26 August, 2009

Resource Generation (RES) — Buy

Developing a Huge Coal Resource

Summary

RES holds extensive interests in the Waterberg Coal Field in South Africa, located ~1200km inland from the port of Richards Bay. RES is spending US$5m to earn a 70% interest in several tenements including Waterberg No.1, where a 1.1bt indicated coal resource plus a 300Mt saleable coal reserve have been established following a drilling program earlier this year. The coal seam is up to 120m in thickness, at a shallow depth enabling potential low-cost extraction at a very low strip ratio.

The company plans to develop a mine in order to service both domestic and export coal needs, with feasibility studies and mine permitting underway.

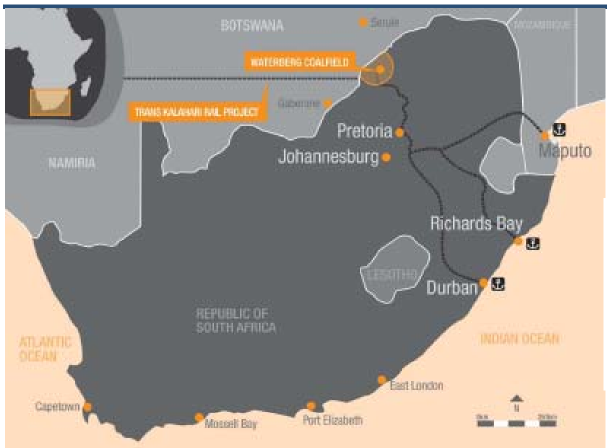
RES recently raised A$30.8m via the issue of 76.8m shares at A$0.40ps for the purpose of land acquisition and completing feasibility work.

Valuation and Recommendation

We currently value RES at A$0.87ps, assuming the following key milestones are achieved over the next 12 months:

- Granting of a Section 11 approval;
- Earning 70% of Waterberg and 74% of Ledjadja properties by producing a positive pre-feasibility study for mine development;
- Identification of preferred near-term coal export port/rail opportunity;
- Ongoing positive investment view of the coal sector (prices according to our forecast).

We initiate coverage on RES with a BUY recommendation and a A$0.90ps price target on a twelve month view. The stock offers highly leveraged coal exposure due to the huge size of the resource relative to the market capitalisation of the company. Whilst we note the stock is high risk, we would expect significant re-rating above our target price on receiving a successful contract for domestic coal supply.



Location of project showing rail options

Investment Summary

Share Price $ps	**$0.52**
Target Price (12 month) $ps	**$0.90**
Energy	
www.resgen.com.au	
Issued Capital M (diluted)	**163M**
Market Cap $M	**A$85M**
Net Cash (est.)	**A$35m**
Analyst Name	**Geoff Muers**

Share Price Chart

Year Hi-Lo $ps			**$2.41 - $0.16**
Avg Monthly Vol (M)			**1.4**
Performance %	**1 m**	**3 m**	**12 m**
Absolute	39.3%	-17.9%	-72.5%
Rel Top 200	23.1%	-34.1%	-58.2%

Shareholders	%
Commonwealth Bank of Australia	9.5%
CVC Pty Ltd	8.1%
Equitas Nominees A/C (investor)	6.4%
PAPY Pty Ltd (Paul Jury)	5.7%

Company Activities

Resource Generation Limited (RES) is investing in coal projects in the Waterberg coalfields, South Africa. The company also has interests in Tasmania and Cameroon.

Level 15, 60 Castlereagh Street Sydney NSW 2000 Tel (02) 9238 1238
Level 20, 90 Collins Street Melbourne VIC 3000 Tel (03) 9268 1000
55 Phillip Street Parramatta NSW 2150 Tel (02) 98915644

Valuation

Current valuation of A$0.87ps

We presently adopt a risk-weighted valuation of A$0.87ps for RES, which allows for a 60% discount for pre-feasibility stage* and takes a split weighting between our base case domestic supply scenario (No.1) and a combined domestic/export scenario (No.2). In Summary, our assumptions include:

- Long term coal price of US$60/t for Richard's Bay Thermal Coal (spot US$64/t) and US$83/t for semi-soft coal, and Rand220/t for domestic thermal;
- A$/Rand rate of 6.5 from FY2009 until FY2013 followed by a flat 7.1 into the long term. The latter has been derived from an A$/US$ rate of 0.70 and a Rand/US$ rate of 8.5 (now 8.0). We note applying recent exchange rate and spot coal pricing does not significantly impact NPV;
- Production rate of 36Mtpa ROM for base case domestic project, 21Mtpa for export scenario. Allows for 7yr ramp-up;
- Estimated total capex is Rand6,243 million (A$960 million) with Rand4,995 million (A$770 million) spent in the three years prior to production and Rand1,249 million (A$190 million) spent in years 6 to 8 of operation[1] (RES share 70%),
- Ex mine costs of A$21 per tonne equivalent with an FOB equivalent cost in the export scenarios of A$40 per tonne rising to A$45 per tonne in year 8.

RES: Summary Valuation

Total Issued Capital	154.1
Options (total)	8.5
Diluted Capital (m)	162.7
NPV A$m (Scenario 1)	344
NPV A$m (Scenario 2)	523
Average A$m	434
Assume ownership of 70%	303
Discount for pre-feasibility*	60%
Current Valuation (A$m)	121
+Est. cash balance (A$m)	35
- Less land costs (A$m)	15
Valuation per share (A$ps)	0.87

Table of Resources/Reserves (Mt)

	Resource	Reserve
Waterberg 1	1100	566
Waterberg 2-3	123	-
Ledjadja	-	-

(W1) Indicated resource. Probable reserve.
(W2) Inferred resource
Ledjadja: pending. All JORC compliant.

For further details on the various mining scenarios, please refer to section on Mine Planning, commencing on page 4, with 'upside' valuation scenarios presented on page 6.

[1]Scenario #2 capex has been reduced by 15% given the maximum ROM tonnage of 21 Mtpa versus 36 Mtpa in the base case. However an additional amount of Rand421 million has been included to cater for an export coal rail load-out facility.

*Adapted from Baxter & Chisholm, 1990.

Background

Acute shortage of power in South Africa

Coal was discovered in the Waterberg area in the north-east of South Africa in 1922, although the first mine (Grootegeluk) was not developed until 1980 and remains the only Waterberg coal operation. Current production is ~ 20 Mtpa of which approximately 15 Mtpa is conveyed to Eskom's 4,000 MW Matimba power station with the balance sold as domestic metallurgical coal (4.5 Mtpa) and export quality semi-soft and thermal coals (1.1 Mtpa).

Eskom, the state owned power utility, is currently constructing the 4,800 MW Medupi Power Station nearby to Matimba and is considering plans to develop an additional two plants of similar design and size due to an acute shortage of power in South Africa. These plants will source coal from the Waterberg Coal Field.

Previously owned by BHP Billiton & BP

In November 2007 the company agreed to acquire 100% of Isicebi Mining, a South African company with the right to earn a 70% interest in three coal projects located in the Waterberg coal field. These three properties were 100% owned by Lukale Mining a Black Economic Empowerment (BEE) group and prior to that owned by BHP Billiton and BP Coal.

