AUSTRALIAN RESEARCH
INDEPENDENT INVESTMENT RESEARCH

Allegiance Coal (ASX:AHQ)

Update - December 2018

INDEPENDENT INVESTMENT RESEARCH

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Allegiance Coal (ASX: AHQ)

Update - December 2018

Note: This report is based on information provided by the company as at December 12, 2018

Investment Profile	
Share Price - Dec 11, 2018	A$0.051
Base case valuation	A$0.396/share
Issued Capital:	
Ordinary Shares	510.0m
Unlisted Options	14.1m
Fully Diluted	524.1m
Market Capitalisation	$26.01m
12 month L/H	A$0.03/$0.08
Cash, September 30, 2018	A$3.32 million
Initial Itochu Payment	~A1.54 million
Debt	A$0.6 million

Board and Management
Mr David Fawcett: Non-Executive Chairman
Mr Mark Gray: Managing Director
Mr Malcolm Carson: Non-Executive Director
Mr Jonathan Reynolds: Finance Director
Mr Dan Farmer: Chief Mining Engineer
Mrs Angela Waterman: Environment & Government Relations

Major Shareholders	
Altius Resources Inc	10.92%
Maguire Family	5.47%
John Ashton	4.92%
Doug Gray	4.92%
Monaco Family Office	4.82%
Bernard Laverty	4.80%
Mark Gray	4.70%
Board and Management	6.10%

Price Chart

Senior Analyst – Mark Gordon

The investment opinion in this report is current as at the date of publication. Investors and advisers should be aware that over time the circumstances of the issuer and/or product may change which may affect our investment opinion.

DFS DUE EARLY 2019, PARTNERED WITH ITOCHU

Subsequent to our March 2018 update, Allegiance Coal ("Allegiance" or "the Company") has made major progress on key fronts on its Tenas Coking Coal Project ("Tenas" or "the Project"), located just 375km by rail from the under-utilised Ridley Island Coal Terminal ("RICT") in northwestern British Columbia, Canada.

To reiterate, Tenas has the potential to produce mid-volatile, semi-soft coking ("SSCC") or PCI coal at FOB costs in the lower 5% of the global sea-borne trade with resultant robust returns from the Project. This is by virtue of the low strip ratio and access to infrastructure; the Project has ready access to power and transport, including being just 24km from the Canadian National Rail ("CNR"), which links directly to the RICT.

The Company is currently undertaking a definitive feasibility study ("DFS") which is expected to be completed in Q1, CY19; this is predicated on a 20 year mine life producing 750,000 tpa of clean product with a low estimated up-front capital cost of US$70 million and operating costs in the order of US$55/tonne saleable product. The production profile has changed from those as presented in previous studies, largely due to the requirement to complete a comprehensive permitting process. Given this permitting requirement it was decided to go with a larger up-front production, however the expected commencement of production is now in 2022.

A key milestone has been entering into a contributing joint venture ("JV") with Itochu Trading Company of Japan ("Itochu"), a major global commodities trader and a Fortune 500 company. The first stage of the two stage earn-in includes Itochu paying staged payments totalling C$6.6 million for 20% of the Project, and then having the right to earn up to a further 30% equity at the Project level through a consideration based upon a valuation for Tenas based on all permits to operate being in place.

Benefits flowing from this agreement include that the Company will likely now be fully funded through to production, without the need to raise equity (and hence dilute shareholders) to fund their share of the up-front capital and pre-development costs. The association with Itochu (who will have the coal marketing rights) will also provide access to potential offtake partners and Japanese banks.

Coal quality test work has confirmed the suitability of the Tenas coal for the sea-borne mid-volatile SSCC and PCI markets, with this supported by tests carried out by a number of north Asian steel mills, with interest now being shown for offtake.

Key milestones over the short to medium term include completion of the DFS, finalisation of offtake and financing and successful permitting.

KEY POINTS

Funded through to production: The JV with Itochu, dependent upon the Stage 2 stake, means that Allegiance should be fully funded through to production - the upshot of this is that there should be no more (or only limited) dilution of shareholders.

Community relations: The Managing Director, Mark Gray, has relocated to Telkwa, which should prove invaluable in forming and nurturing strong community relations.

Potential for a niche product: The potential Tenas product is such that may be in demand to fill a niche market as a blending metallurgical coal, and thus attract a premium over other SSCC products.

Steady news flow: The ongoing activities should result in ongoing positive news flow over the short to medium term.

VALUATION SUMMARY

We have updated our valuation for Telkwa, with the total risked company value increasing from A$125.2 million to A$207 million. This results in a risked, base case diluted per share valuation of A$0.396/share, up from A$0.326/share. However, given that our current valuation is financed and post tax, and also has Itochu as a JV partner, the previous and current valuations cannot be directly compared. This valuation is also based on assumptions regarding Itochu's final Project stake and the price paid for that.

