17 JULY 2018

AUSTRALIA (NT)

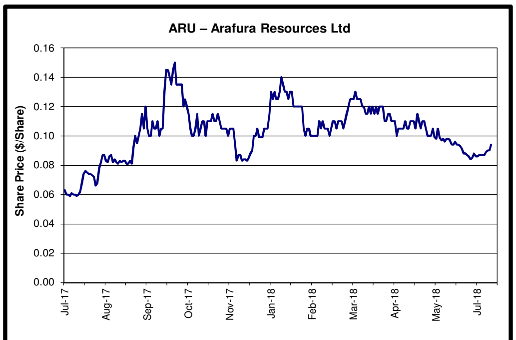
RARE EARTHS (NdPr), PHOSPHORIC ACID

FEASIBILITY STUDY

EXCHANGE: ASX:ARU

CAPITAL PROFILE

Share price (A$)		**0.094**
52 week range (A$/share)	0.059 to	0.155
Number of shares (M)		**575.8**
Options and warrants (M)		8.4
Converting notes (M)		0.0
Fully diluted (M)		584.1
Market capitalisation (undiluted) (A$M)		**54.1**
Debt (A$M) - Jun 18F		0.0
Enterprise value (A$M)		**47.3**
Major shareholders: East China Min Expl & Devel Bureau (ECE, 24.9%), JP Morgan Nominees (23.5%)		
Avg monthly volume (M)		19.1
Cash (A$M) - Jun 18F		**6.8**
Price/Cash (x)		4.6
Price/Book (x)		0.4
Listed company options:		No



DIRECTORS

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ARAFURA RESOURCES LIMITED

Predicted supply shortages confirm that magnet metals should benefit from the very strong projected future growth in electric vehicle (EV) demand. ARU presents a prime opportunity for exposure to the anticipated upside in this sector.

Share Price: A$0.094 — Speculative Buy

The impending EV revolution in the global automotive industry is creating strong investor interest in sectors with upside leverage such as lithium and cobalt. After a brief surge in 3Q17, NdPr prices have eased, but we think further strong (and sustained) NdPr price rises are inevitable based on the need for non-Chinese supply growth primarily to meet EV, wind power and other demand. Corporate valuations in the NdPr development space are still very low and represent excellent value for taking investment positions in this sector. In relative terms ARU looks to be one of the most under-valued.

INVESTMENT POINTS

- Accordingly, after years of low magnet metal prices, we expect strong medium term price rises for NdPr oxide which will stimulate investment in new non-Chinese production and drive investor interest in the sector.
- Lynas Corporation (ASX:LYC) owns the only major magnet metals mining and processing project in operation outside China. LYC's revenues have more than doubled in the past year, and the share price is up by >400%, a sure sign that the sector is moving back into favour.
- The world's EV component suppliers will want increased secure, stable NdPr supply established in low geopolitical risk regions outside China.
- ARU's Australian-based Nolans NdPr Project is competitively positioned to become one of the new generation suppliers of NdPr. The feasibility study is well advanced and key environmental approvals have been secured.
- Nolans is underpinned by a world-class long-life NdPr resource which will ensure a mine life in excess of 25 years.
- Projected unit costs per kilogram of NdPr are lowest in class for development projects, while ARU's ratio of enterprise value to forecast NdPr production suggests significant under-valuation relative to peers.
- Our forecasts (assuming US$70/kg NdPr price) predict ARU will achieve revenues of A$442M per annum and EBITDA of A$252M per annum when the Nolans Project reaches full capacity. After tax NPV is A$418M.
- Capital raising risk for the US$680M project can be addressed with export credit agency and offtake partner funding, plus, in our view, a modest project equity sell-down, minimising equity capital raising requirements.

COMPANY STATISTICS

Year End June	Mar-18a	Jun-18F	2017a	2018F	2019F
Exploration and evaluation (A$M)	1.42	3.50	6.07	8.75	14.00
Corporate (A$M)	0.47	0.50	1.75	1.75	2.00
Exploration/(Expl.+ Corporate) (%)	75	88	78	83	88
Funding duration at current burn (years)			1.6	0.6	0.1
Shares on issue (pr end) (m shares)	575.8	575.8	546.9	568.5	643.9
Drilling - RAB (m)	0	0	0	0	0
Drilling - RC/Diamond (m)	0	0	0	0	0
Land holding ('000 ha)	187	187	187	187	187
Tenement costs ($k per year)	-	-	-	-	-
Capital raisings (A$M)*	0.0	0.0	6.8	3.2	10.0
Funding from JV partners (A$M)	0	0	0	0	0
Cash (A$M)	10.7	6.8	12.5	6.8	1.1
Cash backing (Ac/share)	1.9	1.2	2.3	1.2	0.2
Net asset backing (Ac/share)	17.9	17.8	18.6	18.0	17.2

* Capital raising of A$10M @A$0.11 per share assumed in FY19

COMPANY COMMENT

Overview: ARU's flagship is the advanced Nolans Rare Earths Project (Northern Territory (NT), Australia). The Nolans deposit is 135km NNW of Alice Springs, and has Measured and Indicated JORC resources of 34.9Mt @ 2.79% total rare earth oxides (TREO) and 12.1% phosphate (P_2O_5). This is equivalent to over 970,000t of contained TREO. The current mine plan supports a mine life of >25 years at a production level of 14ktpa equivalent TREO. The project is world scale, and strategically important with a high content of potentially critical magnet metal rare earths (REs) neodymium (Nd) and praseodymium (Pr) which will drive the economics.

EVs and Wind Turbines to Drive RE Demand: When we talk of RE demand we are really focusing on one key RE component – NdPr oxide ("NdPr") which is a critical raw material input to permanent magnets that are essential in the development of permanent magnet synchronous motors found in most hybrid, plug-in hybrid and battery electric vehicles (EVs) and generators for wind turbines. NdPr magnets are about three times stronger and one tenth of the weight of conventional magnets, and there is no known substitute to achieve similar performance.

As much as the lithium sector has been ignited by the projected rapid demand growth for lithium in relation to lithium-ion battery energy storage for the impending EV revolution, we see similar demand potential for NdPr being predominantly driven by the same revolution in EVs – cars, light duty vehicles, mass transit vehicles and bikes. Demand growth of 8% CAGR looks readily achievable, which means that demand for NdPr oxide could increase by around 30,000tpa in the next decade.

