AMBRIAN

Metals & Mining

Archipelago Resources

Buy

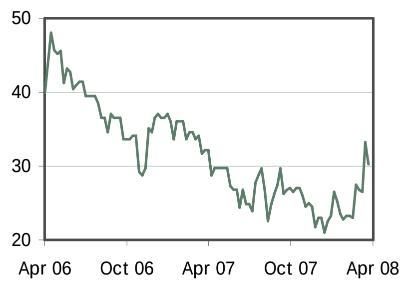
AMDAL Approved

9 April 2008

Upcoming Events
Finance finalised (2Q08)
Debt drawdown (2Q08)
Construction started (2Q08)
Commercial production (2Q09)

Market cap	**£50.7m**
Ticker	**AR.**
Price	**27.75p**
Target price	**52p**
Resource (Moz)	1.77
Reserve (Moz)	0.96
LOM prod'n rate (oz Au pa)	167,000
LOM cash cost (US$/oz)	360
EV/2009E prod'n (US$/oz)	1,913
Est. cash in hand (£m)	5.3
52-week (p)	
High	39.0
Low	22.5
3M-avg daily vol (000s)	**408.8**
3M-avg daily val (£000)	**116.6**
Shares	
Basic	**182.7**
Fully diluted	**200.3**
Top shareholders	
Baker Steel	13.2%
JP Morgan	7.0%
MLP Investment	6.4%
Asia Image	5.4%
Total	**32.0%**

Share Price Performance (p)



Source: Fidessa

Ambrian acts as Broker to this company

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In March 2008 the State Government of Indonesia issued Decrees approving the development of the Toka Tindung gold project, 85%-owned by Archipelago. The environmental AMDALs for the Toka Tindung project have now been approved under Indonesian law as outlined in the decree, which also approves the operating companies' entitlement to recommence construction.

Milestones ahead of Archipelago include financing and construction at the mine itself. We will undertake a site visit shortly, following which we will present a more detailed review of the operational steps the company will take ahead of production.

We value Toka Tindung on a DCF basis, with a post-tax 1x NPV$_{10\%}$ of US$177.8m, or 52p/share. Archipelago is currently trading well beneath its fundamental value as a result of the perceived risk the market still applies to the project. Although we believe remaining hurdles can be overcome, such a perception cannot be ignored, so ahead of ahead of financing and construction we use a 1x NPV target price, equating to 52p/share. When finance is finalised and construction begins, we expect to update our valuation to 1.25x NPV (65p/share). When in full production, currently targeted for 1H09, a 1.75x NPV multiple may be achieved (91p/share), offering potential returns of over 200% over 12-18 months before any equity dilution (if equity is required).

Toka Tindung NPV Sensitivities to 2011+ Gold Price and Discount Rate

		Gold Price US$/oz 2011+				
		450	**650**	**728**	**800**	**1,000**
7.5%		28	38	45	52	71
10.0%		33	43	**52**	60	82
12.5%		38	50	60	69	95
			2009E	**2010E**	**2011E**	**2012E+**
Gold price	**(US$/oz)**		843	780	728	728

Source: Ambrian estimates

The project offers further fundamental and valuation upside, but political and commissioning risks remain. We have modelled a nine-year mine life, with 1.5Moz mined from a resource of 1.8Moz (1.1Moz current mine plan), but believe there is potential for further mine life extensions. However, although we argue that the long delaying regulatory hurdles are cleared, some political risk lingers, despite local and State support. Also, like any mine, commissioning risk is inherent.

Ambrian Financial Forecasts for Archipelago Resources

	2009E	**2010E**	**2011E**	**2012E**
Revenue (£m)	0	45.4	69.3	63.5
EBITDA (£m)	-1.7	16.7	32.5	26.1
EV/EBITDA (x)	-	6.0	3.1	3.9
EPS (p)	-	4.6	10.1	7.6
P/E (x)	-	6.1	2.7	3.6

Source: Ambrian estimates

Valuation

Post-tax 1x NPV valuation of US$177.8m for Toka Tindung

We value Toka Tindung at 1x $NPV_{10\%}$ of US$177.8m on an attributable project basis based on post-tax project free cashflow for Toka Tindung, with 15% minority interest removed after the recoup of carried debts. Debt finance of US$60m has been modelled; no equity dilution or hedging is incorporated, although one or both may be required once the company finalises its capital budgeting plans in the near future. Archipelago typically presents the NPV of pre-tax operating cashflow, thus excluding the tax, capex and minority interest charges that we have applied.