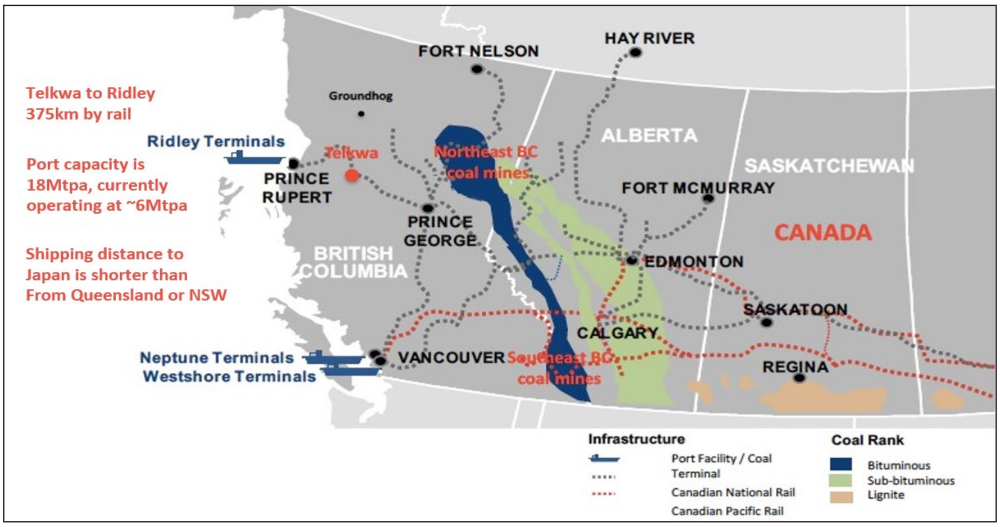
There is upside by virtue of the potential for future expansions (dependent upon the approval of all stakeholders) of an already very robust project - this upside has been demonstrated by the results of the staged PFS as released to the market in July 2017, and would only require minor additional up-front capital expenditure due to the use of a modular coal preparation plant and leasing of mobile equipment.

We would expect share price catalysts to be the completion of, and positive results from the DFS and material progress on offtake, financing and permitting.

ACTIVITIES UPDATE

- This report presents an update to our initiation report published in September 2017 and March 2018 update report - both reports are available on IIR's (www.independentresearch.com.au) or the Company's (www.allegiancecoal.com.au) websites, with the initiation report providing a full description of the Tenas Coking Coal Project (Figure 1) as of the report date.
- Activities have been focussed on advancing Tenas (with the Company making significant progress in the two years since acquisition), with the aim to commence production in 2022, with this timing largely dependent upon permitting.

Figure 1: Telkwa location map



Source: Allegiance

- Key activities and milestones, concentrating on the DFS, permitting and financing, completed since March have included:
  - A partnership agreement with major Japanese trader, Itochu,
  - Drilling (eight diamond, 14 rotary and 12 sonic geotechnical holes),
  - Geological reinterpretation and Resource update of the Tenas deposit, resulting in a significant decrease in the strip ratio through a reduction in waste,
  - Completion of coal quality test work (including the first coke oven test on coal from the property), with this showing the suitability of the product as a PCI or niche SSCC blend product - this included testing by three North Asian steel mills,
  - Change of the Project scope to 750 ktpa saleable coal, replacing the original 250 ktpa "small mine" start up scenario, with this revised scenario to be used in the DFS expected for completion in Q1, CY19,
  - Appointment of SRK as lead DFS consultant - this follows on from SRK leading the two previous pre-feasibility studies,
  - Ongoing baseline environmental studies, due for completion by the end of 2018,
  - Continuing engagement with stakeholders; and,
  - Formal commencement of the environmental assessment and permitting process.
- The Company raised A$6.4 million before costs in two placements, including one of A$3.97 million at A$0.05/share in the March 2018 quarter and A$2.4 million at A$0.052/share in September 2018.
- These funds, in combination with C$6.6 million in funds due over coming months from the partnership with Itochu (discussed below) should be sufficient to cover commitments through to a decision to mine and the development funding.
- On the management front, Mr Mark Gray, the Managing Director, has relocated to Telkwa, with Mr David Fawcett assuming the role of Non-Executive Chairman.

ITOCHU JOINT VENTURE AGREEMENT

- As announced to the market on November 5, 2018, Allegiance and Itochu have signed a JV agreement, whereby Itochu can acquire up to 50% of the shares of Telkwa Coal Limited ("TCL," the subsidiary that owns 100% of Tenas), with proceeds from the share subscription expected to fund Allegiance's share of the capex equity.

- The agreement comprises two parts; the first stage includes the acquisition of 20% of the Project through staged payments totalling C$6.6 million (~A$6.8 million) through to completion of permitting, with Stage 2 giving Itochu the right, following the granting of permits to mine, to invest in up to a maximum of 50% of the issued shares in TCL.
- The Stage 1 payments assign an EV of A$33 million or A$0.068/share to the Project, which at the time represented a considerable premium to the then share price of A$0.05/share.
- The Stage 1 payments include:
  - C$1.5 million for a 5.3% interest in TCL, following the issue of a section 10 order under the Environmental Assessment Act of British Columbia (which formally acknowledges the Tenas Project has been accepted for environmental review and permitting), with this being received in mid-November 2018,
  - C$1.5 million for a further 4.8% interest in TCL, following completion of a positive Tenas DFS, targeted for completion in Q1 2019, subject to Itochu's approval at the time; and,
  - C$3.6 million for a further 9.9% interest in TCL, following lodgement of an application for an Environmental Assessment Certificate, targeted for Q3 2019, subject to Itochu's approval at the time.
- Also, as part of the Stage 1 investment, Itochu shall have the right to appoint two directors to the board of TCL (one of who will be the Marketing Director), with Allegiance having the right to appoint three directors.
- Itochu will also be granted all marketing rights to coal produced from the Project.
- Stage 2 allows for Itochu to acquire, through additional investment in TCL, up to a maximum of 50% of the ordinary shares of TCL.
- The investment will be based on a "post permit to mine" valuation, with the size and value of the investment to be discussed following completion of the DFS and prior to the completion of permitting.
- We are of the view that the Stage 2 investment should be at least of such an amount to cover Allegiance's expected equity contribution to the initial capital expenditure; in addition Itochu will prove invaluable in attracting the required debt financing.
- The Company has provided guidance that the expected up-front capital requirement for the 750 ktpa scenario is US$70 million; the conceptual funding structure is US$25 million in equity, US$25 million in debt and US$20 million in equipment leasing.
- Itochu is a major Japanese commodity trading house and one of the largest globally, ranked at 204 on the Fortune 500 list.