New NdPr Projects Essential to Meet Demand: To avoid a major supply shortfall a large number of magnet metals projects will need to come online in the next decade. In this report we have assessed potential NdPr production from ten magnet metals-dominant RE projects in the development pipeline (at PFS level or beyond). If all ten projects (including the Nolans Project) are commissioned in the next ten years this would only provide an additional 24,000tpa of NdPr supply, based on the projected output levels of these projects.

Magnet Metal Supply – Diversifying away from China: Currently about 85% of the world's REs comes from Chinese-sourced (sanctioned and illegal) supply. Due to environmental crackdowns, elimination of illegal production and industry consolidation, Chinese supply of magnet metals is unlikely to increase in the next few years (see graphic on page 4).

Potential end-users of NdPr oxide, particularly those in the western world, will no doubt place great importance on security of supply when establishing offtake agreements as the demand from EVs and wind turbine manufacture grows. They will be particularly keen to enter into supply agreements with non-Chinese suppliers with mining and processing operations in stable, low sovereign risk countries, which is likely to underwrite the financing and development of RE projects in these jurisdictions. In this regard ARU's Nolans Project is one of the standouts. Currently Lynas Corporation (ASX:LYC) with 5,300tpa NdPr production (targeting 7,200tpa in CY19) is the only major western world supplier of magnet metals.

NdPr Price Rises Required to Fund Major New Projects: The ten global NdPr development projects reviewed in this report will require a total capital spend of US$4.5bn (based on current capex estimates) to achieve the projected combined 24,000tpa of NdPr output – and that does not include additional refining capacity for those projects producing non-separated REOs. In our view, sustained NdPr prices in excess of US$70/kg are needed to underwrite this significant capital investment required to bring on meaningful new production, and it is only a matter of time before we see these price levels. It is hard to see any major new projects being fully funded at levels satisfactory to project owners at current NdPr prices. We saw NdPr oxide prices rise to nearly US$80/kg in August-September 2017 (see chart page 3), but that proved to be a false dawn. Prices now are around US$52/kg. Admittedly much improved on the ~US$40/kg prices seen in the second half of calendar 2016, but nowhere near enough to drive industry growth.

Lynas – the NdPr Bellwether Stock: The improved price rises have transformed the profitability of LYC which is now exhibiting strong cashflow, dramatically reducing the company's perceived risk profile after a near-death experience in 2015-2016. As the charts on page 4 indicate, LYC's revenue has risen strongly since 2016, and its share price has increased more than 90% in 12 months. This is a sure sign of increased investor confidence in this sector, which will rapidly flow towards companies with magnet metals development projects such as ARU once we see higher NdPr prices. This was evident in August-September 2017 when NdPr prices did surge.

Nolans Status and Development Timetable: A key development milestone was reached in May 2018 when ARU received environmental approval from the Australian Government (already having similar approval from the NT Government) for the Nolans Project. The Nolans Project has attained Major Project status with the Australian and NT governments which should help reduce approvals timelines. ARU is now focusing on completing the Nolans Definitive Feasibility Study ("DFS") by the end of calendar 2018, paving the way for detailed engineering and financing in 2019 and possible first production in 2H21. The ore beneficiation, phosphoric acid production and pre-leach stages have been successfully piloted. Currently the acid bake process is being piloted, with the completion of pilot plant work on RE extraction and separation expected to be completed by the end of calendar 2018.

Production and Earnings Forecasts: As shown on page 5, Nolans is forecast to produce 3,600tpa NdPr oxide out of a total output of 14,000tpa total TREO and 110,000tpa of phosphoric acid by-product. In terms of revenue, the NdPr magnet metals will dominate – forecast 75.9% of revenue, phosphoric acid by product 11.3% and other REs just 12.8%. Our model forecasts FY23 (nameplate capacity) revenue of A$442.5M pa and EBITDA of A$252.0M pa.

RCR Project Valuation: Our after-tax valuation (based on a 10% discount rate, 100% equity basis and 25 year mine life) is A$417.7M or A$0.73 per share (undiluted). The base case assumes a long-term NdPr price of US$70/kg. We consider this to be a conservative price forecast based on the demand outlook. Each US$10/kg increase in the NdPr price increases the assessed after-tax NPV by ~A$210M or ~A$0.36 per share.

Global Peer Group Comparison: In this report we have compared forecast operational and cost metrics for ARU and nine other NdPr-dominant global RE development companies, as well as benchmarking against the current producer LYC. This comparison shows that ARU is a stand-out in this emerging producer group in relation to having the lowest projected operating costs (US$ per kg NdPr oxide), long mine life, low sovereign-risk mining jurisdiction and low ratio of enterprise value to projected NdPr production. Capital costs for the Nolans Project (inclusive of a RE separation plant) are at the high end of the scale. However, we believe capital raising risk will ultimately be addressed by NdPr price rises, and can be reduced by engagement with offtake partners (including OEMs) and export credit agencies (ECAs) and a modest reduction in project equity through partnering.

Corporate: As at 31 March 2018 ARU's cash balance was A$10.7M. The cash burn rate for project development, project evaluation and overheads is expected to be ~A$3.8M per quarter in 2H18 so we would expect a further capital raising in the next six months to maintain project development momentum, hopefully in a period of improved NdPr prices.

Investment Comment: Recent subdued NdPr prices, after the 3Q17 surge, have reversed share price gains for most NdPr development companies. ARU's share price, after hitting A$0.15 when NdPr prices jumped in 3Q17 is now back below A$0.10. Our contention, based on Nolans Project attributes and relative value compared to its development peers, is that this represents excellent value with inevitable NdPr price rises likely in the next 12 months.

