



Danakali Ltd

Global | Mining | ASX:DNK/LSE:DNK

11 September 2018

Share data

Shares - m (basic/fully diluted)	263.8m / 267.1m
52-week high/low	A\$0.94 / A\$0.56
Free float	62%
3M average daily volume	148,420
Market capitalisation (US\$m)	140
Net debt (cash) (US\$m)	-15
Enterprise value (US\$m)	125
Dividend yield	0.0%
Fair Value (A\$)	2.14

DNK base case val'n	A\$m	A\$/sh
DNK share of Colluli (NAV)	399	0.81
Salt resource	56	0.12
Net cash (debt)	15	0.03
Unpaid capital	156	0.32
NAV	626	1.28

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Source: Arlington Group, Bloomberg

Ethiopia peace deal a game-changer

On 9 July 2018 the Ethiopian and Eritrean governments signed a peace deal to end decades of unrest between them. One of the areas in which the two countries agreed to work together is on port development and we believe that this could have significant impacts for DNK.

Development of a bulk terminal at Anfile Bay would be a game-changer for the Colluli project because it would mean a reduction in trucking costs from US\$60/t to US\$10/t which would not only boost profitability but it would also open up the potential to ship other lower value bulk commodities such as rock salt and gypsum which, up to now, have been uneconomic to ship.

We have developed a scenario analysis to study the impact of certain incremental project improvements for Danakali's valuation.

Accelerated development of Module 2

Our base case is that the second SOP production module for Colluli would come into full production in 2027E, however we believe that the increase in profitability from development of the port would make it viable to develop earlier, with full production perhaps as early as 2024E.

Monetisation of by-products

Including a port would allow shipment of low value bulk materials like salt. There is also potential to spend US\$45m per module to add up to 225Ktpa of SOP-M product to Colluli. SOP-M is a premium product and retails at c.US\$400/t and we believe that such a development would be incrementally extremely valuable to the project.

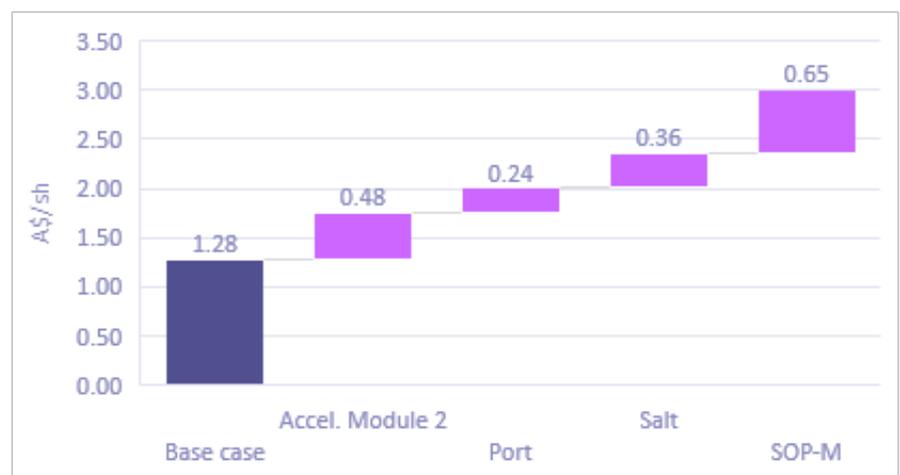
Incremental upside of A\$1.73/sh

Incorporating port development, salt & SOP-M production and acceleration of Module 2 would add an incremental US\$520m or A\$1.73/sh to our base case valuation for Danakali with only the need to access c.US\$100m of external debt funding. Given the current share price of A\$0.78, we believe that this is an important consideration.

Attractive valuation

Our base case SotP valuation uses a DCF at 10% discount rate for Colluli and yields a valuation for DNK of A\$626m (A\$1.28/share fd). We suggest a blend of the base case and incremental valuations is justified, which yields a valuation of A\$2.14, nearly three times the current share price.

Incremental upside to Danakali base case NAV



Source: Arlington Group estimates

Prepared by Arlington Group Asset Management Limited

See important disclosures at end of this report

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Great strides forward

A number of important events have occurred in the past nine months which have significantly enhanced the valuation case for Danakali, in our view:

1) Delivery of FEED study

In January 2018, DNK published the Front-End Engineering Design (FEED) for Colluli. This further refined the capex and opex assumptions for the project, finalising up-front capex for module 1 at US\$302m and average total operating costs at US\$258/t FOB. We updated our model to include the FEED parameters and, given the slight delay in completing the FEED report, we were compelled to alter our start-up timing for the project model with the result that we have now moved construction start to CY19E and production start-up to CY21E.

