RESEARCH

RESOURCES

3 February 2015

RECOMMENDATION

Hold

Implied Valuation $0.74-$1.02

12 month volume	113.4m
12 month share low	$0.13
12 month share high	$0.50

Market Risk	High
Liquidity Risk	Med
Infrastructure Risk	Low
Country Risk	Low

IRESS & DJC Research

ISSUED CAPITAL

ASX	HCH
Share price	$0.14
Mkt cap[1]	$48.7m
Ordinary shares on issue[1]	348m
Options (various)	11.5m

Diluted for new shares *Source: IRESS*

DIRECTORS

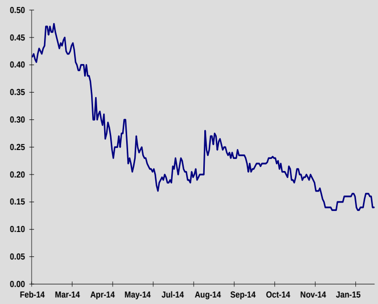
Murray Black	Chairman
Christian Easterday	Managing Director
Dr Alan Trench	Non-Exec Director
Michael Anderson	Non-Exec Director
Roberto de Andraca	Non-Exec Director

MAJOR SHAREHOLDERS

K.A.S. Pty Ltd	19.3%
CAP. SA (Port Finance)	11.8%
Taurus Funds Mgt	11.7%
Lundin Mining	6.3%
Exploration Capital Partners	5.4%

As at 15 February 2013

12 MONTH PERFORMANCE



Source: IRESS

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Hot Chili Ltd (HCH)

Productora Infrastructure MoU Ratified but timeline lengthened

HCH has announced the ratification by both Boards of the MoU announced in August 2014 giving some certainty as to the structure going forward. Changes have been made to the terms originally agreed, which effectively splits the payments made to HCH into two tranches. This will add 12 to 18 months, in our view, to the point at which HCH will receive full value for their 32.6% relinquishment of the project, should CMP exercise the option. We recognise that the macro environment has changed, particularly with respect to CMP's major revenue stream – iron ore. The changes reduce financial risk to CMP from a cap to the payment to HCH for the increased stake, which potentially increases the likelihood of the option being exercised. The agreement therefore seems pragmatic to both parties in the current environment. However, the addition of 12-18 months to the timeline for value realisation comes as an opportunity cost and there is still no certainty that CMP will exercise the option. We down grade our Speculative Buy recommendation to Hold.

Key Points

- **Change to the terms of the APO:** The major change since the original execution of the MoU in August 2014 is seen in the Additional Purchase Option (APO) agreement, which has been divided into two tranches, and the application of a maximum value to the payment made to HCH for CMP's 32.6% additional stake. The Joint Infrastructure Agreement remains unchanged from that outlined in August last year.

- **Additional Purchase Option tranches**: The APO, should CMP exercise it, will see CMP take a 50.1% ownership stake in the Productora Project. The first tranche, due 90 days after the results of a PFS and independent experts valuation report, is for US$26m and will represent between 7.71% (on maximum valuation of US$110m) and 10.6% (on minimum valuation of US$80m) of Productora, depending on the value placed on the project in the independent valuation. Tranche Two will be the remaining balance, and is due on completion of a DFS, project financing terms and decision to mine.

- **HCH envisage being fully funded until a decision to mine:** The first tranche will be employed to eliminate the resultant debt owing to Sprott Resource Lending Partnership and any remainder to part funding of HCH's portion of the DFS costs. HCH currently has a US$25m debt facility with Sprott, with current draw down of US$10m. Upon exercise of Tranche One, CMP are to provide HCH with a secured loan of US$13m to part fund HCH's portion of the DFS. This loan plus interest is to be re-paid from the Tranche Two payment at a decision to mine.

- **Implied valuation of between $0.74 and $1.02 per share:** Under the new terms of the IA the implied valuation ranges from $0.74 to $1.02 per share should CMP exercise the additional purchase option. While the implied valuation has increased since our last note, as a result of exchange rate movements, the 12-18 month delay in value realisation to late 2016 – early 2017 sees us downgrade our Speculative Buy recommendation to Hold, notwithstanding likely positive news flow over the coming months with respect to the oxide mineralisation, increasing Productora resources and reserves and the addition of an Alice resource estimate to the project.

HCH / CMP Ratify Infrastructure Agreement

HCH released the ratification of the terms of the MOU with its Joint Venture partner CMP on the Joint Infrastructure Agreement (JIA). The terms of the JIA are essentially unchanged from those released upon execution of the JIA in August 2014.

CMP will acquire a 17.5% interest in the Productora Project in exchange for the granting of surface rights, access to infrastructure corridors and mining rights.

Changes to the Additional Purchase Option

Below is a table comparing the terms of the MoU between HCH and CMP between August 2014 and January 2015.

