

Metals & Mining

Buy

24 September 2009

Upcoming Events:

HK Jewellery/Gem Fair (21-25 Sep-09)
3 Sights to be held in 2H09
Tucson Gem Fair (Jan-10)
Resource update for tsavorite (1H10)

Price (p)	17.25
Target price (p)	39
Ticker	TNZ LN
Market cap (US\$m)	18.1
Cash in hand (US\$m)	5
52-week (p)	
High	46.5
Low	10.5
3M-avg daily vol (000)	179
3M-avg daily val (£000)	27
Shares	
Basic (m)	105
Fully diluted (m)	107
Top 3 Shareholders (%)	
Michael Adams	9.5
Nicholas Sibley	4.2
Other Directors	5.8
Total	19.5

Share Price Performance (p)



Ambrian acts as Broker to and as a Market Maker in this company

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TanzaniteOne

Site Visit, Interims and New JV

Following a recent site visit, we believe TanzaniteOne offers good equity exposure to a recovery in the coloured gemstone market. The 1H was broadly breakeven, with an interim net loss of US\$0.58m. The company has reduced corporate overheads to meet the challenges of the depressed gemstone market by closing down the South African office (US\$1.2m of immediate savings), reducing its marketing costs and scaling back its production and workforce.

The new JV (*TanzaniteOne CuttingEdge*) is expected to lead to better operating profit margins by the optimised grade/price segmentation of a portion of its mined product. The JV is headed up by a former Sales Executive for Argyle Diamonds and CEO of Charles Edward International (an Australian gemstone retailer). With well established downstream relationships, the potential exists to grow the presence of tanzanite in Asia and Europe. The JV's focus will be on marketing a new classification grade of the stones (the top 20-30% of what was all previously C-grade), alongside different cutting strategies.

We model 1x NPV_{10%} for the tanzanite operation of 29p/share, add a nominal value for the Tsavorite Project at 0.1x NPV_{10%}, and add cash at face value to derive our valuation of US\$67m, or 39p/share. As such, we maintain our BUY and upgraded our target price from 35p to 39p.

Sum-of-the-parts Valuation for TanzaniteOne	
Tanzanite mine	US\$50m/29p per share
<i>1.0x NPV_{10%}, LT tanzanite price US\$12/ct by end-2011 E/US\$ 1.64</i>	
Nominal value for future Tsavorite Project	US\$12.4m/7p per share
<i>0.1x NPV_{10%}, LT tsavorite price US\$12/ct E/US\$ 1.64</i>	
Operations	US\$62m/36p per share
Cash	US\$5m/3p per share
Total NAV	US\$67m/39p per share

Source: Ambrian estimates

In the short term, the tanzanite price and sales performance in the 2H09 sights are the key drivers. News from the development of the new JV could also help support the share price (eg, recent MOUs announced with the JV), and cash from the May 2009 equity raise should support exploration of the Tsavorite Project, adding growth in the longer term (1H09 resource update expected). The key risk is prolonged weakness in the luxury goods market.

Financial Forecasts for TanzaniteOne					
Yr to Dec	07A	08E	09E	10E	11E
Revenue (US\$m)	42.6	26.9	13.0	27.7	39.2
EBITDA (US\$m)	13.5	(6.2)	1.2	6.1	16.0
PAT (US\$m)	9.5	(9.4)	(0.8)	6.5	10.6
EPS (US¢)	9.0	(8.9)	(0.8)	6.2	10.0
P/E (x)	13.4	N/A	N/A	4.6	2.8
EV/EBITDA (x)	5.6	N/A	20.2	4.0	1.5
Dividend yield (%)	8.4	25.6	0.0	0.0	0.0

Source: Company data, Ambrian estimates

We have modelled up to 1.7Mct full-year production for the tanzanite mine this year, ramping up to a maximum of 3Mct pa production in 2012

Valuation – Cost Saving Initiative Ups NPV

We model the tanzanite operation on a post-tax DCF basis, presenting an operational and financial summary below. The nominal value we attribute to the Tsaveite Project is generated by the application of a 0.1x NPV multiple to a forecast operational model (consistent with the discount we normally apply to projects without a feasibility study). For this operation we have used management guidance for operating costs (having observed the similar processing routes in operation in South Africa) and the same LT price (US\$12/ct) as the tanzanite model, which we consider conservative given that tsaveite, on a per carat basis, trades at a considerable premium to tanzanite. We add cash at face value.