This resulted in a reduction in our forecast project NAV (attributable to DNK) from our previously-published (11 October 2017) US\$326m to US\$279m.

As part of the changes to our model as a result of the FEED study we decided to update our assumptions on the funding structure for Colluli module 2. Management has guided that it would look to access external funding for module 2, which would allow quicker pay-back of DNK loans by the project company.

We therefore assumed that the project company, Colluli Mining Share Company (CMSC), would look to source US\$100m of third party debt funding in 2021E rather than try to finance module 2 only from cash flow as we had originally assumed.

This change, and associated changes to the payback dates for DNK's loans to CMSC result in a decrease to our project valuation to US\$671m from US\$702m and an increase in our project NAV attributable to DNK to US\$307m from US\$279m. This raises our sum of the parts valuation for DNK to A\$1.21/sh.

2) Signing of Take-or-Pay offtake agreement with Eurochem

On 12 June 2018, DNK announced to the market that it had signed a 10-year take-or-pay offtake agreement with Eurochem for production from Colluli Module 1. Under the agreement Eurochem will take, pay and distribute up to 100% (minimum 87%) of the SOP. Colluli Mining Share Company (CMSC) the Colluli JV company has the option to sell up to 13% of production through alternative sales channels if it wishes.

This was a step-change for the company in our view. With the offtake agreement in place, the company is free to pursue debt funding with the knowledge that it can place its product in the market, generate revenue and hence pay interest.

In the weeks following the announcement, the stock's price moved materially and this could have a significant impact on valuation, in our view, because the company may now be able to raise equity at a price higher than that at which we originally assumed it would have to raise. Hence it would have to offer less shares and there would be less dilution of existing shareholders.

On the date of publication of this report, DNK's shares are trading at A\$0.78 on the ASX and have been as high as A\$0.91. If we assume a 10% discount on an equity raising then shares might be placed at A\$0.70 rather than the A\$0.62 that we assumed in our October report.

This results in our per share NAV for DNK rising to A\$1.28 from A\$1.21.

3) LSE listing

On 24 July 2018 the company's shares were admitted to trading on the Standard Segment of the London Stock Exchange (LSE). We regard this as a significant event for the company. There are a number of listed fertiliser development projects on the London markets (LSE and AIM) and we believe that the Colluli project compares extremely favourably with each of the projects being developed by those companies. As a result, we believe that over time DNK can realise a valuation premium over its London-listed peers. While many may be concerned about the liquidity of the London markets, we note that this is an issue for AIM and not the Main Board where DNK is listed.

4) Peace treaty between Ethiopia and Eritrea

Of all the developments, we regard this as potentially the most important. When talking to investors the political situation in Eritrea has often been a point of concern, so the announcement on 9 July 2018 that the state of unrest between Ethiopia and Eritrea had "come to an end" is likely to be a significant turning point for how Danakali is seen by investors.

On its own the deal is likely to reduce the political risk attributed to the DNK stock by several orders of magnitude, in our view. And that is likely to have significant impacts on Management's ability to access capital for the project.

The rapprochement not only ends a decades-long "cold war" between the two countries but also has potential strategic implications for how the Colluli project is developed, as described in the next section.

Ethiopia to participate in port development

Part of the contention between Ethiopia and Eritrea is that Ethiopia is landlocked, while Eritrea, which split away from Ethiopia in 1993 (after a long battle for freedom after having been annexed by Ethiopia following the Second World War) has access to a number of ports on the Red Sea.

As part of the peace treaty, both countries agreed to "work to promote close cooperation in political, economic, social, cultural and security areas" and a key area within this is participation in the development of ports, potentially a huge boost for both countries.

While this could result in investments to the port of Massawa, into which the company had intended to truck its product, we believe that it also puts on the radar the potential to develop a port at Anfile Bay, which would be a game-changer for Colluli, in our view.

Cheaper to truck to Anfile than Massawa

The DFS assumes a cost of trucking product in containers from the mine site to Massawa of US\$60/t. While this could now fall with the better political situation (as more trucking companies are happy to operate in Eritrea), we believe that a significantly better solution for the company would be to develop the bulk port at Anfile Bay. We estimate that the cost of trucking bulk product between Colluli and Anfile Bay would be of the order of US\$10/t, a significant reduction.

