

Dacha Capital: A Discussion With Patrick Wong

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Gareth Hatch

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Introduction

Dacha Capital [TSX.V:DAC, OTCQX:DCHAF] is a relative newcomer to the rare earths sector. Instead of owning rare earth deposits or the shares of junior mining and exploration companies, the company's focus is on the purchasing of physical inventories of rare earths and other materials as an investment strategy.

Given the unusual nature of Dacha's investment philosophy, I took the opportunity recently to ask Patrick Wong, chief investment officer for Dacha Capital, a variety of questions about Dacha's business model and its approach to the market.

Discussion

Gareth Hatch: Patrick, thank you for taking the time today to spend some time discussing Dacha and its business model.

First of all, can you summarize for us the business model that Dacha is using in the rare earths space - and why this space, and not any other?

Patrick Wong: Dacha is a corporation that raises capital and invests it in strategic rare earths and other minor metals. The concept for the fund was created over three years ago as we saw the 'writing on the wall', where all signs pointed to an inefficient market where prices were too cheap given their importance in our everyday lives. We have started with particular heavy rare earths like dysprosium and terbium, because of their diversified demand profile, and the inability for the supply side to respond to large changes in demand.

GH: So just to clarify, Dacha offers investors the opportunity to take ownership of shares in the company, as opposed to direct ownership of some specific amount of physical inventory, right?

PW: Yes, that is correct. It is the most tax efficient way of investing directly into these physical inventories, as Dacha Capital will have the appropriate tax structure set up.

GH: Is Dacha focused only on rare earths or are you looking at other metals and materials too?

PW: Currently Dacha holds strategic heavy rare earths like dysprosium, terbium, europium, and yttrium, but the plan has always been to expand into other minor metals which share the same fundamental profiles as the rare earths, are inefficiently priced because they don't trade in a liquid market and are relatively undiscovered by the markets. There is currently no other vehicle like ours that intelligently invests in a diversified basket of strategic metals that we use every day.

GH: What are your thoughts on the strategy of companies like Dolefin, with their REE Fund, and Van Eck Associates' Market Vectors Minor Metals ETF, compared to that of Dacha?

PW: My personal opinion is that ETFs that are comprised mostly of other public companies, do not offer as much value because you can just replicate the portfolio yourself, and the only major benefit is in the transaction cost savings. Dacha wanted to give investors the ability to get exposure into the actual commodities, without taking the equity or mining risk that's associated with these junior mining companies. Valuations of those companies can go up and down - that has nothing to do with the fundamentals of the strategic minerals. Also, all of these companies have exposure to the less strategic and therefore less valuable rare earths, and investors are forced to buy into things they don't want.

GH: Turning to Dacha's recent acquisitions of physical inventory - can you summarize the recent purchases, in terms of tonnage and dollar values?

PW: We believe in transparency and investor communication so we post all of our trades on our website, as well as a net asset value [NAV] that we will update on a regular basis. I encourage everyone to visit our site at www.dachacapital.com.

GH: Can you give us just an approximate number for the total invested so far?

PW: The NAV will be posted shortly so I'll just wait for that to come out - but all of our transactions are posted in press releases.

GH: From whom does Dacha buy these materials, and where are you storing it?

PW: At the very inception, we hired Alastair Neil who has had 15 years of experience in the rare earth market, where he ran business units for AMR/Neo Material Technologies. Alastair uses his knowledge and contacts, to get us product directly from the separators so we minimize transaction costs for investors. It would be very difficult, if not impossible, for individual investors to get this close to the source.

GH: In the absence of transparency in this market, how does Dacha decide what is a reasonable price to pay for what are significant quantities of material?

PW: Well, keep in mind that this material is used every day and there is really no significant stockpile, so the market feeds hand-to-mouth on a regular basis. Because we work hard to maintain excellent relationships with our suppliers, we have found we get excellent and competitive quotes.

GH: Despite there not being a lot of price transparency, do you get any sense that Dacha's activities in buying such significant amounts of materials, have affected the overall average prices for these materials?

PW: It's tough to say but all things being equal, any increase in marginal demand should result in price increases. The market is in a very interesting state of flux right now, where customers don't want to pay higher prices, but may not have a choice as their inventories are running dangerously low. Meanwhile, overall demand for the end products looks strong given data points like LCD year-on-year demand increases.

GH: With the news earlier this month that the Chinese authorities are further restricting the export of rare earths out of China, how does this affect Dacha's game plan for acquiring these materials?

PW: Because Dacha is currently interested in the higher priced elements, this change in export quotas does not really affect us. Separators will use their quotas to ship the more valuable material first,

before using quotas on lower-priced elements such as lanthanum and cerium. Dacha has done much work on studying this whole export quota issue and some would find the results surprising.

It's funny because if you ask those who are upset over the quota changes, what rare earths they deem as being really important and ones we should be worried about, they'll name those heavy rare earths and perhaps neodymium. However, when you look at exactly what the export quotas are most used for, it's not in those elements so they've got it all wrong.

GH: Is information on the specific rare earth products being exported from China readily available or on the public domain?

