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Danakali (DNK)

COMPANY REPORT – INITIATION OF COVERAGE

Fertile ground

- **Initiation of coverage:** We initiate coverage of Danakali with a BUY recommendation and target price of $0.50ps on a diluted basis based on our modelling of the NPV over time. Our valuation for DNK is $402m or $0.66ps after diluting for an equity raising at $0.30ps to fund the equity portion of the project development (assumed to be 30%). The risk rating is Speculative as the company needs to arrange debt and equity financing to take the Colluli Sulphate of Potash Project forward.
- **Cost and capital advantage from open pit hard rock potash:** Hard rock mining of potash has been carried out for centuries however it is typically done utilising capital intensive underground mining operations. The muriate of potash mined then needs to be processed to produce sulphate of potash, adding further to the cost. The traditional low cost route for sulphate of potash (SOP) production is from brines. DNK's Colluli project benefits from low capex and opex through shallow open pit mining and a mineral assemblage which lends itself to established processing methods to produce SOP. Danakali's DFS indicates that the Colluli project could be the lowest cost producer of SOP globally.
- **Eritrea is pro-development:** There are a lot of mixed messages regarding Eritrea. However, the government does need income and mining is viewed as a key means of acquiring foreign income and investment. China is actively investing in mining and infrastructure. The development of Colluli would see the government receiving income through it 50% ownership of the operating company, and through its corporate taxation. We estimate that the long run annual income when Phase 1&2 are up and running will return ~US$170m to the government per annum. It is therefore in the government's interest to support the development of Colluli and other mining projects in Eritrea.
- **Investment thesis and risks:** Scalable project, discount due to location, potential corporate appeal for companies familiar with the region, offtake MOU's in place, and operating costs are forecast to be at the bottom of the cost curve and competitive with brine production. We would therefore expect that production from Colluli would go to new markets or displace high cost Mannheim production. Colluli's position in the cost curve should assist in raising equity and debt funding from producers and consumers as well as traditional markets. Funding an Eritrean development, given the perception of its political instability is likely to fall to those investors, companies or governments willing to cope with the risk.

INVESTMENT SUMMARY

Year End: 31 December		2014 (A)	2015 (A)	2016 (E)	2017 (E)	2018 (E)
Revenue	$mn	0	1	1	1	1
EBITDA	$mn	-1.2	-0.7	-0.7	-0.7	-0.7
EBIT	$mn	-4.5	-0.7	-0.7	-0.7	-0.7
Reported Profit	$mn	-4.4	-0.4	-0.7	7.0	1.8
Adjusted Profit	$mn	-4.4	-0.4	-0.7	7.0	1.8
EPS (Reported)	¢	-2.6	-0.3	-0.3	1.1	0.3
EPS (Adjusted)	¢	-2.6	-0.3	-0.3	1.1	0.3
EPS Growth	%		N/A	N/A	N/A	-74.8
PER (Reported)	x	N/A	N/A	N/A	26.7	106.1
PER (Adjusted)	x	N/A	N/A	N/A	26.7	106.1
Dividend	¢	0.0	0.0	0.0	0.0	0.0
Yield	%	0.0	0.0	0.0	0.0	0.0
Franking	%	0	0	0	0	0

RECOMMENDATIONS

Rating	**BUY** ▲
Risk	Speculative
Price Target	**$0.50**
Share Price	$0.31

SNAPSHOT

Monthly Turnover	$0.9mn
Market Cap	$61mn
Shares Issued	200.6mn
52-Week High	$0.57
52-Week Low	$0.21
Sector	Materials

BUSINESS DESCRIPTION

Danakali is developing the Colluli sulphate of potash project in Eritrea. The aim is to produce 425kt of SOP per annum in the first phase and then expand to 850ktpa. The project is expected to be one of the lowest costs SOP project in the world. Colluli is a 50/50 joint venture with the Eritrean government's mining company.

12-MONTH PRICE & VOLUME

RESEARCH ANALYST

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Disclosure
The author owns no shares in DNK.

Financial summary

DANAKALI

Analyst:	Warren Edney	**Rating:**	**Buy**
Date:	08-Jun-16	**Price Target:**	$0.50
Share Price ($A):	$0.31	**Valuation:**	$0.66
Market Cap (A$m):	$61.2	**Upside/(Downside):**	64%
EV (A$m)	$61.2	**Risk:**	Speculative
Year End:	December 31		

KEY RATIOS	CY15A	CY16E	CY17E	CY18E	CY19E	CY20E	CY21E
NPAT - Reported	-0.4	-0.7	7.0	1.8	31.7	90.0	93.7
NPAT - Attributable	-0.4	-0.7	7.0	1.8	31.7	90.0	93.7
EPS - Adjusted	-0.3	-0.2	1.1	0.3	5.2	14.7	15.3
EPS Growth (%)	N/A	N/A	N/A	(74.8%)	1,696%	184%	4%
P/E (x)	(105.7)	(141.9)	26.7	106.0	5.9	2.1	2.0
CFPS (A Cents)	-0.3	-0.1	1.1	0.3	7.4	16.9	17.5
P/CF (x)	-119.3	-273.7	26.7	106.1	4.1	1.8	1.7
DPS (A Cents)	-	-	-	-	-	-	4.0
Franking (%)	0%	0%	0%	0%	0%	0%	0%
Dividend Yield (%)	-	-	-	-	-	-	13.1%
Payout Ratio (%)	-	-	-	-	-	-	26%
FCF Yield (%)	-4%	-4%	-45%	-145%	-102%	116%	166%
EV/EBIT (x)	(275.1)	(275.1)	(275.1)	(275.1)	7.0	2.6	2.6
EV/EBITDA (x)	(275.1)	(275.1)	(275.1)	(275.1)	4.8	2.2	2.2