RESOURCES

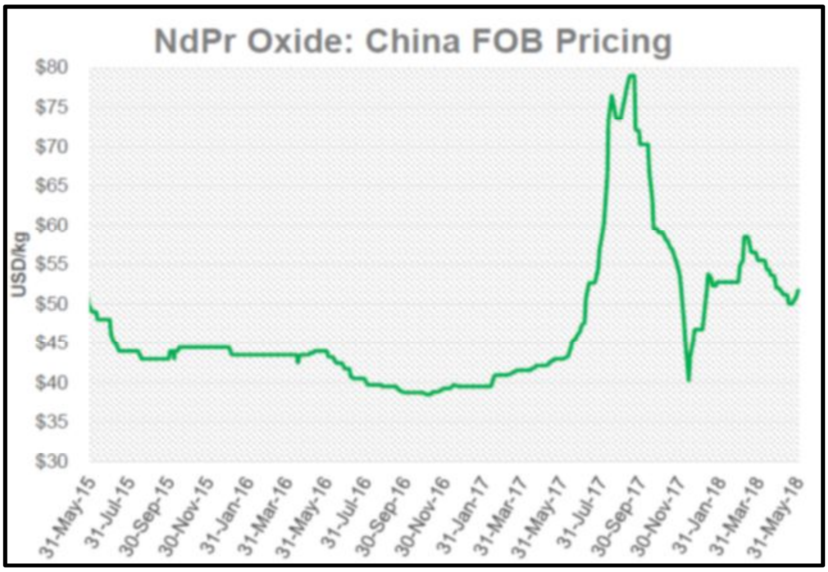
Resources

Code for reporting mineral resources - Australia JORC (2012)

Rare Earth Elements	Classification	Project Equity	Ore mt	TREO %	NdPr * enrichment %	REO kt	P_2O_5 mt
Resources		Cut-off grade for Resources is 1.0% TREO					
Nolans	Measured	100%	4.9	3.2	26.1	158	0.6
"	Indicated	100%	30	2.7	26.1	816	3.6
"	Inferred	100%	21	2.3	26.5	489	2.1
Total Resources			**56**	**2.6**	**26.4**	**1,462**	**5.4**

* NdPr enrichment is the per cent of TREO w hich is NdPr

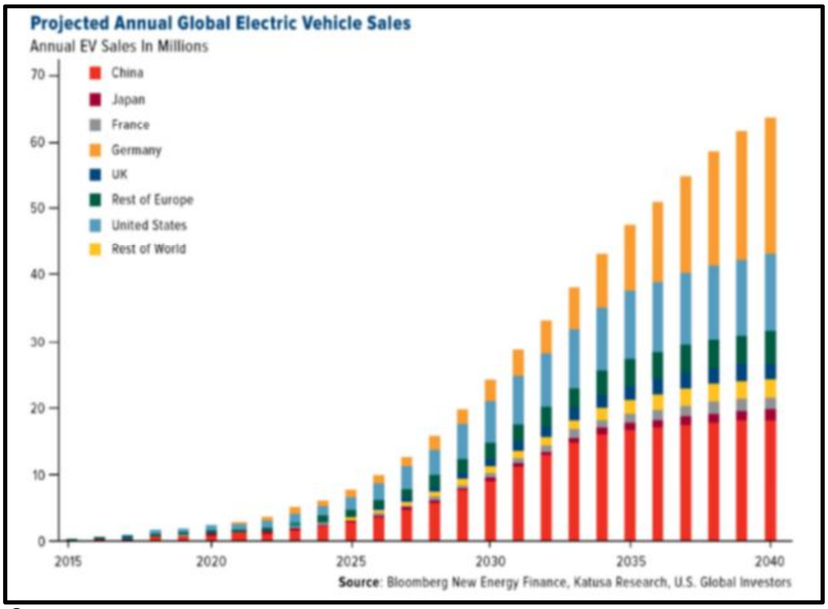
DEVELOPMENTS IN MAGNET METALS MARKETS



Source: ARU

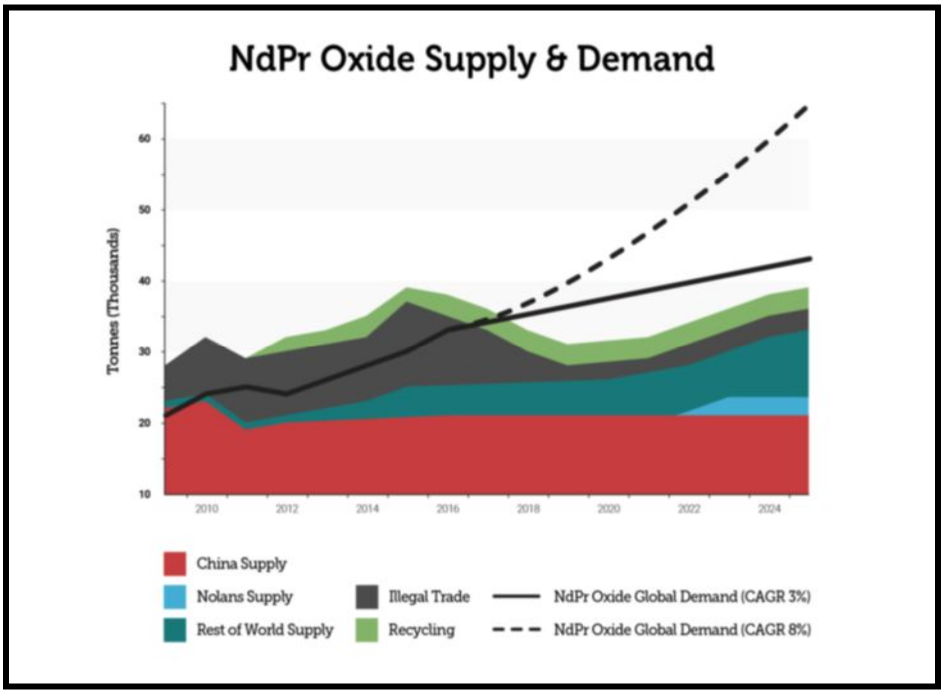
The August-September 2017 spike in prices for the RE magnet metals neodymium (Nd) and praseodymium (Pr), peaking at nearly US$80/kg, is a clear sign of tightness in the market. Prices eased in November 2017 as Chinese NdFeB magnet manufacturers had restocked their NdPr inventories in August-September in the lead up to the month-long mandated shutdown of RE processing operations during October 2017.

We now expect a steady price uptrend to be resumed based on looming supply shortages and the need for higher prices to attract capital funding for new investment in mine supply.



