Specialist Sales & Sales Trading
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Trade Idea – Sundance Resources

Event Angles

What are the Chances of a Higher Offer for SDL?

Hanlong Mining has proposed a 100% cash offer for SDL at 50c per share, using a scheme of arrangement. The SDL Board said that the terms of the offer do not provide adequate value or certainty to SDL shareholders and that it intends to engage in discussions with Hanlong. In the meantime, SDL will continue to progress its advanced negotiations with potential strategic partners in respect to possible JV, financing and offtake arrangements.

SDL marks the 14th stock from the *JPM Specialist Sales Top Takeovers List* that has received a change of control proposal over the past 18 months. In our view, SDL is the last remaining Australian-listed West African iron ore players with scale. Nearly all of the other major projects have been bought by the majors.

In this note, we will discuss the following:

- Overview of SDL
- Ownership structure of SDL's assets
- Overview of Hanlong
- Overview of West African iron ore region
- Current JV sale process
- Transaction comps analysis
- Chances of a bump
- Chances of a counter offer
- Probability weighted scenario analysis

Overview of SDL

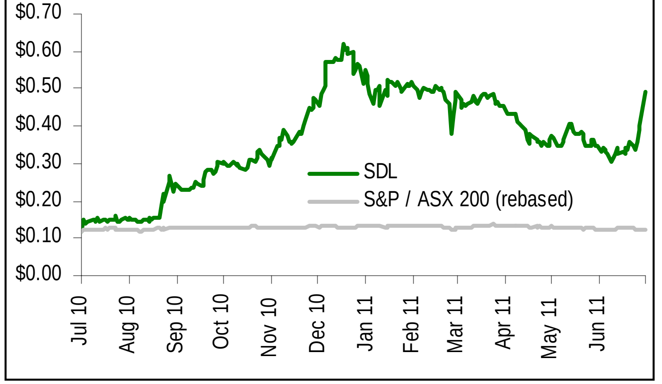
SDL is a West-African iron ore developer. It has two primary iron ore deposits as part of its Mbalam project. Its Mbarga mine in located in Cameroon and its Nabeba mine is located in the Republic of Congo (RoC). As shown in chart 1, the Mbalam project runs across the border of these two countries.

The project is large scale with 484mt of high grade (61.1% Fe) hematite resources and 2.3bt of Itabirite Hematite (38% Fe) resources. It is also considered high quality with a very low strip ratio (0.81) which is the primary driver of its very low US$21.20/tn OPEX estimate for Stage 1. Stage 1 involves developing a 35mtpa high grade hematite (DSO) project with a 10 year mine life. Stage 2 involves developing the Itabirite hematite concentrate for 35mtpa for a 15 year mine life (US$40/tn OPEX but expected to attract pricing premium due to the beneficiated product). Stage 1 has a completed DFS while stage 2 has a completed PFS.

Trade Idea

Based on our probability weighted scenario analysis, we believe SDL should be trading at 50.5c per share – 3% higher than the current price. Therefore, we would BUY SDL up to this level in anticipation of a bump to 55c.

Performance



Security Information

Security:	Sundance Resources
ASX Code:	SDL
Bloomberg:	SDLAU
Current Price:	A$0.49
Market Cap:	A$1,407m
Shares Issued:	2,871.6m
Avg Daily Turnover (12m):	37.0m (A$14.0m)

Like other African assets, SDL is constrained by infrastructure. The project requires a 510km railway line to the port. It also requires a 70km spur line from the Nabeba mine to the Mbarga mine. A deep water port also needs to be built with capacity for 35mtpa. The capex for stage 1 of the project is expected to be US$4.7bn with a payback period of ~3 years. The capex for stage 2 is expected to be US$3.1bn and is expected to be funded from the DSO cashflow (stage 1).

SDL currently has MoUs with Chinese infrastructure builders (CRCC, CHEC) for the railway and port construction. FID is expected by the end of 2011 with first ore on ship expected by the end of 2014.

Ownership structure of SDL's assets

Chart 2 shows the ownership structure of SDL's two main assets. Its Mbarga mine is held by Cam Iron SA while its Nabena mine is held by Congo Iron SA. Hold Co SA and Congo Mining Investments SA own 10% and 15% respectively of the two subsidiaries. These companies consist of local private investors that were the original founders of the assets.

