HANSONWESTHOUSE

MINING RESEARCH

Polo Resources

3.925p

The Future is Yellow

19 May 2009

In March, Polo signed an option agreement for a JV with Peabody Energy covering Polo's Mongolian coal and uranium assets. In addition, Polo signed a performance fee agreement with American Patriot to manage its Mongolian interests. This has freed up substantial financial and management resources and allowed the company to refocus on uranium. Since then, Polo has been buying stakes in several pre-production uranium companies including Extract Resources (ASX: EXT) which owns the world class Rossing South project in Namibia.

The Polo directors have proven experience in uranium having sold Uramin to Areva for US$2.7bn in 2007. In addition, Stephen Dattels and Neil Herbert (both Ex-Uramin) have recently increased their own stakes in Polo to 4.69% and 2.25% respectively. We believe that Polo is substantially undervalued, with the current share price trading at a 30% discount to our sum-of-parts valuation of 5.63p. In view of this, we are initiating coverage with a BUY recommendation.

Polo Resources recently purchased stakes in Extract Resources, Berkeley Resources (ASX: BKY) and A-Cap Resources (ASX: ACB), which are all pre-production U3O8 companies. Both Berkeley and A-Cap were bought as part of share placements, whilst the stake in Extract was purchased in the market. This is a marked change in strategy and direction for Polo which up until now, had been focused on coal.

However, this is hardly surprising given that Polo's executive director, Stephen Dattels and its managing director, Neil Herbert, have a very strong track record in the uranium sector. Both are both ex-Uramin directors, who sold the company to Areva for US$2.7bn in 2007.

Polo has existing coal related investments in both Caledon Resources (AIM: CDN) and GCM (AIM: GCM). There was market speculation that Polo would mount a takeover for Caledon last year but this failed to materialise. When Caledon announced that it was in potential takeover talks, Polo insisted that it was not interested; although in March, its purchase of £4.7m convertible loan notes did little to quell the speculation. In May 2008, Polo made a bid for GCM at 175p per share but was unable to reach agreement and the bid was terminated in June. However, as a result of Polo's stated refocusing on uranium we do not believe that Polo will make a bid for Caledon, GCM or any further coal assets.

Polo has not been immune from takeover speculation itself and in January 2009, the group received an unsolicited and highly conditional approach from Denham Commodity Partners Fund. However, no price was mentioned, Polo stated at the time that the offer was highly speculative and greatly undervalued the company's assets.

We estimate that Polo had just over £10m in cash at the beginning of May 2009. However, this was prior to the A$6.4m subscription agreement with A-Cap which is yet to be completed. We expect Polo to make further investments in uranium companies over the coming months, including a potential increase in its stake in Extract Resources.

Our own valuation on a sum of parts basis is 5.63p per share, a significant premium to the current share price. As such, we are initiating coverage with a **BUY** recommendation.

BUY

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SALES & TRADING CONTACTS

See reverse

COMPANY DESCRIPTION

Polo is an emerging energy company focused on acquiring and developing advanced stage uranium and coal properties

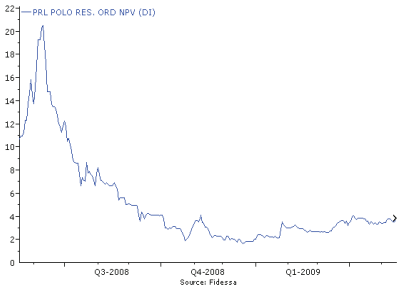
INVESTMENT DATA

Ticker	PRL
Listing	AIM
No. of shares	2,070m
Market cap.	£83.25m
Enterprise value	£72.61m

SHAREHOLDERS	Holding (%)
Luxor Capital Group	6.03
TPG Axon Partners	5.81
RAB Capital Plc	5.13
Southpoint Capital Advisors	4.14
FMR LLC	3.94
Blue Ridge Capital	3.73
Capital Resarch and Management Company	3.51

*As of 7 May 2009

12M SHARE PRICE PERFORMANCE



For important regulatory disclosures, please refer to the information on page 9 of this report.

Background

Polo Resources was admitted to AIM on 4 September 2007 as an investment company aimed at the natural resources sector. Under Aim rules, Polo had 18 months to make a substantial acquisition and in November 2007, the company announced that it had entered into an agreement to acquire coal and uranium assets in Mongolia.

