Danakali (DNK)

**COMPANY REPORT**

**Postcard from Eritrea**

- **Eritrea is not as portrayed on Google or YouTube**: The purpose of visiting Eritrea was to form an opinion on the viability to develop a mine in the sub-Saharan nation rather than relying on posts on the internet. We went as mining analysts, not politicians, diplomats, or mining company executives. We found the Eritrean people to be friendly, proud and very patriotic, not as they are portrayed in some media as downtrodden people who would do anything to leave the country. We did come away feeling that there are a lot of hidden agendas and misinformation on the political front involving the UN, Eritrea and Ethiopia. None of which should substantially interfere with mine development in Eritrea.

- **Developing mining industry**: The government is pragmatic in its approach to the development of the Eritrean mining industry. Its Mineral Proclamation is based on the Western Australian mining code, and it has not changed the mining or fiscal legislation since it was enacted. A prosperous and growing mining industry will provide Eritrea with much needed income as well as employment in the operations and service sector. More foreign trade should in turn lead to the development of a better banking system and also lead to an improvement in various global rankings which suffer due to having virtually no trade or income.

- **Key takeaways on Eritrea**: The government is supportive of DNK’s project and is invested in it being successful - it has not changed the fiscal regime or mining legislation since it was proclaimed, so currently infrastructure is run down, but it is set to improve as income from mining contributes to the economy. The Eritrean people are friendly, patriotic and exhibit no signs of corruption, and the government is actively promoting growth in the mining industry in general, alongside developing a free trade zone at Massawa Port to encourage non-mining development and trade.

- **The Colluli development**: The next step in Danakali’s development of its Colluli project is the funding package (to be done this half). Debt is likely to come from a mixture of European, African, Middle Eastern and Asian banks whose governments appear to be favourably disposed to seeing Eritrea’s economy grow and lift the country’s overall standard of living. As discussed in our last note, we are also factoring in an equity raising of around US$90m to fund DNK’s equity portion of the development. Our target price of A$0.50/share remains unchanged as does our BUY recommendation.
## Financial summary

### DANAKALI

**Analyst:** Warren Edney  
**Date:** 08-Jul-16  
**Share Price ($A):** $0.41  
**Market Cap (A$m):** $82.3  
**EV (A$m):** $82.3  
**Year End:** December 31

### Valuation Sensitivity

<table>
<thead>
<tr>
<th>CY16E</th>
<th>CY17E</th>
<th>CY18E</th>
<th>CY19E</th>
<th>CY20E</th>
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<td>EPS Growth (%)</td>
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<td>N/A</td>
<td>N/A</td>
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<td>Dividend Yield (%)</td>
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<td>0%</td>
<td>0%</td>
<td>0%</td>
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<td>Payout Ratio (%)</td>
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<td>4.9%</td>
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<td>CFC Yield (%)</td>
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<td>-71%</td>
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<td>(275.1)</td>
<td>(275.1)</td>
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<td>E/EBITDA (x)</td>
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<td>(275.1)</td>
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### Assumptions

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<td>Australian Dollar (AUD/USD)</td>
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<td>MOP (A$)</td>
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<td>374</td>
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<td>SOP (US$)</td>
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<td>SOP (A$)</td>
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<td>783</td>
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### Production & Costs

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<th>CY20E</th>
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<td>Colluli - AISC US$/t</td>
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### Profit & Loss (A$m)

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<th>CY20E</th>
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<tbody>
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<td>Operating Revenue</td>
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<td>0.0</td>
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<td>Other Revenue</td>
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<td>0.8</td>
<td>0.8</td>
<td>0.8</td>
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<tr>
<td>Total Revenue</td>
<td>0.8</td>
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<td>0.8</td>
<td>0.8</td>
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<td>Operating Expenses</td>
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<td>Corporate/Other Expenses</td>
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<td>-1.5</td>
<td>-1.5</td>
<td>-1.5</td>
<td>-1.5</td>
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<td>EBITDA</td>
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<td>-0.7</td>
<td>-0.7</td>
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<td>0.0</td>
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<td>0.0</td>
<td>0.0</td>
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<tr>
<td>EBIT</td>
<td>-0.7</td>
<td>-0.7</td>
<td>-0.7</td>
<td>-0.7</td>
<td>-28.6</td>
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<td>Net Interest (ex Expense)</td>
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<td>NPBT</td>
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<td>Income Tax Expense</td>
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<td>0.0</td>
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<td>NPAT - Adjusted</td>
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<td>31.7</td>
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<tr>
<td>Significant Items</td>
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<td>NPAT - Reported</td>
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<td>-0.7</td>
<td>7.0</td>
<td>1.8</td>
<td>31.7</td>
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### Cash Flow (A$m)