Modelled mine production of 1.5Moz from 1.8Moz resources

We model a nine-year mine life, with production commencing in 2Q09 (one quarter of contingency added to mine plan), with 1.5Moz mined from a 1.8Moz resource. This is an expansion over the mine plan of 1.1Moz, but we are confident the resource offers geological upside to support our assumption, exemplified by drilling results released in 2007.

Production Profile and Cash Costs Modelled for the Toka Tindung Project

Source: Ambrian estimates

We model average production of 167,000oz pa with head grade of 3.3 g/t gold

Production of 1.7Mtpa is planned, producing an average of 167,000oz pa at an average head grade of 3.27 g/t. Capex is US$52.8m, excluding working capital, and 2.5% sustaining capex is applied, diminishing in later years. Cash costs vary over the mine life, but average US$359/oz in our model. An additional refining charge of 0.4% and royalty of 2.375% are payable. Tax comes under 30% and 35% contracts, and is applied at 32.5% after a tax asset of US$12m is exhausted.

Cash Cost vs. Forecast Gold Price for the Toka Tindung Project

Source: Ambrian estimates

Gold recovery 94%

An operating model for the project is shown below. Gold recovery is around 94%, while silver is around 70%. Gold equivalent is shown, as calculated from spot gold and silver prices. However, all cash costs are for gold only.

Operating Model for the Toka Tindung Gold Project

	2008E	2009E	2010E	2011E	2012E
Ore processed (Mt)	-	1.08	1.70	1.70	1.70
Gold head grade (g/t)	-	3.19	3.30	3.23	3.39
Gold recovered (000oz)	-	104,463	170,932	166,793	178,250
Silver recovered (000oz)	-	183,158	410,583	512,970	577,992
Gold eq recovered (000oz)	-	107,919	178,681	176,474	189,158
Gold price (US$/oz)	-	843	780	728	728
Silver price (US$/oz)	-	15.5	14.2	12.0	12.0
Revenue (US$m)	-	90.1	137.5	125.8	134.9
Operating cost per ounce (US$/oz Au)	-	382	355	381	323
Operating cost per ounce (US$/oz Au eq)		369.8	340.1	360.2	304.4
Operating costs (US$m)	-	39.9	60.8	63.6	57.6
Refining charge (US$m)	-	0.4	0.5	0.5	0.5
Royalties (US$m)	-	2.1	3.3	3.0	3.2
Project operating profit (US$m)	-	47.7	72.9	58.8	73.6
Net finance income (US$m)	-1.3	-4.9	-0.9	2.4	4.4
Tax (US$m)	-	10.2	21.5	18.0	23.4
Minority interest (US$m)	-	-	-	-	2.2
Project PAT (US$m)	-1.3	32.7	50.7	43.4	52.5

Source: Ambrian estimates

10% discount used for NPV of US$178m

The discounted cashflow valuation for Toka Tindung is shown below: tax, minorities and capex are deducted ahead of operating profit, while interest is incurred for debt, and paid on the accumulated cash balance. We use a 10% discount rate for consistency across all developing mining operations. Our current US$/GB£ exchange rate is 1.96.

Discounted Cashflow Valuation for the Toka Tindung Gold Project

	2008E	2009E	2010E	2011E	2012E
Project PAT (US$m)	-1.3	32.7	50.7	43.4	52.5
Less capex (US$m)	39.7	14.2	1.3	1.3	1.3
Project free cashflow (US$m)	-41.0	18.5	49.3	42.1	51.2
Discount rate	10%				
Present value of FCF (US$m)	177.81				

Source: Ambrian estimates

Recommendation — BUY, Target Price 52p

Currently trading at a discount to NPV based on perceived risk — significant upside offered

Archipelago Resources is currently trading around 0.55x NPV; when in full production we would expect this to rise to 1.75x NPV. Share price drivers are directly linked to the key milestones shown overleaf. As it stands, construction is part-complete (storage dams, jetty, foundations, part fabrication and mill on site, etc), and is now only awaiting debt finance arrangements. As such, although risk remains, because investors have a solid idea of the economics of the project, and the project has received a mandate from the State government to proceed, we believe a 1x NPV valuation is warranted. This equates to 52p/share.