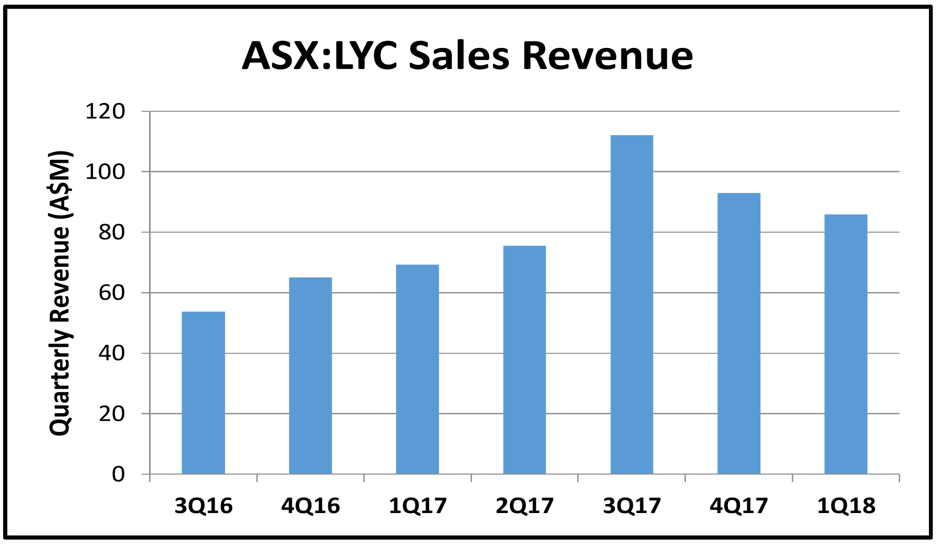
Source:
http://www.businessinsider.com/china-holds-the-keys-to-the-electric-car-revolution-2017-12/?r=AU&IR=T

Sales of (EVs) are predicted to reach 60 million per annum in the next 20 years. Based on an assumed additional 1kg of NdPr required in electric motors for EVs (relative to current average vehicle requirements) this implies an additional demand of 60,000tpa of NdPr in that period. To put that in perspective, ARU's Nolans Project is forecast to produce 3,600 tpa of NdPr oxide, so it would require >16 new Nolans Project equivalents. And that is just to satisfy EV demand. Strong demand growth is predicted from other areas such as wind energy and industrial robotics where highly efficient lightweight electric generators and motors are essential.



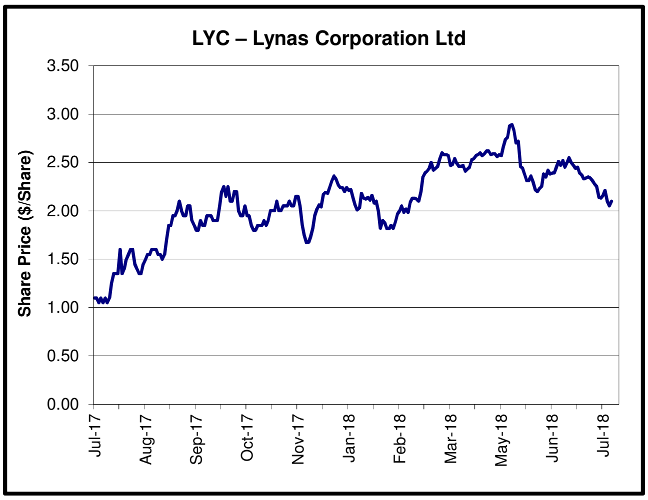
Source: ARU

The looming NdPr magnet metals supply gap is also represented in the demand projections with a forecast increase in NdPr demand of up to 8% per annum (dotted line), which would require an extra ~30ktpa within a decade. Note the recent reduction in illegal trade from China and forecast lack of growth from this country. "Rest of World Supply" is currently Lynas Corporation – the only major Western world producer at present.



Source: company reports

The impact of improving NdPr prices is evident in the improved revenue and cash flow for Lynas Corporation (ASX:LYC). Despite a fall in revenue in the past two reported quarters, average revenue for the past three quarters to 1Q18 (A$97.0M) is up by 80% on 3Q16 revenue (A$53.8M), and hence the company has been able to accelerate debt repayments – inconceivable two years ago.

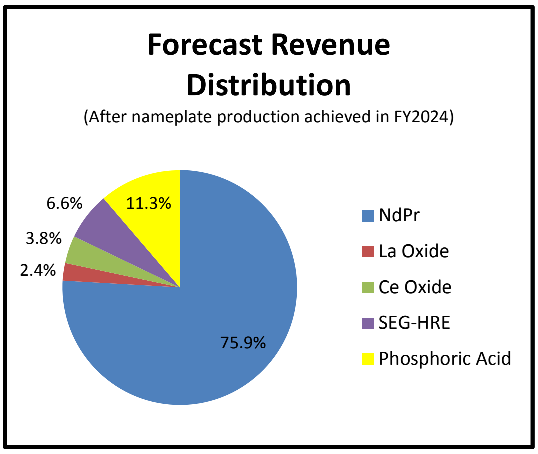


Hence a 91% increase in the LYC share price in the past twelve months. We see LYC as a bell-weather stock which demonstrates the changing investor sentiment in the magnet metals sector – a sentiment that will continue to see increased confidence in the next generation of western world magnet metals producers (of which ARU is a lead contender) which are required to come on stream to fill the looming supply gap.

RCR FINANCIAL MODEL FOR THE NOLANS PROJECT

RCR Nolans Project Financial Model
Base Case Assumptions

Long term exchange rate	A$/US$	0.75
Price escalation	per annum	0.0%
Cost/capex escalation	per annum	0.0%
Tax rate	per cent	30.0%
Average royalty rate (est.)	per cent	3.5%
Product Prices		
NdPr Oxide	US$/kg	70.00
La Oxide	US$/kg	3.00
Ce Oxide	US$/kg	1.80
SEG-HRE	US$/kg	33.00
Phosphoric Acid	US$/tonne	340.00
Production		
Mine life	years	25
Initial production	quarter	3Q21
Nameplate mining rate	kt/year	525
Nameplate production	quarter	3Q23
Nameplate Product Output		
TREO	tonnes p.a.	14,000
NdPr Oxide	tonnes p.a.	3,600
La Oxide	tonnes p.a.	2,660
Ce Oxide	tonnes p.a.	7,080
SEG-HRE	tonnes p.a.	660
Phosphoric Acid	tonnes p.a.	110,000
Operating Costs		
Cash opex	US$/kg NdPr	34.72
Corporate overheads	A$M per annum	8.4
Capital Costs		
Pre-Production	US$M	680
Sustaining	per cent	2.0%
Arafura tax losses	A$M	186



