

2 May 2017

**RECOMMENDATION**

Not rated

3 month average volume / day	364K
12 month share low	\$0.025
12 month share high	\$0.099

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

IRESS & DJC Research

**ISSUED CAPITAL**

ASX	HCH
Share price	\$0.03
Mkt cap <sup>1</sup>	\$16.3m
Ordinary shares on issue <sup>1</sup>	543.1m
Options (various)	19.0m

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**

Taurus Funds Mgt	13.1%
K.A.S. Pty Ltd	12.7%
CAP. SA (Port Finance)	12.5%
Megeve Fund	5.9%
Exploration Capital Partners	4.4%

As at 31 December 2017

**12 MONTH PERFORMANCE**



Source: IRESS

**Paul Adams**

Head of Research

+61 8 9263 5200

padams@djcar michael.com.au

# Hot Chili Ltd (HCH)

## \$13m funding package and porphyry drilling

We believe it may be time to look once again at Hot Chili Ltd (HCH-AU). HCH has announced a \$13m unsecured Convertible Note funding package from its major shareholders and released the first results from its 2017 porphyry drilling program at its Productora copper project. HCH believe that a successful program into the cluster of porphyry targets east of the main deposit could materially change the scale and economic metrics of the project. The funding package also removes all finance encumbrances on HCH, its subsidiaries and its assets and significantly de-risks the company in our view. HCH offers exceptional leverage to an increase in the copper price and to exploration success.

**Key Points**

- A \$13m funding package, led by Sprott Capital Partners and affiliates, includes support from major shareholders, Taurus Funds Management and CAP, the parent company to HCH's JV partner at Productora. Funds will in part be used to payout the outstanding Sprott US\$6.5m loan. This is important as it will extinguish all finance encumbrances remaining on HCH, its subsidiaries and its assets.
- The 2017 drilling program has begun with a number of reconnaissance RC holes directed towards several porphyry targets east of the main Productora Zone. Diamond drilling will commence once the analysis of the reconnaissance holes has been completed. The 2017 drill program is being conducted by Blue Spec Sondajes Chile, a drilling company associated with HCH's Chairman, Murray Black, at no risk and at no cost to HCH.
- The first drill results have been successful in extending the known mineralisation at the Alice porphyry copper deposit. A 64m intersection of **64m at 0.5% copper, 0.1g/t gold and 185ppm molybdenum**, was recorded from 200m to end-of-hole at 264m before difficult drilling conditions terminated the hole prematurely. This will change the interpretation of the Alice deposit.
- Success at Alice would be incrementally positive for the Productora Project. However, the main game remains the large IP/resistivity/conductivity targets being tested by the RC and diamond drill program. Success from the porphyry copper program would materially change the nature and scale of the project and in our view, be one of the catalysts for CMP to consider its position with respect to the option to acquire more of the Productora Project.
- The next step forward for HCH will largely be determined by the success of this program. We anticipate that diamond drilling follow-up to the reconnaissance RC drilling will start in a few weeks' time. We therefore believe that early results from the program will be announced around late June or early July.
- A recap of the metrics from the 2016 PFS shows how sensitive the Productora Project is to the copper price. A \$0.50/lb increase from US\$3.00/lb (Base Case) to US\$3.50/lb more than doubles the NPV to just over A\$1.0 billion.
- Due to its size, Productora offers HCH exceptional leverage to both exploration success and to an increasing copper price.

### **\$13m funding package with a ‘no risk’ drilling program to HCH**

A \$13m funding package, led by Sprott Capital Partners and affiliates, includes support from major shareholders, Taurus Funds Management and CAP, the parent company to HCH's JV partner at Productora. Funds will in part be used to payout the outstanding Sprott US\$6.5m loan. This is important as it will extinguish all finance encumbrances remaining on HCH, its subsidiaries and its assets.

Our view was that the finance encumbrances were a major influence on the perception of risk around HCH and we think that the removal of those encumbrances is a positive step for the company.