<table>
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<tr>
<th>CY15A</th>
<th>CY16E</th>
<th>CY17E</th>
<th>CY18E</th>
<th>CY19E</th>
<th>CY20E</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash Flow from Ops</td>
<td>-2.4</td>
<td>-2.5</td>
<td>3.4</td>
<td>4.6</td>
<td>11.8</td>
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<tr>
<td>Capex - Development &amp; Sustaining</td>
<td>0.0</td>
<td>0.0</td>
<td>62.1</td>
<td>-124.2</td>
<td>-24.5</td>
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<tr>
<td>Free Cash Flow</td>
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<td>-2.5</td>
<td>-58.7</td>
<td>-119.6</td>
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<td>Cash Flow from Investing</td>
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<td>-10.1</td>
<td>-91.9</td>
<td>-93.1</td>
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<td>Cash Flow from Financing</td>
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<td>7.9</td>
<td>268.2</td>
<td>11.3</td>
<td>11.7</td>
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<tr>
<td>Net Cash Flow</td>
<td>-14.7</td>
<td>-4.7</td>
<td>173.7</td>
<td>-77.3</td>
<td>-50.9</td>
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### Balance Sheet (A$m)

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<th>CY15A</th>
<th>CY16E</th>
<th>CY17E</th>
<th>CY18E</th>
<th>CY19E</th>
<th>CY20E</th>
</tr>
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<tbody>
<tr>
<td>Cash</td>
<td>2.6</td>
<td>205.4</td>
<td>159.3</td>
<td>49.0</td>
<td>77.8</td>
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<tr>
<td>PP&amp;E/Development/Exploration</td>
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<td>0.0</td>
<td>62.1</td>
<td>186.3</td>
<td>197.2</td>
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<td>Assets</td>
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<td>85.2</td>
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<td>150.9</td>
<td>161.9</td>
<td>167.3</td>
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<td>Equity</td>
<td>24.3</td>
<td>23.9</td>
<td>149.8</td>
<td>150.0</td>
<td>160.4</td>
</tr>
<tr>
<td>Net Debt / (Cash)</td>
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<td>-63.5</td>
<td>-8.4</td>
<td>112.9</td>
<td>89.6</td>
</tr>
<tr>
<td>Gearing (%) - ND / (ND + Eq)</td>
<td>-13%</td>
<td>161%</td>
<td>-6%</td>
<td>42%</td>
<td>36%</td>
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**Rating:** Buy  
**Price Target:** $0.50  
**Valuation:** $0.66  
**Upside/(Downside):** 22%  
**Risk:** Speculative
Postcard from Eritrea

- A few days is not enough time to travel throughout Eritrea to meet a cross-section of the population and see how they all live and work. Nevertheless, our impression was positive. There were no concerns over personal safety, in fact we felt safer in Asmara and Massawa than a number of places we have visited in Europe and South America. There is no reason to doubt DNK management’s views on operating in the country without any issues, and with the co-operation of communities and the government.

**FIG. 1: MAP OF REGION**

- **Tension across the border will ensure conscription stays, for now:** 64 countries throughout the world adopt conscription policies, 14 of them within the African continent. Ethiopia and Eritrea’s political, social and trans-national issues are complex. Eritrea has been involved in a border war with Ethiopia on the back of its declared Independence many years ago, and over its border location despite UN delineation. The war and military activity led to conscription and as long as Ethiopia continues to threaten Eritrea, conscription will stay in place. It is important to note that **there is no history of border conflict in the area of the Colluli project**, with clashes limited to two areas contested by Ethiopia. Military service forms part of national service, and views on its significance are polarised. Some view it as de facto slave labour, whereas others see it as defending or building the country.