By February 2008, Polo announced that it had purchased shares in GCM Resources from RAB Capital, positioning itself as an emerging energy company focused on acquiring and developing advanced stage coal and uranium properties. However, when Polo recently acquired its stake in Extract Resources, Chairman Stephen Dattels said that Polo "has made a strategic decision to re-focus its human and financial resources in the uranium sector".

Why uranium?

Availability

The World Nuclear Association has stated that, as of the 1st May 2009, there are currently 436 nuclear reactors globally, 45 under construction, a further 112 planned and 276 proposed reactors. The 436 existing reactors will require 170Mlbs of U3O8 this year, although total production for 2008 was only 115Mlbs.

For the past few years, the shortfall has been sourced from the reprocessing of US and Soviet nuclear warheads under a 20 year agreement which will expire in 2013. Under the agreement, around 400 Mlbs of uranium has been reprocessed (60% of the total available). The end of the agreement will coincide with increased demand of around 190Mlbs as the reactors currently being built come online. If all the planned reactors came online, demand would be around 250Mlbs per year and although it is unlikely that they will all be commissioned, demand is expected to exceed 200Mlbs by 2015.

Pricing

The spot price of uranium hit a low of US$40/lb in April, largely due to the liquidators of Lehman Brothers trying to dispose of a 450,000lb uranium "yellowcake" stockpile that Lehman's had acquired. However the price has rallied since then, reaching US$51/lb last week.

Utility companies account for approximately 50% of recent buying in the spot market but the remainder was purchased by hedge funds that are re-entering the commodities market and see opportunities in the potential demand/supply inequality to impact uranium prices. Spot prices are still a long way off the $136/lb they reached in June 2007.

Most mine production is sold on long term contracts and contract prices currently at US$65-70/lb are still down from the US$96/lb achieved this time last year. There has been a move to nuclear power in recent years, with it being viewed as less environmentally damaging than coal. However, given the perceived shortfall in production, the award of reactor construction contracts has been conditional on having long term offtake agreements in place and many construction groups have not been awarded contracts as a result. This has resulted in construction companies attempting to secure U3O8 offtake agreements and approaching uranium production companies at an early stage to sign an agreement. As the construction companies make their profits on the construction and operation of the reactors rather than mining the U3O8, they are paying a premium to secure the offtake critical to obtaining construction and operating contracts.

A case in point is Areva's US$2.7bn acquisition of Uramin where the uranium deposit itself was quite low grade but Areva paid a high price in order to secure the offtake agreement needed to obtain reactor construction contracts in India.

Polo Resources' investments

Mongolia

Polo Resources has 58 coal assets and 25 uranium assets in Mongolia. Of the coal assets, 37 are in South Gobi and the balance is in central or northwest Mongolia.

Until recently, Polo had been concentrating on the central Mongolian assets aiming to extract over 200Mt of coal across the Ereen, Union and Khashaat projects. However, the company encountered difficulties obtaining coal offtake agreements, or rather, getting paid for the offtake.

In October 2008, Ereen entered commercial trail mining and with the aim of increasing production up to 90,000 tonnes of coal per month. A local power station agreed to take up 0.5Mtpa at US$32 per tonne against costs of US$10 per tonne. Although this appeared to be a good deal on paper Polo was unable to recover payment and has now suspended production. Of the other coal projects, Polo recently announced an updated NI 43-101 for the Union project of 44.5Mt measured, 50.2 Mt indicated and 38.4 Mt are inferred.

Peabody (NYSE: BTU)

On 27 January 2009, Polo announced a joint venture agreement with Peabody Energy Corporation (NYSE: BTU), which would hold all of Polo's coal and mineral interests in Mongolia. Peabody is the world's largest private-sector coal company whose coal products account for nearly 10% of all US electricity and 2% of worldwide electricity generation.

The original deal would have been worth US$73.2m if all options were exercised but at the end of March, Polo announced that Peabody had renegotiated the agreement.