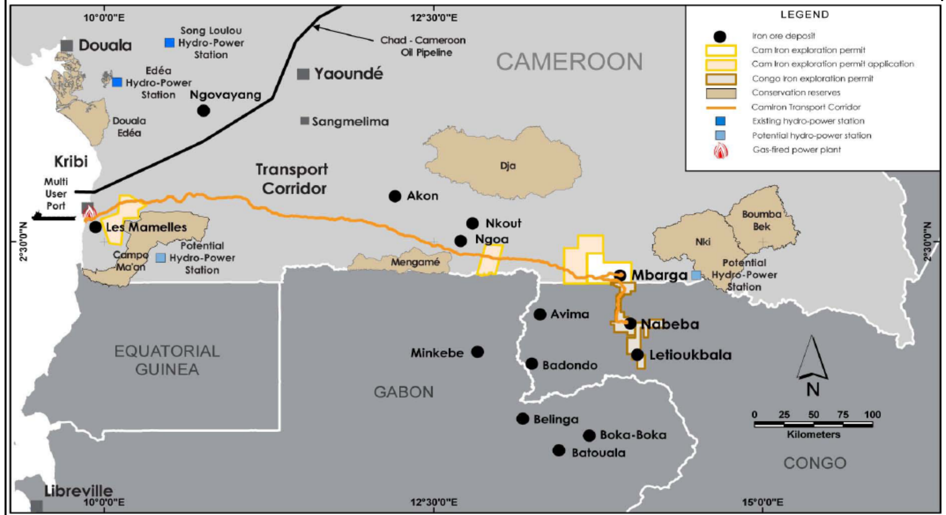
In both countries, the government has a right to a 10% "free carry" interest in SDL's projects under their respective mining codes. Assuming the two governments exercise their options, SDL's pro forma ownership will fall to 81% of Mbarga and 76.5% of Nabena.

We see this structure as a positive for the deal. Cameroon and the RoC have already adjusted their mining codes to ensure they receive some of the benefits from the mining industry. Therefore, there should not be any major surprises when it comes to newsflow from the government. As we have seen with the EXT situation, there is a risk of "nationalisation" headlines when the local government has yet to take stakes in its projects. But with SDL, this has already happened and therefore we do not expect any major negative headlines from the governments during the deal.

Overview of Hanlong

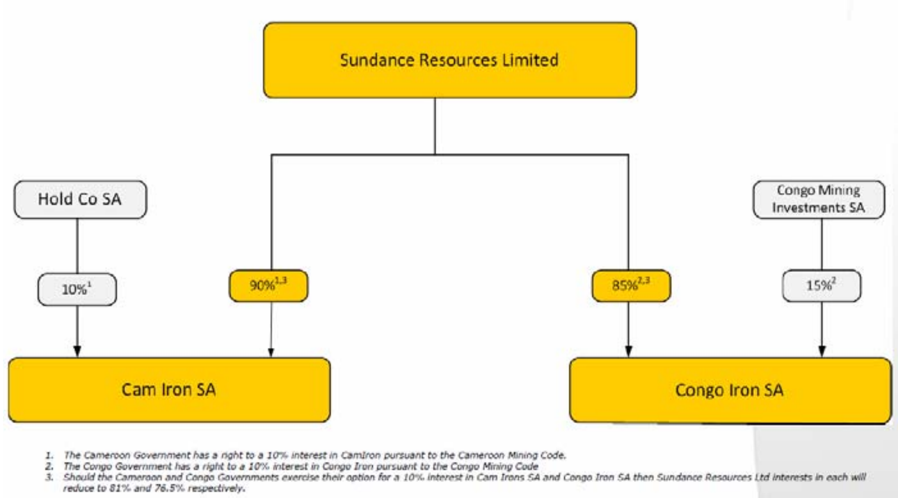
Sichuan Hanlong Group is a large privately held Chinese company with a portfolio of investments including mining resources development, electricity production, infrastructure development, pharmaceutical production, food and alcoholic beverages, real estate development, environmental technology, tourism development and high tech industries. The company has total assets exceeding 36 billion yuan (US$5.6bn) and annual sales revenues of over 16 billion yuan (US$2.5bn). Within Hanlong Group are two listed companies, Hongda Group, listed on the Shanghai stock exchange with a market capitalisation of 16.7 billion RMB (USD2.45 billion) and Jinlu Group, which is listed on the Shenzhen stock exchange with a market capitalisation of 3 billion RMB.

