

Richard Karn: Three Australian Miners Positioned for Success

The Mining Report

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COMPANIES MENTIONED

- Alkane Resources Ltd.
- Carbine Tungsten Ltd.
- Valence Industries Ltd.

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Sometimes the worst of times brings out the best in people. Such is the case in Australia's mining sector, according to Richard Karn, managing editor of *The Emerging Trends Report*. While some companies are floundering or failing altogether, Karn has noticed a few shining exceptions. These are companies with innovative management teams that have approached project funding in this challenging environment as though it were a high-stakes chess game—and their maneuvers are astonishing. In this interview with [The Mining Report](#), Karn takes a look at three mining companies that are defying the odds and may emerge victorious.

Source: [Special to The Energy Report](#)

The Mining Report: Richard, last month you delivered a fairly upbeat presentation on specialty metals at the Mines & Money forum in Melbourne. Why are you so positive on the Australian mining space?

Richard Karn: Well, it wasn't *exactly* upbeat. What I presented was an overview of the specialty metal sector drivers, which are still quite positive, and the impediments to getting Australian projects funded today.

I then presented three brief case studies of companies that are getting their specialty metal projects into production despite the hostile funding environment.

TMR: Are you predicting an imminent rebound in the Australian specialty metal sector?

RK: No, I am not. The shakeout in the resource sector in general, and the specialty metal sector in particular, does not appear to be over. The sector might be bottoming, but I think there is still more pain to come.

At the conference, Dr. Alex Cowie of livewire markets presented findings that showed 16 resource companies have been delisted from the Australian stock exchange in the last six months, and another 210 resource companies now sport market caps of less than AU\$3 million (AU\$3M) and on average have less than AU\$860,000 (AU\$860K) in cash and marketable securities. Without a miracle, many of those companies will go under as well because there is simply too little investor appetite at this time.

TMR: Were there any positive takeaways?

RK: What I was upbeat about was the way opportunistic management teams with good projects were employing a combination of pragmatism, flexibility and sheer determination to move their specialty metal projects toward production, despite the ongoing dearth of commercial project finance and a lingering, somewhat adversarial regulatory environment.

What's happening is a few management teams are quietly excelling while the majority are floundering.

From an investment point of view, being able to differentiate between those specialty metals companies positioning themselves to succeed from those unlikely to survive allows capital to be concentrated where it has the best chance of earning a return.

That is not to say that these companies will be successful and make their shareholders buckets of money—just that they have been able to transition from the "story" stage to the "reality" stage of going into production; whether they can do so profitably remains to be seen.

But most companies in the specialty metal sector have been unable to get beyond the "story" stage, and investors are fed up with the fairy tales.

TMR: What makes Australian specialty metal projects so difficult to finance?

RK: The single biggest obstacle is that many specialty metals do not trade on an exchange, which means the metals are unhedgeable, which in turn means specialty metal projects cannot secure forward sales, which is how commercial banks make sure their loans are repaid. In fact, pricing is purposefully opaque and is often treated as a trade secret because it represents a competitive advantage. This problem is not specific to Australia.

Then there is the complex metallurgy and highly specialized, technical uses that are difficult to understand—even *by end users themselves*.

All too often, executives want the specialty metal regardless of price, but are unwilling to participate in putting specialty projects into production—*despite the fact that such an investment would pay massive dividends going forward, especially in terms of reducing price volatility and improving supply chain security*.

Some of these end users have learned a bitter lesson from a misplaced faith in slogans like "market forces will prevail," which is frequently not the case with specialty metals.

We can make the case that many specialty metal projects would be better served by staying private as a JV between producers and end users, which in effect is how one of our brownfield projects has put itself into production.

TMR: That is a pretty significant set of hurdles to overcome. Under those circumstances, what companies have managed to secure funding, and what are they mining?

RK: The three companies I profiled in my presentation are [Alkane Resources Ltd. \(ANLKY:OTCQX; ALK:ASX\)](#), [Carbine Tungsten Ltd. \(CNQ:ASX\)](#) and [Valence Industries Ltd. \(VXL:ASX\)](#). They have managed project finance in distinctly different ways.

Alkane is actually putting two greenfield projects into production in the vicinity of Dubbo New South Wales, one gold, the other a suite of zirconium compounds, ferro-niobium and rare earth element (REE) products, and the company is utilizing different finance routes for each project.

Carbine Tungsten is wrapping up negotiations to commence the second phase of production from the historic Mt. Carbine tungsten mine in far north Queensland.

Valence Industries is about to start producing a range of graphite products from the stockpiled ore at the historic Uley graphite project, south of Port Lincoln, South Australia.