Our model forecasts ~76% of total revenue will be derived from NdPr. Looking at RE revenue (not including phosphoric acid by-product contribution) the NdPr proportion is ~86%

RCR Base Case Model Outputs Summary

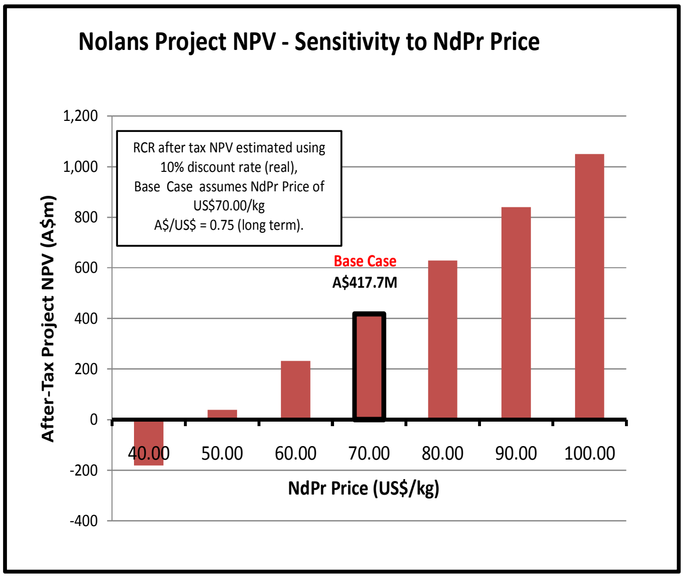
Year: FY2024 (Nameplate Production Achieved)

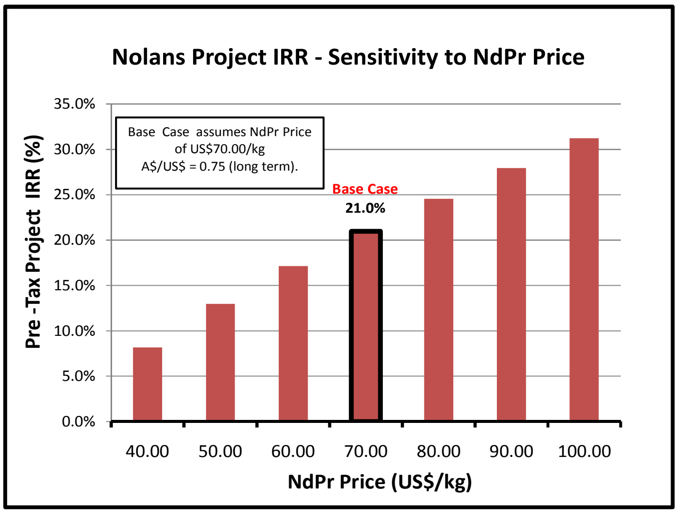
Gross revenue	A$M	442.5
Operating costs		166.7
Admin & overheads		8.4
Royalties		15.5
EBITDA		**252.0**
Depreciation		43.5
EBIT		**208.5**

Corporate Valuation

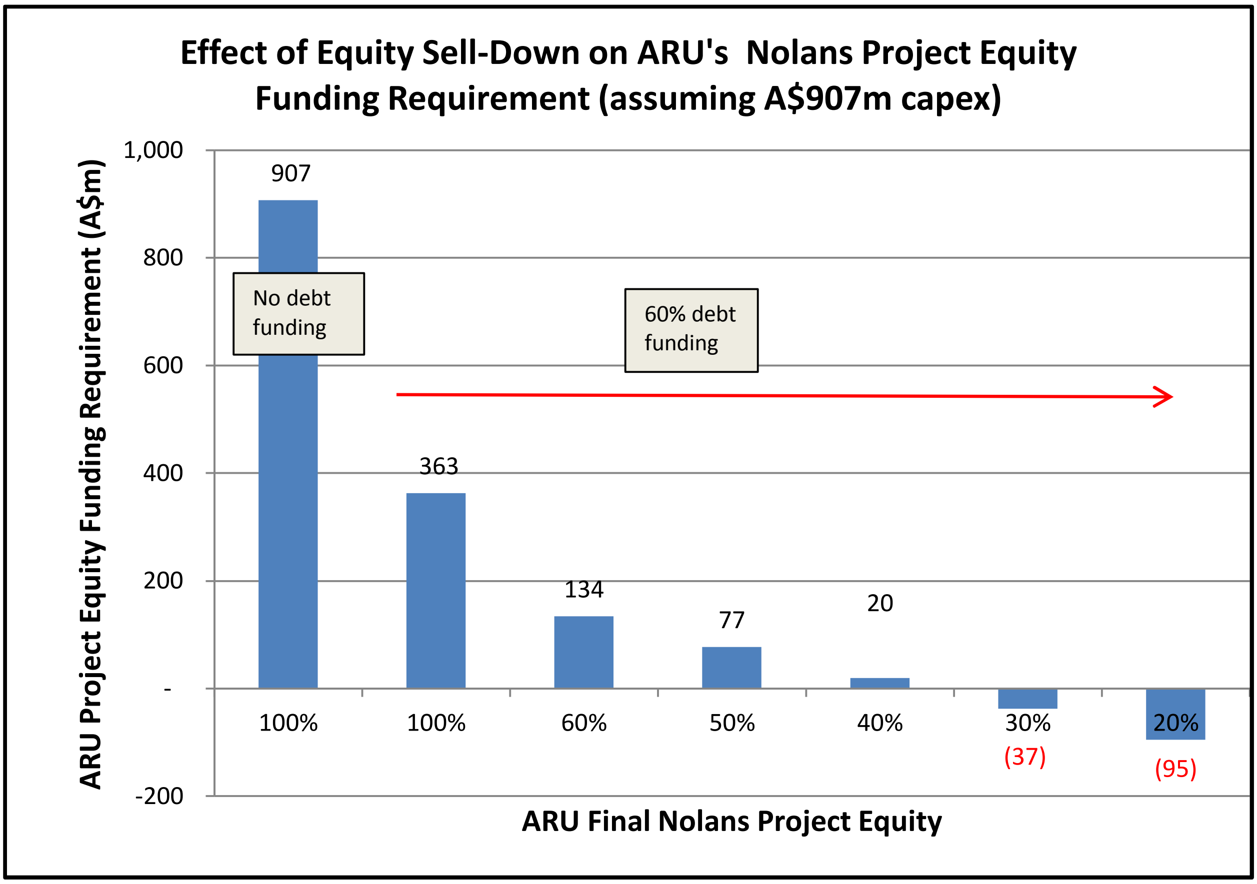
NPV @ 10% discount rate		**417.7**
NPV per ARU share	**A$/share**	**0.73**
Project IRR (pre-tax)		21.0%
Project IRR (after tax)		16.4%

