RBS The Royal Bank of Scotland

16 May 2011

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Alkane Resources

ALK on its way

ALK has announced its first MOU for off take of zirconia product. The MOU outlines plans to build a zirconium oxychloride (ZOC) facility, which would allow ALK to capture upside from value adding processes. We expect further MOU announcments in the near term and maintain our high conviction Buy rating.

Buy

Target price
A$3.01

Price
A$1.930

Short term (0-60 days)
n/a

Key forecasts

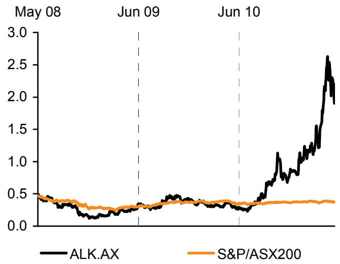
	FY09A	FY10A	FY11F	FY12F	FY13F
EBITDA (A$m)	2.12	7.51	-8.30	-10.0	73.90
Reported net profit (A$m)	11.00	7.79	-5.39	-8.94	26.40
Normalised net profit (A$m)[1]	2.30	7.79	-5.39	-8.94	26.40
Normalised EPS (c)[1]	0.85	2.90	-2.00	-3.32	9.83
Normalised EPS growth (%)	n/a	239.0	n/a	65.80	n/a
Dividend per share (c)	0.00	0.00	0.00	0.00	0.00
Dividend yield (%)	0.00	0.00	0.00	0.00	0.00
Normalised PE (x)	226.0	66.70	n/m	n/m	19.60
EV/EBITDA (x)	242.7	68.50	n/m	n/m	11.30
Price/net oper. CF (x)	-1,596	66.80	-81.3	-59.7	10.50
ROIC (%)	5.26	13.40	-14.2	-17.7	20.40

1. Pre non-recurring items and post preference dividends
Accounting standard: GAAP
Source: Company data, RBS forecasts

year to Dec, fully diluted

Price performance

	(1M)	(3M)	(12M)
Price (A$)	2.63	1.22	0.31
Absolute (%)	-26.6	58.2	522.6
Rel market (%)	-23.5	63.9	514.8
Rel sector (%)	-20.5	54.3	397.7



Market capitalisation
A$519.22m (US$549.95m)

Average (12M) daily turnover
A$1.77m (US$1.81m)

Sector: BBG AP Mining
RIC: ALK.AX, ALK AU
Priced A$1.93 at close 16 May 2011.
Source: Bloomberg

MOU supports 1Mtpa base case

ALK has signed a JV for development of a ZOC production facility which will take about 50% of planned production from ALK's Dubbo Zirconia Project (DZP). The facility will produce 15-20ktpa of ZOC which represents 7-10% of global supply. Terms and conditions including location, ownership structure and management are to be defined in a heads of agreement, which the company aims to complete by 31 December 2011. We believe the MOU adds further credibility to the development plans of ALK and the viability of its processing flow-sheet.

Why so significant?

In ALK's case we believe the announced MOU is of material significance due to a number of factors. 1) The cope of production from the DZP is limited by zirconia demand. This MOU accounts for 50% of zirconia production based on a 1Mtpa plant. Should subsequent MOUs tally to in-excess of ALK's production intentions, it will bring forward the substantial expansion potential of the company's project. 2) The MOU was signed on the basis of downstream test work validating the quality of ALK's product, which we had highlighted as an area of risk. 3) Although the counterparty to the announcement is not disclosed, we believe the support of ALK's product provides positive read through for the support ALK is likely to receive from strategically-interested entities as it endeavours to secure project finance in 2HCY11.

Investment view – expandable zirconia, rare earth and niobium exposure

We believe this MOU will lead to wider industry interest in future DZP supply. Project value is highly sensitive to plant capacity, which in turn is dependant on global demand of zirconia chemicals. Pre-financial crisis demand growth for zirconia chemicals averaged 11%. Should this rate continue near term, the market would absorb production from one DZP per annum. We see ALK as being well placed to meet this demand going forward.

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Important disclosures can be found in the Disclosures Appendix.

Value lies in expansion optionality

Should demand for zirconia chemicals continue at around 10% pa, it would support the expansion of the DZP beyond our base case of 1Mtpa

There is 57% upside to our risk-weighted valuation for ALK on current prices. If we remove the 30% discount we apply to account for development risk, our valuation for ALK increases to A$4.10, representing a 113% upside base on the last close. However, the real upside to ALK in our view lies in the expansion potential of its deposit. Should demand for zirconia chemicals continue at around 10% pa, it would support the expansion of the DZP beyond our base case of 1Mtpa. Due to its long mine life (75 years), expanding production has a substantial positive impact on our NPV as the value of the resource is brought forward.