- **UN accusations don’t fit with the modern landscape:** The political environment and human rights gets the dominant focus in the United Nations and the recent UN Commission of Inquiry was scathing about human rights abuses in Eritrea (it alleges crimes against humanity, including enslavement, torture, murder, rape and enforced disappearance have been committed on a “systematic and widespread” scale). The UNCOI asked the African Union to examine the crimes and bring those responsible to justice. However, with the African Union based in Ethiopia, to intervene over the COI report after Ethiopia’s recent attacks on Eritrea, the border dispute and its own lack of a legal system seems rather misguided. Ethiopia has also been accused of serious human rights abuses, a lack of democracy and repression of the media and many of the so-called Eritrean refugees are believed to be economic refugees fleeing Ethiopia.

The EU has recently announced a US$227m “development fund for the period 2016-2020” for Eritrea and has opened access to a number of emergency finance mechanisms. US$9m has already been earmarked for geothermal exploration to advance geothermal power initiatives.
Eritrea is meeting the UN’s development goals: The UNDP note Eritrea is one of the few countries in Africa to meet some of the UN’s millennium development goals. By 2015, Eritrea had achieved: Goal 4 – the reduction in childhood mortality; Goal 5 – the reduction in maternal mortality; and Goal 6 – the control and reduction of HIV/AIDS. It has also put in place long term policies to achieve Goal 2 which is related to primary education and Goal 7 on environmental sustainability. Goal 1 – on the eradication of poverty and hunger - will take more time as there really is no industrial base to diversify income away from agriculture and food supply which is closely tied to the drought conditions being experience in sub-Saharan Africa.

Media perceptions are changing: Our review of the recent media reports on Eritrea indicates that there may be a gradual, positive, change in the press’ perception of Eritrea and we thought the following two excerpts from the BBC were good examples:

Excerpt from Africa’s modernist enigma By Mary Harper, BBC News, Asmara, Eritrea - 22 June 2016:

… “It is very difficult to work out what's going on.

Human rights groups say there are thousands of political prisoners, tortured and kept in underground cells and shipping containers.

A United Nations Commission of Inquiry says crimes against humanity, including murder, rape and enslavement, have been committed Ever since Eritrea became independent 25 years ago - and it has called on the UN Security Council to refer Eritrea to the International Criminal Court.

The government officially denies these charges, although ministers tell me there are 30 or 40 political prisoners. They say most of them are politicians, military men and journalists who "committed acts of treason" after the 1998-2000 border war with Ethiopia. Some are known as the "G15", a group of senior officials who wrote an open letter to President Afwerki in 2001, criticising him for postponing elections and failing to implement the constitution.

The government says torture is banned and denies prisoners are kept underground. One official said if anyone was caught torturing a prisoner, he or she would be severely punished.” …..


… Eritrea has shown some signs of taking human rights more seriously. It has accepted 92 out of 200 recommendations put forward by the UN’s latest Universal Periodic Review of Human Rights, although implementation is slow.

This year, for the first time, it allowed the UN office of the High Commissioner on Human Rights to visit a prison

Bizarrely, Western diplomats in Eritrea often have very different views from their governments.

One went as far as describing Eritrea as a “perfect development partner” due to what was described as its relatively low levels of corruption, strong work ethic and lack of religious extremism in a region where many countries have been affected by Islamist violence. …

The Country

- **Political structure:** Single party state with no general elections - the president is responsible for appointments. Villages do elect individual leaders which represent the community at a Sub-province and Province level. Provincial and National level representatives are responsible for provision of water, education and health services.

- **Religion:** ~50% Christian and ~50% Islamic – both seem to exist in harmony and are not impacted upon by religious extremists. Religious beliefs appear to be one of the factors which have a positive influence on crime rate and social cohesion.

- **Population:** Estimated to be 5.6 million with 1 million in the diaspora. 74% of the population can read and write as a result of the government building a distributed schooling system.

