

29 October 2008

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Aurox Resources

The magnetite play in the Pilbara

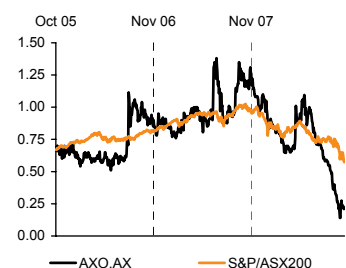
Initiation of coverage

Buy

Target price
A\$1.00Price
A\$0.22Short term (0-60 days)
n/a

Price performance

| | (1M) | (3M) | (12M) |
|----------------|-------|-------|-------|
| Price (A\$) | 0.32 | 0.72 | 1.22 |
| Absolute (%) | -31.2 | -69.4 | -82.0 |
| Rel market (%) | -11.5 | -60.1 | -68.3 |
| Rel sector (%) | 24.3 | -25.3 | -38.4 |

Market capitalisation
A\$33.27m (US\$20.53m)Average (12 mnth) daily turnover
A\$0.27m (US\$0.24m)RIC: AXO.AX, AXO AU
Priced at close of business 28 Oct 2008.
Source: Bloomberg

Analysts

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Aurox has demonstrated that the Balla Balla magnetite resource can support the proposed 10Mtpy iron ore project, with offtake agreements with two Chinese specialty steelmakers for an initial 6Mtpy, increasing to 10Mtpy over five years. We initiate coverage with a Buy recommendation.

Key forecasts

| | FY07A | FY08A | FY09F | FY10F | FY11F |
|---|-------|-------|-------|-------|-------|
| EBITDA (A\$m) | -0.76 | -1.98 | 0.00 | 0.00 | 241.0 |
| Reported net profit (A\$m) | -9.06 | 1.45 | -48.0 | 51.8 | 232.9 |
| Normalised net profit (A\$m) ¹ | -9.06 | 1.45 | -48.0 | 51.8 | 232.9 |
| Normalised EPS (c) ¹ | -4.69 | 0.74 | -24.4 | 26.3 | 118.4 |
| Normalised EPS growth (%) | n/a | n/a | n/a | n/a | 349.4 |
| Dividend per share (c) | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| Dividend yield (%) | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| Normalised PE (x) | n/m | 29.8 | n/m | 0.84 | 0.19 |
| EV/EBITDA (x) | n/m | n/m | n/a | n/a | n/m |
| Price/net oper. CF (x) | -6.90 | -3.33 | -0.90 | 0.84 | 0.15 |
| ROIC (%) | 0.00 | -91.6 | 0.00 | 0.00 | 350.5 |

1. Pre non-recurring items and post preference dividends
Accounting standard: IFRS
Source: Company data, ABN AMRO Morgans forecasts

year to Jun, fully diluted

Balla Balla - sales contracts with specialty steelmakers

Chengde Iron & Steel and RockCheck Steel are China-based specialty steel makers, with track records of expanding production. Aurox has finalised two 15-year sales contracts, each for 3Mtpy from 2010, with the RockCheck tonnage increasing to 7Mtpy (total 10Mtpy) within five years of commissioning, most likely by 2014. For these specialty steelmakers, the relatively high vanadium content at Balla Balla is an important market differentiator, as they can recover the valuable vanadium from the slag. Pricing is on terms equivalent to the Hamersley Premium Fines price.

A A\$1bn development for a 10Mtpy mine

The Balla Balla resource is 502Mt at 44.5% Fe and 0.65% V₂O₅, and reserves are currently 155Mt at 45% Fe and 0.64% V₂O₅, more than adequate to meet the two initial sales contracts and support a 10Mtpy mine over a 25-year-plus life. Aurox Resources (AXO) has secured an agreement with the Port Hedland Port Authority, under which it will pre-pay a port facility charge to export an initial 6Mtpy of magnetite ore over the Utah Point berth from 2010 into the two 15-year sales contracts, with a subsequent expansion to 10Mtpy. Capital requirements for the mine and associated mine site and processing plant infrastructure, the proposed 110km slurry pipeline to Port Hedland, and the dewatering, stockpile and reclaim facilities at Port Hedland are likely to exceed A\$1.0bn and we believe the financing of this development represents the greatest challenge for AXO in the current credit and equity markets.