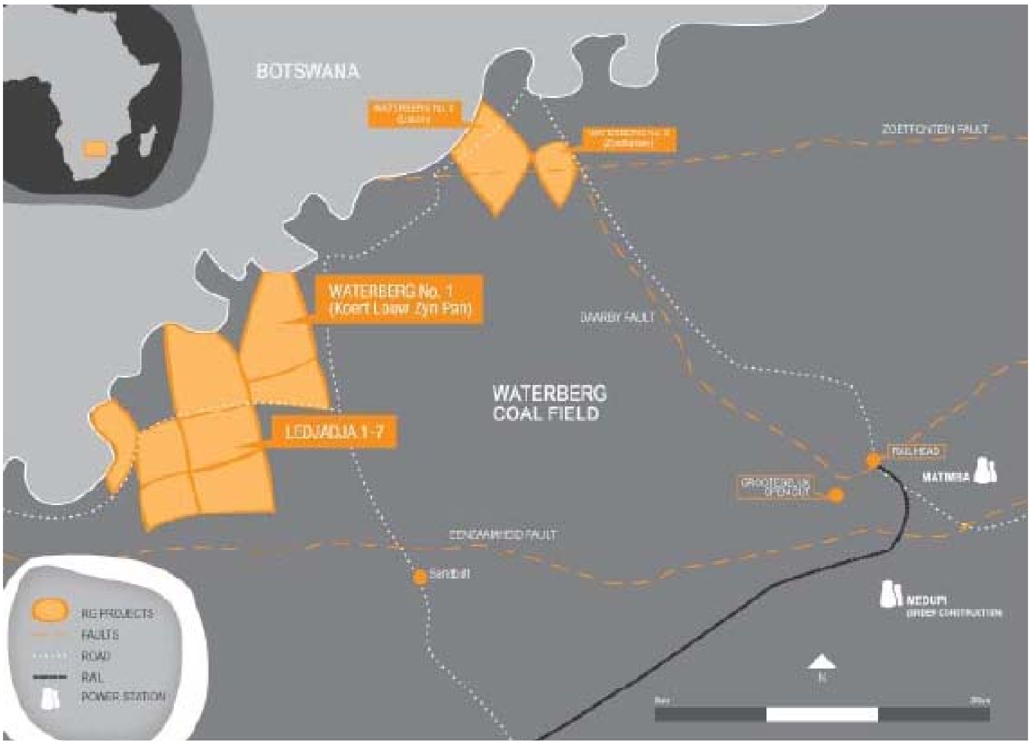
Ownership

RES earning between 70% and 74% of tenements

The RES South African assets are held in the 100% owned Isicebi Carbon Mining and Apex Resources Holdings Inc. Isicebi can earn 70% of the Waterberg Coal Joint Venture that holds three Waterberg tenements and RES is spending US$5m to earn this 70% interest with US$2.8m spent to 30 June, 2009. Apex can earn 74% of the Ledjadja Joint Venture that holds seven Waterberg tenements by spending Rand20 million.

The Black Economic Empowerment (BEE) partner of RES in the Waterberg Coal Joint Venture is Lukale Mining Company (Pty) Ltd. Under development agreements in South African, the BEE is required to hold a minimum of 26% of the project. Partners in the Ledjadja Joint Venture are Yakani Resources and Shango Minerals.

Location of Tenements



Resources/Reserves

The coal seams of the Waterberg Coalfield vary from very thin to over 8m thick, as part of maximum sequence thickness of approximately 120m (see diagram, below). The 11 zones typical of the Waterberg geological profile contain five layers of interbedded shales and 16m to 20m of overburden, characterised by thick sequences of shale and stone bands interbedding the coal.

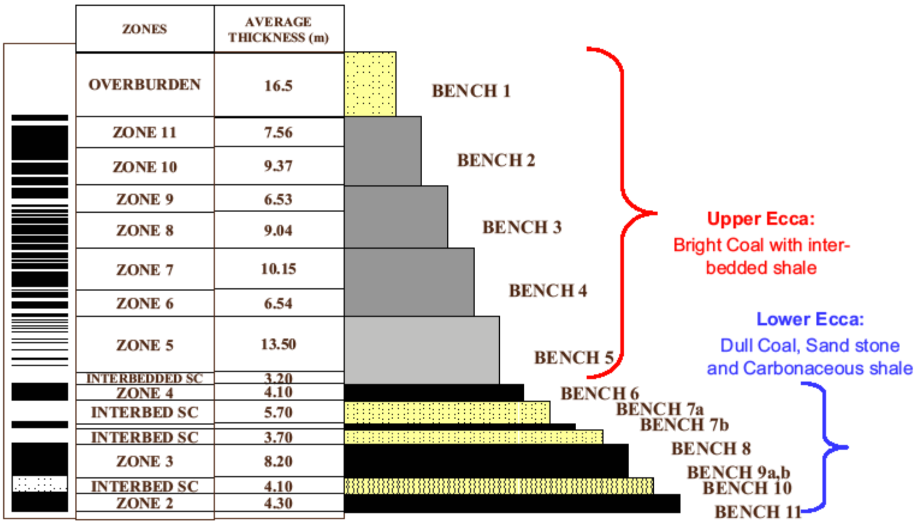
JORC compliant coal resources of 1223Mt

The initial inferred resource announced by RES in 2008 of 415 Mt for Waterberg 1 was upgraded after a 98 hole drilling program covering the three Waterberg properties.

