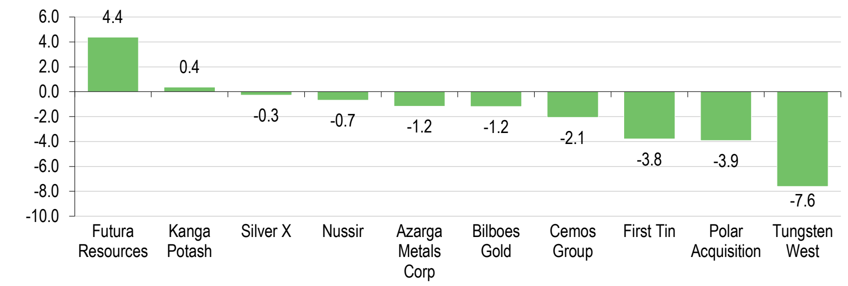
Baker Steel Resources Trust

Adjusting to the new reality

Investment trusts
Metals and mining

Baker Steel Resources Trust (BSRT) recently faced headwinds from weaker equity and industrial/precious metals markets and the impact of cost inflation on the budgets of junior mining projects. BSRT's NAV declined by c 18.5% ytd mostly due to a fall in the share price of recently floated holdings (Tungsten West, First Tin), lower share prices of listed peers (Cemos, Nussir), agreed sale price (Bilboes) and a 50% write-down of holdings with exposure to Russia (Polar Acquisition and Azarga Metals) in February 2022. BSRT's five-year NAV total return (TR) stands at 8.6% pa (versus the EMIX Global Mining Index's c 12.4% in sterling terms). Despite the tougher environment, BSRT was able to agree the sale of Bilboes Gold.

Contribution of key holdings to BSRT's NAV TR ytd to end-July 2022 (in pp)



Source: Company data, Edison Investment Research. Note: Azarga Metals Corp's contribution to end-May 2022 (last available data).

Why consider BSRT now?

BSRT is more than a simple beta play on commodity prices (some of which dropped recently), given its focus on realising the valuation upside from project development and its investment in projects that offer a solid safety margin in terms of an internal rate of return (IRR) based on consensus price forecasts (which are often below current spot prices and more aligned with long-term historical levels). This strategy provides a level of protection alongside BSRT's investment through convertibles (13% of the portfolio at end-June 2022). BSRT remains an interesting long-term play on the structural growth in demand for commodities (eg from the electric vehicle (EV) and renewable energy industries).

The analyst's view

The risk of potential project cost overruns within BSRT's portfolio has increased in recent months. For now only Tungsten West has announced major project changes due to a spike in operating expenses, while Bilboes' new owner seems to prefer a phased development approach to reduce peak up-front capex. The macro environment may also affect BSRT's earlier plans to complete three to four IPOs in its portfolio in 2022 (so far only First Tin was floated), suggesting that some holdings may seek alternative ways to fund project development and construction (eg through a private placement). Other major near-term potential drivers of BSRT's NAV include the production launch at Futura Resources (27.6% of NAV at end-July 2022) and production expansion/vertical integration at Cemos (20.3%).

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5 August 2022

Price	**65p**
Market cap	**£69m**
NAV	**£85m**
NAV*	80.2p

*At end-July 2022.

Discount to NAV	19.0%
Yield	0.0%
Shares in issue**	107.2m
Code/ISIN	BSRT/GG00B6686L20
Primary exchange	LSE
AIC sector	Commodities & Natural Resources

52-week high/low*	85.0p	59.5p
NAV** high/low	98.4p	80.2p

**Including 700k treasury shares.

Gearing

Net cash at 31 July 2022	0.0%

Fund objective

Baker Steel Resources Trust (BSRT) is a closed-ended investment company aiming to achieve long-term capital growth through investing in equity, loans and related instruments issued by private natural resources companies, targeting a global concentrated portfolio of 15–20 investments. BSRT's objective is to create value through driving the development of investee companies, as well as exploiting market inefficiencies and pricing anomalies.

Bull points

- Exposed to project development gains – not a simple beta play on commodity prices.
- Downside protection is provided by BSRT's focus on realising value from project development, valuations based on consensus forecasts for commodity prices and the use of convertible debt.
- Maturing portfolio, with several projects approaching mine construction.