Valuing Balla Balla

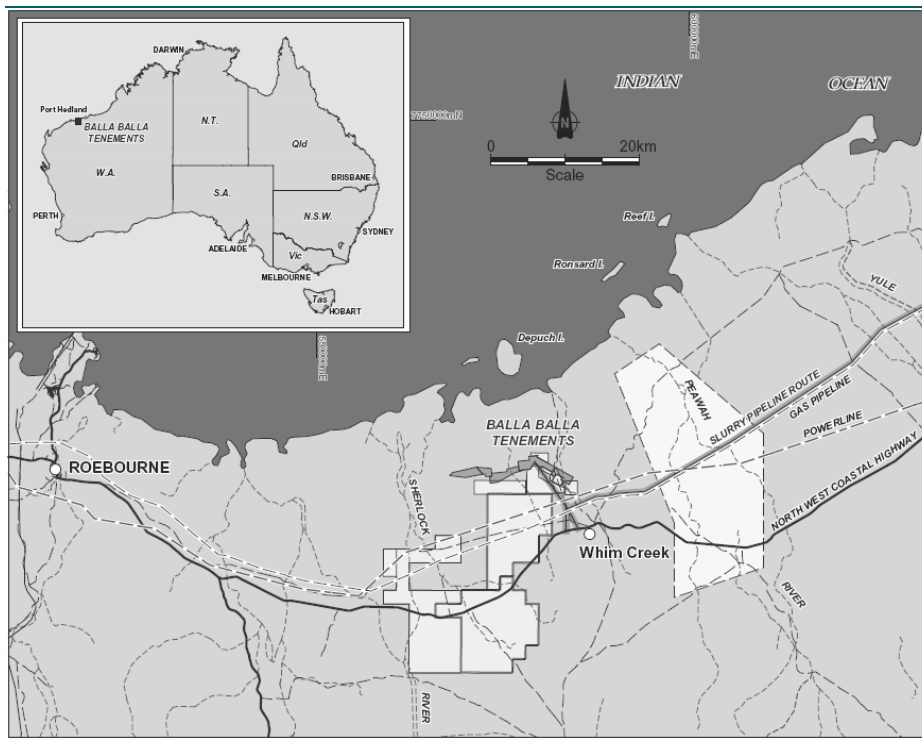
The sales contracts and pricing confirm the attractiveness of AXO's product. The company has a 100% equity interest and A\$36m in cash, and has selected a syndicate of five banks to undertake due diligence for the proposed debt component of the financing. Valuing the magnetite ore (45% Fe) at A\$2.00/t reserves (cf A\$4.00/t DSO (more than 57.5% Fe), generates a value of A\$2.00 per AXO share. Our target price is A\$1.00 per share, assuming a dilution of equity. Valuing the project on an NPV basis can generate higher values, but funding options remain open.

Important disclosures can be found in the Disclosures Appendix.

Overview

Junior iron ore player Aurox Resources (AXO) is developing the Balla Balla magnetite iron project 110km from Port Hedland, in the west Pilbara mineral field of WA. The company has secured an agreement with the Port Hedland Port Authority to export an initial 6Mtpy of magnetite ore through the Utah Point multi-user facility from 2010 into two 15-year sales contracts for 3Mtpy each. The mine, plant and export infrastructure will be constructed to accommodate expansion to 10Mtpy of exports and AXO has secured a linear stockpile at Port Hedland capable of servicing a 10Mtpy shipping operation.

Figure 1 : Balla Balla project location



Source: Aurox Resources

The Balla Balla deposit is a tabular body of massive vanadiferous (vanadium-bearing) titanomagnetite. It is the highest grade of its kind known in Australia and is high grade in a world context. The resource (defined to JORC Code standards) is now 502Mt at 44.5% Fe and 0.65% V₂O₅ (vanadium pentoxide) and extends over an 18.3km strike length to depths of around 140m. Proved and probable ore reserves in two conceptual pit shells, defined over a 7km portion of the resource base, are 155Mt at 45% Fe and 0.64% V₂O₅, more than adequate to meet the two initial sales contracts. Further drilling is expected to demonstrate the capacity of the reserves to support a 10Mtpy mine over a 25-year-plus life. We believe capital requirements likely to exceed A\$1.0bn will challenge the junior, but we think technical and cost advantages, and the offtake agreements, place the Balla Balla development in a sound position.