Table 1 : ALK sensitivity to DZP expansion

Plant throughput	1Mpta (RBS base case)	2Mtpa	3Mtpa
capex	400	800	1200
NPV (incl 30% discount)	3.01	5.46	6.74
Mine life (years)	75	37.5	25

Source: RBS forecasts

We acknowledge that considering the upside potential for a plant which is at least six months away from beginning construction may be premature. We also believe that the expansion potential and continuity of long-term supply are relevant in light of recent demand growth in zirconia chemicals and current market tightness.

Zircon, zirconia and zirconium oxychloride

Zircon ($ZrSiO_4$) is the most widely used raw material for zirconia (ZrO_2) chemical production. About 20% of global zircon demand is attributable to downstream zirconia chemicals, which is also the fastest growing source of zircon demand (11% CAGR). It is the zirconia chemical market that ALK is targeting via future production from the DZP. Zirconium oxychloride ($ZrOCl_2$.8H2O) or ZOC, which is about 36% zirconia (ZrO_2) by weight, is used as a precursor for the manufacture of end-use zirconium checmicals (Figure 1 below).

China dominates

ALK's Dubbo Zirconia Project offers the potential for material quantities of ZOC production not directly linked to zircon or Chinese markets

Existing ZOC production relies on zircon as the key raw material for downstream zirconium products. China dominates world ZOC supply with about 90% of the 200ktpa market. About 40% of ZOC production is exported with the balance being consumed in China. Recent tightness on zircon markets has flowed into downstream ZOC markets, resulting in both China and non-Chinese customers experiencing difficulty in sourcing supply. ALK's Dubbo Zirconia Project offers the potential for a material quantities of ZOC production not directly linked to zircon or Chinese markets.

Table 2 : Zircon, zirconia and zirconium

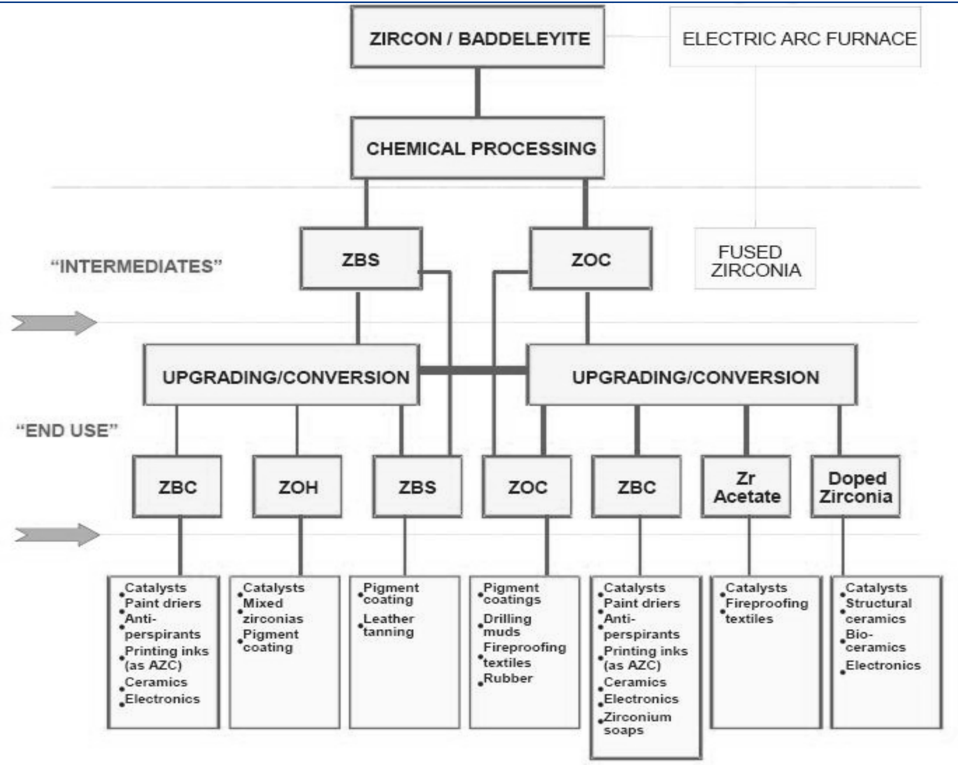
Product	Chemical formula	Produced by	Use	Global demand (ktpa)	Price (US$/t)
Zirconium	Zr	high end refining	nuclear power plants	5-10	150,000-200,000
zirconia	ZrO2	chemical manufactures (ALK from 2013)	multiple chemical applications	200	7,500-8,000
zircon	ZrSiO4	miners	tiles	1200	1,600-1,700

Source: Company data

Leveraged to global consumption

Zirconia chemicals are used in a diverse variety of end products in wide number of industries including construction, consumer goods and automotive manufacturing. So there is not one sector zirconia chemical demand is particularly leveraged to. Rather, zirconia demand is a function of increasing global GDP and demand for consumer products.