The package is via an unsecured convertible note structure (\$100 per Note), with an annual 8% coupon charged on a quarterly basis in cash or shares, at the election of HCH. The notes have a 5-year maturity and were issued at a \$0.03333 per share, a premium to the share price of \$0.025 at the time of the announcement. The issue of the Notes is still subject to shareholder approval, which we anticipate around early June. Sprott will also nominate a Non-Executive Director to the HCH Board.

#### **Two points are worth mentioning about the Notes:**

- i) Notes will automatically convert to shares on maturity or earlier conversion by the Note holder. However, on maturity, the Notes will automatically convert to shares at 95% of the 10-day VWAP of shares traded on the ASX immediately prior to the Maturity date, or the conversion price, whichever is lower; and
- ii) That HCH will apply to have the notes listed on the ASX and, in time, take reasonable commercial steps to have its ordinary shares listed on the TSX-V.

We view a TSX-V listing positively, despite the likelihood of increased administration costs to HCH. The ability to access a new group of potential retail and institutional shareholders with more experience in South America than Australian-based investors could be advantageous.

The remaining funds, after re-payment of the Sprott debt facility, will be used for exploration purposes and general working capital however the 2017 drilling program is being undertaken at no cost to HCH. See below.

### **Reconnaissance RC drilling to be followed up by diamond**

The drilling program is being undertaken and paid for by Blue Spec Sondajes Chile, a drilling company associated with HCH's Chairman, Murray Black, with no risk and no cost to HCH.

Existing drilling, conductivity and geophysical data have been used to target the 2017 porphyry program.

A reconnaissance RC drilling program is being conducted east of HCH's large Productora copper deposit in the coastal cordillera of Chile. A cluster of seven porphyry targets is being drilled with the aim to extend mine life which will be incorporated into a DFS.

A number of RC holes program have already been completed on the porphyry cluster. Lithological and alteration information from the RC holes is being compiled to vector deeper diamond drilling on the most prospective targets.

Subsequent to the results from the RC reconnaissance program, Blue Spec has agreed to undertake the diamond drilling program on the same basis as the RC program.

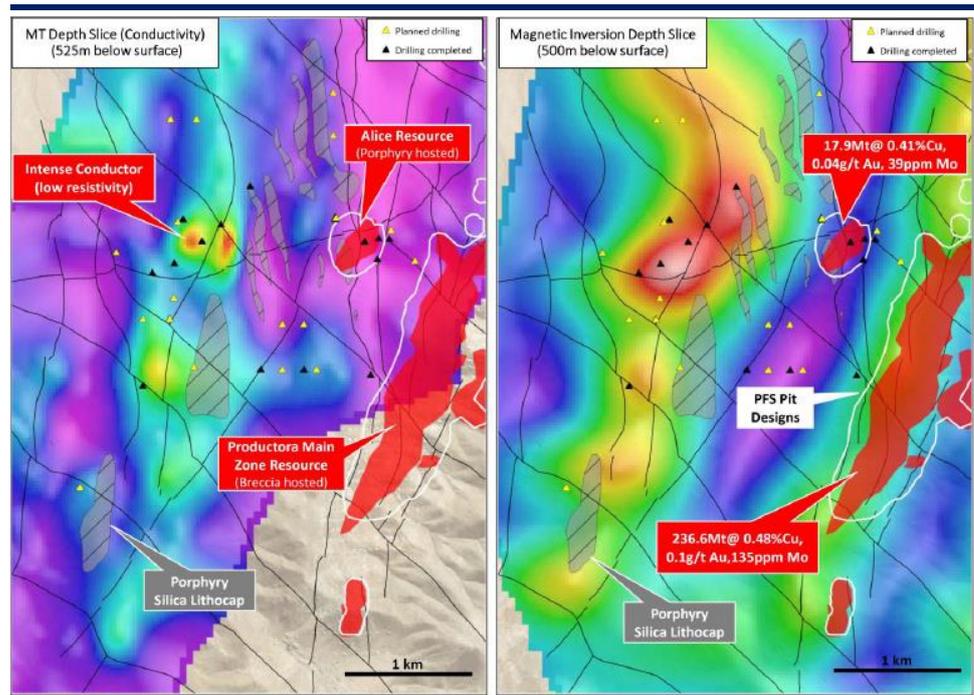


Figure 1. Conductivity, Magnetics and hole location for the porphyry drilling Source: HCH