The drilling program completed in January 2009 enabled a JORC compliant inferred resource estimate of approximately 2,000Mt. The coal seam formation was confirmed to be typically 120m thick and 20m below the surface. The resource was recently upgraded to a proven and probable JORC compliant resource of 1100Mt at Waterberg 1, plus a probable reserve of 566Mt (ROM) or 302Mt saleable coal (07/08/09).

Additional resources of 123Mt were described for Waterberg 2 and 3 (refer to table, p2) giving a total JORC resource of 1223Mt. Drilling is ongoing at Ledjadja, and maiden JORC resources are pending.

Typical geological profile of coal sequence (Exxaro Coal)



Source: Exxaro Coaltrans Presentation September 2007

Coal Quality

Potential for export quality coal

The coal in the Waterberg field is suitable for production of thermal and metallurgical coals (PCI, semi-soft) from various seams within the sequence. Coal quality is reported best at the top of the sequence, which can produce a semi-soft coking coal, with some PCI potential reported in the lower sequences. The majority of the coal is suitable for the domestic thermal market, with the nearby Grootegeluk mine (see coal quality table below) taking the whole 100m of the sequence for processing/washing, and obtaining about a 45% yield on average.

The indicative coal qualities that could be produced from the RES Waterberg Coal Project are shown below. An export thermal coal of around 15% ash with a heating value of 6,500 kcal/kg and less than 1% sulphur is believed possible. Yields for export coal are estimated at 40% to 50%, though selective mining has potential to improve yields and efficiencies.

Typical coal quality of the Waterberg area (RES, June'09 presentation)

	Waterberg No.1 Coal		Hunter Valley
	Coking Coal *Export grade*	Domestic Thermal	Semi Soft Coking Coal *Export grade*
Ash %	10	35	8.5
kcal/kg gar approx	6,772	4,400	6,915
Roga Index	60 min		55-75
Swelling Index	4 min		6 min
Volatile %	38.0 max	22 max	35.5
Moisture %	10 max	11	8 max
Sulphur %	1.1	1.4	0.56

Mine Planning

RES plan to construct an open cut operation of a similar scale to the nearby 20Mtpa mine

RES is awaiting Mines Department (Section 11) ownership approval for the project, following on from which the granting of a mining licence is anticipated in due course. RES is expected to complete land acquisition shortly with A$15m allocated to purchases in key areas of proposed mine development.

RES plans to construct an open-cut operation similar to the Grootegeluk mine operated by Exxaro Resources (JSE: EXX, Market Cap: US$3.8b) however intends to use selective mining techniques. Such a mine could produce domestic coal for one or both of Eskom's two planned 4,800MW power stations (similar to Medupi) and also produce export thermal and/or semi-coking coals.

The potential for export coal, both thermal and metallurgical depends on rail and port access. Richards Bay Coal Terminal, despite undergoing a Rand 1,200 million expansion from 72 Mtpa to 91 Mtpa, is not believed to have unallocated capacity at this stage. RES is investigating obtaining access through other ports including Durban and Maputo in Mozambique, or through the dry bulk terminal at Richards Bay. RES is also involved in discussions on the construction of a trans-Kalahari railway through Botswana to Walvis Bay in Namibia.

Current mine planning assuming a domestic contract is obtained centres around the Waterberg 1 (W1) reserve, and moving gradually in a south-easterly direction onto the Ledjadja 2 (L2) property supporting a 50 year mine life. Initial planning is for a strip mine benching eastwards with the typical 13 m to 20 m of overburden removed by dozers, shovels and trucks. The pit would be divided into 11 benches. ROM coal would be drilled and blasted then mined by two 60 m^3 electric shovels and dumped into one of two crushing circuits by a fleet of 12, 300 tonne trucks. Each circuit would be rated at 2,000 tph and consists of a mineral sizer, rotary breaker and a double roll tertiary crusher to produce a <50 mm product. This will be delivered to a 400,000 tonne live stockpile with an additional 200,000 tonne push out reserve.