There are iron ores and iron ores

Magnetite ore compared to hematitic ore

In Australia iron ore is more commonly sourced from banded iron formations (BIF) that formed as fine-grained sedimentary rocks that were subsequently metamorphosed, or from channel iron deposits, which formed from the erosion and resedimentation of the BIFs. The typical direct shipping ores (DSOs) mined in the Pilbara have a grade of more than 57.5% Fe, and although consisting of limonite, goethite and martite, are classed as hematitic (Hematite – Fe₂O₃) iron ores.

The magnetite ores (Magnetite – (Fe, Mg)Fe₂O₃) are commonly also formed as BIFs, with a grade of 25-35% Fe, compared with the hematitic DSO grade of more than 57.5%. The grain size of the magnetite and the comingling with contaminant minerals determine the size to which the rock must be ground and, with the hardness of the rock, determines the energy required for

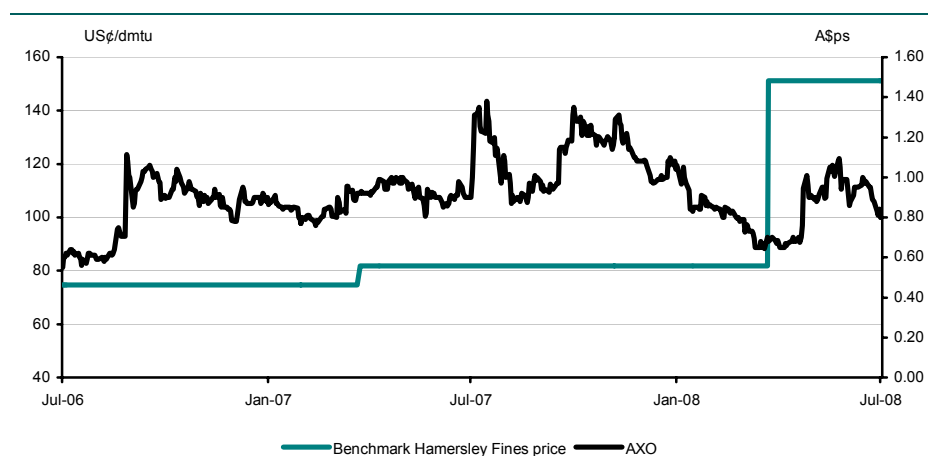
efficient magnetic separation, after crushing and grinding, to provide a saleable magnetite concentrate.

Vanadiferous titanomagnetite ore

The Balla Balla deposit was formed by magmatic iron accumulation as opposed to the metamorphosed sedimentary deposits, and has a grade of 45% Fe. It is relatively coarse grained and does not require the energy input for grinding that is needed for most other magnetite ores. However, it has a relatively high titanium content of about 12%. While titanium has a deleterious effect on the liquid metal in blast smelters, some specialty steelmakers can use high-titanium feedstocks to produce high-value ferrotitanium, commonly with a titanium content of more than 20%, but varying from 15% to 45%.

For these specialty steelmakers, the relatively high vanadium content at Balla Balla is also an important market differentiator, as they can recover the valuable vanadium from the slag. AXO has finalised two 15-year sales contracts with Chinese steelmakers Chengde Iron and Steel and RockCheck Steel, on terms equivalent to the Hamersley Premium Fines price. The negotiated offtake is for 3Mtpy from 2010 for each contract, with the RockCheck contract increasing to 7Mtpy (total 10Mtpy) within five years of commissioning, most likely by 2014. Both customers are growing their steel production and AXO anticipates attracting further strategic investment from these and/or other Chinese customers given the by-product differentiator.

Chart 1 : AXO vs benchmark Hamersley Premium Fines



Source: IRESS, ABN AMRO Morgans

The Balla Balla project

The advantages of Balla Balla

Magmatic magnetite ores are beneficiated in essentially the same manner as the metamorphosed sedimentary (BIF) ores, but are usually more easily upgraded with crushing and screening as the ores have a higher magnetic susceptibility. Balla Balla ore should require less grinding than comparable BIF deposits, resulting in upfront capital and operating cost savings in the form of lower milling capacity requirements and significant power savings. Balla Balla's relatively high in-situ iron grades at 45% Fe, combined with higher recovery rates, result in almost double the concentrate production per tonne of feed compared with some BIF magnetite deposits.