Figure 1 : Zircon and zirconia end products



Source: TZMI, ALK

Valuation and target price

Our DCF valuation for ALK is unchanged at A$3.01ps. We base our valuation on developing a 1Mtpa operation at the DZP and first production by 2013. We apply a 30% discount to our DZP valuation to reflect development risk. We do not factor in the development of the Tomingley or McPhillamy gold deposits, and we apply nominal option values for these. Upside risks to our valuation include lower capex and operating costs than we have forecast and higher commodity prices. Downside risks include delays in the finalisation of the DFS, securing project finance and lower commodity prices than we forecast.

ALK – Financial summary

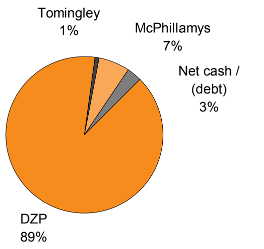
Number of shares (m)			269
Market capitalisation (A$m)			519
Enterprise value (A$m)			500
Enterprise value (US$m)			505

	Tonnes	Grade	Ounces
Resources	**(kt)**	**(g/t)**	**(koz)**
Gold resources	66,747	1.34	2,883
Gold reserves	3,600	1.78	205
EV/oz Gold resource (A$/oz)			173
EV/oz Gold reserve (A$/oz)			2,434

Valuation

Description	A$m	A$ps
DZP	675	2.51
Tomingley	5	0.02
McPhillamys	50	0.19
Total Operations	**730**	**2.71**
Net cash / (debt)	22	0.08
Corporate overheads	-8	-0.03
Exploration	66	0.24
Total Valuation	**810**	**3.01**
P/NPV		0.64

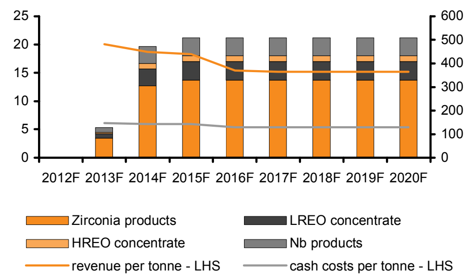
Operational NPV split



Valuation inputs	
Rf rate	5.3%
MRP	6.0%
Equity beta	1.36
Ke	13%
Kd	7.5%
Gearing	30%
Tax rate	30%
WACC	11%
DCF (A$)	3.01
Prem/disc	0%
Target (A$)	3.01

Sensitivity (US$m)	NPV(A$)	2012F	2013F
NPV / NPAT	3.01	-8.9	26.4
zr +10% increase ($m)	3.20	-8.9	29.5
zr +10% increase (%)	6%	0%	12%
nb +10% increase ($m)	3.23	-9	29
nb +10% increase (%)	7%	0%	8%
reo +10% increase ($m)	3.17	-9	30
reo +10% increase (%)	5%	0%	12%
AUD + 10% ($m)	-0.47	0.00	-7.48
AUD + 10% (%)	-16%	0%	-28%
AUD + 1cent ($m)	-0.06	0.0	-0.8
AUD + 1cent (%)	-2%	0.0	0.0