So we're talking about two greenfield and two brownfield projects that have managed to fund their projects into production.

TMR: Could you tell us more about these different paths to financing?

RK: The first of Alkane's projects is the AU\$115M Tomingley gold project, which is a 2.2 g/t open pit operation on track to commence production in February 2014. It will produce 50–60,000 oz (50–60 Koz) of gold per year at an all-in cost of roughly AU\$1,000 per ounce (AU\$1,000/oz), which at the current gold price will throw off about AU\$25M per year in cash flow.

Alkane operated the nearby Peak Hill gold mine profitably from 1996-2005, so it wasn't much of a leap to make the decision to put Tomingley into production in 2011, even as the company was simultaneously pursuing its flagship mega-project, the Dubbo Zirconia project.

So back in mid-2011, when the gold price and the Australian stock market were more buoyant, Alkane provided Credit Suisse with the mandate to put together a AU\$45M debt facility to help put Tomingley into production. One of the terms required the forward sales, or hedging, of 90 Koz of gold production, which was done at a strike price of AU\$1,450/oz.

Then in 2012, Alkane made two decisions that resulted in Tomingley being developed without commercial finance. The first was a AU\$100M capital raising in April; and the second was the sale of Alkane's 49% interest in the McPhillamys Gold project for AU\$70M in Regis Resource Ltd. (ASX: RRL) shares.

With the flexibility this liquidity provided, Alkane was able to respond proactively to the collapse in gold prices in April 2013: The company closed the 90 Koz gold hedge at a AU\$7M profit and made the decision to self-fund the Tomingley gold project—all the while completing the bankable feasibility study (BFS) for the Dubbo Zirconia project and actively negotiating offtake and financing arrangements.

In fact, the cash flow from Tomingley will provide Alkane with additional flexibility as it puts together the financing package for its mega-project: the AU\$1 billion (AU\$1B), polymetallic Dubbo Zirconia project.

Briefly, the Dubbo Zirconia project is a unique zirconium, hafnium, niobium, tantalum, light and heavy rare earth elements (LREE and HREE) and yttrium project. The AU\$1B project will pay for itself within roughly five years and will throw off more than AU\$250M per year in free cash flow for more than 30 years—and potentially for as long as 70 years.

There are two key aspects to financing a specialty metal project of this scale: convincing market participants that Alkane's products are of strategic long-term importance, and being able to deliver commercial product samples to potential end users. Supply concerns related to China's supply dominance of a number of specialty metals has secured the former, and the demonstration plant Alkane has had running at Australian National Nuclear Research and Development Organisation since 2007 has supplied the latter.

So today, Alkane is looking to fund the Dubbo Zirconia project through a combination of Export Credit Agency (ECA) loans, strategic investments, standard commercial project finance and a potential equity raising.

Alkane is looking to fund roughly half of the Dubbo Zirconia project with an ECA debt facility. These are large sovereign institutional loans for the development of

projects deemed to be of strategic importance to that country that are offered at very competitive rates and terms. The only codicil is that the project must buy that country's products, employ its firms or have offtake agreements with companies operating in that country. And there is interest in the Dubbo Zirconia project from countries all over the world—effectively from any country that has to compete with China.

The Dubbo Zirconia project is held in a private company called Australia Zirconia Ltd., and Alkane is prepared to sell anywhere from 10–15% and potentially as much as 30–45% of interest for the project to key end users and/or sovereigns. The rationale behind the purchase would be for end users and/or sovereigns to participate more fully in the running of the company as well as to share in the enormous potential profits. From Alkane's point of view, the larger the strategic investment, the less equity dilution would be necessary to fund the Dubbo Zirconia project through to production.

Alkane's product suite has also put it in an enviable position in terms of securing standard commercial project finance for a portion of the required AU\$1B. Generally, such finance is tied directly to offtake sales agreements, and to date Alkane has reached agreements with Austrian powerhouse Treibacher Industrie AG (private) for the purchase of the first five years of the Dubbo Zirconia project's ferro-niobium production as well as a Memorandum of Understanding (MoU) with Shin-Etsu, Japan's largest chemical company, to toll treat Alkane's HREE and LREE chlorides with an option to buy any or all of the products. Negotiations continue with more than a dozen Japanese, Korean, North American and European companies for the 14–16 tonnes of annual zirconium compounds Alkane will produce. Once the zirconium compound agreements are finalized, the size and scope of commercial finance package will be determined.

Alkane anticipates that as the primary debt facilities are finalized, the market will reward the Dubbo Zirconia project's successful financing with a dramatically higher share price, which would suggest a far smaller equity raising and minimal dilution.