**Extension of Alice mineralisation to the east**

First drill results from the 2017 RC reconnaissance program have been successful in extending the known mineralisation at the Alice porphyry copper deposit. The RC intersection resulted from an extension of a previous hole (PRP0930) that recorded mineralisation at the bottom of the hole at 200m.

A 64m intersection of **64m at 0.5% copper, 0.1g/t gold and 185ppm molybdenum**, was recorded from 200m to end-of-hole at 264m before difficult drilling conditions terminated the hole prematurely.

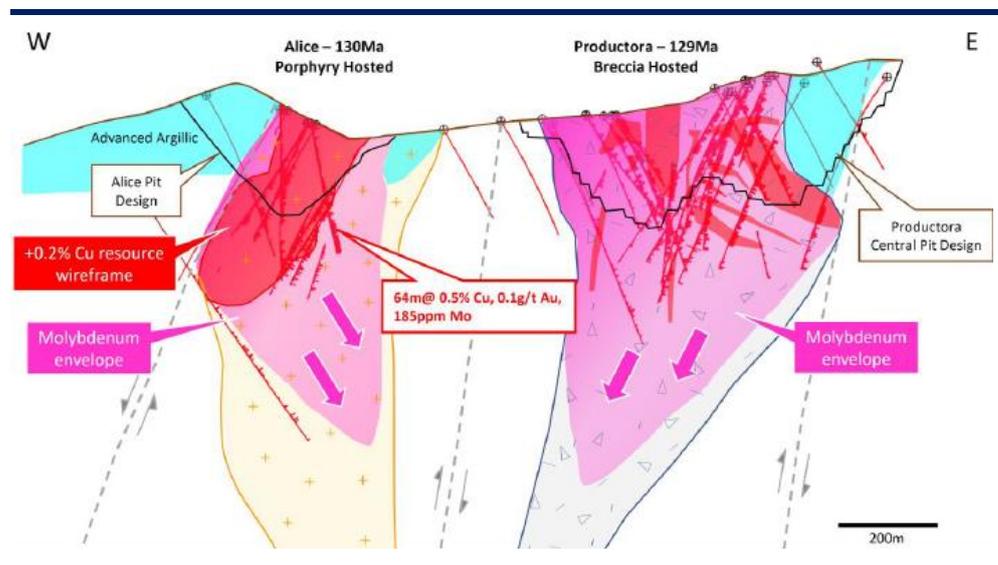


Figure 2. Cross-section with new mineralisation at Alice Source: HCH

The intersection confirms that mineralisation dips to the east, towards the main Productora deposit. HCH postulate that the two mineralised zones could coalesce at depth. Analysis of the molybdenum (Mo) data shows that the Mo assays are four times the tenor of other Mo results at Alice and more akin to the Mo grades at the main Productora deposit.

The implication for Alice is that the current west dipping interpretation on the copper zones may be incorrect. If so, this may have significant ramifications for Alice and the design of the remainder of the program.