Existing Altius Agreement Conditions

- The Itochu agreement does not negate the terms of the existing agreement with Altius Resources, with these including performance payments and royalties on production.
- These milestone obligations and payments are summarised in Table 1.

Table 1: Telkwa farm-in obligations

Telkwa farm-in obligations		
	Milestone	**Status, Obligation**
1	Deliver NI 43-101 JORC compliant report	Completed
	Complete internal scoping studies	Completed
	Up-grade geo-model to a PFS standard	Completed
	Incur C$1M of expenditure	Pay C$200k for 20% project equity - Completed through issue of shares
2	Complete baseline studies	
	Complete affected party agreements	
	File small mine permit applications	Pay C$300k, however small mine application requirement now negated by decision to go to a 750ktpa operation
3	Grant of small mine permits	Pay C$500k, now negated
4	Sale of 100k tonnes from a small mine	Pay C$2M, now negated
5	Grant of major mine permits	Pay C$2M, expected late 2020
6	Sale of 500k tonnes from a major mine	Pay C$5M, expected early 2022

Source: Allegiance

- The following gross sales royalties payable to Altius remain:
  - 3.0% where the thermal benchmark coal price is less than US$100/tonne,
  - 3.5% where the price is US$100 - US$109.99/tonne,
  - 4.0% where the price is US$110 - US$119.99/tonne, and,
  - 4.5% where the price is US$120/tonne or greater.

TECHNICAL ACTIVITIES

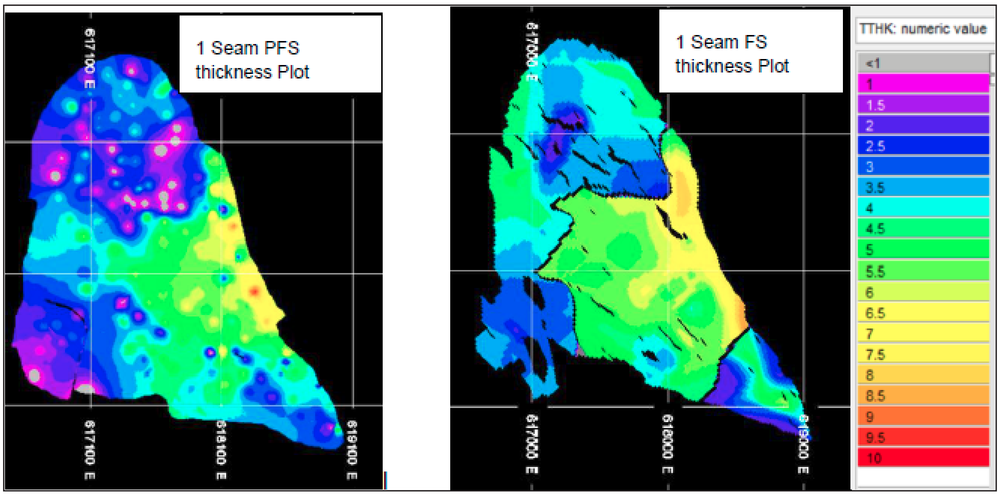
Drilling

- Key technical activities have followed on from the drilling programme completed in March, 2018, with the drilling including the following:
  - Eight PQ diamond core holes: three for the installation of water monitoring wells and five for rock samples to support geochemical studies;
  - 12 sonic geotechnical holes to gather data to support the feasibility study; and
  - 14, 150mm core drill holes, recovering 1,400 kilograms of coal for coke oven tests by the Company and four Asian steel mills.
- The results of the drilling were also used in the reinterpretation of the Tenas deposit and an updated Mineral Resource Estimate ("MRE").

Geological Interpretation and MRE Update

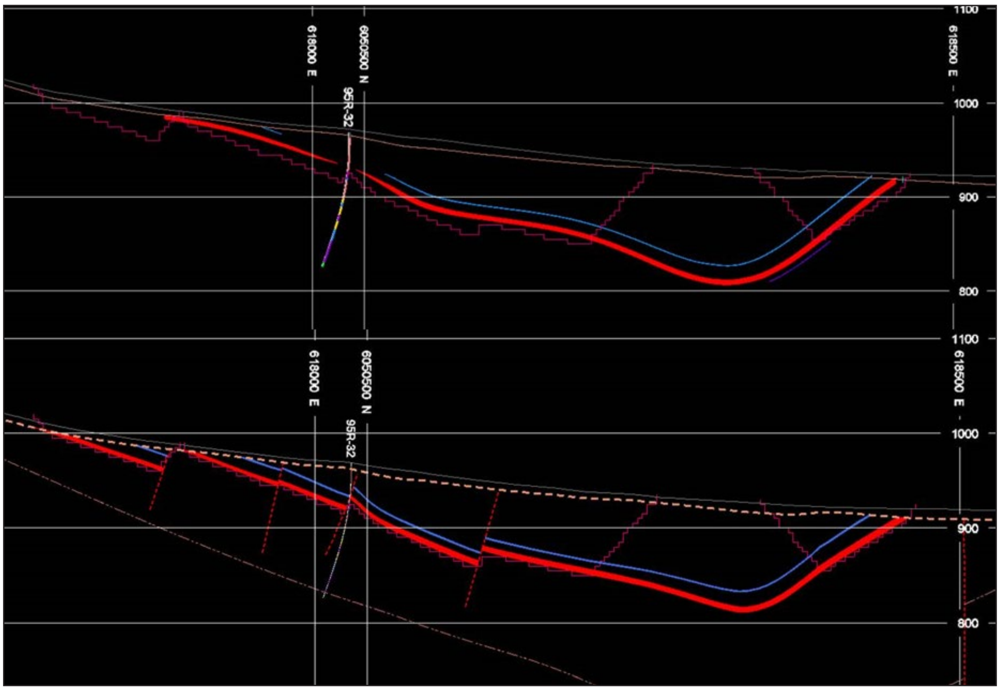
- The reinterpretation of the Tenas deposit included the results of the recent drilling, as well as the inclusion of historical data not included in the geological interpretation used in the two pre-feasibility studies.
- The historical database over the property includes 826 holes for 91,000m dating from 1979, including work completed by Shell and Manalta Coal.
- A key difference in the recent model is the inclusion of 34 faults, with previous modelling generally presenting an unfaulted deposit.
- The previous interpretation had also resulted in what were considered unrealistic thinning and thickening of individual coal seams/plies - this has been removed by the reinterpretation.
- More significantly, the reinterpretation has decreased the amount of waste material through the uplifting of some fault blocks, thus decreasing the expected strip ratio - one of the major costs in any coal mining project is waste removal, and thus significant decreases in the strip ratio will significantly decrease operating and capital costs.
- Differences are shown in Figure 2 (1 Seam thickness plan) and Figure 3 (Section 3625).
- Average seam widths are C (1.6m), IU (2m) and C (3.6m).