Once a reserve estimate and feasibility study for the Tsaveite Project are released (forecast for 1H11), we will integrate forecast production into the financials and increase the multiple applied to NPV.

Operational Model for the TanzaniteOne Operation						
Yr to Dec	07A	08A	1H09	09E	10E	11E
Tanzanite sold (Mct)	2.57	1.81	0.13	0.70	1.98	2.95
Mined tanzanite price (US\$/ct)	9.0	9.0	6.0	7.0	9.3	11.4
On-mine cash cost (US\$/t)	N/A	4.6	4.0	4.3	4.6	4.6
Revenue (US\$m)	42.6	26.9	4.9	13.0	27.7	39.2
Operating costs (US\$m)	32.3	33.2	5.0	13.7	23.1	25.1
EBITDA (US\$m)	13.5	(6.2)	1.0	1.2	6.1	16.0
Finance income (US\$m)	0.3	(0.0)	(0.1)	0.0	0.2	0.5
Depreciation (US\$m)	1.7	2.2	1.1	1.8	1.4	1.8
PBT (US\$m)	12.1	(8.4)	(0.2)	(0.5)	5.0	14.8
Tax (US\$m)	2.5	1.1	(0.8)	(0.8)	(1.4)	4.3
Minority interest (US\$m)	0.1	0.1	(0.0)	(0.1)	(0.1)	(0.1)
Attributable PAT (US\$m)	9.5	(9.4)	(0.5)	(0.8)	6.5	10.6
EBITDA (US\$m)	13.5	(6.2)	1.0	1.2	6.1	16.0
Tax (US\$m)	2.5	1.7	0.0	0.0	(1.4)	4.3
Less: mining capex (US\$m)	2.7	4.1	0.5	1.5	2.0	2.0
Interest-bearing borrowings (US\$m)	0.0	(0.5)	0.5	0.9	0.9	0.9
Attrib FCF from operations (US\$m)	8.3	(11.6)	0.5	(0.3)	5.6	9.7
NPV _{10%} (US\$m)	50.0					

Source: Company data, Ambrian estimates

The numbers shown above are generated by our forecast modelling of the tanzanite operation, which is based on the assumption of a graduated increase in the tanzanite price for mined stones and 'bought stones' (ie, those purchased from the garimpeiro-produced market based around Arusha). For mined stones, this changes from an average of US\$8/ct for 2H09 to our LT forecast of US\$12/ct in 2012. For bought stones, we apply a similar ratio of price increases.

Target Price Sensitivities to Average LT Tanzanite Prices on Mined Product				
Discount	US\$9.0/ct	US\$10.5/ct	US\$12.0/ct	US\$13.5/ct
8%	14	29	44	58
10%	13	26	39	52
12%	13	24	35	47

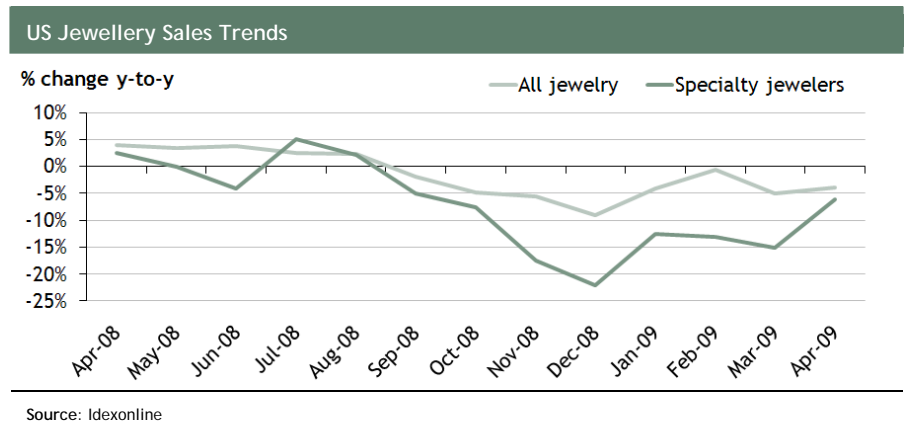
Source: Ambrian estimates

Future growth potential to come from the new marketing JV

We believe that the new marketing JV has the potential to boost earnings in the future for TanzaniteOne, both in terms of the structure of the profit realisation for TanzaniteOne and the JV's intention to focus on sales that could help to optimise value realisation for a significant portion of the mine's product stream (see below for more detail). However, until these synergies can be quantified we are not forecasting any effective impact.

