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Kalium Lakes makes quick progress

The mining industry would be a pleasantly different place for investors if ASX-listed Kalium Lakes was typical.

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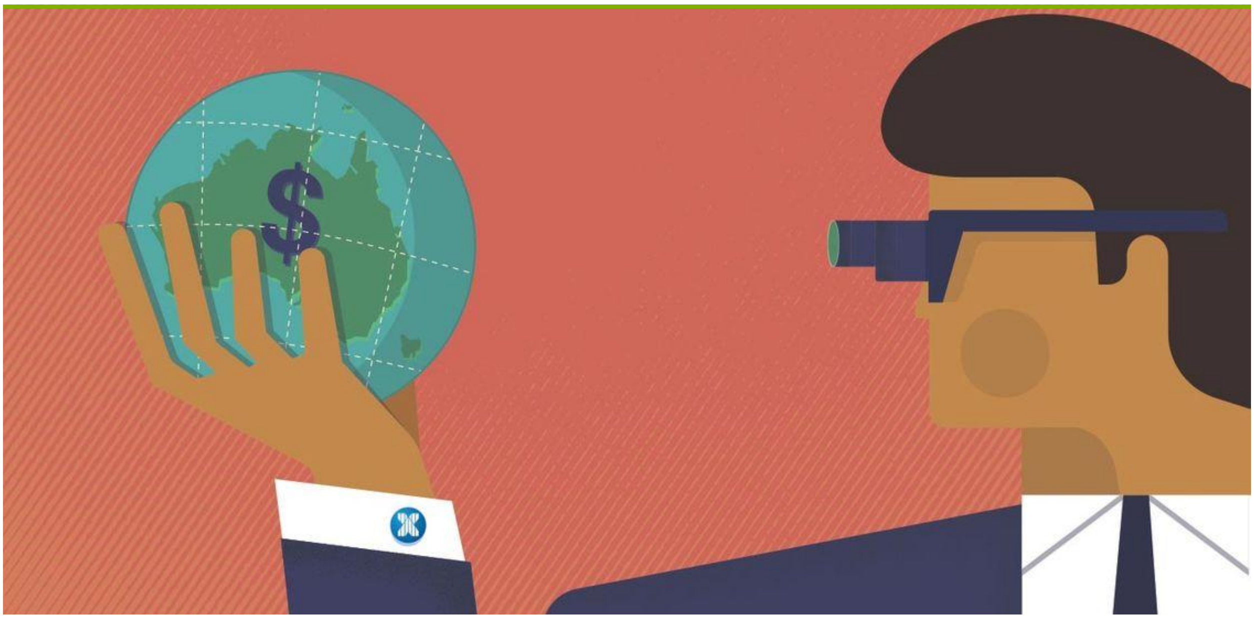

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Kalium Lakes was listed in December 2016 to develop a potash brine resource in Western Australia near the iron ore centre of Newman. The company describes its Beyondie project as Australia's first sulphate of potash (SOP) operation.

At first glance, Kalium looks like any number of other early stage mineral developers with a resource, a grand plan, just enough cash to keep the dream alive but hundreds of millions of dollars short of what will be needed and a feasibility study which says it can create value many times greater than what investors are currently willing to pay.

The striking difference which dawns as CEO Brett Hazelden runs through his plans, as he did in Melbourne recently, is the speed of progress.

Whereas other companies' fortunes will have ebbed and flowed over the years as investors await the next timetable iteration, Kalium directors appear to have steered a steady course, hitting permitting, analytical, funding and development targets in respectably quick succession.

The company was formed in 2014 before raising A$6 million on listing in exchange for 25% of the outstanding shares. Since then, it has raised a further $43 million, including a $20.8 million equity commitment in exchange for a 20% stake, earlier this month. It had $5.3 million in cash to carry it forward at the end of December 2018.

An extensive range of permits and approvals have been granted including those covering native title and federal environment requirements. Early stage work approvals have been received.

Last month, the Western Australian Environmental Protection Authority recommended the government approve development, leaving the company on track to begin producing during 2020.

After a bankable feasibility study at the end of September 2018, Kalium directors pushed ahead to complete the front end engineering and design works at the beginning of March.

At this stage, many companies would still be floundering in their search for funding and offtake agreements. Kalium has locked in a A$74 million commitment from the government sponsored Northern Australia Investment Facility. It has also agreed non-binding terms with KfW IPEX-Bank for A$102 million of debt funding which it hopes to complement with a German government export credit guarantee.

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The company is edging closer to its needed A$216 million in first stage capital. A further A$125 million will be needed to push production from an initial 90,000 tonnes per annum rate to 180,000tpa over the remaining 30 years of project life.

Debt funding for an anticipated two thirds of the company's project needs will mean equity investors will be called on this year before a final production commitment.

Shoring up the funding options is an offtake agreement inked at the end of March. German fertiliser producer K+S has agreed to purchase up to 90,000t of SOP annually for 10 years, accounting for all of the company's first stage output. K+S will sell product into the Australian market which is currently 100% supplied from overseas.

Investors have recognised the progress, taking the Kalium Lakes market value from $27 million at the end of 2016 to $105 million presently. A 150% share price gain has outstripped the 26% move in the ASX small resources share price index over the same period.

A small number of remaining approvals, including completion of financial due diligence, and sufficient equity funding will help buoy sentiment, as they occur.

Increasingly, though, with most of the good news having been delivered and the company entering a 15-month construction hiatus, further value appreciation will hang on confirmation the company will hit its production targets and meet its financial guidance.

An investor would need to spend A$390 million (in equity and project funding) to realise cash flows of A$2.4 billion over 30 years, according to the company's plans.

This would be equivalent to buying a long term bond with an annual yield of 17%.

Kalium directors have foreshadowed an average annual EBITDA of A$126 million. A potential market value for the company in four or five years of A$600-50 million would be a reasonable expectation from an untroubled move into production. This would represent an annualised investment return a little better than 35% for an ordinary shareholder, bearing in mind the need for additional equity this year.

One cautionary note is needed. Kalium's arrival on the scene itself highlights the chance of a future shift in the industry's cost structure possibly undermining the veracity of its own numbers.

Global SOP production is presently dominated by the Mannheim process which treats potassium chloride with sulphuric acid to produce SOP and a hydrochloric acid by-product. Mannheim process costs can be more then twice the costs of direct production from brine.

As the need for SOP grows and experience with large scale brine extraction methods becomes more commonplace, the incidence of direct production will almost certainly increase with a consequential reshaping of the industry cost curve.

Kalium's financial modelling assumes selling prices rise by 2% a year from US$530 to $961-997 per tonne over the life of the project even as industry production costs are potentially falling.

Generally, without an exogenous and unexpected demand shock, commodity prices will edge toward costs of production. A near doubling of prices as costs potentially halve is an especially heroic assumption. Nominal SOP prices could be lower in 30 years than they are today with the market still amply supplied.

The difference in life of mine revenue between a US$530/t flat price and one escalated at 2% would be around $1,350 million. That would translate into an average EBITDA erosion of 35%, possibly equating to a A$200-225 million loss in market value and stripping 10 percentage points from the investment return.

Unthinkingly adopting a central bank target for consumer price inflation as the benchmark for SOP prices, while that market is undergoing an idiosyncratic structural adjustment, may prove a lucky guess but, as is more likely, simply lazy analysis and a flaw in an otherwise exemplary record.

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