### Main Game remains the big targets

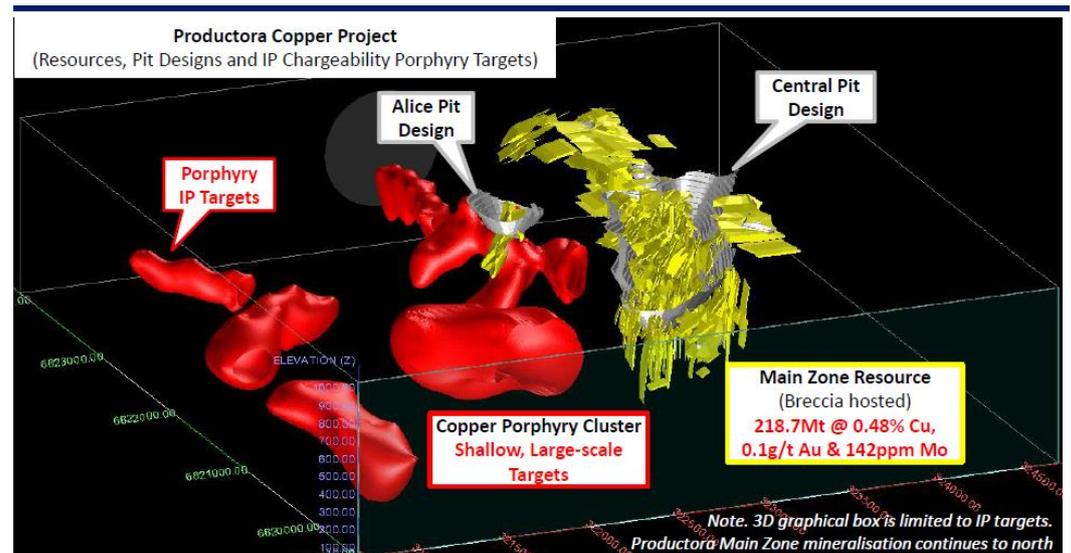


Figure 3. Porphyry IP targets and Productora deposit

Source: HCH

Success at Alice would be incrementally positive for the Productora Project. However, the main game remains the large IP/Resistivity/conductivity targets being tested by the RC and diamond drill program. Figure 3 above shows the IP targets next to the existing Productora resource and pit shell envelope.

### Catalysts

Success from the porphyry copper program would materially change the nature and scale of the project and in our view, be one of the catalysts for CMP to consider its position with respect to the Additional Purchase Option on the Productora Project.

CMP took an additional 2.5% interest in the Productora Project for US\$1.5m, with funds applied to help reduce the Sprott debt from US\$9.5m to US\$6.5m, CMP's stake in the project rose from 17.5% to 20%.

### CMP's Additional Purchase Option (APO) re-cap

The APO, should CMP exercise it and if the terms remain the same, would 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.

Therefore, as CMP has already acquired an additional 2.5%, the APO, if existing terms remain, would allow CMP to take an additional 30.1%, for between US\$74m and US\$102m.

The terms of a revised agreement are not yet known, but suffice to say much has changed since January 2015 when the MoU between HCH and CMP was ratified. Not least the copper price.

The next step forward for HCH will largely be determined by the success of this program. We anticipate that diamond drilling follow-up to the reconnaissance RC drilling will start in a few weeks time. We therefore believe that early results from the program will be announced around late June or early July.

### Updated capital structure and implied value of APO

HCH currently has 543.08m shares on issue, giving HCH a market capitalization of \$16.3m at \$0.03 per share. HCH has 8m 2018 and 11m 2019 dated options at exercise prices of \$0.10 and \$0.30 respectively.

- HCH intend to issue 85,000 \$100 Notes to Sprott and its Affiliates
- HCH intend to issue concurrently an additional 45,000 \$100 Notes to major shareholders Taurus and CMP, for a total of 130,000 Notes.
- If all the Notes were converted to shares prior to Maturity, an additional 390m shares would be issued, resulting in a total 933.1m FPO shares, excluding interest paid as shares.
- At full dilution, the APO would be worth between \$0.114 to \$0.157 per share to HCH and imply the value of HCH's remaining equity (49.9%) in the project at between \$0.186 and \$0.258 per share, for a total of \$0.299 to \$0.414 per share, determined by the valuation of the project at between US\$74m to US\$102m for an additional 30.1% (\$US\$80m to US\$110m for 32.6%) and assuming a USD:AUD FX rate of 0.75

### Original PFS metric re-cap

The original PFS used a copper price assumption of \$3.00/lb and showed that the project was highly sensitive to copper price.