Fair Value Calculation for Archipelago Resources

Present value of FCF (US$m)	177.8
2Q08 GB£/US$ exchange rate	1.98
NPV multiplier (x)	1.0
Project valuation (£m)	89.7
Estimated net cash (£m)	5.3
Enterprise value (£m)	95.0
Shares in issue (m)	182.8
NPV per share (£)	0.52

Source: Ambrian estimates

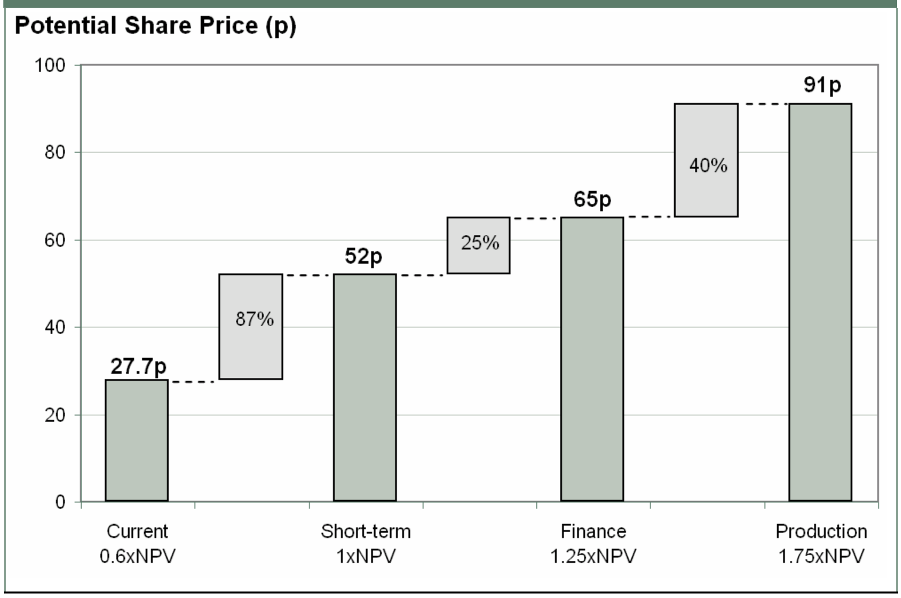
Once finance finalised and construction commences we expect to increase our target to 1.25x NPV

The current share price is clearly trading at a discount to NPV. Much of this discount is related to the remaining perceived political risk surrounding permitting of the project, with delays caused by opposition to the mine from the local Governor a historic issue. Also, with equity and debt financing to be completed, dilution and hedging requirements are not yet finalised. Once these two milestones are reached we would expect to update our valuation to 1.25x NPV (65p/share).

Once in full production a 1.75x NPV could be achieved

Construction comes with risk; with many gold projects running behind schedule at the construction phase, delays often come from difficulties in securing basic equipment (pipes, wiring, tyres, etc) and manpower. Thus, once in production and construction is fully de-risked (currently targeted for 1H09), a 1.75x NPV multiple may be achieved (91p/share). This offers potential returns of close to 200% over 12-18 months, although this could be diluted if further equity raising is required.

Key Milestones/Share Price Drivers and Potential Valuation Uplift



Source: Ambrian estimates

Licensing

AMDAL is required for mining

Mining projects in Indonesia are required to have their environmental impact assessment approved, as signified by the granting of an AMDAL. The AMDAL also includes aspects on community involvement and social development plans.

AMDAL must be *accepted* then *approved*

For the project to progress to the construction phase of the Contracts of Work, AMDALs, or in the case of Toka Tindung revised AMDALs (originals having been approved in 1998), must be *accepted* by the Environment Department, and then *approved* in law at State level (but not necessarily by the Environment Department). Importantly, the approval of the AMDAL depends not only on environmental management plans, but also on community input. That said, the Provincial Governor, who may be consulted on AMDAL approval (as was the case for Archipelago) has no authority in law to decide on the matter.