Development of the road between Colluli and Anfile Bay is already included in the capex estimate for the project. We believe development of a port large enough to cope with c.1.5Mtpa of bulk product could have upfront capital costs in the region of US\$55m. Further capacity could then be added at a later date.

While it is possible that the project company could look to build the port itself, given the political imperative to develop ports, we believe it is likely that the Eritrean Government may take this as on as a project and that would obviously be extremely positive for the company.

We have carried out a scenario analysis to evaluate the valuation impact of building the port.

Port would enable other parts of the resource

However, it is important to stress what a material impact port development could have on the project, beyond lowering the cost forecasts for SOP.

In the present project plan the company has to mine through a rock salt layer to get to the ore. Rock salt is a commodity product and there is a market for it, in our view. But with an average FOB price of US\$50/tonne, the US\$70/tonne trucking and port costs to Massawa would make it uneconomic.

However, if trucking and port costs were in the region of US\$20/t to Anfile Bay, then the company could look to utilise this wasted resource and sell its salt production.

Accelerated development of Module 2 also possible

Given the improved political situation and the potential to develop the port, we believe that an accelerated development of the second SOP production module is more likely. In our base case model, we assume that Module 2 would enter full production in CY27E, but with the cash flows available and likely easier access to capital, we believe that Module 2 (which would double SOP production) could enter full production as early as CY24E.

SOP-M production would add significantly to value

SOP-M or Potassium Magnesium Sulphate is a low chloride, premium fertiliser which is generally applied to high value crops such as leafy plants, fruits and vegetables.

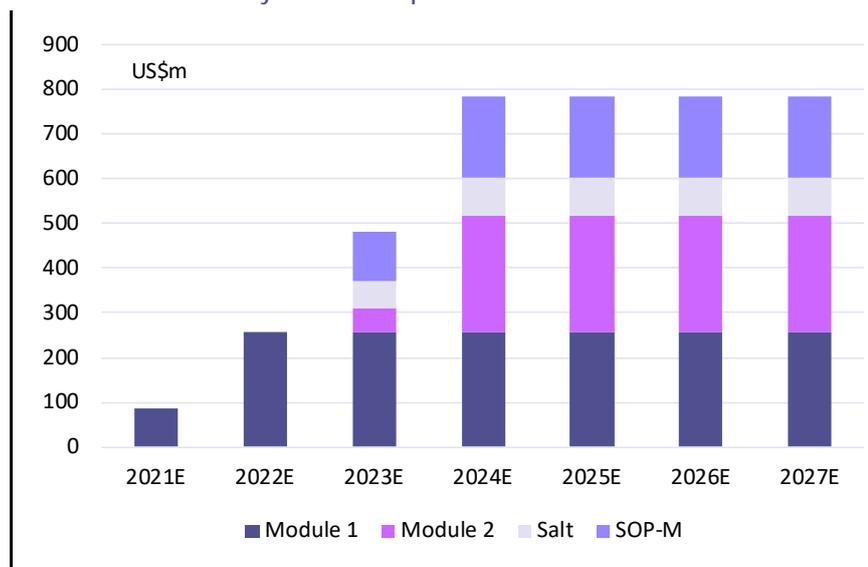
It can be extracted from the Colluli resource quite easily with the addition of a processing circuit within the plant. We estimate that it would cost c.US\$45m to add an SOP-M processing option for each module of the Colluli project. Each circuit could see in the order of 225Ktpa of SOP-M produced.

SOP-M is a relatively small market of c.1.7Mt in 2017, so the amount of material that could be produced from Colluli may be expected to have a material impact on the market, raising the risk that prices could be depressed. However, DNK management believes that the market size is so small because of a lack of supply in the market, not a lack of demand. We have used a conservative US\$400/t FOB price forecast in our model.

We believe that, with the addition of the bulk port, relatively small investments in SOP-M production (US\$90m for both module 1 and module 2) could have a significant positive impact on the bottom line for DNK.

However, with a capital cost of US\$45m per unit, added to the accelerated development of Module 2, we do forecast that the company would need to access an additional US\$100m of external funding. In our model we have treated this as third-party debt funding.

Chart 1: Scenario analysis revenue profile for CMSC



Source: Arlington Group estimates

Valuation

Our base case valuation for DNK utilises a sum of the parts valuation based on a DCF for the Colluli project (10% discount rate), an EV/resource tonne multiple for the salt resource and the current net cash position.