ASSUMPTIONS	CY15A	CY16E	CY17E	CY18E	CY19E	CY20E	CY21E
Australian Dollar (AUD/USD)	0.75	0.74	0.72	0.72	0.73	0.73	0.74
MOP (US$/t)	304	275	250	250	250	250	255
MOP (A$/t)	404	371	347	347	342	341	346
SOP (US$/t)	667	575	550	550	550	550	555
SOP (A$/t)	886	776	764	764	753	751	754

PRODUCTION & COSTS	CY15A	CY16E	CY17E	CY18E	CY19E	CY20E	CY21E
Colluli- SOP prodn (kt)	0.0	0.0	0.0	0.0	212.2	424.3	424.3
Colluli - C1 cost US$/t of SOP	0	0	0	0	57	105	101
Colluli - FOB Cost US$/t of SOP	0	0	0	0	287	264	255
Colluli - AISC US$/t	0	0	0	0	315	278	270

PROFIT & LOSS (A$M)	CY15A	CY16E	CY17E	CY18E	CY19E	CY20E	CY21E
Operating Revenue	0.0	0.0	0.0	0.0	73.3	146.2	146.8
Other Revenue	0.8	0.8	0.8	0.8	0.8	0.8	0.8
Total Revenue	**0.8**	**0.8**	**0.8**	**0.8**	**74.1**	**146.9**	**147.5**
Operating Expenses	0.0	0.0	0.0	0.0	-30.4	-56.0	-54.2
Corporate/Other Expenses	-1.5	-1.5	-1.5	-1.5	-1.5	-1.5	-1.5
EBITDA	**-0.7**	**-0.7**	**-0.7**	**-0.7**	**42.2**	**89.4**	**91.8**
Depreciation & Amortisation	0.0	0.0	0.0	0.0	-13.6	-13.6	-13.5
Exploration/write-offs	0.0	0.0	0.0	0.0	0.0	0.0	0.0
EBIT	**-0.7**	**-0.7**	**-0.7**	**-0.7**	**28.6**	**75.9**	**78.3**
Net Interest / (Expense)	**0.3**	**0.1**	**7.7**	**5.3**	**5.0**	**14.9**	**16.8**
NPBT	-0.4	-0.6	7.0	4.6	33.6	90.8	95.2
Income Tax Expense	**0.0**	**0.0**	**0.0**	**-2.8**	**-1.9**	**-0.7**	**-1.5**
NPAT - Adjusted	**-0.4**	**-0.7**	**7.0**	**1.8**	**31.7**	**90.0**	**93.7**
Significant Items	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
NPAT - Reported	**-0.4**	**-0.7**	**7.0**	**1.8**	**31.7**	**90.0**	**93.7**

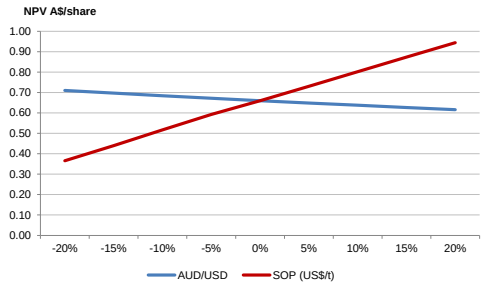
CASH FLOW (A$M)	CY15A	CY16E	CY17E	CY18E	CY19E	CY20E	CY21E
Cash Flow from Ops	-2.4	-2.5	3.4	4.6	11.8	85.3	105.6
Capex - Development & Sustaining	0.0	0.0	-31.0	-93.1	-74.3	-14.3	-4.1
Free Cash Flow	-2.4	-2.5	-27.7	-88.5	-62.6	70.9	101.5
Cash Flow From Investing	-19.9	-10.1	-91.9	-93.1	-74.3	-14.3	-4.1
Cash Flow From Financing	7.7	7.9	268.2	11.3	11.7	0.2	-15.1
Net Cash Flow	-14.7	-4.7	179.7	-77.3	-50.9	71.2	86.4

BALANCE SHEET (A$M)	CY15A	CY16E	CY17E	CY18E	CY19E	CY20E	CY21E
Cash	2.8	205.4	159.3	49.0	77.8	173.5	250.3
PP&E/Development/Exploration	0.0	0.0	62.1	186.3	197.2	187.7	178.3
Assets	24.9	24.4	297.2	313.1	328.8	393.0	448.8
Debts	0.0	141.9	150.9	161.9	167.3	143.0	118.7
Liabilities	0.7	0.7	146.4	157.0	168.2	155.8	131.5
Equity	24.3	23.9	149.8	155.0	160.4	209.9	289.7
Net Debt / (Cash)	-2.8	-63.5	-8.4	112.9	89.6	-30.5	-131.5
Gearing (%) - ND / (ND + Eq)	-13%	161%	-6%	42%	36%	-17%	-83%

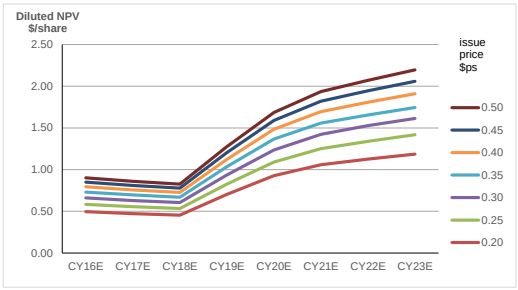
VALUATION SUMMARY

WACC 10.4%	A$m	A$/Share
Colluli	350	0.57
Exploration	0	0.00
Corporate	-11	-0.02
Equity Project debt	-142	-0.23
Cash	205	0.34
Total Valuation	402	0.66
Diluted for equity issue at	0.30cps	