Figure 2: 1 seam interpretations - PFS (left) and current (right)



Source: Allegiance

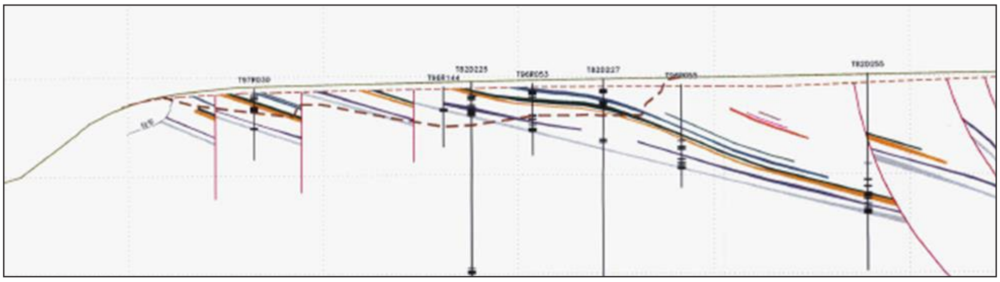
Figure 3: Tenas section 3625, showing PFS interpretation (top) and current interpretation (bottom)



Source: Allegiance

- Interestingly, the original interpretations for Tenas were carried out by a different group than those for Goathorn and Tenas North - the interpretations for the latter had included faulting with one section for Goathorn shown in Figure 4.

Figure 4: Goathorn cross section



Source: Allegiance

- As mentioned previously, the results of the reinterpretation have been used in a revised MRE for Tenas, and thus for the Project overall (Table 2).

Table 2: Telkwa updated MRE

Telkwa Updated MRE				
Coal Resource Deposits	**Measured Mt**	**Indicated Mt**	**Inferred Mt**	**Total Mt**
Tenas	27.1	9.4	-	36.5
Tenas Previous	*58.8*	-	-	*58.8*
Goathorn	59.5	9.2	0.2	68.9
Telkwa North	15.7	3.7	1.0	20.4
Total Telkwa	**102.3**	**22.3**	**1.2**	**125.8**
Tenas Coal Resource	**Measured Mt**	**Indicated Mt**	**Inferred Mt**	**Total Mt**
C seam	4.5	1.5	-	6.0
1U seam	4.5	1.6	-	6.1
1 seam	18.1	6.3	-	24.3
Total Tenas	**27.1**	**9.4**	**-**	**36.5**

Source: Allegiance

- This reinterpretation has also arisen from the results of the PFS, in that only three (1, 1U and C) seams of the 13 at Tenas were converted to Reserves due to thickness and ash content; as such the restated MRE only includes those three seams, thus decreasing overall Resources, however the Resources contained in the three seams have increased from 30.9 Mt to 36.5 Mt

- The overall decrease in Resources will not negatively affect the Feasibility Study, given the close to 100% conversion of the Tenas Indicated and Measured Resources to Reserves in the PFS, and that it is only the three seams mentioned that were used in those Reserves.
- The MRE update has also resulted in some of the previously Measured Resources being downgraded to Indicated Resources due to the effects of faulting; this again should not have any negative impact on the DFS.