Bear points

- Risk of cost overruns due to the inflationary environment.
- Some projects located in high-risk mining jurisdictions.
- High portfolio concentration by project.

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Edison profile page

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Macro environment triggers budget reviews

The recent public market turmoil, sanctions against Russia and the inflation spike have led some junior mining companies to revisit their development plans. The current situation has also had an impact on BSRT's portfolio, with Tungsten West (14.7% of BSRT's NAV at end-2021) announcing a temporary pause in the redevelopment of its key asset, the Hemerdon tungsten project in the UK, back in April 2022. This decision was prompted by a considerable inflation in costs, primarily in operating expenses such as electricity (in the 12 months to April 2022 the price per kWh increased from 11p to 28p) and diesel, and to a lesser extent steel, cement and ammonium nitrate prices, which influence the capital expenditure (capex) budget. This has led to an increase in the project's development budget to £54m (at the time of the announcement on 21 April 2022) compared to £35m estimated in the Bankable Feasibility Study (BFS).

In July 2022, Tungsten West announced a new plan for the Hemerdon project, covering changes to crushing, ore sorting and the use of equipment within the processing plant aimed at reducing energy consumption by c 30%, as well as a new ramp-up schedule targeting processing volumes of 2.1 million tonnes per annum (mtpa) in year one, 2.6mtpa in year two and reaching 3.5mtpa in year three (vs 2.7mtpa in year one and steadily rising to 3.5mtpa assumed in the BFS). The company targets the production re-launch in H123. As a result, Tungsten West now expects capital expenditures at £26–36m (with £3.1m already spent on equipment). The company had cash on hand of £22.9m at end-June 2022 and intends to cover the remaining funding through raising further debt or other non-equity capital (eg prepayment finance, asset-backed financing, royalties) to avoid further share dilution.

Tungsten West's share price fell by 59% in H122 to 25.50p (though rebounded to c 30p after the new plan announcement) and at end-July 2022 the holding represented 8.7% of BSRT's NAV. While BSRT has not reported similar changes to the development plans of its other holdings, we think that the risk of cost overruns has increased materially in recent months. Having said that, cost pressures could ease somewhat if commodity prices decline further in response to a global recession.

A 50% write-down of two Russian assets due to the war

BSRT has two major assets located in Russia: a 1.8–0.9% net smelter royalty in the Prognoz silver mine held through Polar Acquisition (PAL, 7.5% of BSRT's NAV at end-2021), which is owned and developed by Polymetal International, and the Unkur copper silver project in the far east of Russia owned by Azarga Metals (2.4% of BSRT's NAV at end-2021), where BSRT has a 36% equity stake following the US$3.5m loan conversion in April 2022.

BSRT made a 50% downward adjustment to PAL's carrying value in February 2022 to reflect the higher risk related to investments in Russia. This is despite Polymetal International being registered in Jersey and therefore not directly subject to sanctions. Polymetal highlighted that the Prognoz mine is at an advanced stage of construction and will progress according to the original plans. However, we also note that in its business update released on 23 June 2022, Polymetal flagged that its silver bullion inventory continues to accumulate due to the lack of reliable export channels and domestic demand (though it is in discussions with potential commercial and industrial international buyers). We also note that on 19 July, Polymetal announced it is evaluating the potential disposal of its assets in Russia. PAL's carrying value was also affected by the 13% decline in the silver price in H122 (though this was largely offset at BSRT's portfolio level by the positive foreign exchange effect from the strengthening US dollar versus sterling), bringing the project's share in BSRT's NAV to 4.4% at end-July 2022.

In February 2022, BSRT also reduced by half the carrying value of Azarga metals (2.4% of NAV at end-2021). According to BSRT, cutting off Russian banks from SWIFT impaired its ability to fund Azarga's Unkur project and 'could jeopardise the viability of the company's business operations in Russia'. Consequently, Azarga Metals will instead focus on its second project, the copper-rich Marg Volcanic Massive Sulphide exploration project in Yukon, Canada. In exchange for agreeing to the above-mentioned loan conversion, BSRT received an option to acquire the Unkur project (at a negligible price) until end-2023.

