STOCKS DOWN UNDER

31 DECEMBER 2020

Resources Stocks Down Under

> *Be at war with your vices, at peace with your neighbors and let every new year find you a better man.*

- Benjamin Franklin (1706 - 1790), American diplomat, politician, and inventor

LOTUS RESOURCES

Positioned for the uranium comeback

GIBB RIVER DIAMONDS

Fancy some yellows?

ELIXIR ENERGY

Energising Genghis & Co.

LOTUS RESOURCES

Positioned for the uranium comeback

Stocks Down Under rating: ★★★★

ASX: LOT
Market cap: A$ 97M

52-week range: A$0.017 / A$0.145
Share price: A$ 0.13

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Share price chart

Source: Tradingview

Sometimes the best mines aren't the ones that just got developed, but the ones that have passed through multiple hands where the previous owner in effect paid the 'tuition fees' for the current owner. For example, the Murrin Murrin nickel-cobalt mine in Western Australia didn't make much money for Anaconda Nickel / Minara Resources, which had to build the mine and processing plant and then figure out the optimal processing route. By all accounts it does quite nicely under the aegis of its current owner, Glencore. We think membership of the 'Second Owners Club' will also be beneficial for the shareholders of Lotus Resources.

US$200m in assets for a song

When Lotus bought a majority stake in Kayelekera what it got was a mine that had soaked up around US$200m in capital costs but could produce around 3 million pounds of uranium annually. The existing resource was 37.5 million pounds, so there was plenty of life in the operation, even without exploration at multiple targets within trucking distance of the operation. All that was needed was a decent uranium price. It was low prices that had landed Kayelekera in care and maintenance back early 2014, only five or so years into its mine life.

Lotus Resources, back when it was called Hylea Metals, picked up Kayelekera for a song when the deal closed in March 2020. It bought 65% of the mine from Paladin, alongside a company controlled by Perth businessman Grant Davey, which got 20%, while the government of Malawi retained its previous 15%. The price for Lotus's 65%? A$200,000 in cash and A$1.8m in scrip, plus additional A$3m worth of shares in 2023. Oh yes, Lotus also had to buy out Paladin's environmental bond of US$10m over three years, and the vendor was entitled to a 3.5% royalty on gross returns from the mine up to a maximum of A$5m. Not much for a US$200m mine, don't you think? That's how pessimistic people felt about uranium's long-term prospects in mid-2019.

An easy restart

The reason Hylea Metals changed its name to Lotus Resources was to reflect Kayelekera's address in Malawi, the lotus being the national flower of that country. Kayelekera sits at the top end of Malawi near Karonga, a town on the shores of Lake Malawi. As sub-Saharan African countries go Malawi doesn't rate well in terms of the level of economic freedom its citizens enjoy – America's Heritage Foundation ranks it behind 12 other neighbours in this regard – but the mine is permitted for production and, as we noted above, the state owns 15% so the regulatory burden of a restart is low.

We think Lotus is nicely leveraged to the return to form of uranium after a long bear market. Uranium, you'll recall, peak at around US$140 a pound in mid-2007 on expectations that nuclear power was on the rise globally as a way to deal with greenhouse gas emissions. The commodity eased off for the next three years but by 2011 was recovering before the Fukushima Daiichi nuclear disaster of 2011 put the cat among the pigeons. As many nations responded by moving away from nuclear power the result was prolonged bear market that didn't end until the lows below US$20 in late 2016. The general trend since then, however, has been upwards.

Uranium is turning

Lotus argues that the good times are coming again for uranium. More nuclear reactors are coming on line, mostly in emerging countries, meaning structural deficits in uranium supply by about 2023 thanks to the dearth of recent new mines. The alacrity with which uranium jumped in March 2020 when Cameco (TSX: CCO) temporarily shuttered the Cigar Lake mine in Saskatchewan is telling you that the bias to uranium pricing now tends towards the upside. Cigar Lake restarted in September and uranium is still close to US$30.

How long it will take before Lotus can join in the fun with Kayelekera? Paladin had estimated it would take US$49m in capital to get the mine back up and running, and Lotus's own scoping study confirmed this in late October 2020. That same study suggested that Kayelekera's cash costs would be about US$33 a pound on the restart.

Working the coming supply squeeze

US$33 seem daunting at the moment, but many industry players believe utilities are willing to lock in higher than spot prices in order to avoid the supply squeeze that's coming. Liken it to the deal BP made in 1967 with Aristotle Onassis on tanker chartering. The shipping tycoon offered his entire fleet to BP at double the rates prevailing the day before. BP took the deal. Tanker rates promptly quadrupled.