PW: The information is difficult to compile but we've been able to do it and have made some interesting observations.

GH: Why do you think China has taken these steps, stirring things up as some commentators are saying by cutting back on exports and looking to fix prices?

PW: I think China has been consistent in its message to the world. They have expressed concerns over the limited resource they have; it is definitely a valued resource that allows them to fuel the large manufacturing base that they have there. It's important to note that when you are talking about Chinese demand, the bulk of it is not organic Chinese demand; it's actually from the foreign - owned manufacturing plants that have been put there.

Their recent cut in exports may seem like a surprise given the sharp decline, but they are simply doing a better job at matching their export demand forecasts with the actual quotas issued. The past few years, we've used less than 50% of what was granted by this policy, but you don't hear anyone bringing that up. That being said, the probability that there could be a shortage of export quota rises naturally, but when you look at what might get cut off first, it is lanthanum and cerium.

GH: You've just said that quotas were not fully used in the past. I'm not sure that this is widely known. Can you give some specific numbers for the last couple of years?

PW: From looking at the highest volume products such as lanthanum oxide, cerium oxide, cerium carbonate, dysprosium oxide, neodymium oxide etc., Dacha believes we only used approximately 53% of the quotas in 2009 and only 66% in 2008. If you go further and break down the element that uses the most export quotas, you will also see that a change in processing, or a shift in manufacturing, could result in a material amount of quotas becoming unused.

GH: Dacha's model includes a form of price discovery for rare earths. Given the news that the Chinese authorities are also going to set prices on a regular basis for rare earths, how does this affect that particular element of the Dacha model?

PW: Well it's not that our model includes or assumes some sort of price discovery. Our model tries to identify situations where risk is limited and upside price appreciation is much higher. Part of this is finding these 'pinch points', and the belief that the process of price discovery will create more efficient markets, and therefore a better recognition of value. We believe people may be getting price transparency and price discovery confused. Dacha views price transparency as a means of pricing data to be a true representation of the market at that time, while price discovery is the process of markets identifying or recognizing fair value for assets.

GH: Are specific elements among the rare earths more significantly affected by the tighter quotas - i.e. have the Chinese authorities published a list of the specific elements in addition to the specific producers who have been allocated the quotas?

PW: Yes, there are certainly elements that have greater risk of falling under the pressures of an export quota shortage. Think of it as a waterfall, the light rare earths, the ones that trade at a lower value will be the first to be affected, because given a choice, separators will use precious quotas to ship out the higher valued products first. In addition, unlike any other commodity, this export policy blankets a large number of elements that are not correlated to one another, yet the situation for one exported element may greatly affect the others.

GW: Do you envision the implementation of further granularity by China, in the rare earth quotas in the future i.e. specific quotas for specific groups of rare earths [e.g. heavies versus lights], or even individual rare earths?

PW: At first we thought that separating the quotas by element or grouping i.e. lights vs heavies would be a logical idea, but we can now see a benefit to grouping them together in terms of adding complexity to the market, and strengthening any perception that rare earths are more difficult to access - even though the export market is still a small part of the overall production.

GH: How do you see these recently announced changes affecting the business models of existing non-Chinese junior mining and exploration companies?

PW: Well in so far as the export quota change, we don't see much affecting the business models of the non-Chinese mining companies. We think there may be the pressure to change the nature of a few elements that currently fall under the export quota, but these changes could result in a very large change in the usage of export quotas. If this happens, you may see quotas drop even further but we still won't run out of them. The one wild card is the change in perception this could cause, and if people do become nervous, then they may decide to build stockpiles which will result in a one-time blip in demand.

Keep in mind that the change in export quotas does nothing to change the size of the 'demand pie'; all it does is reallocate who gets the 'pieces of pie'. If a refiner who normally buys catalysts from a source that may get affected by export quotas, they still have a demand for catalysts and will look to sources inside China, but the demand doesn't change. This will translate to any potential drop in export demand to be taken up by an increase in domestic demand, so they really cancel each other out. The assumption here is that China has sufficient production capacity to satisfy this possible shift in demand.

Any true shortage of quotas will result in an increasing spread between FOB prices and domestic prices but that doesn't necessarily mean that the FOB price will increase. What it may do is encourage manufacturers to look more seriously at off-takes with future producers and oddly enough this would be better for the light rare earth deposits with regards to this specific change in export policy.

GH: By 'spread between FOB prices and domestic prices', are you referring to the spread between exported product, and product purchased for use within China?

PW: The spread between FOB prices and domestic prices should theoretically change with every data point we see in the usage of the export quotas. If anything, I don't think we'll see a drop in domestic prices as demand should be just shifted to Chinese producers but I think FOB prices might rise as a result of any shortage in export quotas. The export quota situation will affect each element differently so it takes some good analysis. It definitely bodes well for our product that we have outside of China.

GH: OK, and by 'off-takes with future producers', are you referring to non-Chinese producers?

PW: Yes. I'm sure China would like to deal with non-Chinese producers especially since they have an excess of separation processing capacity; however, it may be difficult for non-Chinese producers to get financing off a transaction like this. Also, customers may want to see a diversification of supply so would rather see product come from other sources than China.