NPV is calculated after tax, allowing for ARU current tax losses (Est. ~A$186M).
Assumes 100% equity funding (ungeared).





ADDRESSING THE PROJECT FINANCING RISK



We consider that perceived capital raising risk is one of the major factors that results in valuations of magnet metals development companies such as ARU being greater than one order of magnitude less than that of the current ASX-listed producer – LYC. The question is asked, "How can a company such as ARU capitalised at around A$50M raise the estimated US$680M (A$907M) capital expenditure to get into production?"

Obviously an anticipated strengthening of NdPr prices in the next 12 months will be a crucial factor, but in our view, the key to opening the door to project funding could come from a project equity sell-down, which will facilitate the path to project financing – particularly if it involves partnering with an end-user who is more interested in offtake contracts than making a killing on the investment (i.e. likely to pay more than an arms-length investor).

To illustrate this, the graph above shows, (based on our valuation assumptions), that if 60% debt financing is secured for the Nolans Project, bringing in a partner to take up 40% project equity at a 50% discount to our assessed after-tax NPV of A$417.7M would leave ARU with A$134M equity funding to raise. A 50% partner would require ARU to raise just A$77M equity.

If an incoming partner paid an equivalent of 70% of our assessed project NPV, then ARU could retain 60% of the project and only need to raise A$101M for its share of equity funding for the A$907M project.

BENCHMARKING ARU AGAINST MAGNET METALS DEVELOPMENT PEERS

ASX-LISTED COMPANIES

Company	ASX Code	Project	Project Equity	Location	Stage	First REO production*	Product	Share Price (A$)**
Arafura Resources Ltd	ARU	Nolans	100%	NT	DFS well advanced	2022	Sep REO	0.094
Greenland Minerals & Energy Ltd	GGG	Kvanefjeld	100%	Greenland	FS Completed	2022	Sep REO	0.078
Hastings Technology Metals Ltd	HAS	Yangibana	70-100%	WA	DFS complete	2020	Mixed RE Carb	0.250
Lynas Corporation Ltd	LYC	Mt Weld	100%	WA/Malaysia	In Production	2013	Sep REO	2.100
Northern Minerals Ltd	NTU	Browns Range	100%	WA	DFS complete	2023	Mixed REO	0.084
Peak Resources Limited	PEK	Ngualla	75%	Tanzania	DFS complete	2021	Sep REO	0.036

OTHER LISTED COMPANIES

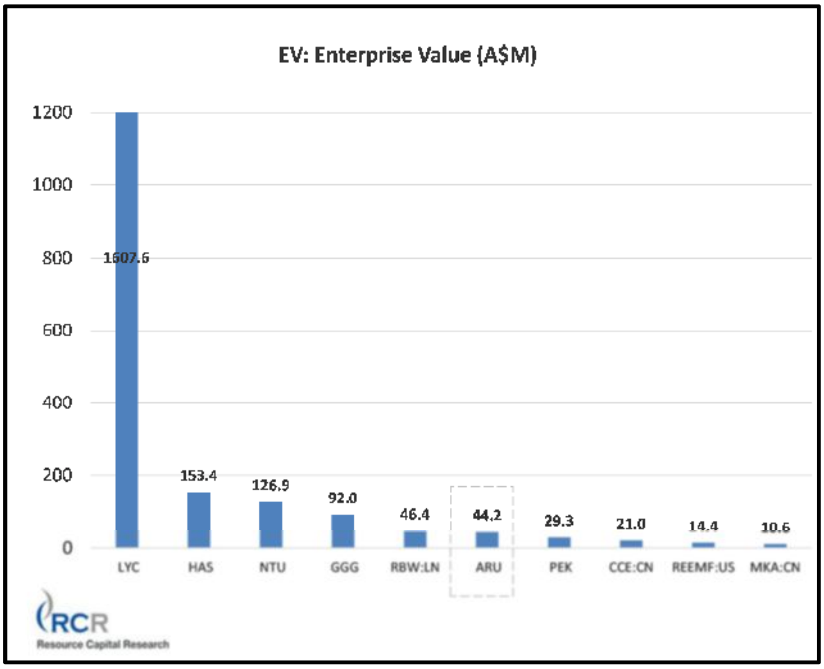
Company	Code	Project	Project Equity	Location	Stage	First REO production*	Product	Share Price **	
Mkango Resources Ltd	MKA:CN	Songwe Hill	51%	Malawi	PFS,Commencing BFS	2023?	Mixed REO conc	CAD	0.140
Commerce Resources	CCE:CN	Ashram	100%	Canada	PFS in progress	2023?	Mixed RE carb. conc	CAD	0.065
Rare Element Resources Ltd	REEMF:US	Bear Lodge	100%	USA	FS underway - low activity	unclear	Mixed REO conc	USD	0.200
Search Minerals	SMY:CN	Foxtrot	100%	Canada	Updated PEA Apr 2016	2022?	Mixed REO conc	CAD	0.040
Rainbow Rare Earths	RBW:LN	Gakara	90%	Burundi	Trial mining underway, no FS	2018	Beneficiated conc	£	0.155

* First production based on current projections in company releases and/or RCR estimates based on current status. LYC is already in production. NTU is currently commissioning a pilot plant operation on site - not deemed commercial production. Production for development projects is contingent on successful project financing and offtake agreements.

