AUSTRALIAN

RESEARCH

INDEPENDENT INVESTMENT RESEARCH

Allegiance Coal (ASX:AHQ)

Update - March 2018

INDEPENDENT
INVESTMENT RESEARCH

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Note: This report is based on information provided by the company as at March 5, 2018

Investment Profile	
Share Price - 5 March. 2018	A$0.06
Base case valuation	A$0.326/share
Upside valuation	A$0.74/share
Issued Capital:	
Ordinary Shares	385.8m
Unlisted Options	14.1m
Fully Diluted	399.8m
Market Capitalisation	$23.15m
12 month L/H	$0.019/$0.08
Cash and Liquid Investments	$3.02 million
Debt	$0.6 million

Board and Management
Mr Malcolm Carson: Non-Executive Chairman
Mr Mark Gray: Managing Director
Mr David Fawcett: 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	14.31%
JA Ashton Nominees (Qld)	6.45%
GFT Nominees (Qld)	6.45%
Telkwa Holdings (Mark Gray)	5.62%
Bernard Laverty	5.57%
Top 20	74.52%
Board and Management	6.70%

Price Chart (adjusted for consolidation)

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.

CONSIDERABLE PROGRESS AT TELKWA

Subsequent to our September 2017 initiation, Allegiance Coal ("Allegiance" or "the Company") has made progress on key fronts on its now 100% owned Telkwa Coal Project ("Telkwa" or "the Project", located just 375km by rail from the under-utilised Ridley Island Coal Terminal ("RICT") in northwestern British Columbia, Canada.

To reiterate, Telkwa, with a targeted 2020 commencement of production, has Saleable Reserves of 42.5Mt of metallurgical coal, has the potential to produce 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 RICT.

One of the key advances in the past six months has been moving to 100% ownership of the Project, with the original farm-in agreement being for it to earn 90%, and with the ultimate vendor, Altius Minerals Corporation ("Altius", TSX: ALS) to retain a 10% free carried interest ("FCI") on any future small mine (<250ktpa saleable coal) operation. The move to 100% (for 40.6 million shares) took place when Allegiance had earned 20%, and simplifies the ownership structure, and leaves Altius with a cornerstone 14.31% stake in Allegiance.

This has allowed the Company to carry out negotiations with potential offtake partners with the confidence of having certainty in project ownership; to date Allegiance has had interest from a number of Japanese and South Korean steel mills - a current drilling programme, which is also part of the recently commenced Feasibility Study (targeted for completion in Q4, 2018) has been partly designed to collect core samples for potential offtake partners.

The drilling programme, and other activities associated with the Feasibility Study, are being initially funded through an oversubscribed placement that raised A$3.6 million in Q4, 2017.

KEY POINTS

100% ownership: The move to 100% has given certainty in ownership of Telkwa, and will simplify any funding arrangements that would have occurred under a joint venture/FCI scenario; this also adds leveraged value from that under the small mine, FCI scenario.

Interest from steel mills: Obtaining offtake will be critical in securing development funding for any future operation, and as such the interest now being shown by steel mills is vital in working towards the ultimate development of Telkwa - Telkwa is ideally situated to supply North Asian customers through its accessibility to the RICT, and provides a much needed alternative to Australia, which supplies some 65% of the sea-borne metallurgical coal trade.

Cashed up, feasibility commenced: With A$3 million in the bank as of December 31, 2017, the Company is in a good position to fund a significant proportion of the Feasibility Study (with an expected cost, including drilling, of A$2.5 to A$3.0 million); however we would expect that more funding will be required during CY2018, with the Company currently being in the position to place up to 25% of its current share capital without shareholder approval.

Drilling underway: The Company has recently commenced a diamond core and sonic drilling programme, with the aims of the programme to provide core samples for metallurgical test work and soil and rock samples for environmental study purposes; in addition environmental base line studies will be recommencing after winter.

Steady news flow: The above activities should result in ongoing positive news flow from Allegiance through to completion of the Feasibility Study.

Strong metallurgical coal market: The metallurgical coal market remains strong, with this driven both by improving market fundamentals and some one off disruptive events.

VALUATION SUMMARY

We have updated our valuation for Telkwa, with the total risked company value increasing from A$83.5 million to A$125.2 million. However, due to dilution from the October 2017 placement and the allotment of shares to Altius, the risked per share valuation has decreased 9% to A$0.326/share; this is significantly above the current price of A$0.06.