Coal Test work

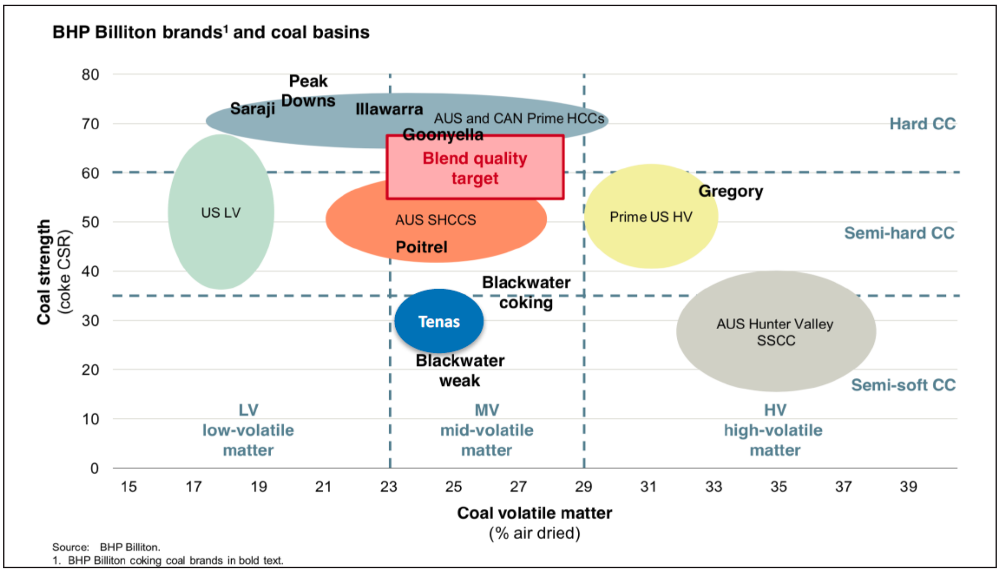
- Coal samples collected during the drilling were sent for test work which initially included:
  - Birtley Coal & Minerals Testing in Calgary, Alberta, for sizing, washability, and comprehensive coal quality analyses; and
  - SGS Mineral Testing in Lakefield, Ontario, to undergo a pilot wash to generate product coal samples for coke oven tests by the Company, and for three steel mills in Japan and one in South Korea.
- The work was carried out on a composite sample collected from eleven of the holes.
- This was followed up by further work, including coke oven tests by the Company and the four steel mills as mentioned in the point above.
- The results of this work as presented in Table 3 and Figure 5 show that the coal is generally suitable for use as a blending mid-volatile SSCC or PCI coal; the main out of specification parameter is the low fluidity, however this will be able to be overcome with appropriate blending at the steel mills, and this is a common and expected characteristic for Canadian coking coals.
- The steel mills have indicated their interest in the coal as either a blending SSCC or PCI product, with one also highlighting the limited supply of similar mid-volatile SSCC in the sea-borne market - as such Tenas has the potential to be the only non-Australian provider of mid-volatile SSCC into the market and as such could be a niche provider commanding premium prices to a market dominated by lower value high volatile SSCC from predominantly the Hunter Valley in New South Wales, Australia.

Table 3: Tenas deposit coal properties (top) and typical specifications (bottom)

Tenas deposit coal properties (top) and typical specifications (bottom)										
Moist.	Ash	VM	Sul	FC	CV	RoMax	Fluid.	FSI	CSR	Phos
%	%	%	%	%	kcal/kg		ddpm			%
1.1	9.4	25.8	0.95	64.1	7,600	0.95	10	3-5	30	0.045
<1 - 4	<12	34	<0.8	>53 for HV SSCC	>7,000 (for PCI)	0.7-1.5	>100 (N/A for PCI)	>3 (N/A for PCI)	See Fig 5	<0.1

Source: Allegiance

Figure 5: Tenas coal quality compared to BHP coals



Source: Allegiance

DFS SCOPE

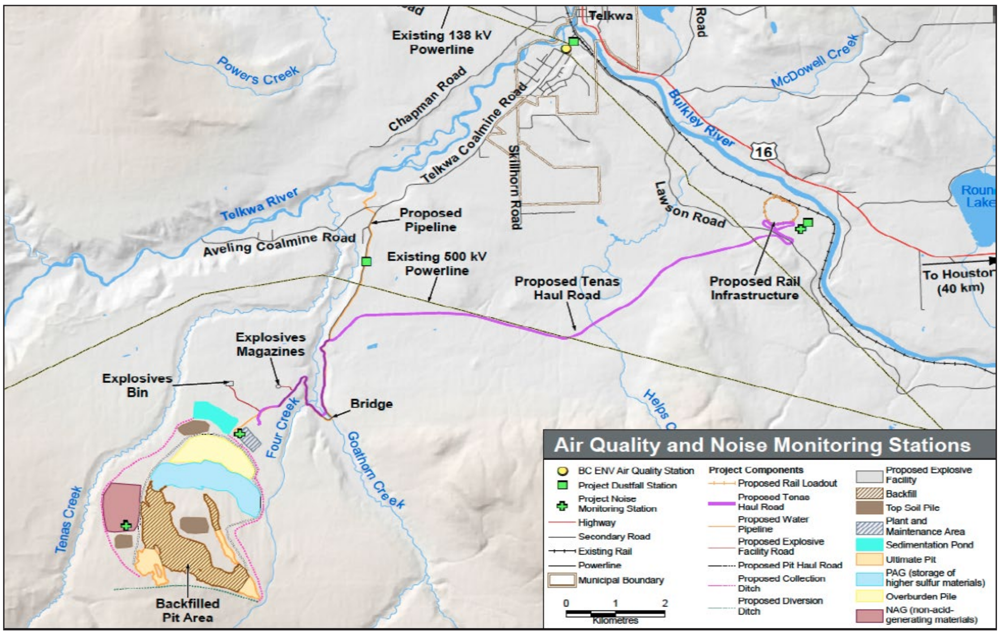
- The results of the work described above have been used in developing the framework for the DFS production scenario as presented in Table 4 - this has been developed in association with SRK, the lead consultants for the study, and Sedgman, the processing engineers; a conceptual site plan is shown in Figure 6.
- Our view is, when compared with and scaled from the results of the previous studies, that the costs appear to reasonable.
- The strategy is to minimise upfront capital costs, and as such the Company will be looking to a two circuit modular coal preparation plant operating at 140 tph which can be upgraded to 190 tph through the addition of a third mid-size circuit at an estimated cost of C$5 million; additional capital cost savings will be through the planned leasing of mobile equipment
- Plant options were selected by Sedgman, with the large mine PFS envisaging a total cost of ~US$30 million for the plant; the initial cost for the DFS scenario is expected to be lower than this.
- A key capital item will be the construction of a rail loop that will accommodate 116 wagon sets - loading is planned to be done by front-end loader - the 750,000tpa production scenario will require 160, 90 metric tonne wagons to be loaded weekly, or approximately three trains every two weeks.
- We have used the following (in association with information presented in the previous development studies) as a guide for our valuation as presented later in this note, however we note that parameters may change as the study progresses.