Chart 1 – Mbalam project geographical location



Source: SDL Investor Presentation, May 2011

Chart 2 – Asset ownership structure



Source: SDL Investor Presentation, April 2011

Hanlong Group's overseas interests are solely in the mining resources sector. These interests include:

- 18.6% of SDL
- 57% of Moly Mines (MOL AU) – Explores for molybdenum and copper in Australia
- 11.5% of Marenica Energy (MEY AU) – Uranium explorer in Namibia and WA
- 12.5% of General Moly Inc (GMO US) – Develops, explores and mines molybdenum in the US

Within China, Hanlong owns listed investments in:

- 4.6% of Sichuan Jinlu (000510 CH) – Manufactures and markets polyvinyl chloride resins, caustic soda, and other chemical products.
- 1.1% of Atlantic China Welding (600558 CH) – Manufactures and markets welding rods, wires, and liquid. Through its subsidiaries, the company also operates in food processing.

Hanlong also announced a (A$143m) change of control proposal for Namibian uranium player, BMN, last week.

Hanlong's most significant investment in Australia is its controlling stake in MOL. On 19 October 2009, MOL announced that it had entered into a subscription agreement with Hanlong under which Hanlong will:

- provide US$200m in equity and debt funding to MOL; and
- commit to provide or arrange US$500m debt funding for the 10mtpa Spinifex Ridge Molybdenum/Copper Project.

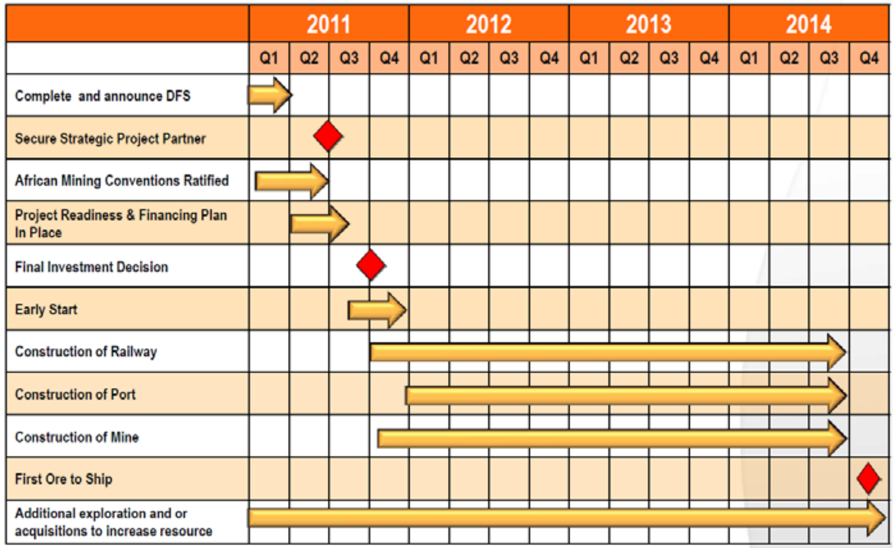
The following is the timetable that the deal was completed on:

- 19 October 2009 – Signing of the subscription agreement
- 18 November 2009 – FIRB approval
- 22 January 2010 – NDRC approval
- 28 January 2010 – Ministry of Commerce approval
- 15 March 2010 – State Administration of Foreign Exchange approval

Therefore, it took nearly 5 months for Hanlong to gain Chinese approvals in order to complete its deal with MOL. This is longer than the normal deal timeframe of ~3.5 months. However this could have been due to the deal running over the Chinese New Year.

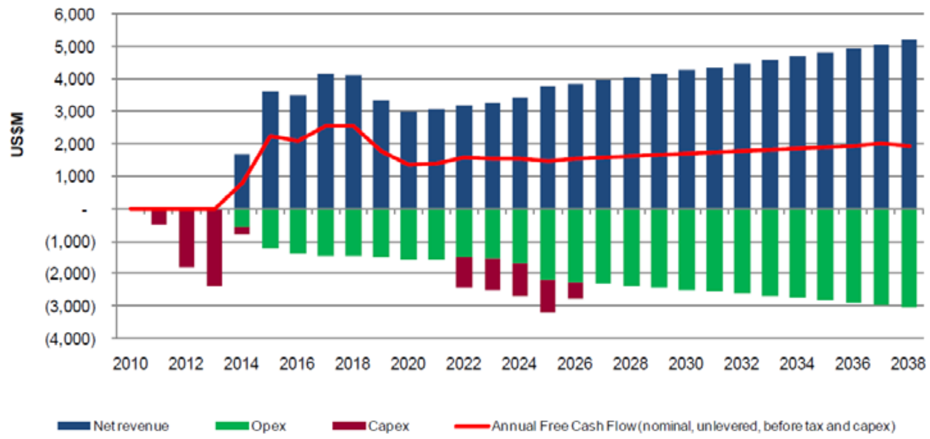
With regards to Hanlong's role with SDL, it first acquired its 18.6% stake in March this year. It accumulated ~3% on-market on the days leading up to a large line of ~15% which it bought from the Talbot Group. The average entry price of these transactions was 44.7c.