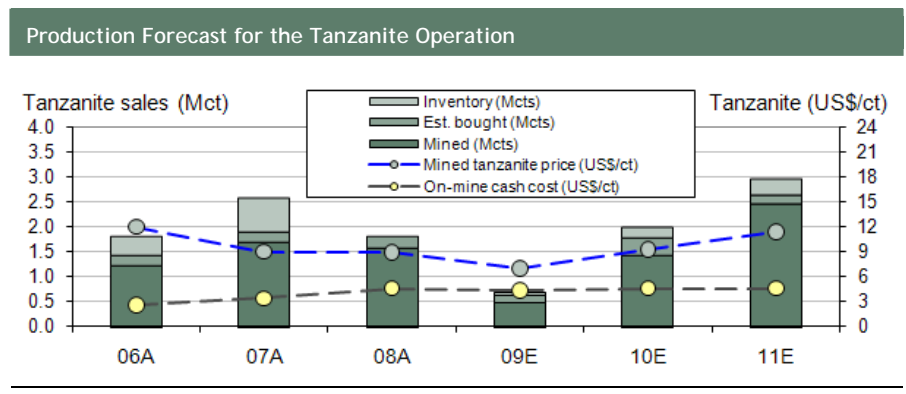
The bigger picture is one of a gradually recovering luxury goods market, which will lag the recovery in the wider economy. We think that because the tanzanite market is smaller than that of diamonds, it is arguably more controllable. Whilst the 'Christmas stocking period' provides positives for the diamond market, some short-medium-term challenges have to be faced before diamond prices recover to 1H08 levels.

Many diamond producers are switching supply back on (De Beers, Debswana, etc), and some are making U-turns on decisions to idle capacity over this winter (eg, Rio Tinto's Diavik mine), and this additional supply has to compete with Russian excess supply from 1H09 stockpiles (they never switched off). Against this backdrop, TanzaniteOne could thus provide equity exposure to a recovery in the luxury goods market earlier than investing in a diamond producer.



Operations Outlook

Our forecast sales volumes and assumptions for mined tanzanite pricing and on-mine cash costs are depicted below.



Having reviewed operational developments at site recently, we are confident in forecasting that the company will reach a mined run-rate of 3Mct pa. We forecast production of 1.7Mct for this year as production has been scaled back in line with the contraction in the tanzanite market.

We model the 3Mct run-rate being achieved in 2012 (at the same time as our pricing forecast reaches its LT average of US\$12/ct).

Recommendation

The 1H09 interims demonstrate that the company has managed to cut its costs to accommodate a different operating environment – one with a relatively depressed tanzanite price. This has been achieved by scaling down mine production and workforce, the closure of the South African office, and savings achieved via reduced costs for the Tanzanite Foundation marketing.

Rough Tanzanite Purchasing in Arusha



Source: Ambrian

The timing of the dividend payout at the end of last year was unfortunate as it came immediately before the collapse of the gemstone market. This move reduced the company's working capital to a level that prevented it from its usual practice of buying up the top-grade stones that arrive into the marketplace in Arusha from artisanal mining operations. During 1Q09 this working capital buffer would have allowed the company to purchase a good portion of high-grade rough stones at knock-down prices.

The subsequent greater volume of high-grade inventory would have allowed further consolidation of its price-making influence downstream. The equity raise in May (US\$5.3m) has now addressed this issue and provided some funding for the Tavorite Project's development.

The announcement of the new JV and subsequent MOUs shows that TanzaniteOne has made strides in its pursuit of gaining an increased market share in Asia and Europe. Whilst these new avenues will take time to develop, we anticipate that this move a) will increase the exposure of tanzanite in a previously under-tapped markets and b) has the potential to generate more revenue from a larger proportion of mined product should the JV find a decent appetite for the new B-grade stone classifications (see below for detail).

With this new prospective growth area, the company seems well placed to offer equity exposure to a recovery in the gemstone sector, with longer-term upside presented by the development of the Tavorite Project

Both TanzaniteOne and members of the new JV are currently marketing and taking part in the Hong Kong Jewellery and Gem Fair held between 21-25 September 2009. We anticipate that, along with the two sights already lined up by the company for 2H09 (having completed a third to be added to the full-year results earlier in July), there could be additional sales realised through the new partnership.

