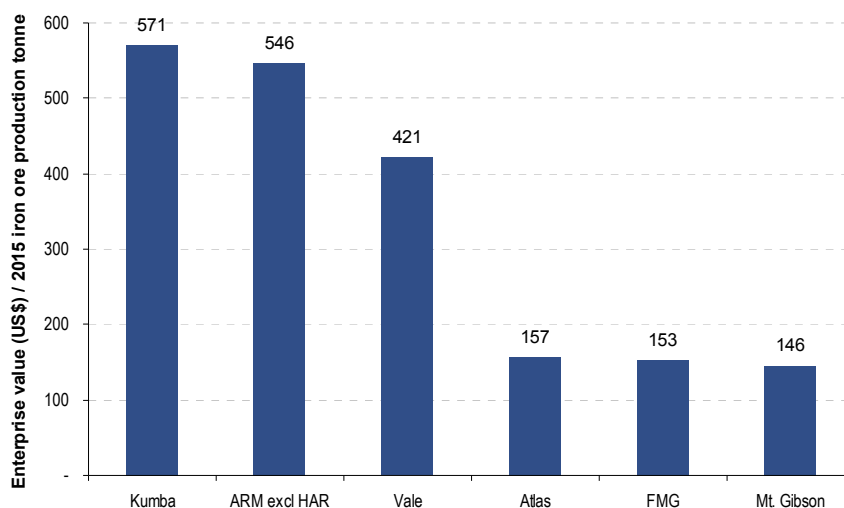
Figure 7. Calculation of one-year target price and forecast one-year return

DCF fair value per share as at 7-5-2012 (Rand)	198
Plus: Cost of equity of 15%	29
Less: Expected dividends (included in cost of equity)	-6.85
One year target price (Rand)	220
Ruling share price (Rand)	178
Capital upside (%)	24
Plus: dividend yield (%)	4
Total one-year return (%)	28

Source: Citi Investment Research and Analysis

To put it differently, ARM (excl HAR) trades at an EV to 2015 production tonne of US\$546, which is a 4% discount to Kumba's EV per 2015 production tonne of \$571.

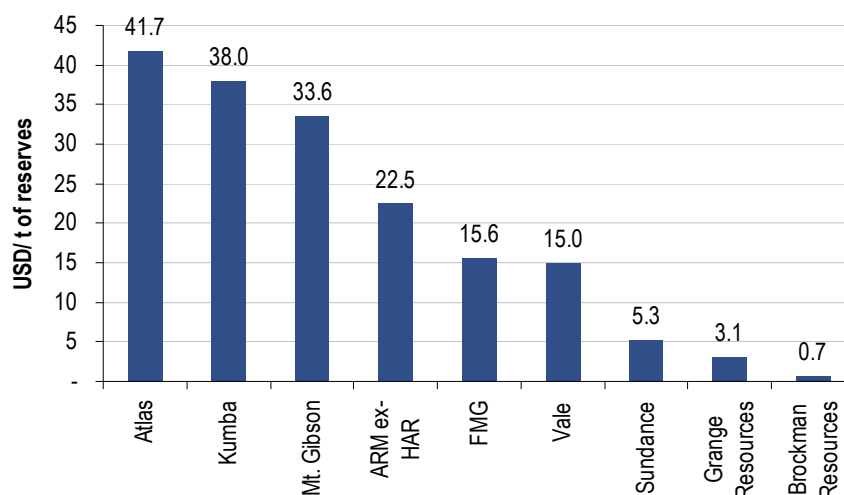
Figure 8. Miners' enterprise value per 2015 iron ore production tonne (US\$)



Source: I-Net, Bloomberg, CIRA

ARM (excluding Harmony) looks even cheaper on an EV per reserve tonne of USD22.5, which is a 41% discount to Kumba's USD38/t. Especially if you consider you effectively get ARM's other divisions worth \$21bn for free on our estimates.

Figure 9. Miners' enterprise value per reserve tonne (US\$)



Source: I-Net, Bloomberg, Company reports, CIRA

African Rainbow Minerals

Company description

ARM is a South African diversified mining company with long-life, low-cost assets in platinum, nickel, iron ore, manganese and coal through partnerships with major players in the global resource sector. Its strong BEE credentials, solid track record and healthy balance sheet give ARM access to attractive mining deals.

Investment strategy

We rate ARM Buy (1). ARM is a quality mining company with long-life, low-cost operations and strong growth opportunities, in our view. Partnerships with mining majors lead to knowledge transfer and the ability to participate in mega projects. ARM's large reserves support long asset lives and expandability and it operates low-cost mines with strong growth prospects.

Valuation

We use a discounted cash flow approach to derive our one-year target price of R220, based on:

A WACC of 13.34%; long-term (2015-2028) nominal revenue growth of 5% per annum; long-term EBITDA margins of 38%; long-term capex/EBITDA ratio of 33%; long-term ROE (excluding Harmony) of 20%; and nominal terminal growth rate (after 2028) of 6.5%, implying an exit PE multiple of 12x.