GH: OK. Now, since China may increase the quotas if they perceive an increase in demand - what is the primary purpose of the quotas if they are possibly subject to change in the future?

PW: China has increased and decreased quotas over time so the question of what drives this policy is an important one. Some might say that this policy is driven off of China's desire to cut the world off or control the market but we disagree. Our opinion is that China's export quota policy is largely driven off of its expectations of export demand as well as the desire to move value added manufacturing into its country to promote employment and the development of new technology.

GH: Let's talk a little about China itself. What is your overall sense of what is happening internally in the rare earths market in China?

PW: It's tough to say what's actually happening in China, and even more difficult to understand their policies. We've spent a lot of time make educated attempts at understanding the market better, and 'knock on wood' so far we've been bang on.

Our view on what's happening in China is that they are simply trying to maximize the value of an important resource, and balance environmental issues, which is always tough to do. The employment created by all the industries that have

been established in China, to partly get access to raw materials, is very important to China, which is why we don't see them cutting anyone off. However, the important factor to watch is the ratio of organic Chinese demand to the rest of the world demand that's located in China.

GH: In order to sustain your business model, how much additional capital do you anticipate the company needing in the next two years?

PW: Our business model is pretty simple in that we simply invest what we raised. The majority of our capital is just invested back into the rare earths themselves. Of course, our unique corporate structure allows our expense ratio to fall when we increase assets, which is good for all shareholders - this is very different than the fixed expense ratios of ETFs.

GH: OK, but if you do want to raise additional money, how might you do it? Private placements, issuing new stock, debt instruments etc.?

PW: Well just like any other public corporation we will access capital by selling shares to the market, which is in essence a statement of investors wanting to invest in rare earths and other strategic metals.

GH: Does Dacha have target peak inventory levels for each physical metal or compound that it buys?

PW: No, I think this is where people get a bit confused as to what Dacha does. Our job is to put investor money to work. While we are able to trade a small amount of inventory to take advantage of customers who might really want product and are willing to pay a premium for it, we do not want to decide when to buy or sell. Of course, if someone approaches us to take our entire inventory of a certain element, then this is something we would consider - or if there was a change to the fundamentals, we would look to adjust our portfolio but we are not there to be market timers.

GH: How does Dacha plan to deal with the challenges of physical inventory management - are there 'expiration dates' on some of the materials being acquired, which will need to be sold off and replaced on a regular basis?

PW: We make sure we buy material that is very stable and for the most part that means oxides. Occasionally we will look at the metal too.

GH: Long term storage of even oxides, requires carefully controlled warehousing, and presumably periodic quality checks. On an annualized basis, what are the approximate costs associated with this storage regime, as a percentage of the value of the materials you are storing?

PW: We are definitely aware of storage issues. Our product is delivered in vacuum sealed bags, stored in metal drums and on pallets in an LME / MMTA [London Metal Exchange / Minor Metals Trade Association] approved warehouse. The costs of storage are very low and can be measured in basis points, as is the cost of insuring the material as well.

GH: When ranking Dacha's individual stock and warrant holders in descending order, in terms of size

of shareholding, how many individuals make up the first 25% of ownership?

PW: Share ownership always changes so that's impossible to tell.

GH: Finally, does Dacha have much interaction with its 'stablemate' Valencia Ventures, under the Forbes & Manhattan umbrella? What are the differences / similarities in their strategies?

PW: Valencia will focus on building value by advancing its exploration activities, while Dacha focuses on building its strategic stockpile.

GH: OK Patrick - thank you for your time today.

PW: You're welcome!

About the Author

Gareth Hatch is a Founding Principal of Technology Metals Research, LLC. He is interested in helping people to understand the challenges associated with the growing demand for rare earth elements [REEs] and other critical and strategic materials, and how those challenges affect market sectors throughout the entire technology supply chain. He is based in the suburbs of Chicago, Illinois, USA.

For several years Gareth was Director of Technology at Dexter Magnetic Technologies, where he focused on the design & application of innovative magnetic materials, devices and systems, in order to solve real engineering problems. He led a stellar team of engineers who helped customers and clients in the aerospace, defense, medical, data storage, oil & gas, renewables and industrial sectors. He holds five US patents on a variety of magnetic devices.

A two-time graduate of the University of Birmingham in the UK, Gareth has a B.Eng. (Hons) in Materials Science & Technology and a Ph.D. in Metallurgy & Materials, focused on rare earth permanent magnet materials. He is a Fellow of the Institute of Materials, Minerals & Mining, a Chartered Engineer and a Senior Member of the IEEE. Gareth is also a Chartered Scientist and a Chartered Physicist through the Institute of Physics.

Gareth is the Founding Editor of Terra Magnetica, an Editor at RareMetalBlog and is Newsletter Editor and Chicago Chapter Chair of the IEEE Magnetics Society. He is Founder of the Magnetism & Electromagnetics Interest Group and Strategic Materials Network, both at LinkedIn.com. Gareth is also an Advisor to Energy Scienomic, a non-profit organization focused on best practices and standardization of global energy production data and information.

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