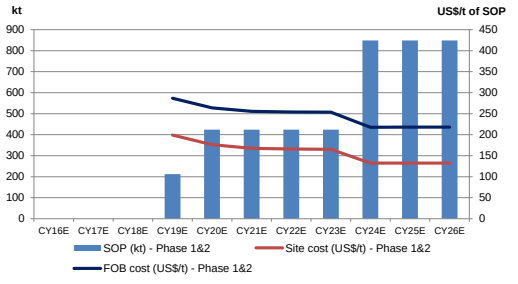
VALUATION SENSITIVITY



VALUATION SENSITIVITY TO EQUITY ISSUE PRICE AND TIME



PRODUCTION AND COSTS

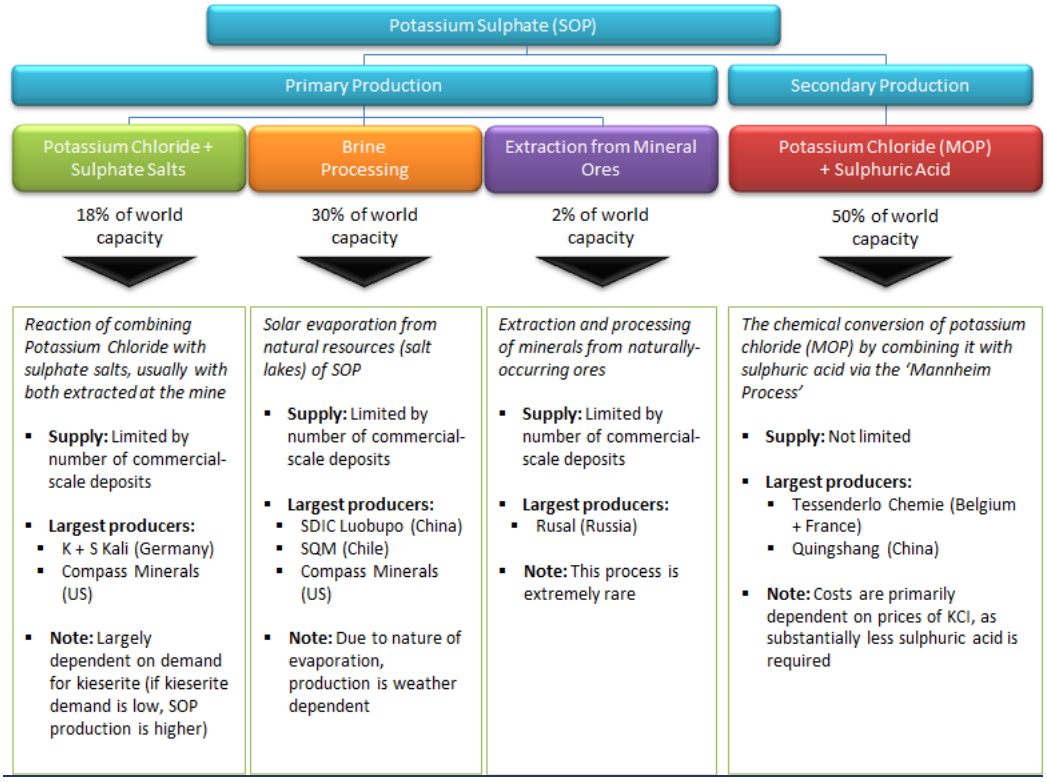


What is SOP and why do we need it?

- **Naturally occurring SOP is rare so most of it is manufactured:** Potassium sulphate can be made either by: 1) the Mannheim process where potassium chloride reacts with sulphuric acid; or 2) natural complex salts (FIG.1). The two basic reactions forming potassium sulphate are: 1) the transformation of Kainite to schoenite followed by water leaching; and 2) the adding of sylvite to kainite, langberite or kieserite.

Potassium is one of the three major agricultural nutrients

FIG.1: SOP PRODUCTION METHODS



Source: Crystal Peak, Parthenon, CRU

- **Improved agricultural productivity:** Globally, there is ever-increasing pressure to improve the productivity of arable land to feed a growing population. The use of fertiliser in the developed world and the developing world is on the increase, as is its production. MOP is widely used but also suffers from over-capacity (current utilisation is 70%), capacity additions and a decline in the prices of crops which utilise MOP as a fertiliser. On the other hand, SOP has a higher cost structure and is used on high value crops where the cost is less of an issue and where salt tolerance is important (FIG.2).

FIG.2: CHLORIDE TOLERANCE BY CROP

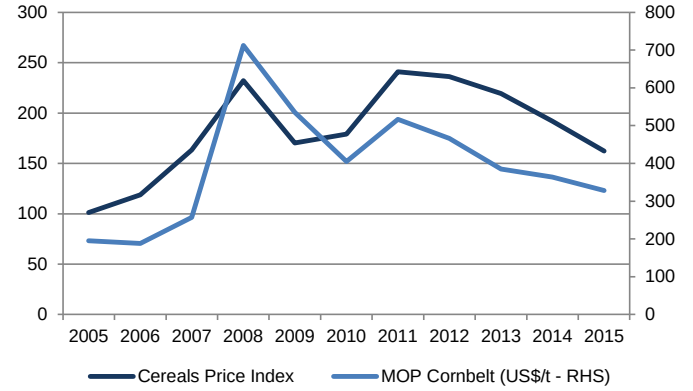
Classification	Chloride tolerance	Crop
Tier 1	Highly sensitive	Tobacco, tea, almonds, grapes
Tier 2	Sensitive	Potatoes, oranges,tomatoes, cashews
Tier 3	Partly sensitive	Sunflower, coffee, peas, spinach, carrots
Tier 4	Tolerant	Cereal, maize, rice, soy bean, sugar cane