A Coal handling and Preparation Plant (CPP) with a washing capacity of 16.8 Mtpa (2,400 tph times 7,000 hours per annum) is envisaged for preparation of domestic coal. The plant would feature dry screening followed by high gravity dense medium cyclones that would produce a domestic thermal product. The overall yield from ROM coal (excluding waste) is expected to range between 50% and 60%. A secondary wash plant can be constructed to generate export coking and thermal coal. Yields for the export products are expected to be approximately 40% to 50%.

Production scenarios

Two scenarios presented for valuation purposes

We have assumed two scenarios for valuation purposes, which involve slightly different product mixes however both assume commencement of sales in FY13, with gradual ramp-up periods:

1) Base case scenario: Assumes domestic supply only, supply commences in FY13, initial rate of 10Mtpa achieved by FY15, with 20Mtpa achieved in FY10 (see below table);

2) Export scenario: Assumes domestic supply of 8Mtpa and 1Mtpa of export coal from FY14 (80% thermal, 20% coking) increasing to 3Mtpa export and 8Mtpa domestic from FY20.

An additional scenario modelled involves a delay to domestic supply until FY17, with 1mtpa exports from FY13 and ultimate domestic and export supply scenarios as Scenario 2. The end result is an NPV around 7% higher than the base case scenario. The two preferred scenarios are presented below:

	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21	FY22
Base case										
ROM	6.0	12.0	18.0	18.0	18.0	24.0	30.0	36.0	36.0	36.0
Domestic	3.3	6.6	9.9	9.9	9.9	13.2	16.5	19.8	19.8	19.8
Exports	0	0	0	0	0	0	0	0	0	0
Scenario #2										
ROM	5.5	16.8	16.8	16.8	16.8	16.8	16.8	21.2	21.2	21.2
Domestic	3.0	8.0	8.0	8.0	8.0	8.0	8.0	8.0	8.0	8.0
Exports	0.0	1.0	1.0	1.0	1.0	1.0	1.0	3.0	3.0	3.0

Valuation

Valuation allows for conservative capital cost estimates

Note that unless otherwise stated all figures relate to 100% of the project. RES share estimated at 70%. Abbreviations of A$ for Australian Dollar and Rand for South African Rand.

Under the base case scenario (domestic supply only) estimated total capex is Rand6,243 million (A$960 million) with Rand4,995 million (A$770 million) spent in the three years prior to production and Rand1,249 million (A$190 million) spent in years 6 to 8 of operation. These amounts include provisions for water, power and rail plus a 10% contingency and an 8% capex fee and appear generous (A$1,000 million).

Operating cost data may be conservative given it was obtained from operating mines and then escalated by 30%. Application of this data generates ex mine costs of A$21 per tonne with an FOB equivalent cost in the export scenarios of A$40 per tonne rising to A$45 per tonne in year 8.

For Scenario 2 capex has been reduced by 15% given the maximum ROM tonnage of 21 Mtpa versus 36 Mtpa in the base case. However an additional amount of Rand421 million has been included to cater for an export coal rail load-out facility.

Cash flows based on these unescalated prices and flat costs were calculated net of capex and tax of 28% although we estimate that no tax may be paid for seven years due to expensing of capital costs. A royalty of 2% of revenues has also been used pending a government decision on the rate and formula.

These cash flows were then discounted to generate NPVs for each scenario using a real discount rate of 9.8% comprising a CAPM rate of 7.8% plus a sovereign risk addition of 2.0%.

The company expects higher export sales than our forecast

We note the company may plan a smaller-scale, lower capex initial operation exporting say 3-4Mtpa of coal and the company views the above production scenarios (1 & 2) as conservative and expects earlier and higher export sales (3-5Mtpa) and, subject to the outcome of discussions with Eskom, similar favourable movements in domestic sales.

We have provided ‘upside valuations’ on this basis, assuming an export level of 3Mtpa of coal, 80% export thermal from FY14, increasing to 5Mtpa from FY20.

Valuation Summary Table

	NPV (A$m)	RES 70%
Scenario 1	344	241
Scenario 2	523	366
Combined upside[1]	1115	781
Export only[2]	830	581

[1] Assumes Initial 3Mtpa of exports from FY14, increasing to 5Mtpa from FY15. Capex remains the same as Scenario 1 (A$960m). Domestic sales from FY13 in line with Scenario 1.