Table 4: DFS production parameters

DFS production parameters		
Parameter	**Figure**	**Notes**
Clean Coal Production	750 ktpa	
Mine Life	20 years	
Washing yield	74%	To a 9% ash product
Rom Coal Production	1.01 Mtpa	
Strip Ratio	3.8:1	bcm waste:tonnes RoM coal, results in a clean strip ratio of 5.1:1
Initial capex	US$70 million	Estimated US$25 million equity, US$25 million debt and US$20 million equipment leasing
Operating costs	~US$55/tonne FOB	Close to transport infrastructure, including Ridley port and rail - close to the lowest cost seaborne producer globally

Source: Allegiance

Figure 6: Conceptual site plan



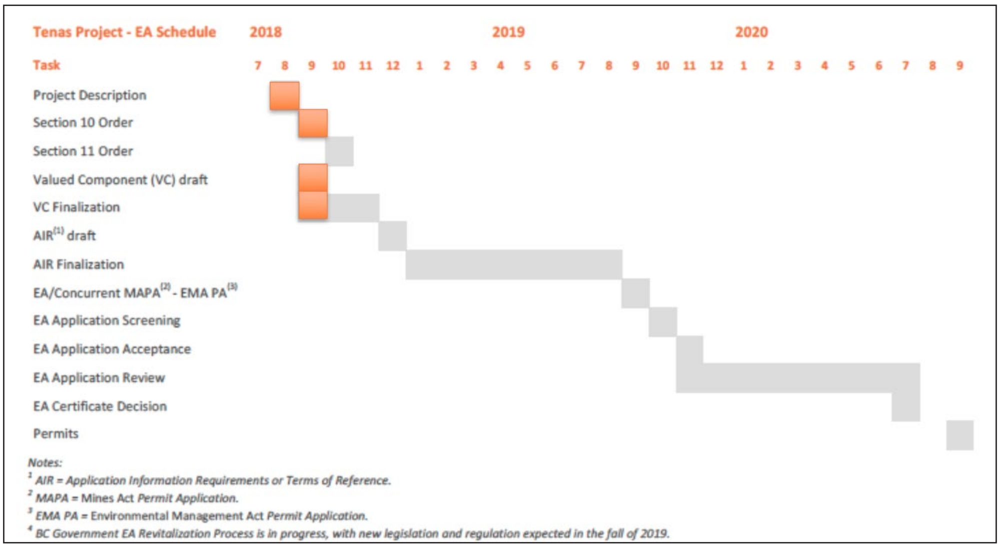
Source: Allegiance

CURRENT AND UPCOMING ACTIVITIES

Permitting and Stakeholder Engagement

- One of the key aspects of the successful development of the Project is permitting (which includes stakeholder engagement) - on the stakeholder engagement side the Managing Director, Mark Gray has relocated to Telkwa, which is proving invaluable in fostering good relationships with the local community.
- Baseline environmental studies are expected to be completed in late 2018 - these form a vital part of the environmental assessment for the Project, with the environmental assessment document expected to be lodged in Q3, CY19.
- It is expected that the total permitting process will take two years from now (Figure 7) - this is now formally in motion with the issue of the "Section 10" order by the Environmental Assessment Office ("EAO") of the Provincial Government of British Columbia.
- One aspect of the permitting process is that timelines are mandated under the applicable legislation, and as such the regulatory authorities are obligated to operate to them.
- Recent years have seen a number coal mines permitted in British Columbia, thus somewhat mitigating the permitting risks.

Figure 7: Permitting time line



Source: Allegiance

Feasibility Study

- Technical and other studies applicable to the DFS are ongoing, with the DFS expected to be completed in Q1, CY19.

Rail and Port Access Negotiations

- Port and rail agreements are yet to be finalised, however early discussions with RICT have indicated that there is ample capacity to handle Tenas coal given it is only 750kctpa, and that bond payments to secure a place in the port will not be required..
- Although Canadian National Rail is a monopoly, the ability for it to charge "monopoly" prices is constrained through legislation, with there also being an arbitration process in place to resolve any disputes during negotiations.
- There is excess coal loading capacity at the RICT, which is also closer to the target North Asian markets than the key Australian east coast ports.

Financing and Offtake

- This work is being carried out in association with Itochu, and form key aspects of the eventual success of the project.
- The response of the North Asian steel mills, in addition to interest shown by independent coke producers, indicates a good potential for offtake agreements to be settled - this is helped by the JV with Itochu.
- Funding should also be eased through the Itochu association - as mentioned earlier we expect that any Stage 2 payment under the agreement should at least more than cover the Company's equity share of the initial capital costs, and that debt funding will be helped by Itochu's relationships with Japanese banks.