At the end of September Lotus Resources had A$17m in cash and only had to spend A$1.5-2.0m p.a. on care and maintenance at Kayelekera. It raised $5m at 8 cents per share in late November. Lotus stock is currently trading at a relatively low EV/resource of around US$2.00 a tonne. With considerable leverage to the coming upside, and a solid new management team led by the Toronto-based Eduard Smirnov, who formerly led the major uranium player Uranium One, this is a four star opportunity.

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Share price chart

Source: Tradingview

If you want to get in on the coming diamond boom but you want a company with an Australian project, Gibb River Diamond is where the action is at. Late last year this company had acquired the dormant Ellendale Diamond Mine in the Kimberley Region of Western Australia and it is now working on plans to bring it back alongside the nearby alluvial diamond project it has been developing for years.

Fancy yellow, fancy price

Ellendale, about 120 km east of Derby, was started up in 2002 by the original Kimberley Diamond Company. For a long while this mine was the world's leading source of Fancy Yellow diamonds, supplying to Tiffany & Co. under a special marketing arrangement. The London-based Gem Diamond (LSE: GEMD) paid A$300m to buy Kimberley Diamond in 2007 partly because of Ellendale. Gem Diamonds sold the mine for a fraction of that in 2012, on the assumption that it was more or less exhausted. The purchaser was the ASX-listed company that changed its name to Kimberley Diamond and the mine was placed in administration in 2015. At that point the WA government resumed control.

But hang on, what the heck, we hear you ask, is a Fancy Yellow? The best kind of diamonds, price-wise, have no colour and most diamonds graded 'D' to 'Z' are colourless or light yellow. A diamond is 'fancy' when it goes beyond Z. Fancy diamonds are mostly blue, green, pink or red. Fancy Yellow is a little rarer and the diamond market has traditionally favoured these beauties with good premiums.

A different kind of paleo

Back when Gibb River Diamonds was called POZ Minerals it was years into its Blina Diamond Project effort, which covered territory surrounding the mine, looking for the next big source of Fancy Yellows. The company changed its name to Gibb River Diamonds at that time to reflect the importance of the Blina Project - the Gibb River Road is the one that takes you from one end of the Kimberley to the other, from Derby to Kununurra. Two days before Christmas 2019, Gibb River Diamond ended up with Ellendale Diamond Mine leases as well as Blina, under an Expression of Interest process with the Western Australian government.

The Blina Project has been hinting for years that fancy Yellow riches lie within its orbit. Blina is an 'alluvial' diamond project, in that it covers part of an alluvial paleochannel called Terrace 5 where diamond recoveries in trial mining have been favourable over the years. What's a paleochannel? Well, just as today's diamonds show up in rivers and streams washed down from a primary hard rock source, so it was in antiquity, geologically speaking. Paleochannels are simply the remnants of inactive water channels that later got filled by younger sediment, trapping the alluvial diamonds within them.

Going after a large alluvial diamond resource

When Gibb River Diamond has bulk sampled at Blina the result has often been high recoveries in terms of carats per hundred cubic metres, and good prices for the gems themselves, but that hasn't led to a mineable diamond resource yet. One recent block of Fancy Yellows from bulk sampling was appraised in late 2017 as being worth US$3,391 a carat, within a parcel that still got a creditable US$389 per carat. Gibb River Diamond is going after a JORC resource at Blina of 1.6 to 4.1 million carats. That's the company's estimate of the diamonds that are 'missing' from the E9 pipe at Ellendale and must have therefore washed up in Terrace 5. Gibb River has yet to get close to that missing haul, but it continues to systematically bulk sample priority targets and it has some theories about how to use ground-penetrating radar to find the ones with the best payoff.

Edjudina is a new part of the Gibb River story. It covers an old gold field, which was originally discovered in the 1890s, about 150 km northeast of Kalgoorlie. The nearest current mine to Edjudina is the Carosue Dam operation of Saracen (ASX: SAR). The first aircore drilling campaign at a prospect on the field called Neta registered some particularly good intersections, such as 36 metres at 3.97 g/t gold from 4 metres and 18 metres at 3.1 g/t gold from 28 metres. No wonder the share price jumped so sharply when those results came out on 8 October. Gibb River exercised its Edjudina option on 2 December.

Bring on 2021

The Gibb River share price dropped sharply on 21 December even though the headline for that day's announcement was 'Neta Lodes Prospect Strike doubles to 160 metres', but the problem here was that deeper holes than aircore can provide were needed. We think that in 2021 Edjudina will deliver value to Gibb River shareholders given the recent success that other players have had with old and underexplored gold fields close to Kalgoorlie.