Production and costs



Dec Year End	2009A	2010A	2011F	2012F	2013F	2014F	2015F
NPAT Reported (A$m)	11.0	7.8	-5.4	-8.9	26.4	168.8	187.3
NPAT Normalised (A$m)	2.3	7.8	-5.4	-8.9	26.4	168.8	187.3
EPS (A¢)	0.9	2.9	-2.0	-3.3	9.8	62.8	69.6
CFPS (A¢)	-0.2	-0.8	-2.4	-77.6	-48.1	75.0	73.7
DPS (A¢)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
P/E (x)	226.0	66.7	-96.3	-58.1	19.6	3.1	2.8
P/CF (x)	-1170.9	-232.4	-81.3	-2.5	-4.0	2.6	2.6
EV/EBITDA (x)	238.4	67.3	-60.9	-50.5	6.8	1.9	1.8
EPS Growth	n/m	n/m	-169%	66%	-396%	539%	11%
Yield (%)	0%	0%	0%	0%	0%	0%	0%
Production	**2009A**	**2010A**	**2011F**	**2012F**	**2013F**	**2014F**	**2015F**
Zirconia (kt)	0.00	0.00	0.00	0.00	3.43	12.69	13.72
LREO (kt)	0.00	0.00	0.00	0.00	0.83	3.05	3.30
HREO (kt)	0.00	0.00	0.00	0.00	0.25	0.93	1.00
FeNb (kt)	0.00	0.00	0.00	0.00	0.81	2.98	3.22
Total (kt)	0.00	0.00	0.00	0.00	5.31	19.65	21.24
Costs	**2009A**	**2010A**	**2011F**	**2012F**	**2013F**	**2014F**	**2015F**
DZP cash cost (A$/t)	0	0	0	0	146	144	143
DZP cash cost (US$/t)	0	0	0	0	137	124	113
Assumptions	**2009A**	**2010A**	**2011F**	**2012F**	**2013F**	**2014F**	**2015F**
Zirconia (US$/kg)	0.0	3.6	7.5	11.8	12.0	11.2	10.4
LREO (US$/kg)	0	28	60	70	50	35	25
HREO (US$/kg)	0	56	80	90	70	55	45
FeNb (US$/kg)	0	35	35	35	35	35	35
AUD/USD	0.79	0.92	1.02	1.00	0.94	0.86	0.79
Profit & Loss (A$m)	**2009A**	**2010A**	**2011F**	**2012F**	**2013F**	**2014F**	**2015F**
Sales revenue	0	0.0	0	0	121	415	439
Other revenue	4	9.8	0	0	0	0	0
Total revenue	4	9.8	0	0	121	415	439
Operating costs	-2	-2.3	-8	-10	-47	-143	-153
EBITDA	2	7.5	-8	-10	74	272	286
Depreciation	0	0.0	0	0	-4	-8	-8
EBIT	2	7.5	-8	-10	70	264	277
Net interest benefit / (expense)	0	0.3	1	-3	-32	-23	-10
Pre-tax profit	2	7.8	-8	-13	38	241	268
Tax benefit / (expense)	0	0.0	2	4	-11	-72	-80
Profit after tax	2	7.8	-5	-9	26	169	187
Minorities	0	0.0	0	0	0	0	0
NPAT (underlying)	2	7.8	-5	-9	26	169	187
Significant items	9	0.0	0	0	0	0	0
NPAT (reported)	11	7.8	-5	-9	26	169	187
Profitability Analysis (%)	**2009A**	**2010A**	**2011F**	**2012F**	**2013F**	**2014F**	**2015F**
EBIT margin	n/m	n/m	n/m	n/m	58%	64%	63%
EBITDA margin	n/m	n/m	n/m	n/m	61%	66%	65%
Effective tax rate	0%	0%	-30%	-30%	-30%	-30%	-30%
ROA - EBIT / (total assets - cash)	5%	18%	-20%	-4%	16%	62%	65%
ROE - NPAT / equity	5%	17%	-9%	-18%	120%	67%	39%
Cashflow	**2009A**	**2010A**	**2011F**	**2012F**	**2013F**	**2014F**	**2015F**
EBITDA	2	8	-8	-10	74	272	286
Operating cashflow	0	-1	-6	-9	50	210	206
Capex	-1	0	0	-200	-179	-8	-8
Free cashflow	-1	-1	-6	-209	-129	202	198
Investing cashflow	-5	1	0	-200	-179	-8	-8
Financing cashflow	2	0	21	450	0	-200	-150
Net Change in cash	-3	0	15	241	-129	2	48
Balance Sheet Analysis	**2009A**	**2010A**	**2011F**	**2012F**	**2013F**	**2014F**	**2015F**
Debt	0	0	0	450	450	250	100
Equity	44	46	59	50	22	254	478
Assets	45	47	61	503	556	558	606
Cash	5	5	19	260	131	133	181
Net debt	-5	-5	-19	190	319	117	-81
Gearing - net debt/equity	**2009A**	**2010A**	**2011F**	**2012F**	**2013F**	**2014F**	**2015F**
Gearing - net debt/ (net debt + equity)	-12%	-11%	-48%	79%	94%	32%	-20%
Net debt / EBITDA	-228%	-61%	231%	-1895%	432%	43%	-28%
EBIT / net interest	9	23	-14	4	-2	-12	-28
EBITDA / net interest	9	23	-14	4	-2	-12	-29

Source: Company data, RBS forecasts

Recommendation structure

Absolute performance, short term (trading) recommendation: A Trading Buy recommendation implies upside of 5% or more and a Trading Sell indicates downside of 5% or more. The trading recommendation time horizon is 0-60 days. For Australian coverage, a Trading Buy recommendation implies upside of 5% or more from the suggested entry price range, and a Trading Sell recommendation implies downside of 5% or more from the suggested entry price range. The trading recommendation time horizon is 0-60 days.