This is an unfunded, pre-tax valuation for the Stage 1, "small mine" operation only, with significant upside to A$0.74 for any expanded operation. Valuations will be affected by any upcoming funding for both pre-development and development activities - this includes changes to per share valuations due to dilution from new equity issues.

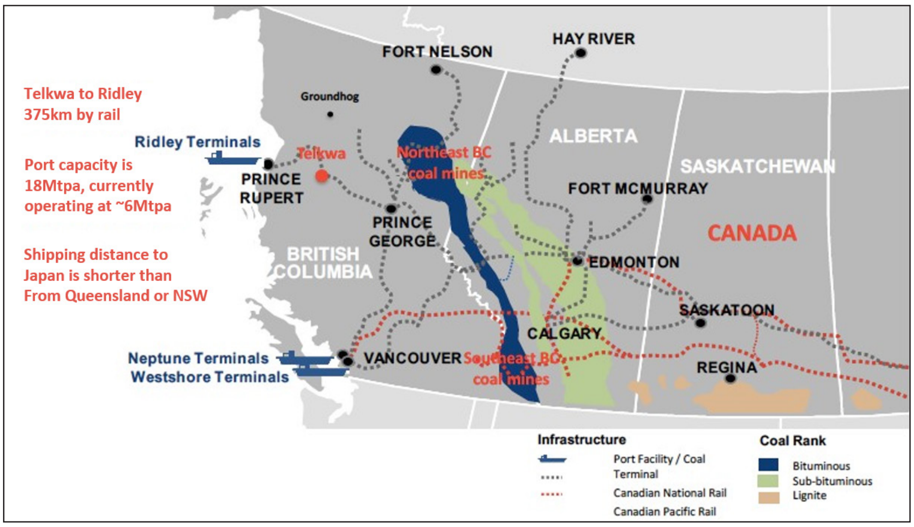
Allegiance base case valuation summary

Asset	Total (A$m)	Risk Factor	Risked (A$m)	Risked/Share	Notes
Telkwa Stage 1 Ops	$94.9 m	70%	$66.4 m	$0.172	NPV_8, Pre-Tax, Unfunded
Other Coal	$564 m	10%	$56.4 m	$0.146	
Net Cash	$2.42 m	100%	$2.42 m	$0.006	Dec 31, 2018, Cash + Debt
Total	**$661 m**		**$125.8 m**	**$0.324**	

ACTIVITIES UPDATE

- This report presents an update to our initiation report published in September 2017; this report, which provides a full description of the Telkwa Coal Project (Figure 1) as of that date is available on IIR's (www.independentresearch.com.au) or the Company's (www.allegiancecoal.com.au) websites.
- All activities have been focussed on advancing Telkwa (with the Company making significant progress in the year since acquisition), with the aim to commence production in 2020, which will be largely dependent upon permitting.

Figure 1: Telkwa location map



Source: Allegiance

100% OWNERSHIP

- As announced to the market on December 5, 2017, Allegiance has now moved to 100% ownership of Telkwa, with this replacing the previous earn-in arrangement whereby Allegiance would earn 90% of the project. The consideration for the change of structure was 40.6 million Allegiance shares, which have taken Altius' holding to 55.2 million shares, or 14.31%; at the time of the transaction the value of the shares was ~A$1.5 million.
- Other terms of the original agreement remain in place, including performance payments and royalties on production
- Remaining 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
3	Grant of small mine permits	Pay C$500k
4	Sale of 100k tonnes from a small mine	Pay C$2M
5	Grant of major mine permits	Pay C$2M
6	Sale of 500k tonnes from a major mine	Pay C$5M

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.

♦ There are a number of key advantages in moving to 100% ownership:
  - Under the original agreement, Altius would retain a 10% FCI in any small mine (<=250,000tpa) operation, with Allegiance having to bear all costs (however both parties would contribute pro-rata to a larger operation).
  - This is removed with the change in ownership, and significantly improves project economics; our modelling, under the FCI scenario, indicated a pre-tax, pre-funding NPV_8 attributable to Allegiance for the Stage 1 operation of A$70.8 million; under the new 100% ownership scenario this improves some 34% to A$94.9 million.
  - This provides certainty in ownership when negotiating with potential offtake partners, and simplifies any project funding arrangements.

STEEL MILL EXPRESSIONS OF INTEREST

♦ A key advancement in the potential development of the project has been, following the completion of the PFS, the interest now being shown by South Korean and Japanese steel mills.

♦ This has included meetings with a number of companies in the two countries, with these followed up by several expressions of interest being submitted to Allegiance, both for offtake and direct investment in the Company.