SOP is ideal for crops which are salt intolerant or in areas where salt build up in soils has become an issue

Source: Crystal Peak

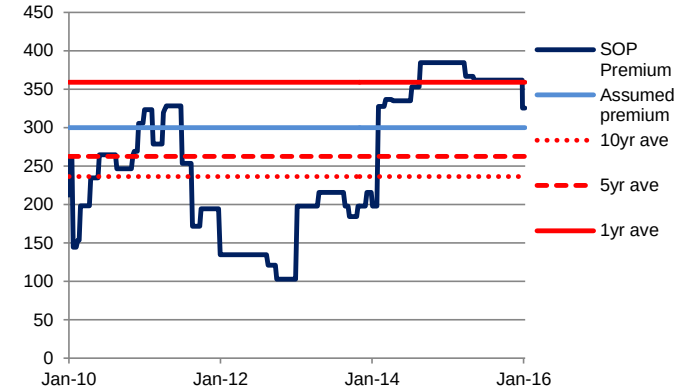
- **SOP offers better operating margins than MOP:** Muriate of Potash or potassium chloride (MOP) is the most widely used potash fertiliser with a global market of ~60Mt. It is typically used on broad acre, low value crops such as wheat and corn. SOP on the other hand is used on salt intolerant, high value crops (almonds, tea, potatoes for instance) for which the global market amounts to 5.5Mt. SOP is currently trading at a US$325/t premium to MOP reflecting the higher cost of production. Over the last four years MOP prices have fallen with increased supply and lower grain prices, however the cost of SOP production and its use in high value crops has supported the SOP price (+4%), while MOP has declined 40%.

FIG.3: CEREAL PRICE INDEX AND MOP PRICE



Source: USDA, World Bank

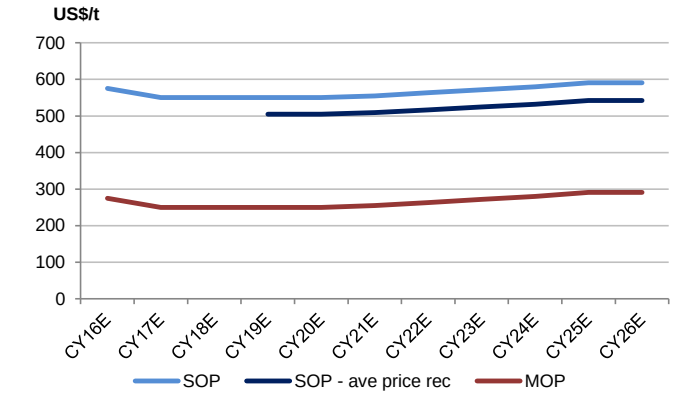
FIG.4: SOP PREMIUM TO MOP (US$/t)



Source: Baillieu Holst

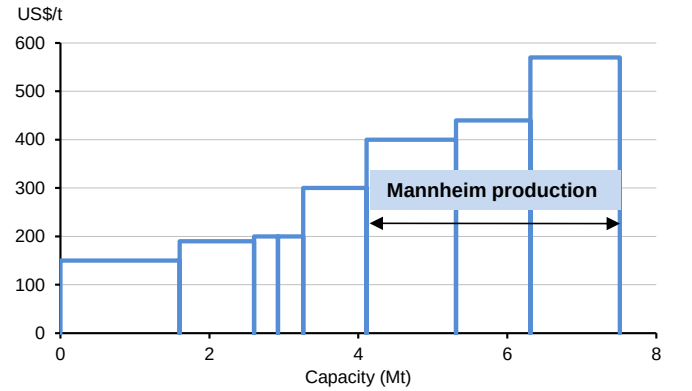
- **SOP's premium to MOP** has risen over the last 10 years (FIG.4) which we feel is related not only to the cost of Mannheim production, but also to the cost of disposal, or the ability to dispose of the hydrochloric acid, which is a co-product. The SOP premium is therefore in part process-route related and not just a value-in-use premium, and will be a feature of the market until Mannheim production is displaced.

FIG.5: FORECAST MOP & SOP PRICES (US$/t)



Source: Bloomberg, Baillieu Holst

FIG.6: SOP COST CURVE



Source: Green Markets

- **Growth potential:** The potential growth in SOP capacity is assumed to lead to a longer term decline in prices and a contraction of the premium, but the cost curve is supportive of price (FIG.6). High cost secondary production capacity will be displaced by projects like SO4's brine project in Western Australia, or potentially Danakali's rock project in Eritrea, or perhaps future solution mines in Ethiopia.

SOP from rock rather than brine

The Colluli Project

- **Location:** The Colluli Project is 75km from the Red Sea Coast, and 180km from the Port of Massawa, located near the border of Ethiopia and Eritrea. The perception of country risk may in part be due to past conflicts between neighbouring countries, and travel warnings from various governments. However, it is a poor country and the development of a mining industry will provide much needed income. The Bisha mine is currently Eritrea's chief source of income (via taxes and its 40% holding), with copper the country's leading export item (30% of total sales abroad in 2014). The exploitation of the Zara gold mine started at the end of 2015 and the Bisha mine should be in a position to produce zinc from the second half of 2016; this will further diversify the country's revenue base. Production at the Asmara copper-zinc-gold and silver mine is expected to start during 2016 and will be operated by a Chinese company and ENAMCO. China is the country's leading investor, creditor and trading partner.