Chart 3 – Project timeline



Source: SDL Investor Presentation, May 2011

Chart 4 – Capex payback



Source: SDL Investor Presentation, May 2011

Hanlong's attempts to acquire SDL and BMN are part of its international expansion strategy. In November 2010, Hanlong signed a co-operation agreement with the Export-Import Bank of China to provide Hanlong with loans of up to US$1.5bn to fund its overseas expansion.

Overview of West African iron ore region

West Africa is quickly being considered one of the next major iron ore provinces in the world. As shown in chart 5, the geological characteristics of the iron ore are similar to that of South America due to the historical continental drift theory. Due to the large potential ore deposits, there is now significant interest in the region by all of the majors. As shown in chart 6, nearly all of the iron ore majors have secured projects (BHP, RIO, Vale). Xstrata has also been highly active in the region as it attempts to aggressively grow its iron ore operations.

The following are some major deals that have been signed over the past 18 months:

- Xstrata's US$100m 50% investment in the Zanaga Iron Ore project in the Republic of Congo.
- Shandong Iron and Steel's US$1.5bn 25% investment in African Minerals' Tonkolli project in Sierra Leone
- China International Funds's US$2.7bn 50% investment in Bellzone's Kalia project in Guinea
- Xstrata's US$523m 100% takeover of Sphere Minerals
- Vale's US$2.5bn 51% investment in BSG Resources' Simandou project in Guinea
- Chinalco's US$1.4bn 45% investment in RIO's Simandou project in Guinea

Republic of Congo

The current government has been in power since 1999 and in 2009 was re-elected for another 7 years. In 2005, the government introduced a Mining Code which led to a 3% royalty on revenues and a 10% "free carry" stake in assets once a mining lease has been issued. Currently, Total, ENI, Chevron and Xstrata have projects in the country.

Cameroon

Compared to other African countries, Cameroon has relatively high political and social stability. Since 1982, power has lied with an authoritarian president, Paul Biya, and his Cameroon People's Democratic Movement party. The last parliamentary elections were held on 22 July 2007.

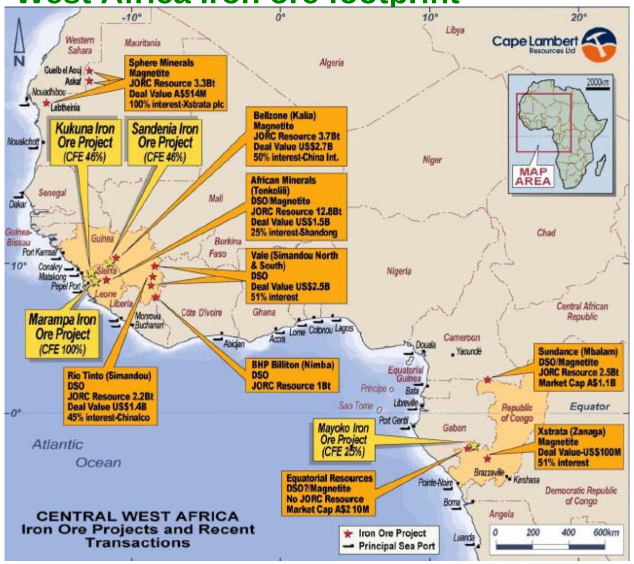
Current JV sale process

On 5 November 2010, SDL announced that it had appointed CITIC Securities to assist in securing both debt and equity funding in China. The capex requirement for stage 1 of the project is US$4.7bn of which CITIC would assist in finding a partner for. This led to a data room process for a number of parties in order for SDL to determine who, and at what price, it will sell a 50% (or less) stake to.