VALUATION

Summary

- We have updated our valuation for Allegiance, with a summary presented in Table 5 - we would expect significant share price movements with a positive DFS and material progress in permitting, offtake and financing activities.
- Given the JV with Itochu we have now completed this on an after tax basis using a conceptual funding model and assumed Itochu's final stake and investment in the project:
  - As a base case we have assumed that Itochu's ultimate equity in the Project is determined through the Stage 2 share subscription covering the expected equity portion of the total up-front capex,
  - We have assumed that Itochu's investment is based on 60% of the pre-tax, ungeared project valuation - calculation methods and sensitivity to the final stake and relative valuation is presented in Tables 6 to 8; and,
  - All funds received from Itochu (both Stage 1 and Stage 2) have been "run through" the Tenas DCF model, and hence do not appear as separate items in the NAV.
- Per share values are calculated on the current diluted share structure (523 million shares, does not include November 2018 A$0.2475 options) - the Company's view is that current cash reserves and payments due under Stage 1 of the agreement with Itochu will be sufficient to fund activities through to the completion of permitting, and as such we would therefore not expect any dilution in that period.
- In funding, we have used the scenario as described earlier, including US$25 million in debt (four year term after commencement of production, 7% interest rate), US$25 million equity (with Allegiance's share funded from Itochu payments), and US$20 million in operating lease financing (7% interest rate, repeating 7 year terms with a 30% residual).
- Costs are similar to those used in our previous valuations (and as presented by the Company), and we have used a forward coal price of US$120/tonne, a AUD:USD exchange rate of 0.72 and have assumed that the Canadian and Australian Dollars are at parity.

Table 5: Allegiance valuation summary - A$

Allegiance valuation summary - A$							
Asset	**100% Value**	**Ownership**	**Un-risked Value to AHQ**	**Risk Multiplier**	**Risked Value**	**Risked/ Share**	**Notes**
Tenas After Tax, Funding	A$368.8 m	68%	A$250.3 m	70%	A$175.2 m	A$0.335	NPV_8
Other Coal - M & I	A$504.0 m	68%	A$342.1 m	10%	A$34.2 m	A$0.065	See point below
Head Office After Tax	-A$8.1 m	100%	-A$8.1 m	70%	-A$5.7 m	-A$0.011	A$700k pa NPV_8
Current Cash	A$3.3 m	100%	A$3.3 m	100%	A$3.3 m	A$0.006	Sep 30, 2018
Option Cash	A$0.9 m	100%	A$0.9 m	100%	A$0.9 m	A$0.002	Assume full conversion
Debt	-A$0.6 m	100%	-A$0.6 m	100%	-A$0.6 m	-A$0.001	Sep 30, 2018
Total Value	**A$868.3 m**		**A$587.9 m**		**A$207.4 m**	**A$0.396**	

Source: IIR analysis

- We have valued the Measured and Indicated Resources at Goathorn and Tenas North at A$6.50/tonne - this is calculated from the Tenas NPV per tonne of original Resources (58.8 Mt) - we have used this figure rather than the current MRE on the assumption that current Resources at Goathorn and Tenas North may also include seams that may be excluded from future estimates.
- Table 6 presents our methodology for calculating the Itochu's increased equity in the Project - note that this is conceptual, and the actual figures will probably be different - Itochu may also decide to increase their equity stake through a payment that is greater than that required to fund the capex.
- Also note that we have based the calculations on the un-funded pre-tax valuation - the actual calculations could actually be made using a different basis.

Table 6: Itochu equity calculations

Itochu equity calculations		
Description	**Value**	**Notes**
Initial Ownership	20%	Completion of Stage 1 payments
Stage 2 Payment - Assume Only Fund Equity Portion of Capex	US$25,000,000	
Telkwa Unrisked Valuation - pre tax	US$343,723,052	
Percentage of Full Valuation to Calc Payment	60%	
Valuation for Stage 2 Payment	US$206,233,831	
Stage 2 Payment as percentage of Risked Valuation	12.12%	
Final Itochu Stake	32.12%	
Allegiance Stake	67.88%	

Source: IIR analysis

- Tables 7 and 8 present the sensitivity of various outcomes to changes in key Itochu investment parameters:
  - Table 7 presents the sensitivity of AHQ's ultimate Project ownership share, the unrisked value of the Company's share of the Project and the Company per share valuation to changes in the percentage of the Project valuation used by Itochu; and,
  - Table 8 presents the sensitivity of Allegiance's ultimate Project ownership to changes in capex and the valuation percentage used by Itochu.

Table 7: Sensitivity to changes in percentage of valuation used

Sensitivity to changes in percentage of valuation used			
% of Project Valuation Used	**AHQ Ultimate Ownership**	**Tenas Unrisked Value Due AHQ**	**Company Per Share Valuation**
30%	55.8%	A$205.6 m	A$0.325
40%	61.8%	A$228.0 m	A$0.361
50%	65.5%	A$241.4 m	A$0.382
60%	67.9%	A$250.3 m	A$0.396
70%	69.6%	A$256.7 m	A$0.406
80%	70.9%	A$261.5 m	A$0.414

Source: IIR analysis

Table 8: Ultimate equity stake in the Project

Ultimate equity stake in the Project					
			Change in Capex		
		-15%	**0%**	**15%**	**30%**
% of Project Valuation Used (Table 6, Item e)	30%	60.6%	55.8%	49.6%	41.2%
	40%	65.4%	61.8%	57.2%	50.9%
	50%	68.4%	65.5%	61.8%	56.7%
	60%	70.3%	67.9%	64.8%	60.6%
	70%	71.7%	69.6%	67.0%	63.4%
	80%	72.7%	70.9%	68.6%	65.4%

Source: IIR analysis

- We note that the "worst case" scenario in Table 8 (30% increase in capex, 30% of valuation used) results in Allegiance's ownership falling below the minimum of 50% as stipulated in the agreement with Itochu.

Upside Potential

- There is the potential for significant expansions at Tenas, as evidenced by the results of the staged PFS (refer release of July 3, 2017, which presented a staged scenario with a ramp up from 250 ktpa clean coal to 1.75 Mtpa clean coal).
- This would also only require minimal additional capital that would most likely be funded out of cash flow, with upgrades to the coal preparation plant being in the order of US$4.8 million, and additional mobile equipment being leased.
- Any such expansion however would only be considered following on from discussions with and approval by all stakeholders.