Project Life	12 years
Stripping Ratio (waste:ore) (including pre-strip)	2.7:1
Project Construction	2 years
First Production	Year 3
Grind Size P80 (µm)	150 (Productora) 180 (Alice)
C1 Cost <sup>2</sup> (US\$/lb paid metal)	\$1.47
C2 Cost <sup>3</sup> (US\$/lb paid metal)	\$2.25
C3 Cost <sup>4</sup> (US\$/lb paid metal)	\$2.28
Pre-production Capital Expenditure	US\$725M
Project NPV (7% real discount rate)	US\$220M
Project After-tax IRR (real)	15%
Payback Period (from start of production)	3.9 years

Table 1. March 2016 PFS metrics at US\$3.00/lb

Source: HCH

PFS Financial Valuation (US\$M)	Copper price scenario		
	Base		Wood Mackenzie (2020 - 2030)
Copper price applied (US\$/lb)	3.00	3.25	3.50
Project Revenue	4,300	4,600	5,000
Operating costs	2,500	2,500	2,500
Royalties (CCHEN and SMT)	82	99	120
Sustaining capital (including capitalised waste)	270	270	270
Project Operating Cash Flow (pre-tax)	1,800	2,200	2,500
Pre-production capital expenditure	725	725	725
Corporate Tax	190	270	350
Project Cash flow (pre-tax)	850	1,200	1,500
Project Free Cash Flow	610	820	1,000
Pre-tax Project NPV (7% discount)	360	560	760
Project NPV (7% discount)	220	360	500
Project Pre-tax IRR (real)	18%	24%	28%
Project After-tax IRR (real)	15%	19%	23%
Payback Period (from Year 0)	5.9 years	5.3 years	4.9 years
Payback Period (from start of production)	3.9 years	3.3 years	2.9 years

Table 2. PFS metrics at various copper prices

Source: HCH

### HCH offers exceptional leverage to an increase in the copper price

- An increase from US\$3.00/lb (US\$6,615/t) to US\$3.50/lb (US\$7,715/t) more than doubles the pre-tax NPV<sub>7%</sub> from US\$360m to US\$760m, or A\$1.01b (USD:AUD 0.75).
- The current copper price is US\$5,688/t or US\$2.58/lb.

In our view, the copper price would have to be higher than today's for CMP to consider exercising the APO. At least US\$3.00/lb, which was the Base Case used in the PFS. However successful drilling in 2017 could materially change the value of the project. Large copper development projects are currently highly sought after by major mining companies and are the focus of exploration and acquisition for companies such as BHP, RIO and other large to mid-tier copper miners. HCH offers exceptional leverage to 2017 exploration success and a copper price rebound.