** Share prices are closing prices as at 13 July 2018

SELECTION CRITERIA
The project developers in the Table all have a major component of magnet-feed NdPr in their projected product mix, or in the case of NTU, Dy, which is also predominantly a magnet feed.

Alkane Resources (ASX:ALK) which is developing the Dubbo Zirconia Project (DZP) has not been included since NdPr only accounts for about 21% of projected revenues (revenue is predominantly derived from Zr, Nb and heavy RE's) and it is not a pure RE stock - the company has current gold production.



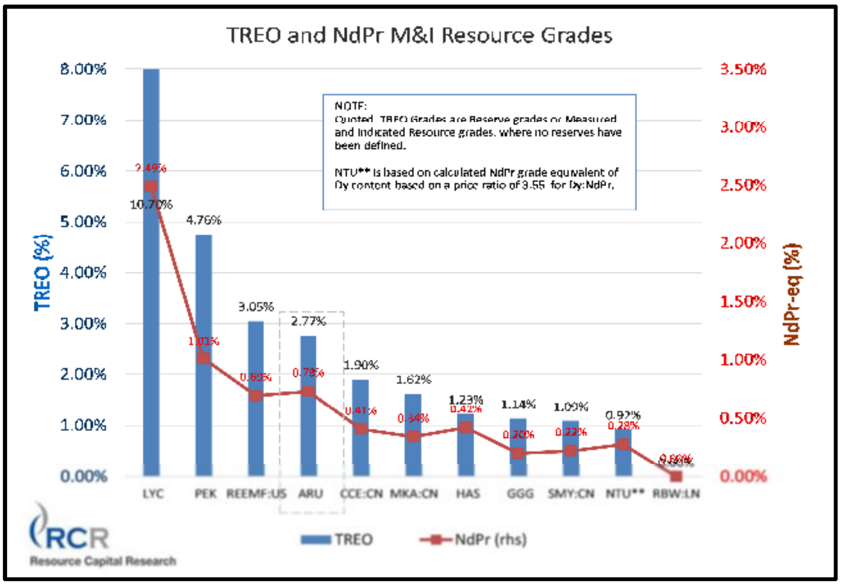
The chasm in enterprise value (EV) between the existing producer (ASX:LYC) and the development companies reflects the perceived capital raising challenges at current NdPr prices but also major potential upside if these projects can be financed and brought into production.

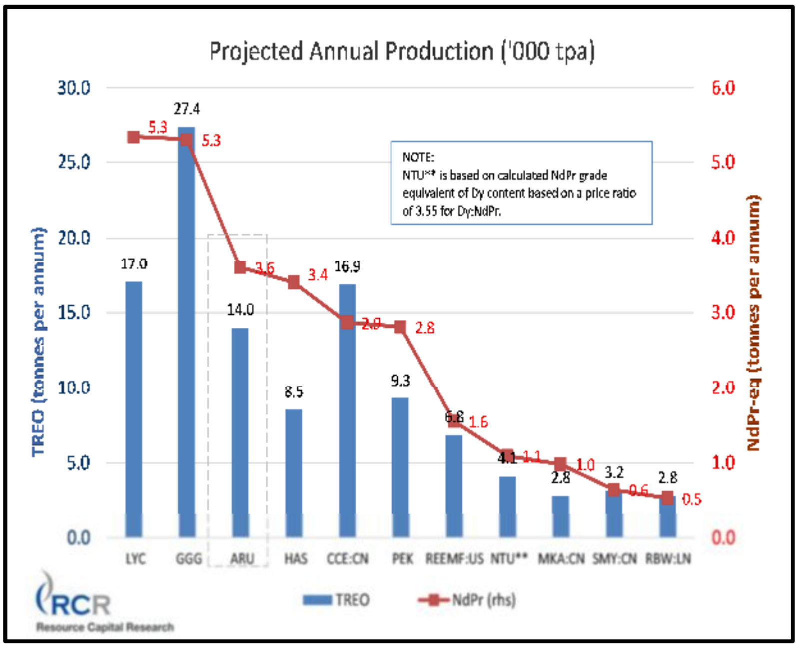
ARU's market valuation in terms of EV looks relatively low relative to three of its ASX development peers, but is significantly higher that the EV of Peak Resources (ASX:PEK) due to sovereign risk issues in Tanzania.

The lower EVs of the non-ASX companies excluding RBW which has commenced trial mining) are partly due to their earlier stage of development.

ARU exhibits fourth-highest TREO grades and, importantly, third highest NdPr grades of the cohort. The NdPr (or NdPr-equivalent in the case of NTU) grades of the lower grade projects are significantly below those of ARU, REE and PEK. LYC's grades stand out.

Note that RBW has no stated reserves or resources, but is probably the highest grade based on current small scale production (279t concentrate produced in 1Q18). RBW has indicated that in situ TREO grades are 47%-67% and the quoted proportion of NdPr is 19% of TREO.