Having changed our model post-site visit to reflect new operating parameters at the mine, we maintain our **BUY** recommendation and have increased our target price from 35p to 39p.

The New JV (*TanzaniteOne CuttingEdge*)

The new JV should allow the company's product to reach cutters and retailers in the Asian and European markets through the existing relationships that the JV partners bring with them. The JV is headed up by a former Sales Executive for Argyle Diamonds as well as the CEO of Charles Edward International (an Australian gemstone retailer).

The additional MOUs (with GRAFGEM and Alankara) should be seen as a positive result of this new JV partnership and are expected to play pivotal roles in the design of jewellery and the production of calibrated size ranges from the rough product sold to it by the JV company. The focus on developing a cut product stream that homogenises stone sizes into ranges is aimed at appealing to retailers looking to develop jewellery ranges in greater bulk.

The JV will also focus on promoting a new classification of B-grade stones that essentially encompasses the top 20% of the old C-grade mined product. These stones are either slightly lighter, slightly included, or slightly fractured relative to top B-grade stones. This is not a new concept to the market as a whole. Previously, Indian buyers have demonstrated success in selling similar grades to cutters at a significant premium to that of the average achieved by C-grade stones.

Historically, TanzaniteOne has classed everything that did not fall into A+B grades into C. This latter group accounts for approximately 70% of mined product, so realising additional value for the top 20-30% of this range could improve profit margins on mined product.



Source: Ambrian

In facilitating the marketing of this new B-grade sub-category, the JV will help to educate cutters and jewellers by presenting a range of specific cutting shapes (hearts and arrows), which can produce stones visually very similar to top colour B-grade (if B_{Included}) or very similar to top clarity A+B grades, only lighter (if B_{Lights}).

We have confidence in management's ability to grow production to the LT goal of 3Mct pa; based on our forecasts for recovery of the tanzanite price, we estimate that this ramp-up would take until 2012

Mining Update

Prior to the economic downturn, TanzaniteOne had the stated production-based goal of reaching a mined target run-rate of 3Mct pa. In the pursuit of this aim the company has made strides in developing the tanzanite mining, processing and security system in the last two years. The fruits of these efforts steadily increased production by 83% to a total of 2.2Mct last year despite the grade declining by 33% over the same period.

Hauling Capacity Increased at CT Shaft



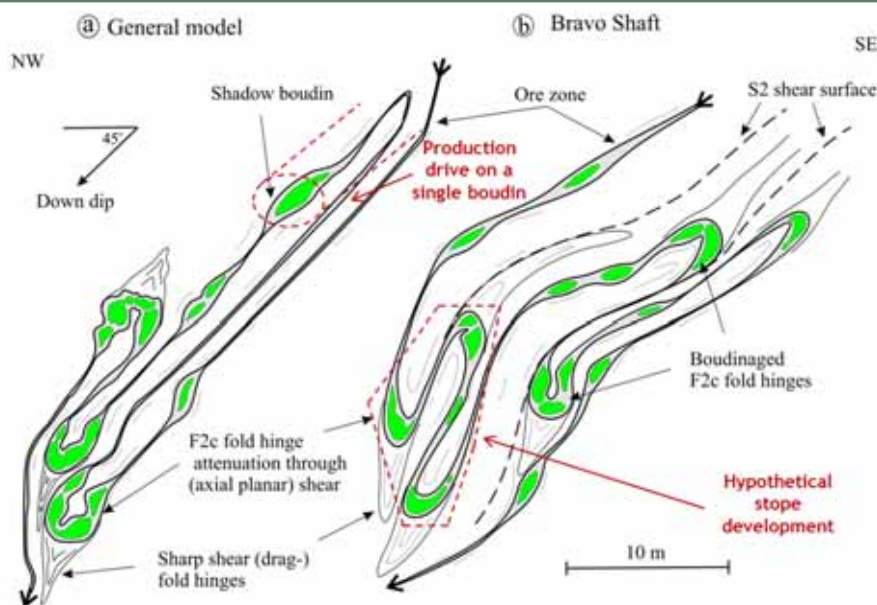
Source: Ambrian

In order to facilitate this ramp-up last year, the haulage system's capacity has been upgraded in a number of ways: hoisting capacity increases at CT and Main Shaft (with Delta and Bravo shafts becoming predominantly utilised for ventilation); numerous new ore passes have been cut; and much larger volume ore bins have been installed underground. In addition to these efforts, a number of large-scale stopes were developed and mined using scraper winches, increasing production volumes.