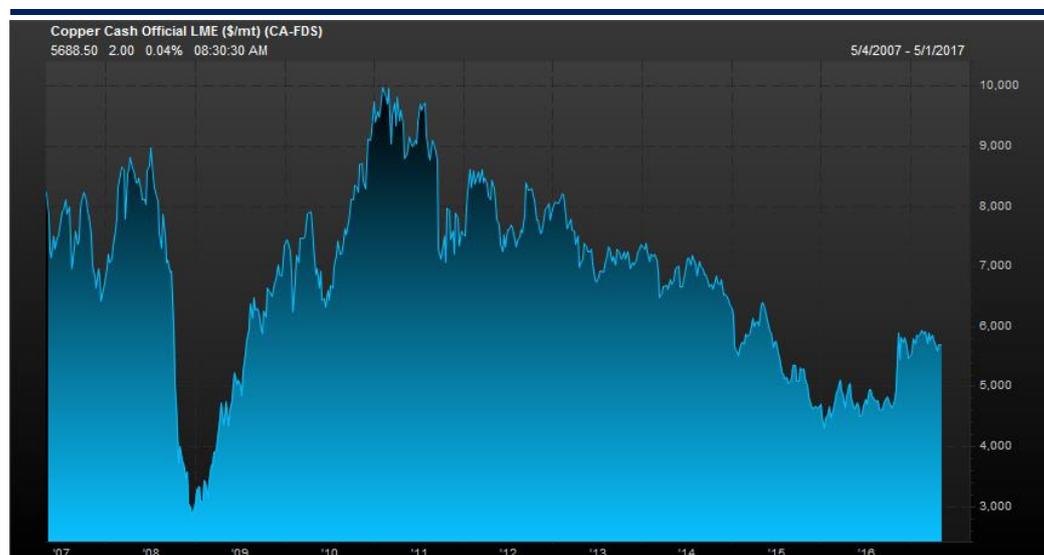


Figure 4. Copper Price (US\$/t) – 10 Year Performance

Source: FactSet

Private Client Dealing		Email	Telephone
Hugo McChesney	Institutional Advisor	<a href="mailto:hmcchesney@djcmichael.com.au">hmcchesney@djcmichael.com.au</a>	+61 8 9263 5214
Chad South	Head of Retail Advisory	<a href="mailto:csouth@djcmichael.com.au">csouth@djcmichael.com.au</a>	+61 8 9263 5225
Tim Bennett	Private Client Adviser	<a href="mailto:tbennett@djcmichael.com.au">tbennett@djcmichael.com.au</a>	+61 8 9263 5351
Matthew Blake	Executive Director - Private Client Adviser	<a href="mailto:mblake@djcmichael.com.au">mblake@djcmichael.com.au</a>	+61 8 9263 5248
Eve Broadley	Private Client Adviser	<a href="mailto:ebroadley@djcmichael.com.au">ebroadley@djcmichael.com.au</a>	+61 8 9263 5324
Gregory Chionh	Private Client Adviser	<a href="mailto:gchionh@djcmichael.com.au">gchionh@djcmichael.com.au</a>	+61 8 9263 5302
Gerry Connolly	Private Client Adviser	<a href="mailto:gconnolly@djcmichael.com.au">gconnolly@djcmichael.com.au</a>	+61 8 9263 5265
Paul Covich	Private Client Adviser	<a href="mailto:pcovich@djcmichael.com.au">pcovich@djcmichael.com.au</a>	+61 8 9263 5257
Andrew Cox	Private Client Adviser (Equities & Derivatives)	<a href="mailto:acox@djcmichael.com.au">acox@djcmichael.com.au</a>	+61 8 9263 5237
Toby Jefferis	Private Client Adviser	<a href="mailto:tjefferis@djcmichael.com.au">tjefferis@djcmichael.com.au</a>	+61 8 9263 5217
Chris Jones	Private Client Adviser	<a href="mailto:cjones@djcmichael.com.au">cjones@djcmichael.com.au</a>	+61 8 9263 5232
Michael Marano	Private Client Adviser	<a href="mailto:mmarano@djcmichael.com.au">mmarano@djcmichael.com.au</a>	+61 8 9263 5238
Derek Steinepreis	Private Client Adviser	<a href="mailto:dsteinepreis@djcmichael.com.au">dsteinepreis@djcmichael.com.au</a>	+61 8 9263 5292
James Titcombe	Private Client Adviser	<a href="mailto:jtcombe@djcmichael.com.au">jtcombe@djcmichael.com.au</a>	+61 8 9263 5254
Zac Paul	Private Client Adviser	<a href="mailto:z paul@djcmichael.com.au">z paul@djcmichael.com.au</a>	+61 8 9263 5272
Jason Murray	Dealers Assistant	<a href="mailto:jmurray@djcmichael.com.au">jmurray@djcmichael.com.au</a>	+61 8 9263 5260
Ben Osborne	Dealers Assistant	<a href="mailto:bosborne@djcmichael.com.au">bosborne@djcmichael.com.au</a>	+61 8 9263 5251
Wealth Management		Email	Telephone
Brad Clarke	Wealth Manager	<a href="mailto:bclarke@djcmichael.com.au">bclarke@djcmichael.com.au</a>	+61 8 9263 5224
Paul Elkington	Wealth Manager	<a href="mailto:pelkington@djcmichael.com.au">pelkington@djcmichael.com.au</a>	+61 8 9263 5285
Domenic Macri	Wealth Manager	<a href="mailto:dmacri@djcmichael.com.au">dmacri@djcmichael.com.au</a>	+61 8 9263 5263
Mark Meacham	Wealth Manager	<a href="mailto:mmeacham@djcmichael.com.au">mmeacham@djcmichael.com.au</a>	+61 8 9263 5247