Chinese investment in Eritrea is leading the way in mining and infrastructure

FIG.7: LOCATION OF ERITREA (IN ORANGE)

Source: GMT.com

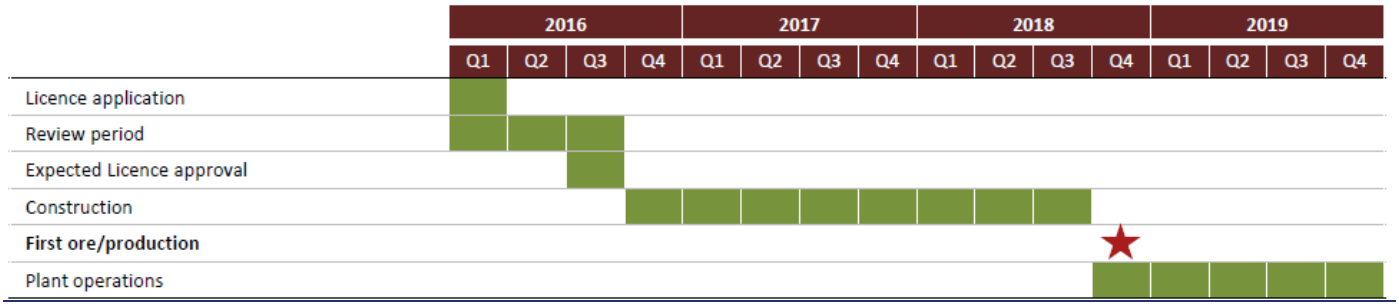
FIG.8: LOCATION OF COLLULI

Source: DNK

- **Government partnership:** DNK is developing the Colluli project in partnership with the Eritrean National Mining Company (ENAMCO). The project will be operated by a JV company, Colluli Mining Share Company (CMSC), with the ownership being 50/50. DNK is responsible for negotiating the capital and funding ENAMCO's equity in the project through an interest free loan. The loan will be repaid using project cash flow giving DNK a 75% share of the distributable cash flow until the loan is repaid.
- **Our assumptions for Capital requirements:** We have assumed that the capital requirements are in line with company estimates outlined in its DFS. Phase 1 costs of US$298m (which we have assumed) will be 70% debt funded (US$208m), and the remaining US$89.4m will be funded by Joint Venture Company, Colluli Mining Share Company (CMSC). DNK will then be required to fund 100% of the equity component and we assume that this component is funded by DNK issuing ~408m shares at 30cps. This is a substantial equity raising given the current market capitalisation of DNK and our assumption is therefore not without some risk in terms of additional shares being required from lowering the issue price. However our analysis of the NPV for the project over time and various issue prices for the equity raising does indicate that it may be possible to do the equity raising at or even at a premium to the current share price. The size of the equity raising probably lends itself to include a cornerstone investor with an interest in the offtake or the project itself.
- **Work to date covers the bases, PFS, DFS, Marketing, Environmental assessment and the MLA:** DNK was required to demonstrate the economics and outline the project's social and environmental management plans in order to apply for a mining licence. It is therefore much more advanced than companies applying for a mining licence in Australia. Front-end engineering and design will start after project financing has been organised.

- **MOU's for offtake indicative of interest:** Based on its recent pilot plant trials and proposed scope of the project, DNK has MOU's with eight multinational consumers, and has secured a broad spread of markets for SOP offtake. The interest level amounts to 800ktpa, just short of the proposed Phase 2 expansion. There has been no indication of the pricing however, so we have conservatively assumed that DNK receives a small discount to our base price in the first few years of production (FIG.5).