This diagram illustrates the effect of stoping areas out with boudin clusters rather than following simpler production drives.

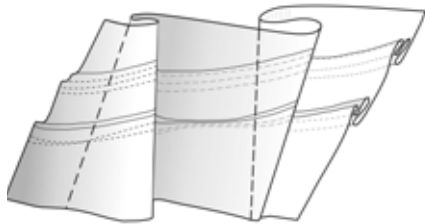
The net effect is to bring the product volume up but with more waste generated. This process helped the company reach record production last year

Vertical Cross-section Through Fold Stacks Being Mined for Tanzanite Along Fold Strike



Source: TanzaniteOne, Ambrian

Schematic of Mineralised Fold Stacks

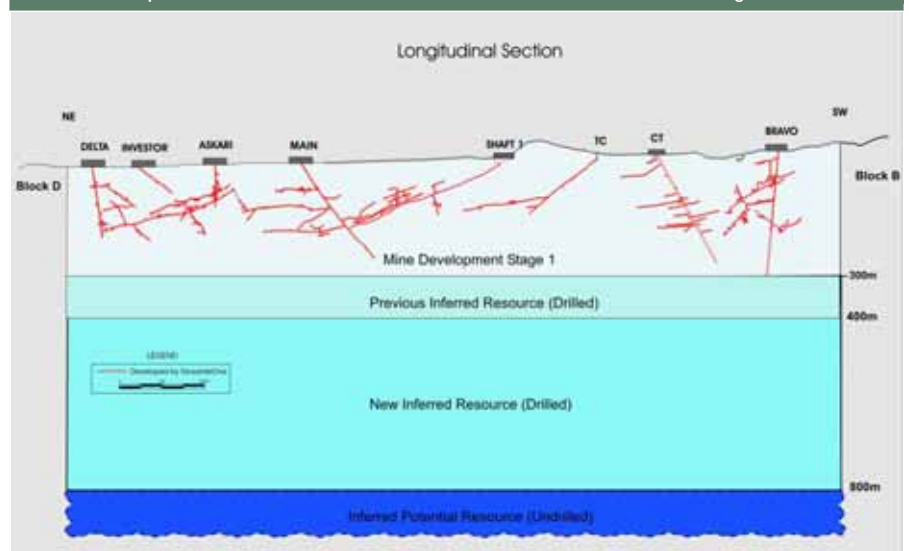


Source: TanzaniteOne

From a geological perspective there are several major structural trends that govern the geometry of tanzanite mineralisation at the site, occurring within isoclinal fold stacks. Ore drives follow these stacks along strike, but occasionally these are displaced via a vertical folded overprint or shearing. Currently, TanzaniteOne has several geologists underground daily (up to five at any one time), mapping and guiding mining progress through what is a structurally complex orebody that we feel the company understands extremely well.

Whilst formal reserves are relatively low in JORC or an equivalent compliant sense, the company has been able to identify several major fold stacks beneath the currently exploited ones, running the length of strike across its mining tenement (C Block). The establishment of this inferred resource has also been aided by the company's analysis of these lower structures as they outcrop on the adjacent mining tenements at shallower depths. The company therefore has a reasonable degree of comfort in the longevity of the operations' resources.

Mine Development and Inferred Resource Across TanzaniteOne's Mining Tenement



Source: TanzaniteOne

Proving up additional resources/reserves to a JORC-compliant standard would not make decent economic sense given the lack of comparability with other projects. In other words, it is unlikely that the market would give the company additional value for doing so, as one might expect for a gold or diamond miner carrying out a similar exercise.

The Main Shaft at the site is about to intersect Fold Stack 3 in this succession, whilst the CT Shaft has recently intersected Fold Stack 4 and the average mining depth is roughly 400m (end-point depth for the mine is estimated at around 800m), with the grade likely to stay at approximately 50ct/t for some years. The mining of Fold Stack 3 from the Main Shaft is likely to take several years. There over 8 Fold Stacks in the succession.

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