Sell-off in public equities weighing on valuations and path to IPO of several holdings

The underperformance of listed peers has affected the valuation of three of BSRT's unlisted holdings: Cemos (carrying value reduced by 9% at the half-year portfolio valuation review), Bilboes Gold (11%) and Nussir (20%). Moreover, weak public equity markets in H122 have been a drag on the carrying value of BSRT's listed portfolio (Tungsten West, First Tin and Silver X) and BSRT's exposure to listed precious metals miners. We believe that this is due to a combination of the overall weak sentiment in equity and industrial metals markets (in response to monetary tightening and recessionary fears) and cost inflation affecting miners' margins and development capex.

We note that at the start of 2022, BSRT intended to list three or four of its holdings this year. It successfully floated First Tin, which was one of the conditions for the sale and purchase agreement that First Tin signed with Aus Tin in November 2021 regarding the Taronga project in Australia. Consequently, together with its projects in south-eastern Germany (Tellerhäuser and Gottesberg), First Tin now owns three advanced, low-carbon tin projects located in developed Western economies. Demand for tin (a solder for electrical connections) should be driven by growth in EVs, renewable energy, mobile phone communications and semiconductors, among others.

First Tin raised £20m at an IPO price of 30p per share (despite the subscription being carried out in March, shortly after Russia invaded Ukraine), which will be used to fund feasibility studies for the Tellerhäuser and Taronga projects. However, its share price subsequently declined to 15.35p at end-June 2022 (13.63p on 4 August). BSRT retained its entire holding following the IPO and Taronga deal, becoming the second-largest shareholder with a 13.5% stake. Here, we note that the current share price still implies a solid unrealised multiple of invested capital of c 1.7x based on BSRT's average acquisition cost of 8p per share. We also note that BSRT is valuing the project at a discount to the current market price to reflect the 12-month lock-up agreed as part of the IPO (the discount was c 18% at end-June 2022, based on our discussion with management). The discount will be unwound once the lock-up expires in Q223 (as will the discount related to BSRT's stake in Tungsten West when the lock-up expires in Q422).

BSRT also considered the listing of Bilboes (developing a gold mine in Zimbabwe), Kanga Potash (a potash project in the Republic of Congo) and Nussir (a copper project in Norway), as well as First Tin's secondary listing in Australia. It recently agreed to sell Bilboes to Caledonia Mining Corporation (see below), while the remaining planned IPOs are likely to depend on the recovery in sentiment in the broad financial markets and investor appetite for exposure to individual commodities through junior mining projects. Hence, we think it is likely that some of these holdings will seek alternative funding routes (a private placement or by attracting a strategic investor).

Futura Resources was the major positive contributor ytd, but production yet to be launched

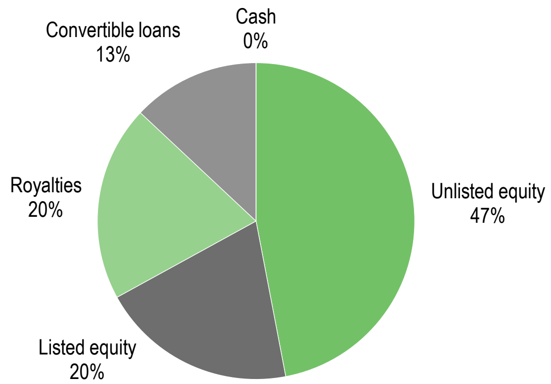
We estimate that the carrying value of Futura Resources increased by c 24% in sterling terms year to date, which made it BSRT's largest holding at a 27.4% share of NAV at end-July 2022. This was driven primarily by a positive valuation effect from the conversion of BSRT's bridging loan to Futura Resources into an additional 0.5% gross revenue royalty (on top of the existing 1.0%). This added £3.1m to the holding's carrying value in April 2022. This was further assisted by the strengthening of the Australian dollar versus sterling year to date. BSRT was able to exercise this option as Futura Resources was unable to secure development financing by end-March 2022 (the pre-agreed deadline). As discussed in our previous note, the company faced prolonged debt financing negotiations, with the agreed equity funding dependent on the debt raise. We understand that these negotiations are ongoing with several potential debt providers (including discussions related to off-take finance agreements).