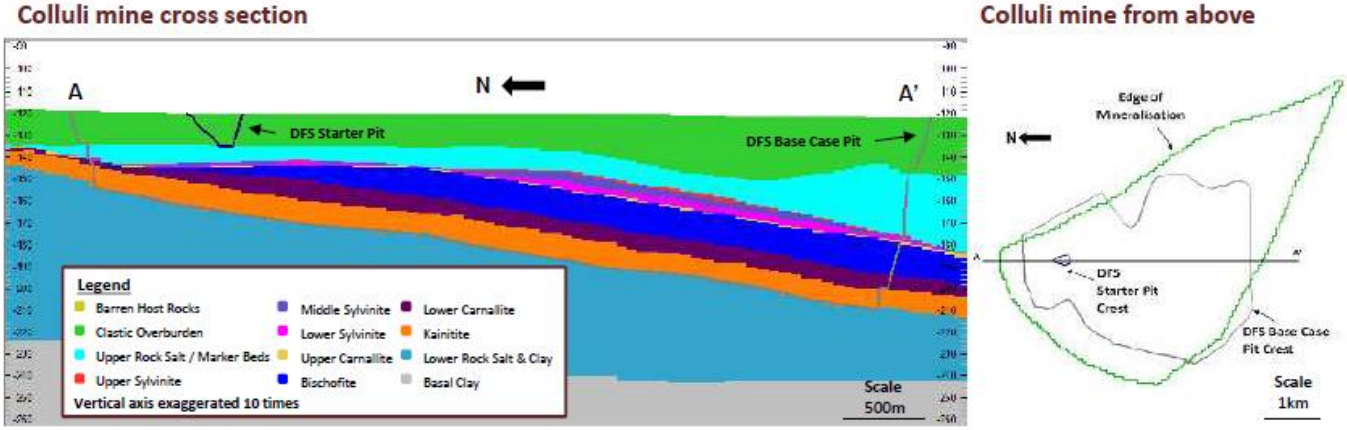
FIG.9: PROJECT TIME LINE



Source: DNK

- **Mining:** Mining by open pit may be different for SOP but not for other minerals. The mineralisation is close to surface at the northern end of the Danakil Basin and DNK can therefore mine the evaporate sequence using a traditional truck and shovel fleet, with the addition of surface miners for ore mining (no drill and blast is anticipated). The fleet will be scaled to meet the strip ratio and ore feed rates. In our analysis of cash flow and earnings we have assumed that all the waste is expensed as incurred, and that once the initial pre-strip (depth to ore is 16m) is completed, that stripping ratios will gradually fall to the life of mine as outlined in the DFS (our overall strip ratios are marginally higher than DFS Phase 1 of 1.91:1 and Phase 1&2 of 1.93:1). To allow for increased pit stability in this tectonically active region of Africa, Colluli's strip ratios do take into account the requirement to have pit wall angles as low as 15 degrees; it is therefore possible that the ultimate strip ratio could be lower once DNK has additional geotechnical data once the mine is operating.

FIG.10: COLLULI OPEN PIT



Source: DNK

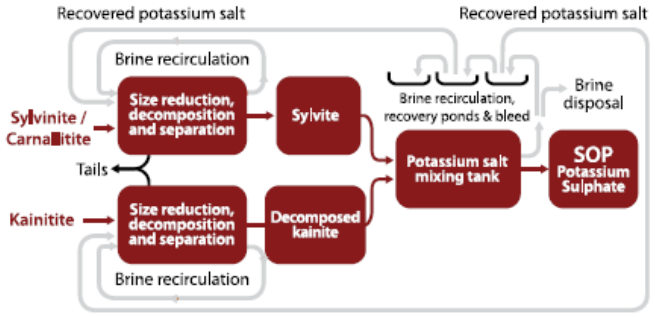
- **Processing:** The process method involves combining ore containing sylvite and carnalite in water and then reacting the product with dissolved kainite to produce potassium sulphate (FIG.12). DNK is proposing a two phase modular development of the plant. The first phase would see SOP at 425ktpa and then Phase 2, a doubling to 850ktpa around five years after the ramp-up of Phase 1 (FIG.15). Besides the ore, the main process requirement is 200m^3 per hour of water, rising to 400m^3 per hour when the process rate is doubled. During the first phase of production the company has indicated that it has identified sufficient sub-surface water near the mine to supply the plant. DNK believes that it is possible a larger sub-surface water resource could be delineated, which would negate construction of a pipeline and subsequent infrastructure to pump 75km from the coast and its desalination at the mine site.

FIG.11: POTASH MINERALS

Potash minerals	Chemistry	$\%K_2O$
Sylvite	KCl	63%
Sylvinite	KCl.NaCl	35%
Carnalite	$KCl.MgCl_2.6H_2O$	17%
Kainite	$KCl.MgSO_4.3H_2O$	19%
Langbeinite	$K_2SO_4.2MgSO_4$	23%
Polyhalite	$K_2S_4.MgSO_4.2CaSO_4.H_20$	16%
Alunite	$K_2SO_4.Al_2(SO_4)_34Al(OH)_3$	11%

Source: Wikipedia

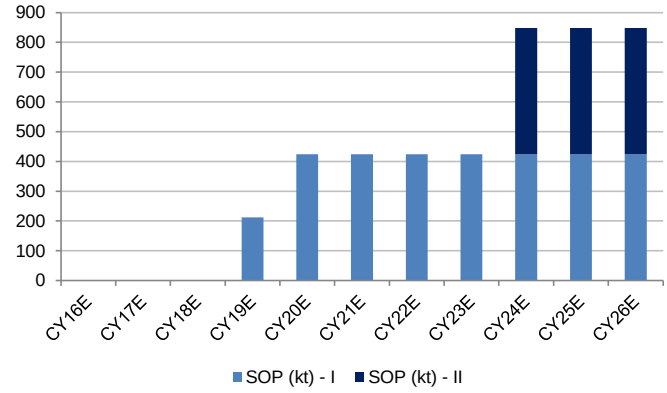
FIG.12: PROCESS ROUTE



Source: DNK

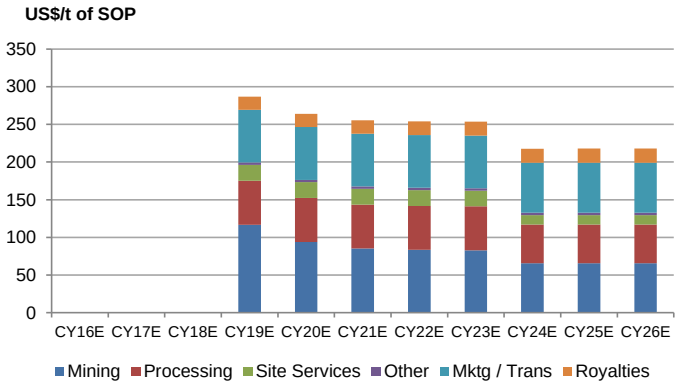
- **Other products are an option:** The geological units in the evaporate sequence and the proposed processing circuit could allow DNK to produce SOPM, MOP, rocks salt, magnesium chloride, magnesium sulphate and calcium sulphate. Scoping study work has commenced on the integration of SOP-M production into Phase 2. We have not included this in our analysis but will review its inclusion when DNK releases the information.