[2] Assumes Initial 3Mtpa of exports from FY14, increasing to 5Mtpa from FY20, export only, capex reduced to A$400m from A$960m in first 3 years, with a further A$200m to be spent to expand to 5Mtpa.

Infrastructure

The properties are all close to the Botswana border and are serviced by good quality roads, and nearby existing key infrastructure in terms of transport and power.

Properties are well serviced by infrastructure

W1 is 60 km and W2 and W3 are within 30 km of the Grootegeluk mine which utilises a rail line to Richards Bay Coal Terminal (1240km) and other ports on the East Coast. This rail line runs within 18 kilometres of the closest Ledjadja tenements. Grootegeluk’s main product, domestic thermal coal, is transported 7 km to the Matimba power station by conveyor.

Water supply is one of the key risks associated with mine development. However the company believes that with 4 large 500ML sized dams and appropriate CPP design, sufficient water will be available to support production at more than 30 Mtpa. A Water Provisioning Report has been prepared that examines surface and groundwater options.

Domestic Supply shortage looming

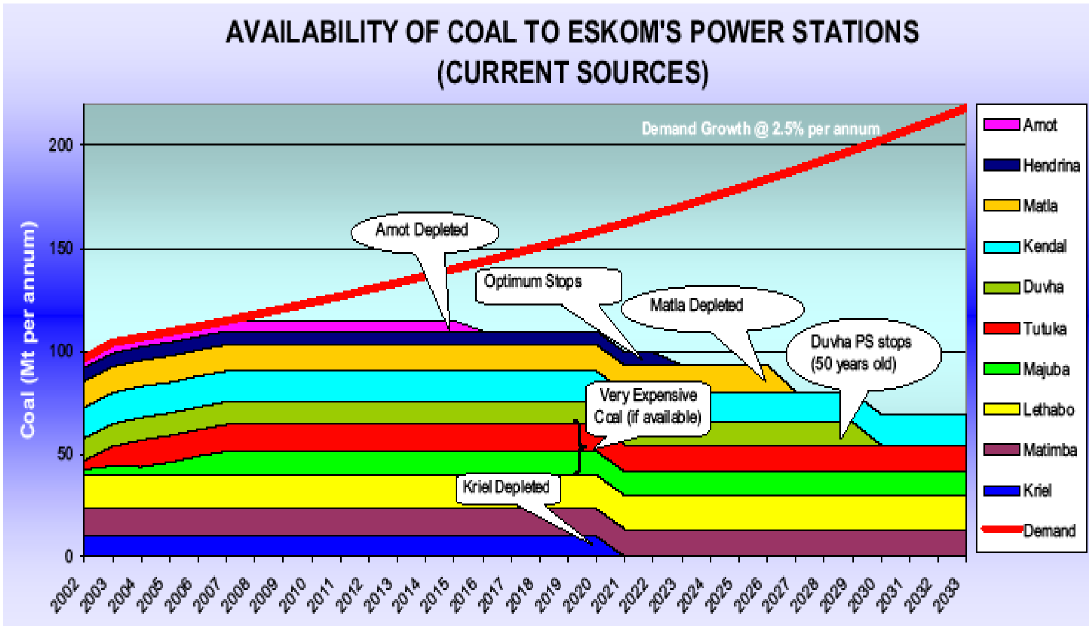
Exxaro's data indicates that if a power demand growth of 2.5% pa is assumed then a significant coal supply shortfall develops in South Africa long before the first of several mines in the Witbank region from which Eskom currently derives most of its domestic coal is depleted. Opportunities are clearly opening up for the development of more coal mines to supply the domestic power market and hopes are high from Exxaro and other Waterberg contenders (ie RES) that this area can cater to future demand. Already the model has been set by the 4,000 MW Matimba station that is supplied by the Grootegeluk mine and features dry cooling compared with the standard wet cooling towers that consume vast amounts of water.

Future need for additional sources of domestic coal supply

The 4,800 MW Medupi station (modelled on Matimba) is under construction and due to be commissioned in 2012 and we believe Eskom is considering construction of two more similar units. Each of these power stations requires approximately 16 Mtpa of thermal coal.