MoU execution **Aug-14**	**MoU ratification** **Jan-15**
In return for surface rights & easements, CMP will emerge with a 17.5% stake in Productora Project	In return for surface rights & easements, CMP will emerge with a 17.5% stake in Productora Project
CMP to be free-carried to conclusion of PFS	CMP to be free-carried to conclusion of PFS
HCH to grant CMP with an option to increase to 50.1%	HCH to grant CMP with an option to increase to 50.1%
Additional purchase option payment of US$1.5m	Additional purchase option payment of US$1.5m
Minimum US$80m for 32.6%	Minimum US$80m **and up to a maximum of US$110m** for 32.6%
Payment to HCH as a single tranche with CMP to make decision within 90 days of receiving PFS and independent valuation report	Payment to HCH in **two tranches**
	First Tranche - exercisable within 90 days of delivery of a PFS and independent valuation report and HCH making a preliminary decision to mine - **US$26m** , representing between 7.71% and 10.6%, depending on independent valuation **CMP to provide HCH wth a $13m secured loan** for working capital **Second Tranche** - balance of amount of independent valuation, between US$54m and US$84m, upon completion of DFS, project financing terms and definitive decision to mine

Figure 1. Joint Infrastructure and Additional Purchase option Agreement terms comparison table

MOU provide see-through project value of between A$314m and A$432m

The Additional Purchase Option provides see through project value. Under the new terms of the APO, CMP can acquire a 32.6% stake in the project for a minimum of US$80m and maximum of US$110m. This would value the project at between US$244.8m, or A$314.6m at USDAUD0.778 at a minimum valuation and US$336.6m, or A$432.6m at the maximum valuation.

Should CMP exercise the option, HCH would have a 49.9% interest valued at A$157m, or $0.45 per share on 347.7 shares on issue on the minimum value and A$215.9 or A$0.62 on the maximum value.

If CMP exercise the option a pro-forma implied sum-of-parts valuation for HCH would look like this:

	Minimum A$(m)	$ per share	Maximum A$(m)	$ per share
Productora Project (49.9%)	157.1	0.45	215.9	0.62
Cash	102.0	0.29	141.4	0.41
Other projects	30.0	0.09	30.0	0.09
Debt	-18.0	-0.05	-18.0 -	0.05
Corporate	-15.0	-0.04	-15.0 -	0.04
Total	**256.1**	**0.74**	**354.3**	**1.02**

Figure 3. Sum-of-parts implied valuation of HCH Source: DJC estimates

On this basis and assuming no further capital dilution, the implied valuation from our sum-of-parts analysis shows a range between $0.74 and $1.02 per share.

Our view

The changes have been made against a backdrop of a much lower iron ore price and difficulty in resource companies obtaining access to equity funding over the short term.

- HCH has recently made the Alice discovery, a porphyry copper-gold project within 400m of the Productora pit shell. In our view, we see opportunities to discover additional material within the Productora Project area. This discovery, and the potential for others within the next 6 months, has the potential to push the valuation upwards. Without a maximum value to the additional purchase option, CMP faced the prospect of an open cheque, the amount determined by an independent valuation report on the value of a 32.6% stake in the Productora Project, which would take its stake to 50.1% and an additional premium for control.

- With a lower revenue stream and the likelihood of a depressed iron ore price for some time, a larger, but still uncertain, option payment would add financial risk to CMP and had the potential to reduce CMP's commitment to the project over the short to medium term. The addition of a maximum value provides some financial certainty to CMP in an uncertain macro environment whilst also providing for some value upside to HCH shareholders, albeit up to a maximum value.

- The two tranches spread the financial risk to CMP over a longer time frame and allows for a decision tree for timing of expenditure. This seems to be a negative to HCH as value for their 32.6% stake will not be fully realized until the end of the DFS. This would add around a year to 18 months to the investment horizon as we assume the DFS would take that long to complete after the PFS. This would place value realization at around the beginning of 2017.

- Whilst there is undoubtedly a number value accreting news events (see below) that would have to potential to increase the share price, the macro environment currently holds sway. The structure of the latest version of the Joint Infrastructure Agreement and Additional Purchase Option, although ensuring debt repayments and an injection of working capital from CMP, delays the value realization for HCH shareholders.
- In our view an improving macro-environment would be required for a sustained re-rating of the HCH share price given the long-dated value realization under the current scenario.
- We therefore down grade our recommendation from Speculative Buy to Hold though recognizing the considerable value up lift that a successful exercise of the Additional Purchase Option would bring.

The next 12 months

Over the course of the next 12 months HCH intend to:

- Increase mine life to +10 years through further exploration at and around Productora
- Include oxide resources into the resource and PFS
- Provide a resource estimate for the new Alice discovery
- Update minerals reserves and resources
- Complete a PFS on the project
- Initiate the DFS
- Present the completed PFS to CMP who will jointly procure an IER on project value
- Receive Tranche 1 of the APO and retire Sprott debt facility

Disclosure Disclaimer **RCAN1236**

This Research report, accurately expresses the personal view of the Author.

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The Author of this report made contact with the **Hot Chili Limited** for assistance with verification of facts, admittance to business sites, access to industry/company information. No inducements have been offered or accepted by the company.

The recommendation made in this report is valid for four weeks from the stated date of issue. If in the event another report has been constructed and released on **Hot Chili Limited**, the new recommendation supersedes this and therefore the recommendation in this report will become null and void.

Recommendation Definitions

SPECULATIVE BUY – 10% or more outperformance, high risk
BUY – 10% or more outperformance
HOLD – 10% underperformance to 10% over performance
SELL – 10% or more underperformance
Period: During the forthcoming 12 months, at any time during that period and not necessarily just at the end of those 12 months.

Stocks included in this report have their expected performance measured relative to the ASX All Ordinaries index. DJ Carmichael Pty Limited's recommendation is made on the basis of absolute performance. Recommendations are adjusted accordingly as and when the index changes.

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