Our take is that the cash flow and flexibility provided by the Tomingley gold project creates an additional avenue for the funding of the Dubbo Zirconia project, such as with the issuance of convertible notes; regardless of whether that option is chosen, having access to the bond market as an alternative can only serve to spur competitive tension between lenders.

TMR: Before we get into your other two companies, can you explain your fondness for brownstone projects?

RK: I confess that I am biased toward a certain kind of brownstone project because I'm partial to overlooked, under-valued assets that have been victimized by circumstance. In cases like those I profiled, these projects represent low risk, high return opportunities.

People tend to forget (and bankers tend to shy away from financing) a large swathe of brownstone projects. Many of these projects were shuttered not because they ran out of ore, or grades deteriorated or they were poorly managed, but because something unforeseen happened to kill the price of the metal they were producing.

In the case of tungsten and graphite, commencing in 1982 when Deng Xiaoping had China "turn outward" in the general direction of a market economy, projects all over the world were closed because they could not compete with the flood of inexpensive supply from China's command economy. That was how China came to control so many specialty metal markets: The government more concerned with

amassing foreign currency reserves and seizing control than they were with profit, and as we've seen, now that they have control, they are exercising it by squeezing supply. As a result, western companies are beginning to take security of supply seriously.

TMR: And this is opening the door for non-Sino sources such as Carbine Tungsten Ltd. and Valence Industries Ltd.

RK: Exactly. In essence, Carbine Tungsten Ltd. and Valence Industries Ltd. are models of perseverance and innovative finance.

Both have taken an incremental approach based on putting historic mines back into production in stages, counting on the quality of their product to help them progress toward full production. We have every reason to believe at this point that they will make it.

Carbine Tungsten has the Mount Carbine tungsten mine in far north Queensland, which operated last as a joint venture between the Roche brothers, Treibacher and Sandvik from 1973-87, with production averaging 0.16% tungsten trioxide.

With funding tight and commercial lenders loathe to commit funds to either mining or reprocessing operations, Carbine Tungsten has adopted a phased approach to putting its mine back into production on a "shoestring" budget.

In 2011 during Phase 1, the company undertook an equity raising to purchase a used processing plant for AU\$1.1M in order to start reprocessing tailings from past operations. The goal was to demonstrate the quality of its tungsten trioxide product for potential clients.

In 2012, Carbine Tungsten brought in a new operations and management team with a successful track record led by Jim Morgan, and for the last 17 months it has been processing feed from the 2 million tons (2 Mt) of tailings that grade 0.1% tungsten trioxide. Production has stabilized at roughly 1500 metric tonne units (MTU) per month, which admittedly is nothing to write home about, but with the [AusIndustry R&D Tax Incentive](#), it has been sufficient for the company to operate at breakeven.

Optimizations continue, and the company is currently weighing an \$800K investment to improve recoveries and adapt to the wet conditions, which would both make operations more profitable and extend the remaining eight-month life of mine (LOM) to 16–18 months.

More importantly, however, the delivery and acceptance of the company's tungsten trioxide product has cemented its relationship with offtake partner Mitsubishi Corp. (8058:JP), which has participated by means of two non-dilutive pre-paid offtake agreements of AU\$400K each. To date, only one of these facilities has been drawn down, and Mitsubishi has purchased all of Carbine Tungsten's production.

This product approval has proven critical in opening the door to a return to full-scale production, albeit incrementally.

TMR: What's the next step for Carbine Tungsten?

RK: Carbine Tungsten is in the process of finalizing a roughly AU\$15M funding facility from Mitsubishi, the terms of which are understandably being withheld, to progress to phase 2, in which the company expands the plant in order to process the roughly 12 Mt of mineralized waste material grading 0.075% tungsten trioxide.

The phase 2 plant expansion will be the backbone of a larger plant expansion

planned for phase 3 and will incorporate x-ray sorting to improve the grade of the mill feed as well as recoveries. It will be more profitable than Phase 1. Environmental permitting is in place.

Importantly, Mitsubishi has committed to purchase 80% of Phase 2 production and 50% of Phase 3 production.

In 2012, Mota-Engil made a AU\$2M investment in Carbine Tungsten toward Phase 3 for hard rock development, a feasibility study and various approvals to put the mine proper back into production. The JORC-compliant resource consists of 47 Mt at 0.13% WO₃ with a high-grade zone under development that currently indicates 4.5 Mt at 0.32% WO₃.