♦ As part of the negotiation process, potential partners have requested core samples for preliminary metallurgical, including coke oven, test work to assess the suitability as a blending coal - drilling is currently underway.

♦ Telkwa is ideally placed to supply metallurgical coal into the North Asian market, with the proximity to infrastructure and the RICT, and the relatively short shipping distance to Japan and South Korea.

♦ These markets are looking for diversity of supply from Australia (which currently supplies ~65% of the global sea-borne metallurgical coal market), with a number of factors, including strikes and cyclones disrupting supplies and adding volatility to prices.

CAPITAL RAISING

♦ In October 2017 the Company completed an oversubscribed share placement to professional and institutional investors which was lead managed by Bell Potter Securities.

♦ Although initially looking to raise between A$2 million and A$3 million, interest was such that A$3.58 million (before costs) was raised through the issue of 119,209,924 shares at A$0.03/share.

ONGOING ACTIVITIES

♦ An active work programme is underway, with the forecast time line shown in Figure 2 - this is as for our September 2017 report, with the Company continuing to meet targets.

Figure 2: Telkwa time line

Calendar Year	2017				2018				2019				2020				2021			
Quarter	1	2	3	4	1	2	3	4	1	2	3	4	1	2	3	4	1	2	3	4
First Nations	Signed first agreement			Ongoing project review			Socio-eco agreement				Continual project participation									
Project studies	Staged PFS complete		Stage 1 PFS complete		Stage 1 FS		Stage 2 FS													
Environmental	Baseline studies commenced						Continual environmental monitoring for stages 1 & 2													
Stage 1 permitting	Constant ongoing Govt. dialogue						Stage 1 filings		Stage 1 decision											
Marketing			Secure JV partner																	
Financing					Secure mine finance															
Stage 1 development										Stage 1 construction										
Stage 1 mine												Stage 1 coal production								
Stage 2 permitting															Stage 2 filings		Stage 2 decision		Stage 2 mining	

Source: Allegiance

Drilling

- As announced to the market on December 5, 2017, the Company has commenced a programme of sonic and diamond core drilling in the Tenas pit area at Telkwa - the purposes of this is:
  - To gather rock and soil for geochemical test work in relation to the Company's waste rock management plans;
  - To gather rock and soil for geotechnical analysis in relation to pit wall and waste rock dump stability;
  - To install three further ground water wells for water monitoring;
  - To gather coal core for the Company's coke oven tests; and
  - To supply coal core to enable steel mills to conduct their own coke oven tests.
- It was originally planned to drill six, 3.25" diameter diamond drill holes to 100m each, and 18 4.75" diameter sonic drill holes to 10m each, however given the steel mill interest the diamond drilling has been increased to 16, 6.00" diameter holes to ensure that enough core is collected to satisfy demand.
- It is expected that the samples will be provided to potential partners in March, and that the Company's coke oven work will be completed in April.

Feasibility Study

- On February 27, 2018, Allegiance announced that it had commenced the Feasibility Study for a 240,000tpa small scale operation as envisaged in the PFS, with the Company targeting completion by the end of CY2018.
- This will target the Tenas pit area only, which has 21Mt of saleable reserves.
- As part of this, SRK Consulting (Canada) Inc. ("SRK") has been appointed as lead manager, with Sedgman Canada being appointed to undertake detailed design work for the coal preparation and handling plant.
- Both firms, which are internationally recognised in their fields, were involved in the 2017 pre-feasibility studies, with SRK being the lead manager of these.
- In addition a number of other consultants have been engaged in specific areas of the planned operations.

Permitting

- Permitting activities are continuing, with these including stakeholder engagement and environmental activities amongst others.
- Allegiance is still working on being able to permit the planned operations under the "small mine" regulations (Scenario 3 in Figure 3), however has mentioned that there is some risk that a more comprehensive regime may need to be followed despite the proposed project falling within the "small mine" requirements.
- Note that time frames below are indicative only, and may well vary on a project by project basis.
- The Company plans to lodge the Project description with the BC Ministry of Energy and Mines ("MEM") in March 2018, following which the MEM will advise Allegiance of the permitting requirements.

