Small-cap Australian events: the gift that keeps on giving

OCTOBER 4, 2022 / PUPPYEH / EDIT

Today's situation somewhat suffers from low liquidity so this will not be a lengthy write-up. But the setup is quite interesting and I think largely misunderstood by the market – as has been an ongoing theme in small-cap Australian event names for much of the past two years, as I have repeatedly discussed here. There have been a number of Aussie deals, both small and large-cap (Infomedia; Ramsay; Atlas Arteria) that have fallen apart of late, most all for financing reasons where the buyer was a financial player (private equity etc). I believe investors in this particular case are being far too wary given this recent backdrop and ignoring this specific deal's imperatives and interests. Let's jump right in.

Danakali Ltd (Australia: DNK) – last price 31.5c – $120mm market cap, $1mm ADV (very recently, lower on a normalized basis)

This writeup has many parallels with our adventures in FAR Ltd (see here for the original writeup). DNK is essentially a one-project, company, owning a 50% interest in the Collusi Sulphate of Potash project in Eritrea: an as-yet unbuilt, un-financed mine in a tricky (putting it mildly) geographic location. DNK has struggled for a number of years to fund the mine's development, despite apparently attractive characteristics (long-life, low-cost, and a premium SOP product output). Most recently, Eritrea was re-

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sanctioned by the US in November, 2021 (after the UN having lifted most sanctions in 2019 post its war with neighboring Ethiopia) – a move that has made financing any kind of foreign direct investment by a Western-affiliated entity like DNK (domiciled in little old Australia) basically impossible.

This is why, perhaps, DNK decided to pull the plug on their Eritrean adventure yesterday, agreeing to sell their 50% interest for a total of $166mm USD gross, or $121mm USD net of all taxes:

ASX Release: **3 October 2022**

Term Sheet Executed in Asmara for Sale of Colluli Interest

Highlights

- **Term sheet executed for the sale of DNK's 50% shareholding in CMSC to Sichuan Road and Bridge Group Co., Ltd.**
- **Total consideration of US$166 million pre-tax consisting of:**
  - **US$135 million consideration for the CMSC equity; and**
  - **US$31 million (subject to adjustment for deferred payment) for the loan purchase.**
- **The deal, net of all government taxes means DNK will receive approximately US$121 million.**
- **The term sheet is non-binding and remains subject to the Purchaser's satisfactory completion of due diligence and the parties entering into definitive agreements.**
- **Key conditions precedent to completion of the Transaction include:**
  - **DNK shareholder approval**
  - **ENAMCO and Eritrean Government Ministry approval**
  - **Chinese regulatory approvals being obtained by the Purchaser**
- **Subject to shareholders approval and following the Transaction, DNK plans to distribute 90% of the net proceeds to DNK shareholders and DNK will continue as a listed company to identify new projects and potential new alternative growth opportunities.**

DNK has basically 370mm fully-diluted shares outstanding, and no other material projects (but also $18mm AUD in gross cash before this deal). If they were to receive this $121mm as per the (non-binding) deal as announced, this would constitute 54c a share AUD in cash, and even 90% – of this amount – the amount they have committed to return to shareholders – would be 45c, and they would still have call it 9c in cash left over after two more quarters of burn at current rates, as summarized below:

	AUD mm	Notes
Net cash Jun'22	18	
Net proceeds from Collusi	186.15	using 65 for FX
Less 2qtrs of burn + buffer	-3.00	2mm neg OCF in 1H'22
Net cash (AUDmm)	**201.15**	
Per share	***0.54***	using 370mm FDSO
Distributable value only	**167.54**	90% of Collusi, none of extant net cash
Per share	***0.45***	
Stock price today	**0.32**	
Upside to total value	***73%***	
Upside to distributable value	***44%***	

There are a number of variables here and we need to discuss the various buckets of risk in this situation, and the implied odds of this deal closing. First let's consider: if this deal were to close, where would DNK trade in six months? Even if the market accorded a very low value to the residual cash in the structure (as I believe it would), it would still have some kind of option value – maybe 50c on the dollar? Thus, if the deal closes, or upside is probably somewhere between these two numbers (45c and 54c). At 50% value on residual cash, we get around 49-50c of deal value if this transaction were to close on terms, all in six months. That amounts to something like a *57% gross return, and obviously a strong triple-digit IRR*…not bad at all. Let's dig a little deeper.

Merger odds and what the price is telling us

Beyond the pure upside, we should try to assess what the market is telling us about deal probability. If this deal closes we get something around 49-50c; but if it doesn't, what are we left with? Before this deal came to light, the stock was trading at 26c…but keep in mind also that if this deal were NOT to proceed there is very real risk that Collusi could be seen as a 'stranded asset', since if the Chinese are not able to buy it, who would be able to in this kind of market? Thus, I think 'deal break' downside is probably worse than 26c – let's be conservative and knock this back to 23c (basically year lows on the stock). There are other outcomes so this is not simply a bi-variable analysis, but simplistically, this tells us ***the market is pricing in a ~33% chance of this deal closing on terms***. That seems far, far too low to me, in this particular case. Let me explain why.