- **Landscape:** 120,000km² (half the size of Victoria).
Economy: Is subsistence agriculture based, with 80-85% of the population relying on farming for food and income. Drought and conflict with Ethiopia have had a disproportionate adverse impact on the country relative to other non-sub-Saharan countries. In Eritrea’s case arable land amounts to ~12% of the land mass and some of the more fertile areas near the Ethiopian border have been mined thereby restricting access. Accurate economic statistics are difficult to come by but it appears that the average estimate from bodies such as the UN and World Bank for per capita income is around US$500-550 per annum.

National Service

National Service a thorn in UN’s side: National service is split two ways – Civil service and military service. We have seen quotes in the press that the government estimates that 10-20% are in the military and the rest have civilian roles in areas such as teaching, healthcare, state owned companies or government departments. Some of these national service jobs are only two days a week and others for the morning or afternoon. Even some of the military roles allow conscripts to return home in the afternoon or work elsewhere depending on where they are posted. Conscription is the most contentious issue on the global stage with the United Nations concerned about the human rights implications. Conscription into the Military in Eritrea has been viewed as involuntary servitude and has been held up as a reason for “thousands” of Eritrean’s leaving the country because the period of service is open ended.

Conscription terms unclear: It was difficult to understand the terms of conscription, particularly in terms of the period of service. We did talk to one Eritrean who did military service for 10 years until his release and he seemed to accept the extended period because of Ethiopia’s attacks on Eritrea and his wanting to play a role in protecting his country. While conscription may lead to some of the population leaving the country, it is believed that many of the refugees fleeing to Europe are from Sudan and Ethiopia and purport to be Eritrean to speed up the visa process. Other Ethiopian refugees are also more economic migrants who wish for a better life away from subsistence farming.
country. We were not able to confirm press reports of pay being as low as $10/mth, but even at twice that rate it would be extremely low compared to the Western World. However, it should probably be seen in the context of the average Eritrean income of US$1.45/day, which in turn may be overstated given the government has not indicated that it has been able to surpass that UN Development Programme Millennium Development Goals goal on poverty which is <US$1.25/day or incomes in sub-Saharan Africa as a whole, which the World Bank estimates is less than US$1.25/day for 41% of the population.

- **Eritrea is not alone in having conscription**: Countries with conscription include Algeria, Angola, Austria (A), Chile, Cuba, Cyprus, Ecuador, Estonia (A), Finland (A), Greece (A), Iran, Israel, Jordan, North Korea, South Korea, Kuwait, Libya, Mexico, Moldova, Norway, Russia, Seychelles, Singapore, Switzerland (A), Thailand, Turkey, UAE, Ukraine, Venezuela (A- indicates an alternative is offered).

**Eritrean Mining and Exploration**

- **The Eritrean government maintains equity in mining projects**: The prospective geological environments in which miners look for prospects are not always found within the most politically stable countries. Escondida for instance would not have been found or developed if companies stayed out of Chile because of General Pinochet, yet has since been generating incomes for the Chilean Government since 1988 (the year Pinochet left power). Political environments can evolve for the better and in our view it is always best if all parties’ interests are aligned. The Eritrean government maintains equity in projects rather than looking for a quick buck and regretting it later. It is providing a stable fiscal and regulatory environment and importantly there is also no evidence of corruption. We noted that government offices are much understated - the only new foreign cars appear to be those driven by the United Nations or Diplomatic staff from other countries.

- **Licensing is progressive**: Legislation is based on the WA Mines Act, and tenements vary from Prospecting Licences, which are valid for one year, to Exploration Licences which are valid for three years. These can be extended by ongoing expenditure and having the area under licence being reduced each year. Mining Licences which are granted for 20 years can be extended with the ongoing operation. In our meeting with the Director of the Ministry of Mines he stressed the necessity for the government to be transparent with companies and have a system which was adhered to and provided certainty.

**FIG.6: ERITREAN MINERAL CONCESSION MAP**

![Eritrean Mineral Concession Map](source: Andiamo Exploration)
Current mining operations/projects in Eritrea:

- **Bisha Mine**: operated by Canadian listed company Nevsun (NSU.TSX C$3.78, not covered). Produces ~100Mlbs pa of copper and has just started producing zinc in concentrate which in the medium term will ramp-up to 70-100M lbs pa of zinc. Development costs of US$250m.