Phase 3 will see a final AU\$40M expansion of the plant, and production in the vicinity of 2,650 tons per annum of tungsten trioxide would commence within 18 months of securing financing. With Mitsubishi committing to the purchase of 50% of production, Carbine Tungsten's management is currently in discussions with potential offtake partners and debt funders.

Continued strides in expanding production combined with success in securing offtake agreements from a return to full-scale mining support management's intention to minimize equity dilution going forward.

TMR: Tell us about Valence industries Ltd.

RK: Valence Industries Ltd. was spun off from Strategic Energy Resources (ASX: SER) and its sole project is the historic Uley graphite deposit in the southern extreme of Eyre Peninsula, South Australia.

Uley last produced in 1992–3 and was just getting the bugs worked out of its plant when the Chinese flooded the graphite market in 1993. The project has been in a care and maintenance phase since that time.

After a number of false starts over the last two years, not least due to the difficult market conditions, new management, led by CEO Chris Darby, appears to be on the verge of putting Uley back in production. They raised an initial AU\$1M from a combination of existing and new shareholders, which is no mean feat in this environment, and the company is undertaking a compliance listing to raise AU\$6.5–10.1M, *AU\$6.5M of which is fully underwritten by Patersons Securities*. A prospectus was issued last week and is available through the company website.

Valence has also responded to a difficult funding environment by adopting an inexpensive, "proof is in the pudding" phased approach to redeveloping its brownstone project. The company will recommence production by processing the more than 70,000 tons of stockpiled ore grading 8–10% graphitic carbon. All permits and licenses are in place.

To date, Valence have secured Letters of Intent (LOIs) from at least five customers for 5,500 tons of graphite products, and the plant and mine site, which has undergone a AU\$3M refurbishment over the last two years, is slated to resume production in Q1/14. Darby expects the stockpiled material to generate AU\$11.5M in cash flow and a AU\$5.5M net profit.

Similar to the route taken by Carbine Tungsten, Valence recognizes that product acceptance and long-term offtake agreements are key to its expansion plans. A BFS based on a detailed scoping study and augmented with production data for the return to full mining production is also due during Q1/14.

We have visited Uley four times over the last three years because the project has always interested me, both as an historic producer laying fallow and as a truly undervalued asset. Not only do the main deposits contain 6.4 Mt grading 7.1% graphitic carbon, it was a true low-cost, dig-and-deliver operation: Not once did the last operators of Uley have to do any blasting. Furthermore, we hiked extensively over its tenements, and just based on the graphite that was visible on the road banks and cuts and that was visible in virtually every hole we dug with a trenching tool, we believe there is substantial exploration upside.

Phase 2 at Uley will see the addition of a AU\$34M modular plant capable of producing 50,000–60,000 tpa of graphite products. As long as they are economically feasible, the two plants will operate side by side. The detailed scoping study Valence produced earlier this year foresees as many as 14 graphite products based on flake size and purity ranging in price from \$890–2,500 per ton, with production costs averaging \$550 per ton.

What we are particularly intrigued by is the way Valence Industries has already secured indicative commitments to provide funding for AU\$30M of the AU\$34M. The company has made arrangements with firms in Singapore and the UK that will see each of the offtake contracts purchased at up to 90% of the face-value, side-stepping traditional commercial finance entirely, and implying a not unreasonable roughly 10% cost of capital. These funding tranches will be provided with each completed contract or on a "project needs" basis, and there is substantial potential for further offtake, royalty or debt facilities should the need arise.

TMR: So how would you summarize what these companies have in common?

RK: What these three abbreviated case studies show is that in order to get specialty metal projects into production today, management teams need to be flexible and pragmatic in their approach. The defining characteristics are product approval and pre-paid offtake agreements, both of which figure prominently in getting projects financed. Doing so with minimal equity dilution is a much-welcomed change as well.

TMR: Any final comments?

RK: I think there is reason to be somewhat optimistic about the outlook for the specialty metals sector in Australia. Deals are getting done. The best-managed companies are quietly excelling. Specialty metal demand, the crux of the opportunity, is increasing.

But it is more critical than ever to understand what you are investing in: Specialty metal price volatility will not disappear, so investing in the sector is not for the faint of heart, the impatient or those too lazy to do their homework. But for those who get it right, we fully expect outstanding returns.

As managing editor of The Emerging Trends Report, [Richard Karn](#) has a broad, multi-disciplinary background and a working knowledge of precious and specialty metals, as well as considerable research, analytical and writing experience. The first nine Emerging Trends Reports have been re-evaluated and updated published in e-book form, as Credit & Credibility. He has written for publications ranging from Barron's, Kitco and Fullermoney to Financial Sense Online.

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