Figure 3: Permitting scenarios

Scenario 1: Project exceeds both Federal and Provincial Thresholds (>= 1Mtpa)			
Environmental Assessment	Permitting	Licensing	Total
3 years	1 year	1 year	~5 years
Scenario 2: Project exceeds Provincial Threshold but not Federal (>= 250,000 tpa to < 1Mtpa)			
Environmental Assessment	Permitting	Licensing	Total
2 years	1 year	1 year	~4 years
Scenario 3: Project is under both Federal and Provincial Thresholds (< 250,000 tpa)			
Environmental Assessment	Permitting	Licensing	Total
Does not apply	1 year	1 year	~2 years

Source: Allegiance

- Even though Scenario 3 has a shorter permitting time frame (largely due to the level of consultation required) environmental requirements are as stringent as for the other scenarios and baseline studies are still required, and on which the Company has been actively working.
- Although halted for winter, it is expected that field work will recommence in Q2, 2018 and be completed in Q3, 2018
- Other activities include the key First Nation engagement, with the initial Communications and Engagement Agreement being signed last year and engagement ongoing; the Company is also engaging with other stakeholders.

VALUATION

Summary

- We have updated our valuation for Allegiance, with summaries presented in Tables 2 and 3 below.
- The Telkwa valuations used in Table 2 are unfunded and pre-tax; Table 3 includes figures for funded, post-tax scenarios for Telkwa operations only - any future funding will affect the Company value, with equity raisings diluting the share base and thus reducing the per share value.
- The previous unfunded/pre-tax valuations were based on the then share base of ~225 million shares; this has subsequently increased to 386 million with the issue of consideration shares to Altius and those issued under the September 2017 placement.
- Most other inputs are as used as in our initial valuation, with the following changes:
  - We have changed the Project ownership to 100%,
  - Given recent events, we have increased the risk multiple for planned operations from 50% to 70%, and,
  - For the "Other Coal Reserves" entries, we have increased the base value from A$8.25/tonne to A$10/tonne to reflect the increase in the NPV/tonne - these refer to coal resources/reserves that are not mined under the modelled scenarios, but may support additional future operations.

Table 2: Allegiance valuation summary

Allegiance valuation summary					
Asset	**Total (A$m)**	**Risk Factor**	**Risked (A$m)**	**Risked/Share**	**Notes**
Base case, 250,000tpa, 18 year operation					
Telkwa Stage 1 Ops	$94.9 m	70%	$66.4 m	$0.172	NPV8, Pre-Tax
Other Coal	$564 m	10%	$56.4 m	$0.146	See point below
Cash	$3.02 m	100%	$3.02 m	$0.008	Dec 31, 2018
Debt	-$0.60 m	100%	-$0.60 m	-$0.002	Dec 31, 2018
Total	**$661 m**		**$125.2 m**	**$0.324**	
Expanded operation, 250,000tpa for five years, 1,000,000tpa for 20 years					
Telkwa Stage 1 and 2 Ops	A$356 m	70%	$249 m	$0.645	NPV8, Pre-Tax
Other Coal	A$333 m	10%	$33.3 m	$0.086	See point below
Cash	$3.02 m	100%	$3.0 m	$0.008	Dec 31, 2018
Debt	-$0.60 m	100%	-$0.60 m	-$0.002	Dec 31, 2018
Total	**A$691 m**		**$285 m**	**$0.738**	

Source: Allegiance, IIR analysis

- Although the changes have increased the overall Company value, due to dilution this has decreased the per share values by ~9% for the unfunded/pre-tax cases; this however has not occurred in the funded cases as the diluted share base in these scenarios is similar to that in our September 2017 report.
- Table 3 presents a summary of pre-tax/pre-financing and funded unrisked valuations for both Telkwa production scenarios.
- In financing, we have used a conceptual 60:40 debt:equity split for the up-front capital, with equity being raised at A$0.10/share as per our initiation valuation.
- This results in a diluted share base for per share calculations of 560.8 million.

Table 3: Telkwa project valuation summary

Telkwa project valuation summary		
Parameter	**Base Case**	**Expansion to 1mtpa**
Telkwa Un-Funded, Pre-Tax NPV_8	A$95 m	A$356 m
Telkwa Un-Funded, Pre-Tax IRR	36.5%	47.1%
Telkwa Funded, Post-Tax NPV_8	A$87.5 m	A$274 m
Peak Annual FCF - Funded	A$12.82 m	A$47.4 m
Peak Annual EBITDA	A$13.8 m	A$50.4 m
Implied 5x EBITDA Multiple	A$69.1 m	A$252 m
Un-Funded, Pre-Tax Value/Share	$0.25	$0.92
Funded, Post Tax Value per Share	$0.16	$0.49

Source: IIR analysis

Sensitivity

- Our analysis indicates that the Project is most sensitive to operating costs and coal prices, with the base case sensitivity being presented in Table 4 (pre-tax NPV) and Table 5 (IRR) - this is for Telkwa only, and not the Company valuation.
- These show however, by virtue of the relatively low operating costs that even the low throughput operation is relatively robust; our view is also that these are the factors that have the main capacity for change.
- The sensitivity to coal price will also be affected by exchange rates.