We include ARM's investment in Harmony Gold in our valuation at listed market value.

Risks

ARM's risk profile is derived after considering several factors, including an assessment of the macro economic environment, industry-specific risks, company-specific operational risks as well as financial risk.

Downside risks include: potential execution risk, given significant new projects; South African infrastructure constraints; skills, electricity and water shortages and onerous regulation in South Africa; higher-than-forecast mining inflation; over-estimation of mineral reserves and government actions.

If the impact of these risk factors is more or less negative than we currently anticipate, then the share price could fail to reach or exceed our target price.

Kumba Iron Ore Ltd

(KIOJ.J; R521.10; 3)

Valuation

Our Kumba target price of R430 is calculated using a discounted cash flow valuation, which takes into account optimistic long-term export EBITDA margins of 52%, as well as Kumba's considerable volume growth. Our DCF assumes a 13.1% nominal weighted average cost of capital; long-term (2016-30) nominal revenue growth of 5% per annum; long-term capex/EBITDA ratio of 22%; long-term ROE of 30%; and a terminal growth rate (after 2031) of 8.4% in rand terms.

Risks

Key risks to projected earnings, cash flows and valuation relate to weaker-than-expected commodity prices/economic growth and US\$. Country risk is a consideration with all producing assets in South Africa. Operating risk in Kumba is principally from higher inflation concerns in South Africa. Kumba is also involved in a legal dispute with ArcelorMittal SA and ICT, which may negatively impact our earnings forecasts and target price.

Four major upside risks to our target price are: 1) China's demand for iron ore outpaces new low cost supply and long-term margins stay at elevated levels; 2) A collapse in the rand, which would boost Kumba's earnings forecasts and valuation; 3) Corporate action - Anglo American already holds around 65% of Kumba and we believe it will have to offer a premium to market prices if it wants to buy out minorities; and 4) Kumba's attractive dividend yield.

Appendix A-1

Analyst Certification

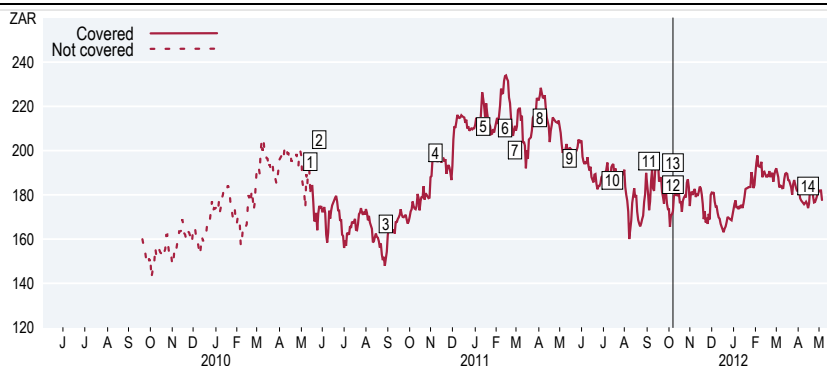
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IMPORTANT DISCLOSURES

African Rainbow Minerals (ARIJ.J)

Ratings and Target Price History Fundamental Research

Analyst: Johann Pretorius
Covered since May 14 2010



	Date	Rating	Target Price	Closing Price
1	14-May-10	*3M	*200.00	181.69
2	27-May-10	*1M	200.00	175.00
3	30-Aug-10	1M	*205.00	151.14
4	7-Nov-10	*2M	205.00	198.50
5	13-Jan-11	*3M	*215.00	223.50

	Date	Rating	Target Price	Closing Price
6	14-Feb-11	3M	*230.00	233.71
7	28-Feb-11	*2M	230.00	211.20
8	4-Apr-11	2M	*250.00	224.89
9	15-May-11	*1M	*260.00	200.00
10	14-Jul-11	1M	*240.00	193.50

	Date	Rating	Target Price	Closing Price
11	4-Sep-11	1M	*230.00	180.40
12	7-Oct-11	Stock rating system changed		
13	7-Oct-11	*1	230.00	172.65
14	15-Apr-12	1	*220.00	176.00

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

African Rainbow Minerals (ARIJ.J)

Ratings and Target Price History

Best Ideas Research

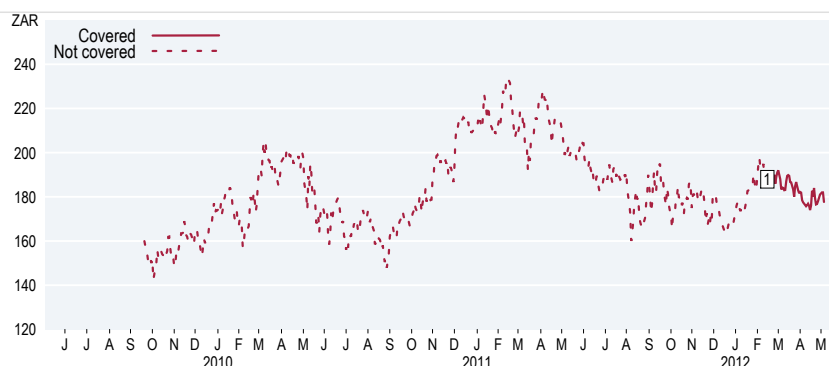
Relative Call (3 Month)