Please see our initiation piece (dated 11 October 2017) for a full discussion of our valuation approach as well as the sources of funding and how we treat them in our model.

Our updated model, incorporating the updates from the FEED report, different debt structure, the later production start and the higher expected equity raising price, yields a base case valuation of US\$671m for the whole Colluli project, and US\$307m attributable to DNK shareholders, which translates into A\$1.28/share on a post-capital basis.

Chart 2: Danakali base case model output

Output			
Project NPV (100%)	US\$m	671	
DNK project NPV	US\$m	307	DNK IRR % 31%
DNK project NPV	A\$m	399	
Sum of the Parts	A\$m	A\$/sh	Funding sources (US\$m)
Colluli project	399	0.81	Third party debt 200
Salt resource	56	0.12	DNK int. bearing loan 30
Cash	15	0.03	DNK interest free loan 45
Unpaid capital	156	0.32	DNK equity 120
Total	626	1.28	Equity raise price 0.70

Source: Arlington Group estimates

Significant incremental upside

Our scenario analysis is based on the following increments:

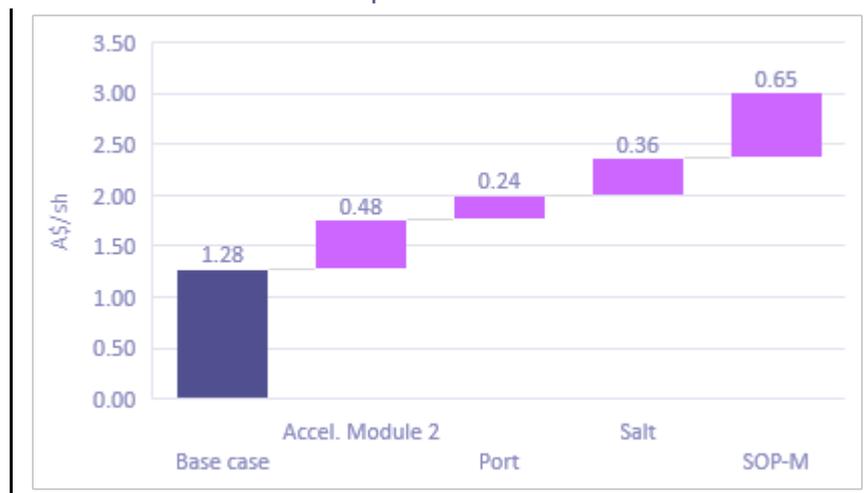
- Acceleration of Module 2 start-up to 2023E;
- Development of bulk port financed by Colluli project co. by 2023E;
- Salt sales from 2023E onwards;

- Incorporation of SOP-M processing circuits in Modules 1 & 2 in 2023E.

As noted previously, we assume that the company will need to access an additional US\$100m of external debt funding in order to progress with these developments.

The inclusion of these projects would result in an increase in our DNK NAV from A\$1.28/share to A\$3.01/share, a 135% increase in valuation and nearly four times above the current share price. [Note we have excluded the EV/resource tonne salt multiple from our NAV because it is already included in the DCF for the incremental scenario].

Chart 3: Incremental valuation upside



Source: Arlington Group estimates

We note that, while we have modelled a capital cost of US\$55m for the port, there is a strong possibility that the Government will develop the port themselves and, if they did so, the requirement for external funding would be less and there would be even greater upside.

Increased valuation

We believe that there is a strong possibility that the company will modify its development plan to include these incremental improvements. As such we think it is fair to incorporate some aspect of this in our valuation.

We have therefore decided to use an equally weighted average of our base case valuation (A\$1.28) and our incremental valuation (A\$3.01) and **we therefore set our blended valuation for Danakali at A\$2.14 per share.**

Catalysts and risks

Catalysts

- Further re-stocking in potash and increases in SOP price.
- Successful debt funding for key components of the project.
- Successful investment by strategic cornerstone investor.
- Further appointments of experienced mine development and operating staff.
- Announcement on Anfile Bay port development.
- Potential to add other bulk products (such as gypsum) to the production slate.
- Incorporation of additional by-product fertiliser or chemical products.
- Construction start.
- Further proving up of additional chemical resources.

Risks

- Political instability in Eritrea or along the Ethiopian border.
- Inability to source debt funding.
- Development risk – cost or time over-runs once in development.
- Strengthening of A\$ against US\$.
- Weakening of SOP price.

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Prices as of close on 10 September 2018

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