The new deal

Polo has now transferred all of its Mongolian assets into a Dutch-based company into which Peabody has gained a 50% interest in exchange for an investment in the JV company. Under the terms of the JV, Peabody must pay US$10m at the outset and a further US$13m within a year. Peabody may also invest an additional US$2.8m if certain acquisitions, that Polo has already identified, are made. Of the total consideration, Polo receives directly US$2.5m, partially reimbursing costs incurred since November 2008. Polo also receives a 1% or US$0.5 per tonne royalty on any coal produced from any of the currently held assets and 50% of the sale proceeds of any non-core assets. This could potentially provide Polo with approximately US$50m.

Peabody will also receive commission for sales and marketing. We believe that this is a sensible move for Polo given Peabody's existing marketing platforms in key markets including China and Polo's negative experience at Ereen. Peabody is also keeping its existing Tavan Tolgoi project outside the JV.

Polo and Peabody will have the same number of directors on the board of the JV company, although Peabody can appoint the Executive Director who will manage the Mongolian operations and have day to day control over the activities of any subsidiaries of the JV.

Peabody, and as a consequence the JV, is focused primarily on the South Gobi assets, which are close to the Chinese border and existing Peabody projects. The funds are now in place and will enable a fast track exploration programme to be implemented, aiming for short term production.

Peabody warrant

In addition to the 50% interest in the JV, Peabody has been granted a warrant to subscribe for 404,866,875 Polo shares or approximately 15% of the fully-diluted share capital of Polo. This deal includes anti-dilutive rights including participation in fundraisings by Polo. The warrant can be exercised up to 18 months from issue at 4.0p.

Should Peabody excise the warrant, it can appoint one member of the Polo board as long as it retains a holding of 5% or more. There is also a standstill agreement in place for up to six months preventing Peabody increasing its stake in Polo unless there is a bid to acquire over 9.9% of Polo's existing share capital.

Management Agreement with American Patriot

Conditional on the JV deal with Peabody, Polo has separately entered into an agreement with American Patriot to manage Polo's share of the JV in Mongolia. American Patriot was instrumental in negotiating the agreement with Peabody and has JV operating experience with a number of international companies including Peabody itself. Under the terms of a "performance fee agreement", American Patriot will receive an annual fee of $300,000, 25% of any royalty payments on mineral sales received by Polo (1% or US$0.5 per tonne under the terms of the Polo agreement) and a performance fee of 20% of any distributions received by Polo from asset sales in excess of $50m.

As part of the deal, 60 million Polo shares were issued to American Patriot and an additional 6 million were issued to Artimas International Limited for its work on the Peabody transaction and ongoing services. In addition, a representative of American Patriot will be appointed to the Polo board of directors.

Benefits to Polo

Although Polo has a lot of promising properties in Mongolia, it does not have the resources, especially in terms of management time, to develop them all. The company has made great strides with the properties it has been working on, including Ereen and Union. However it has found it difficult to turn these projects round into cash flow for the company.

The failure to secure payment at Ereen is disappointing. However, we believe that the deal with Peabody is hugely beneficial for the company. The combination of Peabody's management experience, financial backing and marketing structure will enable the JV to take the best projects into production quickly and dispose of the non-core assets for no additional funding from Polo. With the addition of the American Patriot agreement, Polo is also required to provide minimal management resources.

Strategic investments

In addition to the Mongolian assets, Polo has made a series of strategic investments in both producing and near-production companies. Increasingly, the focus has been on the Uranium sector, where Polo's senior management, many of whom are ex-Uramin, have had a lot of success. A prime example would be Uramin's sale to Areva for $2.5bn in 2007.

Coal

Caledon (AIM: CDN/ ASX: CCD) – 26.2% stake

Caledon was founded by Polo Chairman, Stephen Dattels, to explore for precious metals in China. However, in 2006, Caledon acquired the mothballed Cook Colliery in the Bowen Basin of Queensland, Australia, from Xstrata Coal Pty Ltd. The mine subsequently re-entered coal production in March 2007 and in early May 2009, Caledon issued an updated JORC compliant resource of 406Mt, up from 166Mt in 2007. The Cook mine is now fully operational but Caledon has found mining difficult at Cook and combined with the deteriorating coal markets, has cut its 2009 production forecasts from 900 tonnes p.a. to 400 tonnes p.a. Sales volumes for the first quarter were slightly ahead of expectations. However, they were conducted at spot prices (currently lower than last year's contract prices) as no new contract was settled for the year, which began on 1st April.

