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Graphex Mining Limited (GPX AU, $0.29, market cap. A$16.7m)

Radical changes to the Tanzanian Mining Act negatively impacts our GPX valuation

Background

- Of all the countries in sub-Saharan Africa, Tanzania was considered to be one of the least likely to deliver a slap in the face to the mining industry.
- Tanzanian president John Magufuli came to power on an anti-corruption platform. This saw wholesale sackings from the bureaucracy and ultimately the sacking of the Mines Minister.
- At the heart of the issue appears to be that hoary chestnut: tax payments by mining companies. Tanzania accused the country's largest gold producer, Acacia Mining (formerly African Barrick, not covered), of falsifying its export (of gold bearing concentrate) figures, thereby minimising royalty and tax payments.
- This was vigorously defended by Acacia. But in two, so-called independent reports, Acacia was found to be at fault. Acacia has rejected all claims. (We don't have a detailed understanding of the claim, but on first read it did look odd to us.)
- In mid-June, all looked to be forgiven. 64% Acacia shareholder Barrick sent its CEO to negotiate with the President. All seemed to be well, with promises that all back taxes owed (if there were any) would be paid.
- Earlier, Tanzania bumped fiscal terms for the miners with a 1% export clearance fee, effective 1 July.
- Then the bombshell, which nobody saw coming: changes to the 2010 Mining Act. These changes move Tanzania from 'mid-range' fiscal terms to amongst the most punitive in the world.
- Key changes include the following:
  - An automatic right for the country to take a 16% non-diluting free carried interest (FCI) in any mining and energy project. Previously the State had the right to a 10% FCI in projects with capex over US$100m but would typically not exercise this right for projects under US$100m.
  - The government will have the right to increase its free carried interest in projects to 50% "commensurate with total tax expenditures incurred by the Government in favour of the mining company". It is not clear what "tax expenditures incurred by the Government" means, but it appears to be related to historical tax concessions provided to mining companies. (This we see as a "Get Acacia" clause. Acacia seems to have been singled out for punishment.)

    - Royalties for gold, silver and the PGM's increase from 4 to 6% and from 5% to 6% for uranium. Graphite to remain at 3%.
    - Where companies are found to have behaved with "unconscionable terms", the government can force renegotiating of the mining agreement. Failure to negotiate a satisfactory outcome (to the government) may result in cancelation of the mining agreement.
    - Mining (and presumably oil) service companies are expected to enter JV's with Tanzanian companies, with a minimum local equity of 25%.
- The country has also passed a bill to prohibit mining and oil disputes from being heard in foreign courts.

The likely impact on Graphex

- Graphex is one of the few success stories in the often-mysterious graphite sector. GPX's Chilalo deposit, located in southern Tanzania, is a likely source of high quality coarse and medium flake graphite, suitable for the expandable/fire retardant graphite market, currently in high demand.
- Graphex was awarded a mining lease over Chilalo in late 2016. The 10% free carried interest was not enforced.
- In June, Graphex announced finalisation of a long-awaited term sheet for the involvement of Chinese partners (led by CN Docking, a subsidiary of China National Building Materials Group) in the Chilalo graphite project in Tanzania.
- In summary, the terms of the proposed transaction are as follows:
    - The Chinese syndicate will invest A$24-27m to gain 50% of the Chilalo project
    - The Chinese syndicate will provide a debt guarantee for any debt required by the project and are primarily responsible for sourcing that debt.
    - The Chinese syndicate will take "a minimum of 50% of the product" and will provide assistance to place the balance into expandable graphite markets.
- This would have been an excellent result for Graphex, and would have left their 50% fully funded. However, it is not clear what the reaction of the Chinese partners will be to the change to fiscal terms.

- In the following section, we will evaluate 3 scenarios, and compare to our earlier valuation:

    - **Status quo**, which would see the reversal of the changes to the Mining Act, but incorporating the 1% export levy. This is an unlikely outcome.
    - **Best case outcome**: transfer of 16% free carry to the government, the 1%additional export levy. The Chinese partners stay with the original deal.
    - **The worst-case outcome**: transfer of 50% of the project to the government and full withdrawal from the project by the Chinese. Based on the assumption that prior tax concessions would need to have been provided by the Government to Graphex, we view this as an unlikely outcome.

Previous valuation

- Our earlier valuation, based on the results of the PFS and a US$1217/t basket price for the expandable product was A$170m at a project level (post tax).
- With the Chinese equity contribution and full gearing (65%) our NPV per GPX share was determined at **A$1.49/GPX share** reflecting GPX's 50% fully funded equity in the project.

Status quo

- We see it as extremely unlikely that the current Tanzanian government would reverse the current legislation.
- However, assuming the Chinese deal remains as it is, and the ownership is split 50/50, but with the imposition of the 1% export levy, our valuation would drop to **A$1.46/GPX share**.

"Best case" outcome

- This assumes the government will move to a 16% free carry, and the 1% export levy will apply.
- It also assumes that the Chinese partnership remains in place and so GPX's equity share in the project is 42%. The project remains fully funded in GPX's hands.
- In this case our valuation drops to **A$1.19/GPX share** or 20% below our earlier valuation.
- This demonstrates the robust economics of the Chilalo project, assisted by relatively low capital intensity of the project, rapid payback, the contribution of the Chinese equity to the capital cost, the ability to fully gear the project, and its high margin.
- To deliver this outcome, we believe there could be significant delays, securing the confidence of the Chinese partners and securing suitable debt counterparties. GPX would therefore need modest equity funding to allow finalisation of all commercial terms.

"Worst case" outcome

- The Tanzanian government obtain a free carried interest of 50%, leaving 25% each for GPX and its partners.
- Under this circumstance it would be extremely unlikely the Chinese partners would provide equity funding, let alone support debt funding.
- A valuation for Chilalo in the hands of GPX is imponderable under these circumstances. However we view this as an unlikely outcome.

Commentary from Graphex

Graphex today released its interpretation of the changes to Tanzanian Mining law The company's interpretation is much the same as our own. A couple of points are worth highlighting:

- The 50% provision is unlikely to impact GPX as it has not been the beneficiary of historic tax incentives.
- Chilalo doesn't actually have a mine development agreement (MDA) as it was not required under its Mining Licence.

- The royalty provisions are unchanged for industrial minerals.
- There should be no issue regarding export of graphite as it is already a processed/beneficiated/final product.
- GPX suggest that the capex associated with the 16% share, might be recoverable given that the equity is to be taken at the company, not asset level. This needs to be clarified.

GPX's CEO is currently in China talking with its JV partner, CN Docking.