Chart 5 – Continental drift

Source: EQX Investor Presentation, June 2011

Chart 6 – West Africa iron ore footprint



Source: CFE Investor Presentation, July 2011

Once a stake of up to 50% is sold, SDL is hoping to be in a position to use the cash proceeds to fund its share of the remaining capex bill. This share could be funded through equity (~70%) and debt (~30%), from our understanding.

But the issue with this strategy is that the project NPV is ~US$4bn. Therefore, in our view, it was always going to be difficult to find a partner that is willing to pay ~US$2bn for a 50% stake when it could acquire 100% of SDL for much less.

This is the reason we believe Hanlong made an offer. It realises that SDL is trading at a significant discount to its NPV and therefore it has decided to acquire 100% of the company. To demonstrate how cheap SDL seems, using a LT iron ore price of US$100/tn would lead to EBITDA of ~US$2.8bn at 35mtpa. This was significantly larger than the pre-bid market cap of ~US$1bn. It also leads to a very quick capex payback period of ~3 years (using management's assumptions).

SDL has made two recent updates on its sell down process. On 23 May, SDL's CEO stated, *"We've actually had a player come back into the fold… It's one of the big guys that had sat on the edge before so we've actually got more now than we had two months ago. It was four at one stage; it went to three and now it's five. That's just the Chinese. We still have a couple of parties outside of China… I still want to make a decision by June 30, but only if we've been through the right amount of due diligence… This big guy's just joined in. They're doing all the rights things to get done be around that time. But if they don't, I'm not going to cut it off on June 30 just to make an announcement."*

On 29 June, SDL stated that it had short listed preferred potential partners and had entered into commercial negotiations.

Hanlong's offer has come while SDL was in negotiations with potential partners. Therefore, there are a number of parties that have had due diligence access that may decide to counter bid because a JV agreement may not be possible anymore.

Transaction comps analysis

Due to the large low grade itabirite resource base (that accompanies the high grade hematite cap), it is important to analyse SDL's transaction comp on a Fe unit basis. When adjusting its resources for the average grade of 40.6% (61.4% for hematite and 38% for itabirite), the deal was struck at US$1.33/tn of resource. This is in line with other stranded iron ore transactions involving the Chinese:

- Wah Nam acquisition of BRM – US$1.35/tn
- Wah Nam acquisition of FRS – US$1.39/tn (failed deal)

Table 1 – Stage 1 capex break-down

CAPEX[1]	*US$M*
Mining, Processing and Infrastructure	914
Rail	2,019
Port	537
Subtotal	3,471
EPCM, Owners Costs and Contingency	1,214
Total (US$M, real as at December 2010)	4,686

Source: SDL Investor Presentation, May 2011

Table 2 – Stage 2 capex break down

CAPEX[1]	*US$M*
Beneficiation	1,908
Pellet Plant	400
Subtotal of direct costs	2,308
EPCM, Owners Costs and Contingency	835
Total	**3,143**

Source: SDL Investor Presentation, May 2011

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Chances of a bump

We believe there is a high likelihood of a bump in the range of 5-10%. Hanlong's 50c/share offer seems to be its first offer to start negotiations. Now that SDL has commenced talks with Hanlong, we believe there is potential for a bump in order to obtain a Board recommendation. The first offer is rarely the last offer for any bidder.

From a valuation perspective, Hanlong clearly believes that it can commercialise the asset and therefore a takeover of SDL at these levels would seem cheap. As we discussed earlier, this project has the ability to produce US$2.7bn of EBITDA using a US$100/tn LT iron ore price (spot is US$174/tn).

Chances of a counter offer

We believe that there is a reasonable chance of a counter bid for SDL. All of the iron ore majors have been dominating West Africa and they would most likely want to ensure that the Chinese do not acquire alternative supply. SDL is planning on producing 35mtpa over 25 years and therefore is considered a sizeable project. We would not be surprised if the likes of RIO, Vale and/or Xstrata made a bid. While BHP is a possibility we doubt that SDL will be considered a tier 1 asset in its eyes. BHP typically looks for much larger scale.

Out of the majors, we see Xstrata as having the highest chance of bidding. Xstrata has clearly stated that it wants to expand its iron ore presence. In February 2011, when it exercised its right to buy 50% of the Zanaga project in the RoC, it stated, *"Xstrata's decision to exercise its call option underscores its long stated strategy to enter the iron ore market. Xstrata has assembled an iron ore team, which is currently managed through Xstrata Coal. Taking the Zanaga Project with the projects acquired as part of Sphere Minerals, Xstrata has to date secured control of a resource base of more than 7 billion tonnes of iron ore."*

Like SDL, Xstrata also operates in the RoC and therefore should be comfortable with the country risk.