In 2006, Caledon also acquired the adjacent Minyango project in Queensland and completed a scoping/pre-feasibility study in April of this year. The study confirmed that Minyango is sufficiently attractive to move to full feasibility and is expected to have an overall coal yield of 84%, of which 62% is coking coal and 38% thermal coal. The JORC compliant resource at Minyango, released on 7th May was 342Mt and the company expects the infill drilling program to begin later this month.

Caledon had its first annual net profit of A$8.2 million in 2008, of which A$26.8 million was in 2H08. On 19th January 2009, the company announced that it was in discussions with a number of parties regarding a variety of deals including a possible takeover of the company.

On 4 March, Polo announced that it had acquired £4.7 million of 8.5% unsecured convertible loan notes 2010 issued by Caledon Resources for £4.7m and 162,629,750 new shares in the company for £4.7 million payable for the loan notes. Nevertheless, we do not expect Polo to increase its stake in Caledon but rather an offer will be made by another party allowing Polo to liquidate the investment at a premium to the current valuation.

GCM Resources (AIM: GCM) – 29.83%

Polo acquired its initial stake in GCM Resources in February 2008 from RAB Capital and currently owns 29.83% of GCM. In May 2008, Polo made a 175p per share offer for GCM Resources. This was unsuccessful and Polo terminated discussions in June and cannot make a further offer for a year without board approval.

GCM's primary asset is the Phulburi coal project in Bangladesh. The project has a resource of 572Mt and the development plan would be for a power plant built close to the mine and the export of additional thermal and semi-soft coking coal. Production is targeted at approximately 15Mt per year with total capex, including the power plant, of $3bn.

A feasibility study was completed in 2005 but GCM has not been able to secure approval and funding for the project. Phulburi is located in one of the few areas not prone to flooding and is inhabited by around 40,000 people. As a result, the project has become stalled with successive governments being undecided about the project and international NGOs lobbying against the project to both the government and international lenders. In the face of strong NGO opposition, the Asian Development Bank pulled its $300m loan agreement in April 2008 and in June 2008, Barclays sold its stake in GCM, with the Royal Bank of Scotland following suit in October 2008.

However, the project did receive a boost on the 17th May when Bangladesh Finance Minister Abul Maal Abdul Muhith said Bangladesh was suffering from falling natural gas reserves and increasing demand for power. As a result the government were keen to finalise an energy policy that may allow open coal mining to maximise coal extraction despite the concerns of environmental groups. He added that it still may take some time to finalise coal policy and Bangladesh may import coal until it is finalised.

Our view of this is that if the project is to receive funding, it will most likely come from a sovereign wealth fund in China. However, there are no guarantees that the project will ever go ahead and so GCM has taken out several investments in other companies which currently underpin much of the value of GCM.

GCM Investments

Peoples Tel Ltd

GCM, through its wholly owned subsidiary, Bangladesh Telecommunications, subscribed for 26.5% of the equity in Peoples Telecom and Information Services (Peoples Tel) in February 2007. GCM invested a further £2m in February 2008, increasing the total equity position to 37%. We view this as a strategic investment in Bangladesh to support the application of Phulbari.

Aura Energy Ltd (ASX: AEE)

GCM owns 17.85% of ASX listed Aura Energy, a predominantly Australian focused uranium explorer. In particular Aura Energy looks at sandstone and calcrete-hosted uranium deposits in Western Australia and has a current market capitalisation of A$4.71m.

Regent Pacific Group (HK: 0575.F)

In July 2007, GCM Resources acquired a 6% equity interest in China Coal and Energy Corporation for US$4,166,625. In December 2007, China Coal and Energy Corporation was taken over by Regent Pacific

Group (RPG) based in Hong Kong, resulting in GCM holding 2% of RPG. The co-chairmen of RPG are Stephen Dattels and James Mellon a director of Charlemagne Capital (AIM: CCAP), Red Dragon Resources (TSX.V: DRA) and co-chairman of Emerging Metals (AIM: EML). On 5 May, Regent Pacific Group purchased 2.03% of Kalahari Minerals, taking its total holding to 3.57%. Emerging Metals also holds 9.84% of Kalahari Minerals while Kalahari Minerals holds 38.68% of Extract resources, in which Polo has an interest.