- **Zara Gold project**: JV between SFECO (Shanghai Construction Group - purchased from Chalice gold for US$114m) and ENAMCO. Production has commenced but is yet to reach its average production rate of 100kozpa.

- **Asmara Mining Project**: being developed by Sichuan Road & Bridge (60% sold to SRB by Sunridge Gold for US$65m), which is looking at exploiting four deposits to produce 29kt of copper, 83kt of zinc and 42koz of gold over the first eight years. Potential for construction to start at the end of CY16.

- **Colluli project**: being developed by Danakali.

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**The explorers**: exploration is in its infancy and predominantly is for gold and potash. The most active explorers appear to be:

- Ketina Minerals (Russia based): exploring for gold and base metals;
- Essel Group (India based): exploring for potash and iron ore;
- Andiamo Exploration (UK based) – exploring for gold and base metals, looking at developing small Dewar gold mine;
- Beijing-Sinoma (China based): – exploring for potash.

The JV structure with the government is typically one where the foreign company would have 60% equity in the Applicable Mining Share Company with ENAMCO owning the remaining 40%. ENAMCO’s 40% is typically split 10% free carried and 30% buy in option at an agreed price. In the case of Danakali, the Colluli Mining Share Company is slightly different because of the potential 50-year plus life of the asset and ENAMCO has a 50% interest; it has no free carry but does have its equity component funded by a zero interest loan provided by DNK and repaid out of cash flow.

Fiscal regime for miners

- Corporate tax rate of 38% (which they admit is high but has not stopped anyone investing to date and will not be lowered).
- Royalty of 3.5% on metals and industrial minerals, and 5% on gold.
- Tax on imports of 0.5%.
- Personal tax – 10% withholding tax on expatriates personal earnings. No withholding tax on profit repatriation.
- Accelerated depreciation over four years (100% of capital) and losses carried forward for 10 years.
- No foreign exchange controls.
- There is no windfall tax and the government believes that one would never be introduced as it has a relatively high corporate tax rate and royalty structure, which the government feels is equitable and that changes would adversely impact investment in the country.

Mining services

- Availability of staff: The country has a tertiary education system. The Eritrean Institute of Technology trains geologist, mining engineers and chemical engineers. The government believes in gender equality and would like to see equal numbers of male and female professionals represented at mine sites.
- On the job training: Bisha mining has developed a training facility at site and we envisage that all larger operations would do the same. DNK is proposing to build a training facility near Colluli to assist in upskilling the local and provincial workforce to service its mining and processing operations.
- Explosives: Not required by DNK but a major South African explosives manufacturer is building a plant in Massawa.
- Equipment and spares: Caterpillar and Atlas Copco have offices in Eritrea. Major warehouses for equipment suppliers are in Dubai which could lead to some delays in delivery. However, as more mines are developed we would expect a greater proportion of spares to be held in the country (perhaps as part of the Free Trade Zone at Massawa).
- Transport: Transport costs are currently high as there is little in the way of export. The development of more back haul through exporting of minerals will improve export freight rates. The port of Massawa does have sufficient cargo handling facilities and lay down areas to cope with expanded production from Bisha and exports of SOP from Colluli. Domestic transport costs should gradually improve as more roads and bridges are completed, cutting transport times. Five airlines fly into Asmara (the capital) – Qatar, Egypt Air, Turkish Airlines, Fly Dubai and Eritrea Airlines, and the Massawa airport has just been upgraded to accommodate cargo planes to supply to the free trade zone at the port when it is completed.
Appendix

FIG. 1: LONG TERM MOMENTUM INDICATORS

Source: Iress

FIG. 2: SHORT TERM MOMENTUM INDICATORS

Source: Iress
Analysts’ stock ratings are defined as follows:

Buy: The stock’s total return is expected to increase by at least 10-15 percent from the current share price over the next 12 months.

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.

Sell: The stock’s total return is expected to decrease by at least 10-15 percent from the current share price over the next 12 months.

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