Strategic transactions and aligning the interests of all parties

Whilst you will recall I am quite anathema to non-binding bids, I am also quite excited for transactions that appear much more long-term, and strategic in nature, than purely financial bids. It is true, this is at this stage just a term sheet, but considering the motivations of all players, it seems to me that closing this deal is basically the best outcome for all key stakeholders. Consider the following:

- **the purported buyer is a Chinese SOE** who has built a number of infrastructure projects in Eritrea already; note also that this falls under the ongoing Belt and Road initiative, and Chinese companies have been one of the largest (if not the largest?) provider of FDI to Eritrea over the last decade;
- the largest investor in DNK is the Africa Finance Corporation, a pan-continental development funding entity whose sole purpose is to encourage and implement strategic resources and infrastructure projects on the continent. It is painfully clear that DNK, a small Aussie entity hamstrung by lack of financing and the broader, Western position re Eritrea, is unable to deliver the financing to get this project done. AFC wants this project done as that is their mandate, so it stands to reason they would fully support this ownership change;
- The other 50% shareholder in Collusi is the **Eritrean government** (ENAMCO). Clearly, they have already done a lot of business with the Chinese (see here and here); as per the above, this ownership change solves a huge bottleneck (financing) that enables this project to move forward, many years after they all thought it would be in production already;

- **DNK minority shareholders:** other than AFC, the register is pretty open, such that by the time of the vote, I believe a lot of shareholders will be in fact arbs. Even so, those retail who are still involved would essentially be taken out at 3-year highs on the stock (around 50c), not a bad outcome at all given the best available alternative in this situation. Keep in mind also that a slug of financing for the project was done in recent years at 43c, so whilst not a stellar outcome it is also definitely quite palatable.

Indeed, there are other signals to suggest this deal should be valued at a much higher probability of close than 30% or so. Firstly, the buyer, Sichuan Bridge, is only asking for 30 days due diligence. This is a very short period of time for a transaction of this nature in a place like Eritrea:

Indicative Timeline

The indicative timeline for the Proposed Transaction is as follows:

- The Purchaser completes its due diligence by 30 October 2022.
- The parties enter the Definitive Documents by 30 November 2022.
- Completion between 31 March 2023 and 31 May 2023.

This is basically a tour of the site and a bunch of government meetings in Asmara (I am simplifying but you get the gist). I do not believe the timeline on DD would be so short if it were not basically a *fait accompli* that government/ENAMCO approval on the transaction – one of the key stumbling blocks – would be granted. Given the specific history of Chinese FDI in Eritrea and the disclosure here, this seems a high likelihood outcome.

In fact, to me the biggest risk regarding the transaction does not actually lie in due diligence, nor government approvals in Eritrea or China; rather it is in the termination of the Off-take agreement from Eurochem, a massive Russian fertilizer player, signed in 2018 and mentioned in the Annexure as a further condition precedent to the transaction being consummated:

Conditions Precedent

The key conditions precedent to completion of the Transaction include:

1. Prior to execution of the SPA, completion of due diligence on CMSC and its assets to the Purchaser's satisfaction.

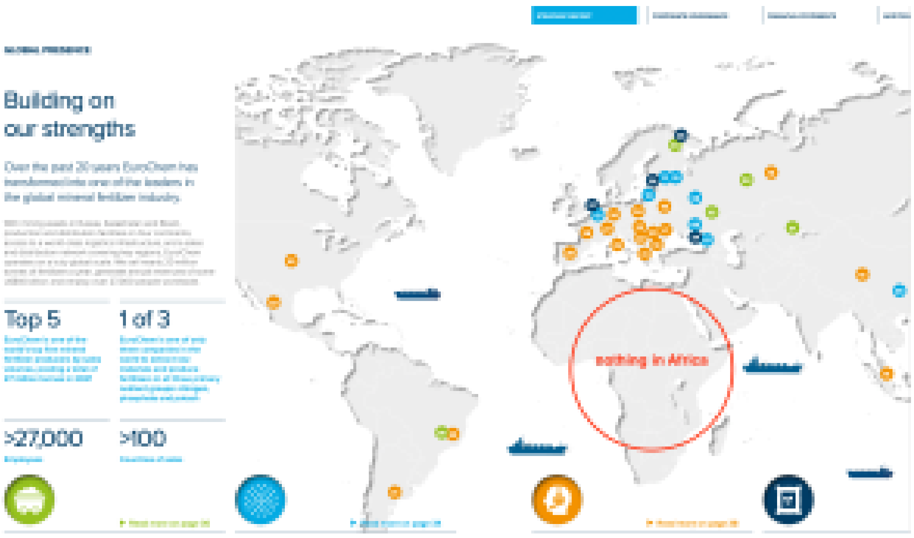
Completion of the SPA will be subject to satisfaction of the following conditions precedent:

1. Receipt of standard regulatory approval in Australia, including but not limited to, approvals from ASX.
2. Receipt of standard regulatory approvals in Eritrea, including but not limited to, approvals from the Ministry of Mines and Energy.
3. Termination of the existing Sulphate of Potash Offtake Agreement with EuroChem Trading GmbH.
4. Termination of the Common Terms Agreement and related documents regarding the facilities borrowed from Africa Export Import Bank and Africa Finance Corporation (including the settlement of fees CMSC is obligated to pay).
5. Confirmation to the Purchaser that there is no ongoing contractual relationship or outstanding claims pertaining to the On-Shore EPCM Contract and Off-Shore EPCM Contract.
6. Confirmation from the Director General of Mining at the Ministry of Energy and Mines that the mining licenses held by CMSC are valid, in full effect and in good standing.

Eurochem is a significant player in the global fertilizer market, and has the financial wherewithal to either block this transaction, or even compete for the entity if they want the whole project (they did >$3bn in EBIT last year, though they are quite levered it seems) – an upside outcome I am not thinking about but that is clearly also plausible.

The off-take agreement they signed re Collusi in 2018 – yes it has been that long and nothing has happened! – is not public, but there is a non-zero chance they could try to throw a wrench in the works here and waylay the best-laid plans of Sichuan and DNK.

But on the other hand, there are also reasons why they may seek a commercial way out. As it stands, Eurochem has zero exposure in Africa today – the Collusi off-take was to be their first transaction – and even that was to be commercially insignificant for them:



There are also political angles here. China and Russia are increasingly close, post the events in Ukraine, and I am sure if Eurochem tried to block an economically-miniscule transaction for competitive reasons (without overbidding for the asset, that is) it may strain relations unnecessarily. Certainly, there may be a *quid pro quo* required from Sichuan Bridge – and I have no idea if that is forthcoming – but I think it is telling that DNK management did NOT include the Termination of the Eurochem off-take agreement as one of the 'key' conditions precedent to closing the transaction on the first page of their release:

- The term sheet is non-binding and remains subject to the Purchaser's satisfactory completion of due diligence and the parties entering into definitive agreements.
- Key conditions precedent to completion of the Transaction include:
  - DNK shareholder approval
  - ENAMCO and Eritrean Government Ministry approval
  - Chinese regulatory approvals being obtained by the Purchaser

no mention of termination of Eurochem off-take here...

- Subject to shareholders approval and following the Transaction, DNK plans to distribute 90% of the net proceeds to DNK shareholders and DNK will continue as a listed company to identify new projects and potential new alternative growth opportunities.
- Transaction expected to be completed between 31 March 2023 and 31 May 2023.

Perhaps they are simply under-selling the risk, or don't understand Eurochem's motivations fully. On the other hand, I believe it is at least 50/50 that Eurochem, having waited 4+ years for this ephemeral and non-core project in a new, virgin geography, simply moves on to business closer to home – such as trying to manage through the current anti-Russian business environment on their core assets.

A few other considerations – mostly bullish

There are a few other angles to consider. The Chinese are paying 30c on the dollar, theoretically, assuming Collusi's latest statements re NPV of $950mm are reasonable (note that the price assumptions are far below spot but I imagine cost escalation has been rampant as well). Crucially, this is an extremely long-life asset and nothing is hotter than fertilizer right now so there is a reasonable chance you see an overbid here or at least agitation in that direction, from the likes of Eurochem (by far the most likely), or other third-party, non-Western players.

But even if this deal is as good as it gets, I believe there is a further opportunity to potentially extract full value (meaning 54c) given that assuming this transaction is agreed and on track to be consummated, *most all shareholders will support an orderly wind-down and return of all value to shareholders*. As discussed previously, by that point I believe at least a meaningful portion of the register will be arbs (10-20%); the legacy core shareholder (AFC) has no motivating interest in seeing the existing Australian corporate entity remain listed (to pursue some other random project that may well be outside their remit anyway); and furthermore this existing management team and entity has demonstrated only their inability to progress a strong asset in the ground to construction and production. Why should shareholders back them to get another go at it? Instead I think a majority would support an orderly wind-down and return of all assets, which could be accomplished within the same timeframe of this deal (assuming binding documents are signed in the next couple of months).

As such, I am strongly considering re-running the FAR playbook here, again assuming the deal proceeds to a binding agreement, AND if enough of the float turns over such that a meaningful minority position would align itself with this call should it be made to the broader market. Those are both to be determined, and to be very clear I would NOT chase this above 36c before a signed deal, but to me this seems the logical next step here.

For now I have taken a starter position and will re-evaluate and potentially increase if (or hopefully when) binding docs are signed in the next couple of months.

Disclosure: long DNK.AX

Uncategorized

DNK.AX

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