Polo Resources (AIM: PRL)

As well as Polo holding 29.83% of GCM, in September and October 2008, GCM purchased 74.8 million (c4%) shares in Polo in the market for £2.8m.

Coal of Africa (AIM: CZA)

GCM, through a wholly owned subsidiary, holds 20.3 million shares or 4.8% of Coal of Africa Ltd (AIM: CZA). Coal of Africa went into production at Mooiplats with the first cut last October. Production is expected to ramp up over the next 18 months to 3Mtpa of coal and 0.5Mtpa of middlings. Mooiplats has a 25 million tonnes indicated and 88.2 million tonnes measured SAMREC resource, with potential to increase this through additional exploration.

Coal of Africa (CoAL) has additional projects at Makhado and Vele which will provide high quality coking coal likel to achieve premium prices. Indeed Arcelor Mittal holds 16.31% of CoAL and ArcelorMittal South Africa has an option to enter into an offtake agreement for 2.5Mtpa of coking coal. However, CoAL, like many companies in South Africa, is still waiting permitting for these projects and this hiatus has been dragging on the share price.

CoAL is currently disposing of its coal project at Holfontein and NiMag, a manufacturer nickel and magnesium alloys.

Uranium

Berkeley Resources (AIM: BKY)

On 15 May, Polo Resources acquired 10 million new shares in Berkeley Resources at A$0.50 per share and was granted 5 million attached options at A$0.75 with a four year expiry. This brings Polo's total holding in Berkeley to 10.5 million shares or 8.93% of Berkley's share capital. Stephen Dattels was also appointed a non-executive director of Berkeley on 15 May. For advising on the deal, Regent Resources Capital Corporation was granted 2.5 million options in Berkley at A$1.00 with a four year expiry.

Berkeley has 450,000 ha of advanced uranium exploration projects in areas of historic mining in Spain. The most advanced of these is Salamanca which has an inferred and indicated JORC compliant resource of 16.9Mlbs of U3O8 at an average grade of 563ppm. The project is currently on care and maintenance having been previously operated by ENUSA Industrias Avanzadas SA (ENUSA) until 2003. The project also includes ENUSA's Quercus uranium processing plant.

The scoping study at Salamanca indicated that the project was economic with forecast costs of US$25/lb and Capex of US$109m for a new plant. Polo's investment was part of a wider A$7m placing to fund the feasibility study. In 2006, Berkeley entered into a Strategic Alliance with Areva NC to explore and develop Berkeley's uranium projects in Spain with Areva providing technical and marketing assistance on any future production.

On 27 April, Berkley received approval from the Spanish Council of Ministers for a co-operation agreement with ENUSA Industrias Avanzadas SA (ENUSA). This gives Berkeley the right to acquire up to 90% of ENUSA's uranium mining and exploration assets, which include state reserve permits containing substantial historical resources and access to the Quercus uranium processing plant, which was previously permitted to produce up to 950tpa of U3O8.

Now that Berkeley has both the approval and the funding, the company's objective is to generate a total resource base for the project of over 65Mlbs of U3O8 across its projects and to complete a feasibility study within 18 months. As a result we would expect Salamanca to return to production in late 2011.

Extract Resources (ASX: EXT)

By 15 April 2009, Polo had acquired 20,731,461 shares in Extract Resources and together with Stephen Dattels and Neil Herbert (directly and indirectly) owned a relevant interest in 22,521,700 shares or 10.17% of Extract. Polo stated that the shares were acquired for investment purposes and depending on market conditions, the company may increase its holding.

Extract owns the Rossing South uranium deposit in Namibia, which is arguably one of the most exciting uranium projects in the world. In January 2009, Extract released a resource of 108 Mlbs of U3O8 at 430ppm Zone 1. Following additional drilling, we expect a resource statement for Zone 2 to be released in August. Mark Hohnen, CEO of Kalahari Minerals (AIM: KAH) believes the total resource is expected to be between 240 and 250 Mlbs of U3O8 for Zones 1 and 2 and at the Kalahari AGM on the 12 May, Mr Hohnen said that he anticipated it could reach 500Mlb of U3O8, once its Namibian land position has been developed and in particular, the Rossing South Zones 1 and 2 and Ida Dome have been fully defined.