While Chinese interlopers are a possibility, the chances of this could be lower due to Hanlong already making a bid. Hanlong is a privately owned Chinese entity.

Conclusion

SDL's Mbalam project is highly attractive. It is located in a region where the majors have been accumulating assets using significant levels of capital. SDL has scale with potentially 35mtpa and it has a long life of ~25 years. The pre-bid market cap was not reflecting a high chance of delivering this project due to the large capital requirements.

While there is risk around Hanlong finalising a formal offer, we believe the next event in this deal is whether it bumps the offer price, or walks away. We believe there is a 90% chance that Hanlong bumps its offer price ~10% in order to gain a Board recommendation. It is very rare to see a bidder not bump its first offer price. We also believe there is a 10% chance that Hanlong walks away due to failure to gain SDL's recommendation. Under this scenario, we assume SDL falls to ~40c per share. While the share price rose rapidly to this level leading up to the bid, we believe the market will see more credibility to the SDL story after this bid. In addition, the market will then wait for the asset sell-down catalyst that should not be too far away. As asset sell down will be considered highly positive because it de-risks the project materially.

Based on this probability weighted scenario analysis, we believe SDL should be trading at 50.5c per share – 3% higher than the current price. Therefore, we would BUY SDL up to this level in anticipation of a bump to 55c.

Appendix

Trade Ideas Performance

Open Positions

Stock	Position	Entry Date	Position Size	Entry Price	Current Price	Dividends	Absolute Return	Annualised Return
CSL	Long	17 February 2011	100%	$35.72	$32.82	$0.35	(7.1%)	(17.1%)
SPT	Long	13 May 2011	100%	$2.31	$2.17		(6.1%)	(32.8%)
FMG/RIO	Long FMG / Short RIO	7 June 2011	100%	$6.225 / $79.2	$6.4 / $81.6		(0.2%)	(1.9%)
BXB	Short	22 June 2011	100%	$7.19	$7.01		2.5%	33.4%
EGP/CWN	Long EGP / Short CWN	23 June 2011	100%	$4.16 / $8.65	$3.97 / $8.57		(3.6%)	(50.4%)
CHC	Long	24 June 2011	100%	$2.11	$2.16		2.4%	34.1%
TWE	Short	5 July 2011	100%	$3.58	$3.38		5.6%	141.7%
QRN	Short	13 July 2011	100%	$3.37	$3.36		0.4%	23.7%