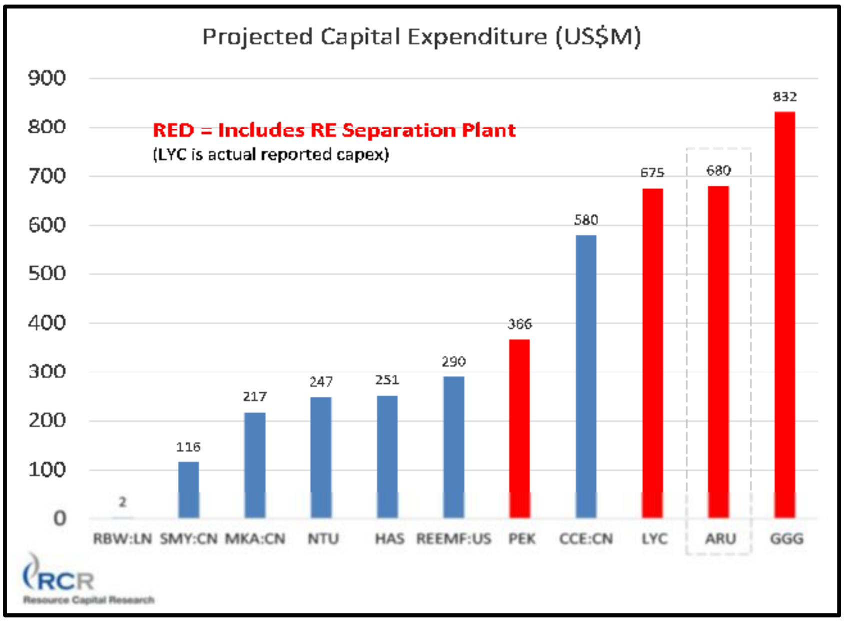


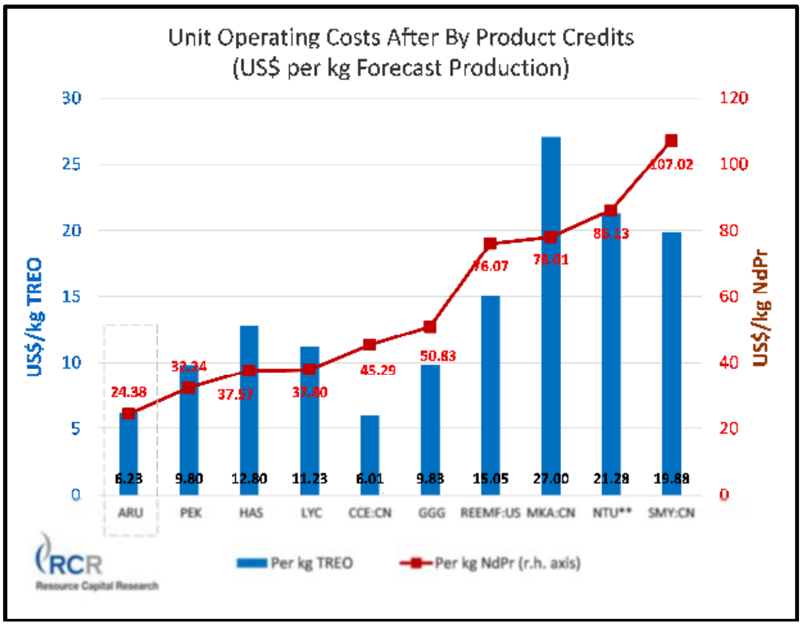


GGG projects major NdPr production but has to also produce large volumes of TREO to achieve this. The larger the gap between the TREO bars and NdPr line, the better. ARU has the third-highest potential NdPr output.

The three proposed projects that plan to include a RE separation plant (to produce higher value-added separated products), and LYC, which already does, not surprisingly, are typically larger scale and at the higher end of the capex scale.

Increased capital intensity increases the capital raising challenge for development companies.





ARU's projected unit operating costs (after by-product credits from phosphoric acid sales) are leading the pack. Of particular importance are the low unit operating costs per kg of NdPr (red data points).

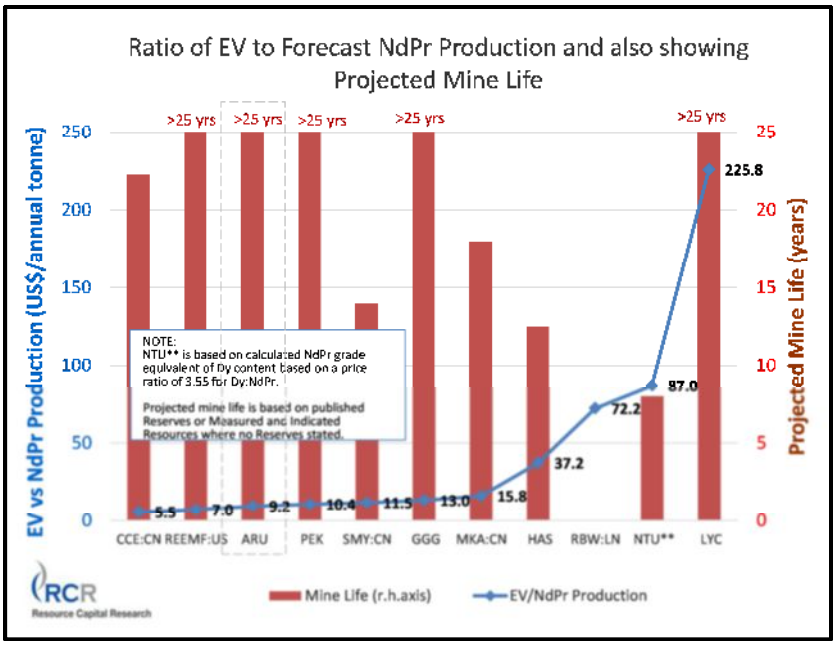
Note: For projects where a mixed oxide (or carbonate) is the final product, we have made a nominal adjustment to project opex to allow for further refining costs (assuming toll treatment). This allows direct comparison between project costs. In some cases companies have specified these projected treatment costs, and typically they range from US$6/kg to US$10/kg NdPr.

There is insufficient data available from small scale mining at RBW's high grade Gakara project in Burundi (which only undertakes ore beneficiation) to include this in the opex comparison.

The ratio of EV to forecast NdPr production shows ARU in a relatively undervalued position relative to its ASX peers, even relative to PEK with its Tanzanian exposure.

The CCE and REE projects are at a significantly earlier stage of development than is ARU's Nolans Project. REE is commencing a FS (current low activity level) and CCE is undertaking a PFS. Neither have progressed the environmental approval process significantly. ARU is one of only four development companies with a projected mine life of over 25 years (based on Measured & Indicated Resources).

Note: RBW has no current reserves or resources.



Notes and assumptions utilised in the preparation of the ASX-listed peer comparison

- Exchange rate s: AUD1 = USD 0.75, CAD1 = USD 0.75; AUD1 = GBP0.56.
- Forecast operating data for development projects based on published company reports and project updates as at 13 July 2018. ARU forecast operating expense includes provision for staff and administration costs.
- Enterprise values based on closing share price and estimated cash, debt on 13 July 2018.
- Contained NdPr tonnes and annual NdPr production is presented on a 100% project basis. and has not been adjusted to reflect the relevant underlying project interest for PEK (75%), HAS (91%), MKA (51%) and RBW (90%).
- LYC NdPr annual production is based on "ready for sale production volumes" and operating costs are based on total operational, production and administration costs (excluding royalties) reported in the last four quarters, up to and including the March 2018 quarter.

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