Danial Fonseca	Wealth Manager	<a href="mailto:dfonseca@djcmichael.com.au">dfonseca@djcmichael.com.au</a>	+61 8 9263 5296
Nick Casale	Portfolio Administration Manager	<a href="mailto:ncasale@djcmichael.com.au">ncasale@djcmichael.com.au</a>	+61 8 9263 5215
Research		Email	Telephone
Paul Adams	Director - Head of Research and Natural Resources	<a href="mailto:padams@djcmichael.com.au">padams@djcmichael.com.au</a>	+61 8 9263 5234
Michael Eidne	Director - Research	<a href="mailto:meidne@djcmichael.com.au">meidne@djcmichael.com.au</a>	+61 8 9263 5213
Michael Ron	Research Analyst	<a href="mailto:mron@djcmichael.com.au">mron@djcmichael.com.au</a>	+61 8 9263 5264
Corporate Finance		Email	Telephone
Davide Bosio	Managing Director & Head of Corporate Finance	<a href="mailto:dbosio@djcmichael.com.au">dbosio@djcmichael.com.au</a>	+61 8 9263 5210
Scott Robertson	Director – Corporate Finance Executive	<a href="mailto:srobertson@djcmichael.com.au">srobertson@djcmichael.com.au</a>	+61 8 9263 5218
Adam Russo	Associate Director - Corporate Finance Executive	<a href="mailto:arusso@djcmichael.com.au">arusso@djcmichael.com.au</a>	+61 8 9263 5290
Matthew Hall	Associate Director – Corporate finance Executive	<a href="mailto:mhall@djcmichael.com.au">mhall@djcmichael.com.au</a>	+61 8 9263 5291
Carly Circosta	Manager - Corporate Finance Executive	<a href="mailto:ccircosta@djcmichael.com.au">ccircosta@djcmichael.com.au</a>	+61 8 9263 5268
Julie Martino	Executive Secretary	<a href="mailto:jmartino@djcmichael.com.au">jmartino@djcmichael.com.au</a>	+61 8 9263 5257
Administration		Email	Telephone
Cadell Buss	Chief Executive Officer	<a href="mailto:cbuss@djcmichael.com.au">cbuss@djcmichael.com.au</a>	+61 8 9263 5204
Belinda Roychowdhury	Administration Manager	<a href="mailto:broychowdhury@djcmichael.com.au">broychowdhury@djcmichael.com.au</a>	+61 8 9263 5216
Gabrielle Bouffler	Head of Compliance and Risk	<a href="mailto:gbouffler@djcmichael.com.au">gbouffler@djcmichael.com.au</a>	+61 8 9263 5221
Janelle Whyte	Chief Financial Officer	<a href="mailto:jwhyte@djcmichael.com.au">jwhyte@djcmichael.com.au</a>	+61 8 9263 5241
Fiona Garvie	Assistant Accountant	<a href="mailto:fgarvie@djcmichael.com.au">fgarvie@djcmichael.com.au</a>	+61 8 9263 5220
Kerry Morrice	Administration Assistant	<a href="mailto:KMorrice@djcmichael.com.au">KMorrice@djcmichael.com.au</a>	+61 8 9263 5279
Brenda Woodenberg	Reception	<a href="mailto:bwoodenberg@djcmichael.com.au">bwoodenberg@djcmichael.com.au</a>	+61 8 9263 5200

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RCAN1394

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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 – Anticipated 10% or more outperformance, high risk

BUY – Anticipated 10% or more outperformance

HOLD – Anticipated 10% underperformance to 10% over performance

SELL – Anticipated 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.

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