Base case 6Mtpy of export port capacity

AXO has an agreement with the Port Hedland Port Authority (PHPA) providing access to an area at the port where AXO plans to construct dedicated dewatering, stockpiling, reclaim and ship-loading facilities. The facility is to feed into the Utah Point Multi-user berth at an initial rate of 6Mtpy, with the agreement effectively underwriting the base production case. The stockpile area assigned is capable of stockpiling ore for a 10Mtpy operation. AXO is to make progress payments to PHPA as the port development proceeds to commissioning. The company anticipates access to additional port capacity can be resolved commercially as developments at Port Hedland unfold, but the terms, structure and timing of any agreement remain uncertain, and will likely prove critical to the realisation of longer-term value. The juniors vying for unallocated capacity through Utah Point include Atlas, BC Iron, Brockman and FerrAus, members of the Northwest Iron Ore Alliance (NWIOA).

Operating costs are low

Simple transport logistics also offer operating cost savings. AXO plans to pump magnetite concentrate via a slurry pipeline to Port Hedland for an estimated A\$1/t, buffering it against exposure to increasing oil prices and the road-haulage alternative, which the company estimates at around A\$14/t. In 2007, consultants GR Engineering estimated total operating costs for Balla Balla product delivered to port at A\$31/t compared with an average of A\$46/t across a collection of comparable projects. Key differentiators are outlined in Table 1.

Table 1 : Balla Balla and its cohort

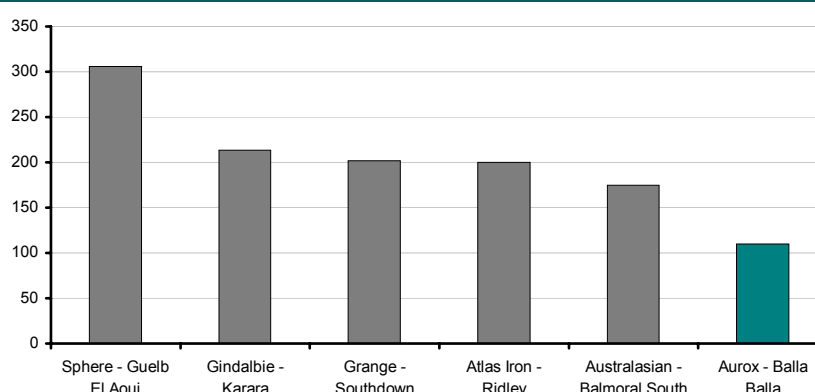
| | Balla Balla | Others |
|----------------------------|--------------------|----------------|
| Genesis | Volcanic | Sedimentary |
| In-situ Fe grade | 43% | 35% |
| Grind size (µ) | 106 | 30 |
| Weight recovery | 62% | 35% |
| Feed/tonne concentrate (t) | 1.6 | 3.0 |
| Concentrate grade | 58% | 65% |
| Operating cost | A\$31/t | A\$42/t |

Source: Aurox; Note: Data averaged across 5 comparable magnetite developments

Capital costs likely to be a challenge

Unlike DSO iron ore projects, magnetite operations require a grinding and upgrading plant, with higher upfront capital requirements. While Balla Balla is relatively high grade and requires less grinding than other magnetite operations, a processing plant with a projected capital cost of A\$230m (October 2007) is required. This has flow-on implications for the size of the accommodation village required for the on-site workforce. The capital cost was estimated by the company at A\$630m in October 2007, but is now estimated at A\$1.1bn, including pre-stripping and development of the mine, the mining fleet, infrastructure, plant, slurry pipeline and port facilities at the expanded capacity of 10Mtpy. Nonetheless, a comparison against comparable magnetite developments in Chart 2 indicates that AXO remains well placed in terms of capital intensity per tonne of annual production. The main areas of capital savings stem from the lower processing requirements on site, and the project's proximity to the existing WA gas pipeline and grid power. Lower capital intensity combined with lower forecast operating costs should provide AXO with better protection than its peers in the scenario of easing iron ore prices.

Chart 2 : Capital intensity (US\$ capex/Mt annual production)



Source: Company data; ABN AMRO Morgans

Phosphate and titanium options?