Table 4: Telkwa base case pre-tax NPV sensitivity - AUD

Telkwa base case pre-tax NPV sensitivity - AUD						
		Change in Operating Costs				
	$94.87	-20%	-10%	0%	10%	20%
FOB Coal Price US$/t	US$90	$71m	$58m	$44m	$31m	$17m
	US$95	$84m	$70m	$57m	$43m	$30m
	US$100	$96m	$83m	$70m	$56m	$43m
	US$105	$109m	$96m	$82m	$69m	$55m
	US$110	$122m	$108m	$95m	$81m	$68m
	US$115	$133m	$121m	$108m	$94m	$81m

Source: IIR analysis

Table 5: Telkwa base case pre-tax IRR sensitivity

Telkwa base case pre-tax IRR sensitivity						
		Change in Operating Costs				
	36.50%	-20%	-10%	0%	10%	20%
FOB Coal Price US$/t	US$90	29.9%	26.0%	22.2%	18.2%	14.0%
	US$95	33.4%	29.6%	25.8%	21.9%	17.9%
	US$100	36.9%	33.2%	29.4%	25.6%	21.7%
	US$105	40.4%	36.7%	33.0%	29.2%	25.4%
	US$110	43.9%	40.2%	36.5%	32.8%	29.0%
	US$115	47.0%	43.7%	40.0%	36.3%	32.6%

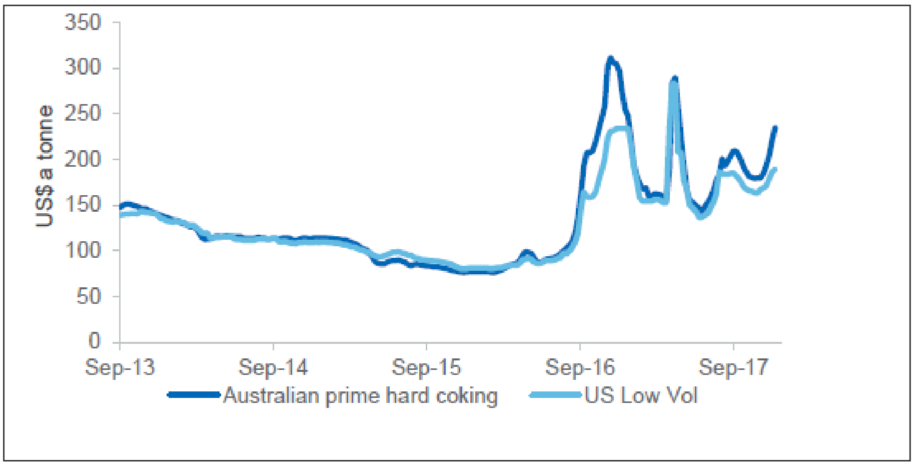
Source: IIR analysis.

SEA-BORNE METALLURGICAL COAL MARKETS

- Telkwa plans to sell metallurgical coal into the global sea-borne market, targeting Asian customers.
- In 2016, the sea-borne trade was ~315Mt, and is forecast to remain relatively stable or grow at ~1-2% per annum over coming years.
- The largest exporter is Australia, which in 2016 exported 189.3Mt, or 60% of sea-borne demand, with Australia being followed by the US (37Mt, 11.7%), Canada (34Mt, 10.7% and Russia (22Mt, 7%).

- 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 2016 China was the largest importer (~60Mt), followed by India (~50Mt), 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 3 shows four year prices for HCC, and highlights a potential base forming at ~US$150/tonne to US$170/tonne for these products - this implies minimum FOB prices of ~US$105/tonne and US$97.50/tonne for PCI and SSCC coals respectively.

Figure 3: Metallurgical coal prices - Australian prime hard vs US low volatile, FOB



Source: Resources and Energy December 2017 Quarterly

Price Forecasts

- Price forecasts, as usual for commodities, are varied; with long term research and broker FOB Queensland forecasts compiled by KPMG in January 2018 ranging between US$110/tonne and US$134/tonne for HCC, US$86/tonne to US$105/tonne for PCI and US$82.70/tonne to $US97/tonne for SSCC.
- We note that these are lower than the forecasts for HCC of US$140-US$170/tonne used in the Company's PFS, however we would consider these to be relatively conservative, with all having prices in backwardation; these are also up ~10% on July 2017 forecasts.

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