Archipelago AMDAL updated to reflect new tailings solution

In 2006 the operating companies were asked to amend their existing AMDALs to reflect a change from submarine (STPS) to land-based tailings (TSF) storage. At the time, STPS practices had led to an investigation into pollution at Newmont's nearby Mesel mine at Buyat Bay. However, Newmont was subsequently cleared of any wrongdoing.

Indonesian Government Structure

State: The highest level, with mining licence approval ultimately determined by the State Minister for Energy and Minerals

Province: The highest tier of local government, headed by a Governor with its own legislative body

Regency/City (rural/urban): One tier below the province, headed by a Bupati/Wlicota with its own legislative body

Sub-districts and Administrative Villages: Beneath the Regency level

Governor withdrew support at Province level

With onshore tailings now planned, Archipelago lodged revised AMDALs based on a TSF which were acceptable to the Environment Department's AMDAL Assessment Commission. However, in February 2007, ahead of a 2009 World Ocean Conference, the Governor withdrew his support on environmental grounds, despite provincial support for mining (as demonstrated by the recent hosting of a seminar on the potential for and sustainability of sea-bed mining).

Regency support led to State-level decision to go ahead — AMDAL is now approved

Despite this political setback, which caused a significant delay, the company received demonstrable support from the local community and leaders. Late last year the Regency parliament voted in support of the project based on the economic benefit to the Regency. The project has now been granted State-level approval to restart construction based, in part, on the support from the local people. The Director General of Mineral, Coal and Geothermal (from the Ministry of Energy & Mineral Resources) issued decrees stating that the operating companies' AMDALs are approved under Indonesian law and approving the re-commencement of construction.

Opinion

Our review suggests positive social impact, all regulatory approvals in place, opposition from limited parties only

Delays in granting the AMDAL had led to media speculation that the Toka Tindung project will not receive permitting based on perceived negative social and environmental considerations. Such speculation is possibly outdated as all necessary permitting is now in place. However, for independent due diligence we undertook a critical review of the NGO, media and company information to date, and are now confident that: (1) the project has a positive social impact and engages best-practice environmental practices; (2) the company is now in receipt of all required regulatory approvals to commence construction and subsequent mining; and (3) opposition to the project is restricted to the Provincial Governor, one lobby group and several NGOs, whose allegations against Newmont were found unfounded.

We believe there is no major groundswell of opposition

Key to our conclusion is that the major groundswell of opposition reported in the media is, in our view, largely baseless. In coming to this conclusion we have reviewed the social and environmental impact and management strategies, as well as reported opposition, as outlined below.

Positive community impact

Community Support: The company actively contributes to the local community through numerous health, infrastructure, education, social and business contributions. In the AMDALs, future programmes have been outlined to ramp up the community support once in production.

Financial contribution at local, regional and State levels

Financial Contribution: Archipelago estimates some 56% of all revenue will be disbursed to the local community, regional government in North Sulawesi, and State government. This comes through royalties, tax and employment — flow-through from the almost 550 direct jobs created is estimated to add a further several thousand jobs indirectly.

Excellent environmental management plan

Environmental Impact: After initial opposition to marine tailings disposal, the company has now engineered an onshore solution. We are particularly impressed with the rigour of the design, including a tailings dam not just upstream of the open pit, but also upstream and abutting the waste dumps (separated by an independently internationally-monitored high-specification sealing wall). While having marginally higher operating costs than a traditional downstream location, it creates added security for the local community, and is the highest specification tailings solution we have ever seen.

Project meets Equator Principles adhered to by lenders

Lending Criteria: Project finance is vital to development in emerging countries, but it is important to ensure that this development is socially responsible, and that sound environmental management practices are used. To this end, many banks have adopted the 'Equator Principles', which provide best practice on this. As part of its AMDAL documentation, Archipelago has outlined a detailed and comprehensive social and community development plan. Based on this, as briefly summarised above, and on the advice of the company regarding the requirements on its financiers, we are comfortable that the project adheres to the Equator Principles, and thus the project will meet lending criteria.

Debt finance next major milestone

Financing: We estimate Archipelago has US$2m cash. The company has an US$8m finance facility with RMB outstanding, which was due to be repaid in January 2008. Discussions are in progress with a syndicate of banks to raise debt finance for the project, with the RMB facility presumably being incorporated. The next milestone will be the securing of the debt, and as part of this bank engineers visited the site in March.

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