The waste rock in the hanging-wall immediately above the titanomagnetite ore zone at Balla Balla contains phosphate (as apatite) at a relatively low grade of 3-7% P₂O₅, and would require beneficiation and upgrading before sale, with phosphate rock commonly sold at a grade close to 30% P₂O₅. The company estimates the target size of the phosphate zone over the strike of the Balla Balla deposit is more than 100Mt, and the mining cost is incurred accessing the underlying iron ore. AXO is progressing technical and financial studies into the potential sale of phosphate from the project to major fertiliser producers in the region.

AXO has also initiated a titanium recovery study that has shown Balla Balla's non-magnetic iron tailings will contain significant amounts of large free-milling ilmenite grains, which have the potential for processing into titanium products. Similar operations in China and Russia are able to recover saleable titanium concentrate from tailings through simple magnetic separation and flotation. The product typically amounts to 10% of the operations tailings output, grading 46% ilmenite, in which case Balla Balla could yield up to 400,000t annually.

Clearing hurdles to production

The mining leases at Balla Balla are granted. Environmental permitting is progressing over both the mine and the Dampier to Bunbury Natural Gas Pipeline (DBNGP) easement, the proposed route for the slurry pipeline to port. Capital and operating cost estimates are being reviewed by AXO's engineering consultants, GR Engineering and Evans and Peck.

AXO has started building the construction camp, ahead of the construction of the village for 400, for the operational phase of the project. It has ordered the long lead-time items for the plant, and is making payments to the Port Hedland Port Authority to maintain access to the stockpile site and multiuser berth capacity.

In this market environment, we believe securing project debt and equity funding is the biggest hurdle to clear before AXO can commence construction. Management has noted that its corporate advisors anticipate debt funding of up to 65% of the project. AXO should continue to attract strategic investment from current and future potential customers, helping to clear the funding hurdle.

Valuation and risks

We initiate coverage of AXO using a A\$/tonne value of magnetite reserves, and have set our target price at 50% of this valuation at A\$1.00 per share, with the expectation that AXO will need to either dilute its equity in Balla Balla, or issue equity in the company, and given the current financial market conditions. We see substantial potential upside from the current share price as project funding is advanced, and with ongoing increases to resources and reserves. A current cash position of about A\$36m (October 2008) places the company in an adequate position to progress project development in the short term, in our view.

The greatest downside risks to our target price are largely related to achieving project financing. While the finalisation of the environmental approval for the slurry pipeline is yet to be formally achieved, the application is in the final stages of departmental approval after submission, public comment and the company's response, with the issues raised having been addressed. We believe the co-alignment of the pipeline with the DBNGP also mitigates the risk.

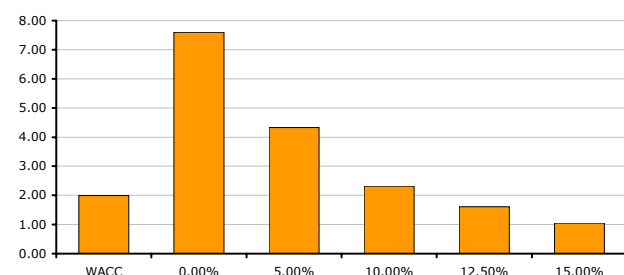
In a strong market for iron ore there may be significant cost pressures on development, with the capital cost estimates likely to face upside risk through construction. Longer term the project will be exposed to iron ore prices and the AUD/USD exchange rate. We see only limited resource risk and limited operational risk.

Expanding capacity to the 10Mtpy case in the medium term is subject to securing the additional port capacity at Port Hedland. Indications are that this will be available at Utah Point, and the company anticipates access will be secured. However, the commercial terms, structure and timing of an agreement remain uncertain, and will likely prove critical to the realisation of longer-term value.