Absolute performance, long term (fundamental) recommendation: The recommendation is based on implied upside/downside for the stock from the target price and, except as follows, only reflects capital appreciation. A Buy/Sell implies upside/downside of 10% or more and a Hold less than 10%. For UK-based Investment Funds research, the recommendation structure is not based on upside/downside to the target price. Rather it is the subjective view of the analyst based on an assessment of the resources and track record of the fund management company. For research on Australian listed property trusts (LPT) or real estate investment trusts (REIT), the recommendation is based upon total return, ie, the estimated total return of capital gain, dividends and distributions received for any particular stock over the investment horizon.

Performance parameters and horizon: Given the volatility of share prices and our pre-disposition not to change recommendations frequently, these performance parameters should be interpreted flexibly. Performance in this context only reflects capital appreciation and the horizon is 12 months.

Market or sector view: This view is the responsibility of the strategy team and a relative call on the performance of the market/sector relative to the region. Overweight/Underweight implies upside/downside of 10% or more and Neutral implies less than 10% upside/downside.

Target price: The target price is the level the stock should currently trade at if the market were to accept the analyst's view of the stock and if the necessary catalysts were in place to effect this change in perception within the performance horizon. In this way, therefore, the target price abstracts from the need to take a view on the market or sector. If it is felt that the catalysts are not fully in place to effect a re-rating of the stock to its warranted value, the target price will differ from 'fair' value.

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The tables below show the distribution of recommendations (both long term and trading). The first column displays the distribution of recommendations globally and the second column shows the distribution for the region. Numbers in brackets show the percentage for each category where there is an investment banking relationship. These numbers include recommendations produced by third parties with which RBS has joint ventures or strategic alliances.

Long term recommendations (as at 16 May 2011)

	Global total (IB%)	Asia Pacific total (IB%)
Buy	785 (13)	513 (3)
Hold	410 (7)	222 (1)
Sell	90 (1)	57 (0)
Total (IB%)	1285 (10)	792 (2)

Source: RBS

Trading recommendations (as at 16 May 2011)

	Global total (IB%)	Asia Pacific total (IB%)
Trading Buy	2 (0)	2 (0)
Trading Sell	2 (0)	2 (0)
Total (IB%)	4 (0)	4 (0)

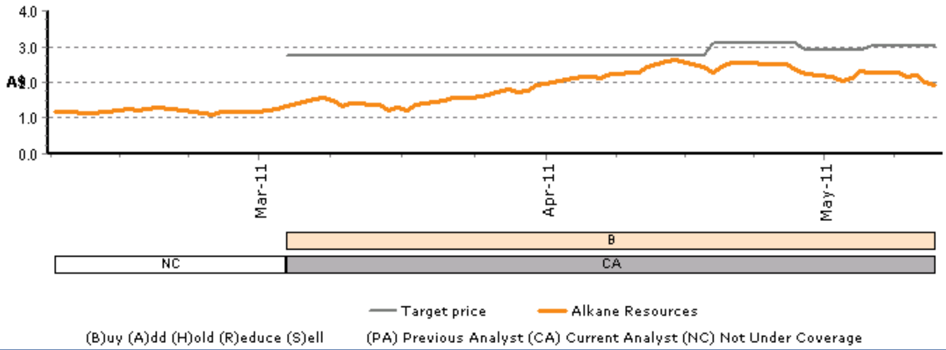
Source: RBS

Valuation and risks to target price

Alkane Resources (RIC: ALK.AX, Rec: Buy, CP: A$1.930, TP: A$3.01): We value ALK using a DCF methodology. Upside risks to our target price include production and commodity prices exceeding our expectations. Downside risks include higher-than-forecast capex, commissioning and development delays, and lower-than-forecast commodity prices.

Alkane Resources coverage data

Stock performance, recommendations and coverage (as at 15 May 2011)



Sam Berridge started covering this stock on 3 Mar 11. New recommendation structure from 7 November 2005. Source: RBS

Trading recommendation history (as at 16 May 2011)

Date	Rec	Analyst
	n/a	

Source: RBS

Regulatory disclosures

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