FIG.13: SOP PRODUCTION (kt)



Source: DNK, Baillieu Holst

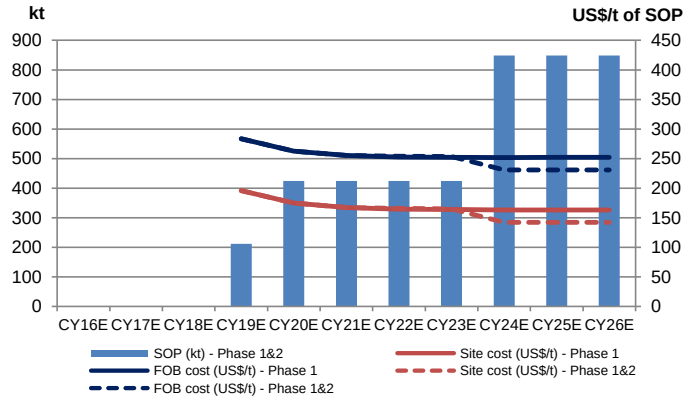
FIG.14: FOB COST BREAKDOWN (PHASE 1&2)



Source: Baillieu Holst

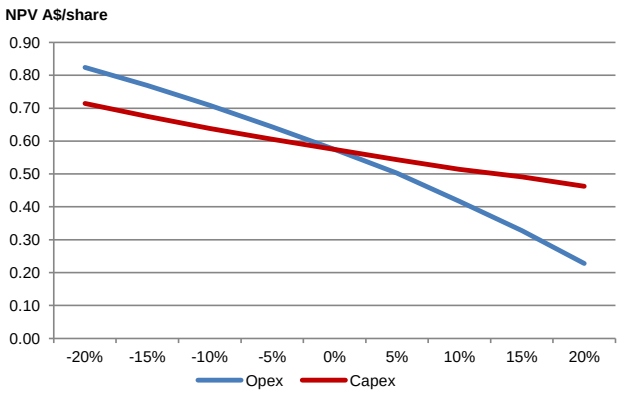
- **Operating costs based on DFS:** We have no reason to dispute the operating cost estimates detailed in DNK's DFS release and have used these as the basis for our analysis (FIG.16 & FIG.17). We have however rounded them up rather than down. DNK believes its estimates have an accuracy of ±15% and we have carried out sensitivity analysis to take this into account.
- **The items we see as positive for the cost are:**
  - It is close to established shipping infrastructure at the Port of Massawa, 180km from the project (only 50km of road needs to be constructed);
  - The mineralisation starts at 16m below the surface;
  - Mining methods are simple and adaptable;
  - Potential for a variety of by-product credits; and
  - The relatively low capital intensity and the mine life of 60 years allows scope for payback and the ability to scale the project to market demand. Once up and running and demonstrating that there are no issues with government interference, DNK could be viewed as an attractive option to a greenfields development from a potash industry participant's perspective.
- **The items we see as risks for the costs are:**
  - The mineralisation is prone to dissolution which could create issues when mining around voids;
  - Unskilled workforce or skilling the work force may result in productivity issues; and
  - Specifications of pilot trial product from laboratory testing are very good, but this needs to be replicated at the estimated cost at full scale production.

FIG.15: PRODUCTION COSTS



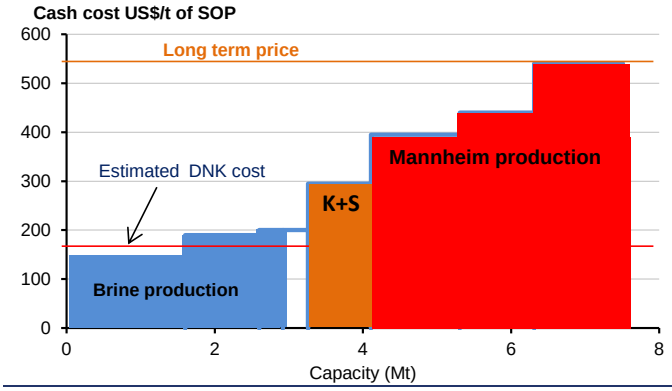
Source: DNK, Baillieu Holst

FIG.16: PROJECT VALUATION SENSITIVITY FOR COSTS (PH 1&2)