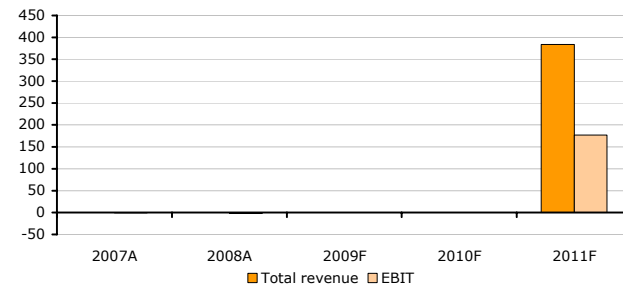
AXO – financial summary

| Aurox Resources | AIFRS | AIFRS | AIFRS | AIFRS | AIFRS | Closing price (A\$) | 0.22 | Price target (A\$) | 1.00 | |
|-----------------------------|--------------|--------------|--------------|--------------|--------------|--|--------------|--------------------|-----------------------------|--------------|
| Income statement | 2007A | 2008A | 2009F | 2010F | 2011F | Valuation methodology | DCF | Val'n (A\$) | \$ 2.00 | |
| Divisional sales | 0.0 | 0.0 | 0.0 | 0.0 | 384.0 | | | | | |
| Total revenue | 0.0 | 0.1 | 0.0 | 0.0 | 384.0 | Valuation summary | A\$m | A\$ps | DCF valuation inputs | |
| EBITDA | -0.8 | -2.0 | 0.0 | 0.0 | 241.0 | Balla Balla | 381.5 | 1.94 Rf | 6.50% | |
| Depreciation & amortisation | -0.1 | -0.1 | 0.0 | 0.0 | -64.0 | Exploration | 38.1 | 0.19 Rm-Rf | 4.50% | |
| EBIT | -0.9 | -2.1 | 0.0 | 0.0 | 177.0 | Net cash | 8.0 | 0.04 Beta | 1.85 | |
| Net interest expense | 0.1 | 1.7 | -48.0 | 51.8 | 56.0 | Corporate | -35.0 | -0.18 CAPM (Rf+Be) | 14.8% | |
| Pre-tax profit | -9.1 | 1.0 | -48.0 | 51.8 | 232.9 | Total valuation | 392.6 | 2.00 | Tax rate (t) 30.0% | |
| Income tax expense | 0.0 | 0.4 | 0.0 | 0.0 | 0.0 | | | WACC | 13.05% | |
| After-tax profit | -9.1 | 1.5 | -48.0 | 51.8 | 232.9 | | | Shares | 196.8 | |
| Minority interests | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | | | | | |
| NPAT | -9.1 | 1.5 | -48.0 | 51.8 | 232.9 | Production (kt) | 2008A | 2009F | 2010F | 2011F |
| Significant items | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | Lump sales kt | 0.0 | 0.0 | 0.0 | 0.0 |
| NPAT post abnormalities | -9.1 | 1.5 | -48.0 | 51.8 | 232.9 | Fines Sales kt | 0.0 | 0.0 | 0.0 | 0.0 |
| | | | | | | Magnetite Sales kt conc | 0.0 | 0.0 | 0.0 | 0.0 |
| Growth ratios | 2007A | 2008A | 2009F | 2010F | 2011F | | | | | |
| Sales growth | n.m | n.m | n.m | n.m | n.m | Key assumptions | 2008A | 2009F | 2010F | 2011F |
| Operating cost growth | | 162% | -100% | n.m | n.m | USD / AUD exchange rate | 0.79 | 0.89 | 0.90 | 0.86 |
| | | | | | | Iron ore - lump (USD/dltu) | 97.51 | 129.46 | 210.06 | 222.10 |
| | | | | | | Iron ore - Hammersley fines (USD/dltu) | 76.41 | 98.04 | 150.66 | 159.29 |
| | | | | | | IOC pellet price (USD/dltu) | 119.27 | 151.07 | 235.39 | 244.11 |
| Cash flow statement | 2007A | 2008A | 2009F | 2010F | 2011F | Per share data | 2008A | 2009F | 2010F | 2011F |
| EBITDA | -0.8 | -2.0 | 0.0 | 0.0 | 241.0 | No. shares | 196.8 | 196.8 | 196.8 | 196.8 |
| Cash flow from ops (1) | -6.2 | -13.0 | -48.0 | 51.8 | 296.9 | EPS (cps) | 0.7 | -24.4 | 26.3 | 118.4 |
| Capex (2) | -0.2 | -37.6 | 0.0 | 0.0 | 0.0 | EPS (normalised) (c) | 0.7 | -24.4 | 26.3 | 118.4 |
| Disposals/acquisitions | -0.1 | -1.1 | 0.0 | 0.0 | 0.0 | Dividend per share (c) | 0.0 | 0.0 | 0.0 | 0.0 |
| Cash flow from invest (3) | -0.2 | -38.6 | 0.0 | 0.0 | 0.0 | Dividend payout ratio (%) | 0.0 | 0.0 | 0.0 | 0.0 |
| Incr/(decr) in equity | 9.5 | 58.5 | 0.0 | 0.0 | 0.0 | Dividend yield (%) | 0.0 | 0.0 | 0.0 | 0.0 |