However, we also believe there is a possibility that Ellendale/Blina can deliver in 2021. Remember, this project is shovel-ready today, with processing equipment on site for the bulk sampling exercise. Any decent sales from that effort in an environment where diamonds are back in favour will likely be received favourable by investors even if the millions of carats aren't quite in the bag yet. So, for both Edjudina and Ellendale/Blina, this one is four stars for us.

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Share price chart

Source: Tradingview

We admit it…we like coal seam gas

At least in Australia, coalbed methane has proven to be one of the more controversial topics of national conversation when it comes to consideration of future energy sources. Coalbed methane, which you may know by its other same of 'coal seam gas' or CSG, is simply the natural gas commonly found in commercial quantities inside coal deposits. The way you obtain that gas is by pumping water out of the seams, which lowers the water pressure that has been trapping the gas in. Why is that controversial? Well, the water is generally a little brackish and the coal seams are often close to good farmland, so the perception is that all that pumped water will play havoc with soil quality. We think that's why, if you poll Australians about their attitude to coal bed methane, about half will be opposed.

At Resources Stocks Down Under we're strongly in favour of coalbed methane, because the approach has been around for a long time and the environmental issues have proven manageable with appropriate water treatment. And, let's face it, Australia's East Coast could use more gas. There are concerns that that part of the country could run short of gas by about 2023 unless new sources are developed.

From the land that brought you Genghis Khan and Oyu Tolgoi

But we digress. This article is about a coalbed methane project located not in Australia, but in the sparsely populated South Gobi region of Mongolia. Coalbed methane in this part of the world is likely to be far less controversial than in Australia because it's mostly desert. Mongolia may be famous for giving the world Genghis Khan in the 13th century, but today the monsters are Oyu Tolgoi, Rio Tinto's gigantic copper and gold mine, and, significantly, a 7 billion tonne undeveloped coal deposit called Tavan Tolgoi. Both lie within Nomgon IX, which is Elixir's project area.

Nomgon IX is a so-called 'Production Sharing Contract' with the Mongolian government that is roughly the size of Belgium in terms of the acreage and is considered to be prospective for coalbed methane of the kind you'd find in Queensland's Bowen Basin. It's called Nomgon IX because the Mongolian government has in excess of 20 such PSCs on issue and this was the ninth one. Elixir's PSC still has a lot of life in it since it was only issued in September 2018 and has an exploration life in excess of 10 years.

Trillions, not billions, of cubic feet of gas

Elixir announced an option over Nomgon IX in October 2017 and exercised it in December 2018. At that time Elixir's independent expert estimated, best case, there could be 7.6 trillion cubic feet (TCF) of gas in the PSC on a 'risked' basis, that is, adjusted for the risk of 'dry holes'. How much is 7.6 TCF? Well, at the moment gas in Australia changes hands at close to A$7 a gigajoule. Obviously the price of gas in China, if Nomgon gas ultimately gets sold there, may be a lot different but that A$7 price equates to a cool US$42bn or so. In December 2020 the estimate was increased to 14.6 TCF. Mmmm.

When Elixir inherited Nomgon IX no well had ever been drilled for coalbed methane. The Nomgon-1 well got everyone involved very excited in February 2020 when it recorded more than 5 cubic metres per tonne of coal across 49 metres of a coal seam called the '100 seam'. The subsequent permeability testing confirmed a gas discovery. Nomgon-2 recorded similar gas content in the same seam in August 2020, also with good permeability. Elixir reckons the quality of Nomgon is higher than what you find elsewhere when it comes to coalbed methane, with thicker coal seams that are more gas saturated and enough permeability to make it worth their while.

From the man that brought you QGC

The location of the Nomgon IX PSC couldn't be better. You can operate all year around down there and there are sealed roads running through the area. Additionally, the Chinese border isn't far away. Needless to say, Chinese gas demand, already robust, continues to grow strongly with market demand expected to double over the next twenty years.

We believe Elixir's leadership team is well placed to succeed on this project. Chairman Richard Cottee is the man who took Queensland Gas, a coalbed methane pioneer in Australia, from a A$20m market capitalisation to more than $5.7bn by the time it was sold to BG Group in 2008. Managing Director Neil Young, a former Santos executive who helped develop that company's capability in coalbed methane, has close to a decade's worth of experience working in Mongolia.

Elixir's share price has enjoyed a strong re-rating since the Corona Crash low of just 1.7 cents on 26 March. However, we see potential for a continued re-rating given the work programme now in hand. The first holes have just been in one sub-basin. There are multiple sub-basins within the PSC area and Elixir is now working to understand that terrain better. Ahead of news flow from the seismic and subsequent holes, we regard Elixir as a four star opportunity.

Pitt Street Research Pty Ltd

95 Pitt Street, Sydney, NSW 2000, Australia

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