Source: Baillieu Holst

FIG.17: SOP COST CURVE

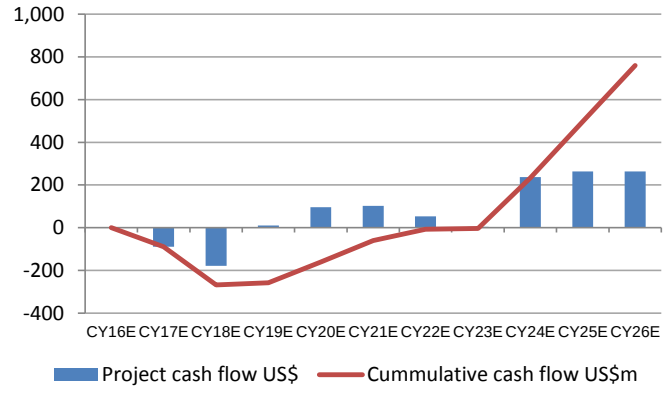


Source: Green Markets, Baillieu Holst

Cash flow and valuation sensitivity

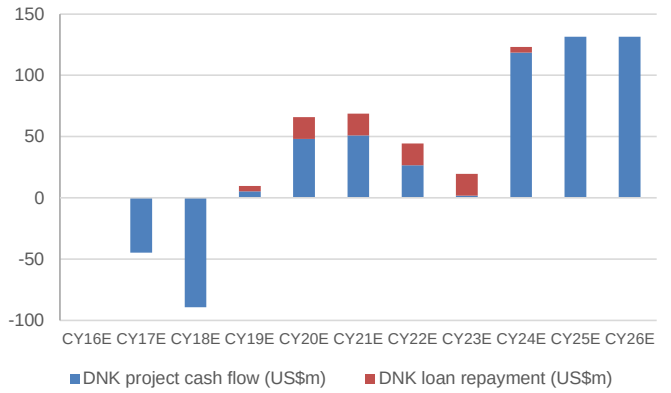
- **Revenue:** Should have some upside, and should be in line with our forecasts as the company has been marketing trial product samples and entered into MOU's with various parties. As previously mentioned we have not included sales of any by-products or their cost of production in our analysis.
- **Capex:** Low development capital intensity for Stage 1 and lower again for Stage 2. DNK estimates capex for Phase 1 to be US$298m, and US$175m for Phase 2.
- **Funding:** Phase 1 (425ktpa): we have assumed that the project is financed 30% equity and 70% debt. As part of the joint venture agreement DNK will be responsible for funding the entire equity component of US$89.4m. Once the project starts production the cash flow will be used to service third party debt and the distributable portion of the cash flow 50/50, 75% of which will go to DNK and repay the interest free loan which DNK provided to fund the government's equity in the development. Phase 2: we have assumed that it is funded out of cash and cash flow from the project.

FIG.18: PROJECT CASH FLOW (US$m)



Source: Baillieu Holst

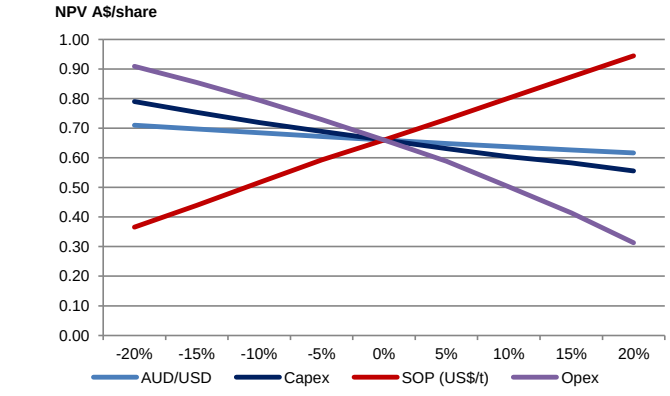
FIG.19: DNK CASH FLOW (US$m)



Source: Baillieu Holst

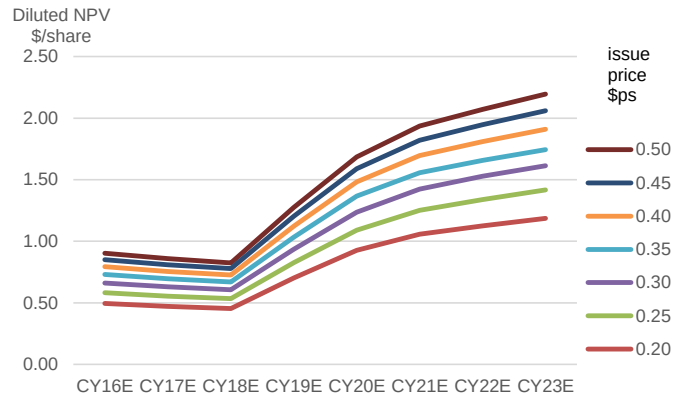
- **Equity funding assumptions:** To fund DNK's equity contribution and the interest free loan to ENAMCO we have assumed that DNK issues shares to raise funds for the entire amount, and that the shares are issued at 30cps or around the current share price. Achieving debt and equity financing should see the share price better reflect the project value and would result in DNK's issued capital increasing from 200m shares to ~600m shares or a ~2 for 1 equity issue. Obviously this would be dependent on the share price at the time, the broader equity market and the appetite for the shares from existing and new shareholders. FIG.21 shows our calculated NPV per share on a fully diluted basis over seven years as the project moves from financing, project build & completion and production.

FIG.20: DNK VALUATION SENSITIVITY



Source: Baillieu Holst

FIG.21: DNK VALUATION OVER TIME (A$/SHARE – DILUTED)



Source: Baillieu Holst

Directors and Management

- **Seamus Cornelius (Non – Executive Chairman):** Corporate lawyer - Cross-border resources commercial negotiations. Chinese investment advice to global companies. Overseas resource project investment to Chinese state-owned entities.
- **Paul Donaldson (Chief Executive Officer & Managing Director):** Mining and engineering - Extensive operational, technical marketing and supply chain management experience from a series of senior management roles with BHP Billiton.
- **Tony Kiernan (Non-Executive Director):** Commercial lawyer - Government relations and approvals (including Eritrea), corporate strategy and corporate governance. Administration and operation of publically listed companies.
- **John Fitzgerald (Non-Executive Director):** Accountant - Extensive project finance experience (Optimum Capital, NM Rothschild and Sons, Investec Bank Australia, Commonwealth Banks and HSBC Precious Metals).
- **Liam Cornelius (Non-Executive Director):** Geologist - Extensive experience in the exploration industry across Australia, Asia and Africa. Founding member of Danakali Ltd.
- **Chris Els (CFO & company secretary):** Accountant - Over 22 years' experience in senior finance executive roles in mining and agribusiness sectors in Australia, South Africa and Brazil

Shareholders

- Well Efficient -15.1%
- Kam Lung Investment Development – 5.0%
- Montezuma Mining – 3.8%
- Danakali Board and Management – 11.6%

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Hold: The stock's total return is expected to trade within a range of ±10-15 percent from the current share price over the next 12 months.

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