| Incr/(decr) in debt | 0.0 | 45.1 | 0.0 | 0.0 | 0.0 | | | | | |
| Ordinary dividend paid | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | Operating performance | 2008A | 2009F | 2010F | 2011F |
| Other financing cash flow | -0.2 | -2.4 | 0.0 | 0.0 | 0.0 | EBIT growth | 138% | n.m. | n.m. | n.m. |
| Cash flow from fin (5) | 9.2 | 101.3 | 0.0 | 0.0 | 0.0 | NPAT growth | -116% | -3408% | -208% | 349% |
| Forex and disc ops (6) | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | Normalised EPS growth | n.m. | n.m. | n.m. | 349% |
| Incr/(decr) cash (1+3+5+6) | 2.8 | 49.6 | -48.0 | 51.8 | 296.9 | Asset turnover (%) | 0.0 | 0.0 | 0.0 | 39.0 |
| Equity FCF (1+2) | -6.3 | -50.6 | -48.0 | 51.8 | 296.9 | EBITDA margin (%) | n.m. | n.m. | n.m. | n.m. |
| | | | | | | EBIT margin (%) | n.m. | n.m. | n.m. | n.m. |
| Balance sheet | 2007A | 2008A | 2009F | 2010F | 2011F | Net profit margin (%) | n.m. | n.m. | n.m. | n.m. |
| Cash & deposits | 4.9 | 54.5 | 6.5 | 58.3 | 291.3 | Return on net assets (%) | -3.2 | 0.0 | 0.0 | 58.8 |
| Trade debtors | 0.1 | 2.0 | 2.0 | 2.0 | 2.0 | Net debt (A\$m) | -54.4 | -6.4 | -58.2 | -291.2 |
| Inventory | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | Net debt/equity (%) | -84.7 | -39.4 | -85.6 | -96.7 |
| Investments | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | Net interest/EBIT cover (x) | 1.2 | 0.0 | 0.0 | -3.2 |
| Other intangible assets | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | ROIC (%) | -91.6 | 0.0 | 0.0 | 350.5 |
| Fixed assets | 0.3 | 37.1 | 37.1 | 37.1 | 37.1 | | | | | |
| Other assets | 1.7 | 32.5 | 32.5 | 32.5 | 32.5 | Comparable multiples (x) | 2008A | 2009F | 2010F | 2011F |
| Total assets | 6.9 | 126.0 | 78.0 | 129.9 | 362.8 | Aurox Resources | EV/EBITDA | | | |
| Interest bearing debt | 0.2 | 0.1 | 0.1 | 0.1 | 0.1 | Year to 30 Jun | PE | | | |
| Trade payables | 0.5 | 18.7 | 18.7 | 18.7 | 18.7 | FerrAus | EV/EBITDA | -4.5 | -5.5 | -0.6 |
| Long-term borrowings | 0.1 | 0.0 | 0.0 | 0.0 | 0.0 | Year to 30 Jun | PE | -7.8 | -7.8 | 0.5 |
| Provisions | 0.0 | 0.1 | 0.1 | 0.1 | 0.1 | Iluka Resources | EV/EBITDA | 4.4 | 4.0 | 2.9 |
| Other liabilities | -0.1 | 42.9 | 42.9 | 42.9 | 42.9 | Year to 31 Dec | PE | 11.8 | 13.3 | 9.0 |
| Total liabilities | 0.7 | 61.9 | 61.9 | 61.9 | 61.9 | | | | | |
| Share capital | 20.3 | 79.1 | 79.1 | 79.1 | 79.1 | | | | | |
| Other reserves | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | | | | | |
| Retained earnings | -18.5 | -20.0 | -68.0 | -16.1 | 216.8 | | | | | |
| Total equity | 6.3 | 64.2 | 16.2 | 68.0 | 300.9 | | | | | |
| Minority interest | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | | | | | |
| Total shareholders' equity | 6.3 | 64.2 | 16.2 | 68.0 | 300.9 | | | | | |
| Total liabilities & SE | 6.9 | 126.0 | 78.0 | 129.9 | 362.8 | | | | | |

Valuation sensitivity to discount rate (A\$/share)



Total revenues and EBIT (A\$m)



Source: Company data, ABN AMRO Morgans forecasts