Closed Ideas

							Total Returns	
Stock	Position / Exit Date	Entry Date	Position	Entry	Exit	Dividends	Absolute	Annualised
CRG/FBU	Long CRG / Short FBU / 31 January 2011	6 January 2011	100%	$8.88 / $5.85	$9.47 / $5.99		4.3%	62.1%
AXA	Long / 8 February 2011	6 January 2011	100%	$6.19	$6.44		4.0%	44.7%
LEI	Short / 14 February 2011	11 February 2011	100%	$30.91	$30.39		1.7%	204.7%
BBG	Short / 18 February 2011	7 February 2011	100%	$8.28	$8.54		(3.1%)	(104.2%)
UGL	Short / 21 February 2011	7 February 2011	100%	$15.44	$15.40		0.3%	6.8%
CBA/ANZ	Long CBA / Short ANZ	13 January 2011	100%	$51.3 / $23.05	$53.85 / $24.69		0.4%	4.0%
WOR	Short / 23 February 2011	21 February 2011	100%	$28.66	$28.20		1.6%	292.9%
ALL	Long / 24 Febaruay 2011	21 February 2011	100%	$3.06	$3.32		8.5%	1033.8%
IIF	Long / 3 March 2011	6 January 2011	100%	$0.53	$0.53		1.2%	7.5%
SPI Futures / AMP	Long SPI Futures / Short AMP / 16 March 2011	6 January 2011	100%	$4725 / $5.22	$4558 / $5.25		(7.0%)	(36.9%)
BLD	Short / 16 March 2011	6 January 2011	100%	$4.83	$4.97	$0.08	(4.5%)	(23.5%)
DOW	Short / 16 March 2011	8 March 2011	100%	$3.86	$3.61		6.5%	295.5%
SGX/ASX	Long SGX / Short ASX / 17 March 2011	6 January 2011	100%				2.0%	10.4%
MRU	Long / 22 March 2011	15 March 2011	100%	$7.03	$6.69		(4.8%)	(248.7%)
EQN	Long / 24 March 2011	23 March 2011	100%	$5.09	$5.33		4.7%	1721.0%
CRG/FBU	Long CRG / Short FBU / 24 March 2011	25 February 2011	100%	$9.64 / $6.37	$10.14 / $6.64		1.6%	22.0%
FGL	Long / 25 March 2011	15 March 2011	100%	$5.45	$5.72		5.0%	180.8%
AQA/AZT/MCC	Long AQA / Long AZT / Short MCC / 28 March 2011	6 January 2011	100%				6.8%	30.8%
TAH/CWN	Long TAH / Short CWN / 28 March 2011	6 January 2011	100%	$7.1 / $8.29	$7.44 / $7.89		13.0%	58.6%
QRN	Short / 28 March 2011	6 January 2011	100%	$2.77	$3.25		(17.3%)	(78.1%)
BTU/COK/MCC	Long BTU / Long COK / Short MCC / 28 March 2011	28 January 2011	100%				7.5%	46.2%
NCM	Long / 28 March 2011	17 March 2011	100%	$35.37	$40.41		14.2%	472.8%
WPL	Short / 12 April 2011	6 January 2011	100%	$42.86	$47.15	$0.55	(11.3%)	(42.9%)
EXT/ERA	Long EXT / Short ERA / 29 April 2011	7 March 2011	100%	$9.825 / $8.4	$7.28 / $5.28		11.2%	77.4%
MGR	Long / 5 May 2011	10 January 2011	100%	$1.24	$1.19	$0.02	(2.4%)	(7.7%)
ASX	Short / 5 May 2011	14 April 2011	100%	$32.86	$31.14		5.2%	91.0%
LEI	Short / 5 May 2011	15 April 2011	100%	$24.65	$23.74		3.7%	67.4%
TAL	Long / 9 May 2011	6 January 2011	100%	$3.89	$4.00		2.8%	8.4%
EXT/ERA	Long EXT / Short ERA / 18 May 2011	11 May 2011	100%	$7.23 / $5.03	$7.2 / $4.815		3.9%	201.2%
IOF	Long / 24 May 2011	29 March 2011	100%	$0.59	$0.62		3.7%	24.4%
MGR/LLC	Long MGR / Short LLC / 24 May 2011	17 May 2011	100%	$1.22 / $8.54	$1.258 / $8.4		4.8%	247.9%
DOW	Short / 24 May 2011	20 May 2011	100%	$3.93	$3.66		6.9%	626.9%
AMP	Long / 6 June 2011	22 March 2011	100%	$5.36	$4.98		(7.1%)	(34.0%)
EQN	Long / 6 June 2011	4 April 2011	100%	$7.57	$8.15		7.7%	44.7%
MRU	Long / 6 June 2011	12 May 2011	100%	$6.84	$7.02		2.6%	38.4%
AZT/WHC	Long AZT / Short WHC / 6 June 2011	16 May 2011	100%	$9.04 / $5.63	$9.97 / $5.38		14.7%	256.0%
FGL	Long / 20 June 2011	14 June 2011	100%	$4.64	$4.55		(1.9%)	(118.0%)
STO/ESG	Long STO / Long ESG / 23 June 2011	6 January 2011	100%				(3.7%)	(6.9%)
GNC	Long / 23 June 2011	6 January 2011	100%	$7.12	$8.43		18.4%	34.5%
SWM/TEN/FXJ	Long SWM / Short TEN / Short FXJ / 23 June 2011	24 May 2011	100%				10.0%	64.9%
LYC	Long / 13 July 2011	6 January 2011	100%	$2.12	$1.97		(7.1%)	(13.3%)
SDL/GBG	Long SDL / Short GBG / 11 July 2011	23 May 2011	100%	$0.357364 / $0.953169	$0.35 / $0.81		13.0%	82.4%
DLX	Short / 11 July 2011	10 June 2011	100%	$2.83	$2.69		4.9%	45.8%
CQO	Short / 11 July 2011	10 June 2011	100%	$3.62	$3.42		5.5%	51.2%