Analyst: Johann Pretorius

Covered since May 14 2010

	Date	Rating	Target Price	Closing Price
1	15-Feb-12	*ADD MP	-	189.14

* Indicates change



Rating/target price changes above reflect Eastern Standard Time

Kumba Iron Ore Ltd (KIOJ.J)

Ratings and Target Price History

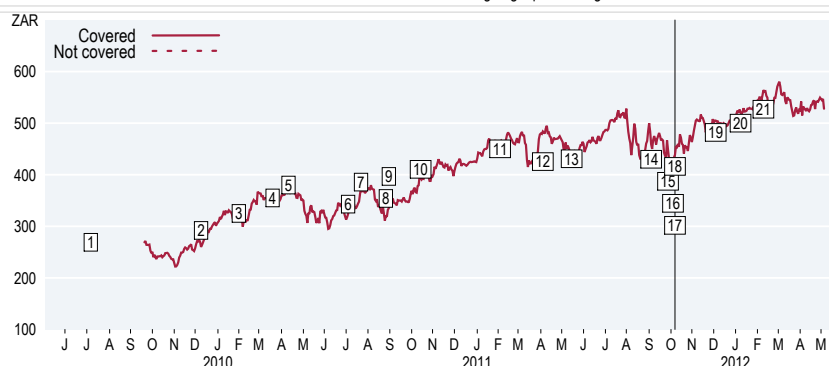
Fundamental Research

Analyst: Johann Pretorius

Covered since December 9 2009

	Date	Rating	Target Price	Closing Price
1	7-Jul-09	*2M	*190.00	NA
2	9-Dec-09	*3M	*250.00	260.00
3	1-Feb-10	3M	*300.00	322.50
4	19-Mar-10	3M	*330.00	344.50
5	12-Apr-10	3M	*360.00	366.50
6	4-Jul-10	*2M	*340.00	317.60
7	22-Jul-10	*3M	*360.00	375.00

* Indicates change



Rating/target price changes above reflect Eastern Standard Time

	Date	Rating	Target Price	Closing Price
8	26-Aug-10	*1M	360.00	320.50
9	31-Aug-10	1M	*370.00	335.27
10	14-Oct-10	*3M	370.00	394.87
11	3-Feb-11	3M	*380.00	464.00
12	5-Apr-11	3M	*420.00	484.00
13	16-May-11	3M	*430.00	440.75
14	5-Sep-11	3M	*450.00	459.36

	Date	Rating	Target Price	Closing Price
15	28-Sep-11	3M	*410.00	448.00
16	5-Oct-11	*2M	410.00	429.00
17	7-Oct-11	Stock rating system changed		
18	7-Oct-11	*2	410.00	438.68
19	5-Dec-11	2	*450.00	505.00
20	9-Jan-12	*3	450.00	520.51
21	9-Feb-12	3	*430.00	564.00

Kumba Iron Ore Ltd (KIOJ.J)

Ratings and Target Price History

Best Ideas Research

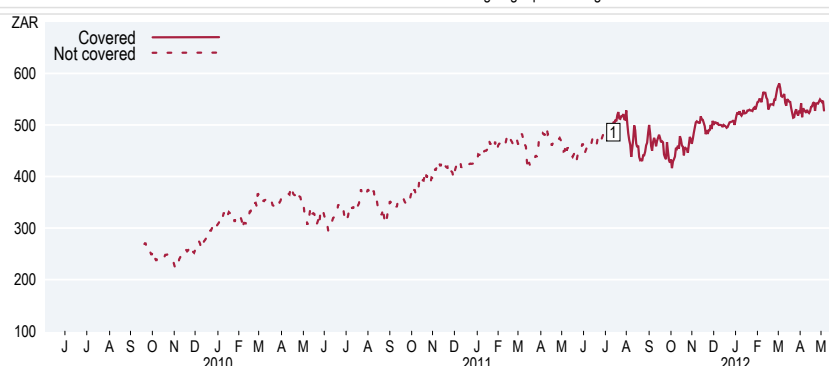
Relative Call (3 Month)

Analyst: Johann Pretorius

Covered since December 9 2009

	Date	Rating	Target Price	Closing Price
1	13-Jul-11	*ADD LP	-	505.00

* Indicates change



Rating/target price changes above reflect Eastern Standard Time

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Data current as of 31 Mar 2012

	12 Month Rating			Relative Rating		
	Buy	Hold	Sell	Buy	Hold	Sell
Citi Investment Research & Analysis Global Fundamental Coverage	52%	37%	11%	10%	79%	10%
% of companies in each rating category that are investment banking clients	44%	42%	40%	47%	42%	43%

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