If Futura Resources can secure funding it can seek to obtain a mining licence and commence mine production at its coking coal projects in Australia. We note that despite the recent moderation in the Australian coking coal price, the projects still enjoy favourable mining economics with the last reported all-in sustainable cost at c US$80/t (in the first quartile of the cash curve) for the Wilton site compared to the current coking coal price at c US$250/t. It is worth noting that if the projects secure an off-take financing agreement, they will sell the coal at a certain discount to the market price. Moreover, the government of Queensland (where Futura's projects are located) recently started charging a higher royalty by introducing new, progressive upper tiers, with a 20% royalty paid on prices exceeding A$175/t, 30% over A$225/t and 40% over A$300/t (previously, the government only charged 7% on the first A$100/t, 12.5% at A$100–150/t and 15% above A$150/t). While this has not materially affected the valuation of BSRT's stake in Futura Resources (as it is based on consensus price forecasts well below current spot prices), it does limit the upside in a scenario where coking coal prices remain above A$175/t for a prolonged period.

Loan conversions bringing BSRT's plain equity exposure to 67%

We note that following several loan conversions over the last 12 months, BSRT's plain equity exposure increased to 67% at end-June 2022 (of which 20% is in listed equity, see Exhibit 1) from c 52% at end-March 2021, despite the decline in the share prices of listed holdings.

Exhibit 1: BSRT's portfolio by investment type at end-June 2022



Source: Company data

The company's convertible loan exposure was only 13% at end-June 2022, mostly in Cemos. Apart from Futura Resources and Azarga Metals (discussed above), BSRT also converted its loan in Silver X. Here, BSRT negotiated a conversion at a c 48% discount to the original conversion price (though at a slight premium to the market share price) and as a result, it became Silver X's largest shareholder with a 13.9% stake (and one seat on the board). Silver X has recently completed an expansion of its Nueva Recuperada processing plant and continued its mine development (on 2 June 2022 it announced a new independent technical report for its silver-polymetallic project).

Sale of Bilboes Gold to Caledonia Mining Corporation

On 21 July 2022, BSRT announced that it had signed (together with the remaining shareholders) an agreement to sell Bilboes Gold to Caledonia Mining Corporation (CMCL), a listed gold producer with the Blanket Mine in Zimbabwe as its primary asset. The total consideration for Bilboes will consist of c 5.1m new CMCL shares (translating into a 28.5% dilution) and a 1% net smelter royalty (NSR) granted exclusively to BSRT (on top of 0.8m CMCL shares, which will give BSRT a 4.5% stake). BSRT decided to negotiate an NSR instead of receiving the full consideration in CMCL shares to continue participating directly in the potential success of the project. The transaction is subject to several conditions, including local regulatory approvals and arrangements with local authorities, which BSRT expects to be fulfilled before the end of 2022.

At end-July 2022, BSRT recognised its stake in Bilboes Gold based on the combined value of the above-mentioned NSR and CMCL shares. The NSR was valued using a development risk-adjusted economic model (in line with BSRT's broader valuation policy), ie at a discount reflecting the development risk. The CMCL shares are carried at a discount to the spot price to reflect the six-month lock-up which they will be subject to from the date of deal completion. As a result, Bilboes Gold's carrying value at end-July 2022 was c 9% below the fair value of BSRT's stake reflected in its NAV reported at end-June 2022.

BSRT's management emphasised significant synergies associated with CMCL as Bilboes' new owner, including better access to financing provided by a cash-generative strategic investor, as well as CMCL's technical expertise and experience in gold projects in Zimbabwe. CMCL plans to take a phased approach to the development of the mine to reduce the peak up-front capital expenditure below US$100m, which would entail an initial production capacity at 60,000 ounces pa, gradually increasing to 168,000 ounces pa. Production from initial oxide mining could start as early as next year, according to BSRT.

While the deal does not translate into immediate cash proceeds for BSRT, it provides the potential for regular income in the future. Firstly, BSRT estimates that upon full ramp-up and at the current gold price, the NSR would generate c US$2.6m pa (the NSR is subject to a cap, which stands at a hypothetical US$75m over the life of the project, according to CMCL). We note that BSRT holds royalties in two further projects in its portfolio (the Prognoz silver mine and Futura Resources), which would also start generating income upon successful production launch. Secondly, CMCL remains committed to be a dividend payer (even after the Bilboes deal) and it has recently distributed a quarterly dividend of US$0.14 per share. This implies an annualised dividend yield of c 5.0% and would represent an annual distribution of c US$0.45m to BSRT, assuming the company does not reduce its stake after the lock-up expiry. Given the capital expenditures associated with Bilboes, CMCL does not expect any dividend increases in the medium term.

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