We currently value Extract's assets at US$4/lb but we are likely to re-rate this to circa US$6/lb based on recent transactions for similar stage projects once the resource for Zone 2 has been defined. This indicates the potential value of the project and why there is so much interest in the project. Rio Tinto owns 15.7% of Extract while Kalahari Minerals hold 38.68%. We would expect Rossing South to enter production by 2013 but this very much depends on whether a JV or takeover is completed and by whom as Rio could enter production much quicker using its existing plant and infrastructure.

A-Cap Resources (ASX: ACB)

Polo signed an agreement on 6 May 2009 to acquire 31,888,770 new shares or 19.9% of the enlarged share capital of A-Cap Resources (ASX: ACB) for A$6,377,754. This is part of a 50 million new share placement at A$0.20 per share in order to raise A$10 million. This will need approval by the existing shareholders at a general meeting on or around 17 June but upon approval, Polo will be able to nominate one of its board members to the board of A-Cap.

A-Cap intends to use the funds raised to advance the Letlhakane uranium project in Botswana, including the completion of a feasibility study and further exploration with the objective of increasing the resource base of the project. A-Cap has previously announced an inferred resource for the Letlhakane uranium project comprising 280Mt at a grade of 158ppm U3O8 for 98Mlb of U3O8 (44,500 tonnes) a cut off grade of 100ppm. We would expect Letlhakane to enter into production in 2012.

Valuation

Our valuation is on a sum-of-parts basis. Each part is valued on the current market value, with the exception of the Mongolian assets which are based on the US$10m Peabody will pay now and the US$23m due within a year. As there is no production this year, we have also not included any royalties due from future production. The value of the Extract holding is based on the holding announced on 15 April although this has increased significantly since then. We have also not included the A-Cap holding as this has yet to be ratified by the A-Cap shareholders.

Our valuation, when fully diluted, generates a target price of 5.63p per share. This is a substantial premium to the current share price of 3.925p per share which we believe is deeply discounted.

Sum of the parts valuation

Component	Value £m
Caledon Resources	£25.43
Caledon Resources 8.5% convertible loan notes	£4.70
GCM	£11.26
Extract Resources	£50.14
Berkeley Resources	£5.36
Mongolia	£15.29
Cash	£10.64
ITM options/ warrants	£3.99
Total	**£120.91**
Share capital (fully diluted ITM)	2,250.65M
Target price	**5.63p**

Source: HansonWesthouse estimates

Conclusion

The Peabody agreement is a good result for Polo as it allows the company to get a return on its investment in Mongolia for very little future expenditure. The sale of assets and the eventual royalties will provide cashflow with which Polo will look to invest or develop its increasing portfolio of uranium assets. Polo's investment in GCM is largely underwritten by GCM's own investments which makes the rest an option on Phulburi receiving approval and being able to secure financing. Caledon is currently a takeover target and we do not see Polo making a bid, which means that Polo could liquidate its Caledon holding easily and at a premium to the current value.

Polo's growing portfolio of uranium assets is very attractive with all the companies aiming to enter production around 2012 when we expect supply to be critical and the wide geographic spread. We expect that Polo will continue making strategic investments in other uranium companies looking for funds in the near future, whilst continuing to build its stake in Extract Resources.

In January, Polo did receive an unsolicited approach from Denham Commodity Partners Fund. Although no price was mentioned, Polo did state at the time that the offer was highly speculative and greatly undervalued the company's assets. Since then there have been no further announcements and we do not expect Denham to come back with a firm bid.

However, we do agree that the current share price of 3.925p substantially undervalues the assets held by Polo. Our own target price of 5.63p per share is a 43% premium to the current share price and as a result we are initiating coverage with a **BUY** recommendation.

We are encouraged by the fact that Polo's directors, Stephen Dattels and Neil Herbert appear to concur with our view that Polo is undervalued given that Stephen Dattels has purchased 12 million shares, taking his own stake to 4.1% and Neil Herbert has purchased 1.3 million shares, taking his ownership to 1.3%.

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