Sensitivity

- Our analysis indicates that the base case Project is most sensitive to operating costs and coal prices, with the un-risked base case sensitivity being presented in Table 9.
- This shows that, by virtue of the relatively low operating and capital costs that even the worst case scenarios present a viable, robust project, with the NPV still a multiple of the up-front capex.
- The sensitivity to coal price (which equates to a change in share price of ~A$0.056 per US$10/tonne change in coal price) will also be affected by exchange rates.

Table 9: Telkwa base case post-tax un-risked NPV sensitivity - AUD, 100% basis

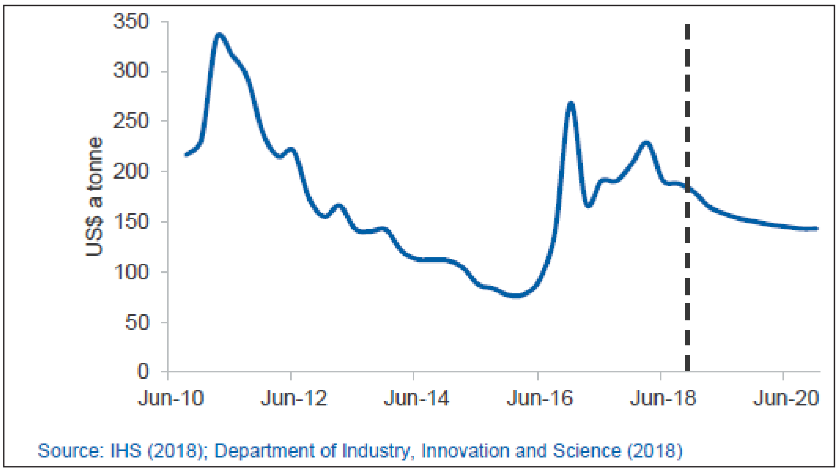
Telkwa base case post tax un-risked NPV sensitivity - AUD, 100% basis						
		Change in Operating Costs				
		-20%	-10%	0%	10%	20%
FOB Coal Price US$/t	US$90	$261m	$224m	$187m	$150m	$113m
	US$100	$323m	$286m	$249m	$212m	$175m
	US$110	$383m	$346m	$309m	$272m	$235m
	US$120	$443m	$406m	$369m	$332m	$295m
	US$130	$507m	$470m	$433m	$396m	$359m
	US$140	$571m	$534m	$497m	$460m	$423m

Source: IIR analysis

SEA-BORNE METALLURGICAL COAL MARKETS

- Telkwa plans to sell metallurgical coal into the global sea-borne market, targeting Asian customers.
- In 2017 the metallurgical trade was ~327Mt, and is forecast to remain relatively stable or grow at ~1-2% per annum over coming years.
- The largest exporter is Australia, which in 2017 exported ~172Mt, or 53% of demand, with Australia being followed by the US (~50Mt, 15%) and Canada (~30Mt, 9%).
- Due to the potential for supply disruptions out of Australia (see below), Asian steel makers, particularly those in Japan and Korea, ideally like to have diversity of supply; this is not so critical in China which can make up shortfalls from domestic supply.
- China is the largest consumer of metallurgical coal, using some 61% of global production, and is followed by India (10%), Russia (6%), Japan (5%) and South Korea (4%); in 2017 China was the largest importer (~76Mt), followed by India (~53Mt) and Japan (42Mt), however with the balance expected to swing in favour of India over the next few years.
- The concentration of supply from Australia, particularly from Queensland, has led in the past to supply shocks resulting largely from tropical cyclones - Cyclone Debbie, which disrupted supply in March 2013 led to a short term price spike to over US$300/tonne for HCC from the then prevailing price of ~US$150/tonne; prices subsequently retraced to around US$150/tonne, however more recently spot prices again reached over $US200/tonne based on a number of factors, including strong steel demand.
- The above prices are for HCC, with PCI coal generally trading at ~70-75% of that for HCC and SSCC trading at 65-70%, although these discounts were exacerbated during the recent price spikes.
- Due to their higher quality, metallurgical coals trade at a significant premium to thermal coals, with this variable, currently being at ~100%, however historically ranging between 50% and 100% - this is naturally exacerbated by spikes in the metallurgical coal prices.
- Figure 8 shows eight year historic and two year forecast prices for HCC, and highlights a potential base forming at ~US$150/tonne on the historic data - this implies minimum FOB prices of ~US$105/tonne and US$97.50/tonne for PCI and SSCC coals respectively, in line with the upper limits of current forecasts.

Figure 8: Australian FOB metallurgical coal prices



Source: Resources and Energy September 2018 Quarterly

Price Forecasts

- Price forecasts, as usual for commodities, are varied; with long term research and broker FOB Queensland forecasts compiled by KPMG in July 2018 ranging between US$120/tonne and US$150/tonne for HCC, US$95/tonne to US$111/tonne for LV PCI and US$80/tonne to $US98/tonne for SSCC.
- We note that these are lower than the forecasts for the Tenas product of US$110/tonne used in the 2017 PFS, and our modelled case of US$120/tonne, however we would consider the forecasts to be relatively conservative, with all having prices in backwardation.
- These are also significantly lower than the September 2018 quarter benchmark prices as reported in Whitehaven Coal's (ASX: WHC) September Quarterly Report - these were US$188/tonne for HCC, US$137/tonne for LV PCI and US$129/tonne for SSCC.
- The potential for the Tenas product to supply a niche potentially means that it will demand a premium to the typical high volatile SSCC products on which the forecasts are based; as well, there is a slight FOB price benefit by virtue of the fact that Ridley Island is closer to markets than the Australian ports.

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