Potential suppliers of coal to Eskom include RES, Sekoko Coal and Firestone Energy Limited. Of these RES to our knowledge is the most advanced with regard to experienced management, detailed resource definition and conceptual mine planning. RES also considers production by 2012 quite feasible.

We also expect that Eskom would prefer several suppliers to Medupi and other future Waterberg stations rather than relying solely on Exxaro's Grootegeluk mine. This could support a Phase I development of the RES Waterberg 1 resource.



Source: *Exxaro Coaltrans Presentation September 2007*

Board/Management

Management are ex-Resource Pacific

Paul Jury (MD) was Managing Director of Resource Pacific Holdings Limited, a company he founded and developed from a small bord and pillar coal operation to a medium sized longwall operation that was taken over by Xstrata in 2008. Paul has over 20 years of experience in the coal business, with previous executive roles including CFO of Coal and Allied (CNA).

Steve Matthews (Executive Director) assisted Paul at Resource Pacific as Commercial Manager and Company Secretary and previously held similar positions with BHP Billiton's Energy Coal Division and other international finance companies.

Scott Douglas became Non-Executive Chairman of the company in December 2008 following the resignation of the then Chairman Michael Hunt. Scott originally conducted the successful negotiations of the Companys coal acquisitions in South Africa and Tasmania. He has considerable experience and skills in project management and strategic corporate advice.

Track record of delivering superior returns to shareholders

Geoffrey (Toby) Rose was appointed as Non-Executive Director in December 2008 and is a geologist with more than 45 years of experience in the NSW coal and minerals industry. He was awarded the Order of Australia for contributions to mining and minerals research. For 10 years until 1992 he was Director General of the NSW Department of Mineral Resources and Chair of the Mines Subsidence Board. Subsequent directorships include Non–Executive roles with Coal Mines Australia Limited, Billiton Coal Australia and Resource Pacific Holdings Limited.

Hennie van den Aardweg was appointed General Manager for South African Operations in October 2008. He has many years experience in the South African coal industry working for and with international coal companies in the development and operation of coal mines.

Register

The register of RES is tightly held, with Board/Management holding around 6-7% of the company, with the remainder a mixture of Institutional and Retail investors. The top 20 hold 48% (31 July, 2009).

Key risks

Key risks include a domestic supply contract and export terminal availability

Whilst progress to date has been significant there remain several key risks to the successful development of the project. For example, outstanding items include the grant of a mining licence, the procurement of a supply contract with Eskom and the establishment of a port allocation at one of several export ports. Other risks include financing due to the large capital required, infrastructure (obtaining power, water etc) and normal geological and mining risks appropriate to such a project.

Conclusion

RES controls a large, world class resource of coal in South Africa, which is well placed to service future expansion in the domestic power generation industry. The project is expected to become large scale, and potentially low operating cost enabling export of thermal and coking coal products should a suitable transport corridor be identified.

High leverage to coal/energy markets

The company appears to have good potential for re-rating based on obtaining a domestic coal contract (ie agreement with the state power utility) and/or negotiating access and transport arrangements for coal exports. Due to the huge scale of the resource compared to the company's market capitalisation, RES looks to offer high leverage to ongoing sector buoyancy in coal/energy markets. The management team at RES has a track record of delivering superior returns to shareholders, most notably in recent history via the successful development of Resource Pacific (RSP).

We obtain a risk-weighted valuation, inclusive of cash at hand less expected land acquisition costs, of A$0.87ps on RES. We initiate coverage with a BUY recommendation and a A$0.90ps price target on a twelve month basis.

Company Directors

Mr Paul J Jury (MD)
Mr Geoffrey (Toby) Rose
Mr Stephen J Matthews
Mr Scott Robert W Douglas

Company Activities

Resource Generation Limited is developing a large scale coal project in the Waterberg region of South Africa, located near the Botswana Border. Total resource potential is believed to be several billion tonnes of mostly low grade coal with a seam thickness over 100m.

References

BAXTER, J.L. and CHISHOLM, J.M. Valuation reflections. The AusIMM Bulletin, Vol. 3, 1990. pp. 22–26.

Disclosures and Disclaimers

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