

20th October 2005

Buy Kenmare at 34.25p

We initiated coverage of Kenmare in July 2004 with a "buy" stance at 15.75p. In the 14 months that have followed the company has achieved everything that it stated that it would do. It has raised the debt and equity needed to construct a titanium minerals mine at Moma in Mozambique and construction of that mine is 41% complete and ahead of schedule. It has also strengthened its board, bringing onboard a Chief Operating Officer with hands-on experience of mine construction and management. And it has continued to sign offtake agreements for Moma. An external bonus has been a significant strengthening in the market prices of titanium minerals.

Kenmare has been working on the Moma project for more than half a decade but the finishing line is now in sight - it should be cash generating within 12 months of production. At present Kenmare is scheduled to produce 703,000 tonnes of ilmenite per annum plus associated rutile and zircon but it has the financial capacity to increase output to 1 million tonnes and we are confident that a decision to increase capacity thus will be announced within the next nine months.

Historically demand for titanium minerals has grown at a steady 3% per annum but the Chinese economic boom has increased the demand while there are still likely to be shortages of supply from 2007 onwards as major mines go into decline. We do not therefore think that the increase in ilmenite sands prices will be reversed. On that basis we have increased our base case estimate of Net Present Value from 35p to 59.1p. Should Moma produce at 1 million tonnes of ilmenite per annum - as we think likely - we have increased our estimate of the NPV from 57.7p to 70.6p. This is a company with a strong balance sheet, with 60% of its stock in the hands of long term institutional investors and with significant upside potential. Hence at 34.25p our stance remains *buy*.

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Key Data	
EPIC	KMR
Share Price	34.25p
Spread	34 - 34.25p
NMS	15,000
Fully Diluted Market Cap.	262 million pounds
12 Month Range	14.75-40.5p
Shares Issued	665 million + 105m warrants outstanding
Market	Full
Website	kenmareresources.com
Sector	Mining
Borrowings	269 million dollars
Contact	FD Tony McCluskey 00 353 1671 0411

Year to 31st December	Sales (£ million)	Pre-Tax Profit* (£ million)	*Earnings Per Share (p)
2004A	0	0.02	0.01
2005E	0	3.0	0.4
2006E	6.0	-6.5	NA
2007E	60.0	42.0	5.5

* Excluding Depreciation & Interest

Most Irish mining juniors follow a traditional storyline of excitement and disillusion based on exploration projects in Eire or Africa, management upheaval and ongoing re-financings. For most of its history Kenmare was no different. Between its move to the official list in January 1994 and 1999 little concrete progress was made. BHP controlled the main Moma asset, however in 1999, Kenmare regained sole control and focussed totally on its development. Kenmare now owns 100% of the Mozambique Titanium Minerals Project covering 44,000 hectares of coastal dunes on the north central coast of Mozambique. The main product from the mine will be ilmenite, with zircon and rutile co-products.

Ilmenite is a naturally occurring mineral which is the world's principle source of titanium. Titanium is a very light and strong metal which is used in the aerospace industry with other high value applications such as medical implants. However its principle use is, as TiO₂ dioxide, in the manufacture of pigment which is in turn used in paint, paper, plastics, fabrics - indeed, anywhere where colour and opacity are required. There is no substitute for titanium pigment.

Rutile is another titanium containing mineral. It is more scarce and is priced at a premium to ilmenite due to its higher titanium content. Zircon is a zirconium mineral which is used in the ceramics industry. As people in Europe, North America and China all use more ceramic tiles per head, zircon is facing very significant increases in demand but is only mined as a co-product of ilmenite mining. In future this premium is likely to increase and indeed has done sharply over the past year.



Historically the consumption of all three commodities has increased by around 3% per annum but the past couple of years has seen a break in the trend - to the upside - thanks to the industrialisation of China and India with growth in 2004 touching 5.4%. There has also been an end of the discounting of prices by Indian producers and hence real market prices have shown double digit growth. We do not see that the process of industrialisation in India and China will reverse and hence the macro-economic demand picture is positive.

Meanwhile the world's two largest conventional mines (Enneaba and Richards Bay) are now entering a period of flat or declining production. The majors have responded tentatively. Rio Tinto recently announced that it was to build a large new mine in Madagascar at a cost of \$585 million and this will supply 750,000 tonnes of ilmenite per annum from 2008. However, to put this in context, this increased supply will - perhaps - only match fifteen month's projected increase in global demand. Given that output elsewhere is declining the supply demand imbalance is still very much in favour of Kenmare. Moreover, the economics of the Moma project are robust - on a global scale it will be a very low cost producer.

The Moma Mine

The word mine is perhaps misleading. At Moma, Kenmare will merely create a pond in which it will float a dredge and a concentrator plant. The dredge will mine from the front of the pond and pump the mined ore into a concentrator plant which will separate the titanium minerals from sand. The minerals are pumped to a separator plant (located at the edge of the orebody) where they are separated into final products and the sand is replacing it at the

back of the pond. Since they are mining sand from the front of the pond and replacing it at the back, the whole pond gradually moves forward through the orebody. This is a very low cost method of mining but is not new technology and is normally employed in titanium mining if the orebody lends itself to such a method. Kenmare will construct a jetty at Moma allowing the minerals to be loaded via a barge to bulk carriers which then have swift access to world shipping lanes.

When we initiated our coverage of Kenmare the company said that the initial plant at Moma was capable of producing 615,000 tonnes of ilmenite per annum, 60,000 tonnes of zircon and 17,000 tonnes of rutile. At that rate of production it was believed that the resource could well last 90 years. However in May 2005, Kenmare announced that its engineers believed that the plant - as designed - could in fact produce 703,000 tonnes of ilmenite per annum with zircon and rutile volumes unaltered. Kenmare is conducting further exploration work on the sands at Moma which is likely to result in an increase in its estimates of the mine life even at higher production rates.

We had assumed that a 615,000 ilmenite plant would generate revenues of c\$90 million per annum. However the increase in sale prices and the increased capacity mean that we now believe that under this revised base case scenario, Moma could easily generate revenues of \$120 million per annum. In our models we assume price increases going forward of just 3% per annum although recent history suggests that this is too cautious.

Moreover, it would cost perhaps as little as \$50 million to expand the separator plant at Moma so that the mine could generate up to 1 million tonnes of ilmenite per annum which would mean base case revenues of \$165 million per annum. Since operating costs would not increase on a pro rata basis this would have a dramatic impact on the NPV of the project.

Based on our discussions with management we expect that, if it can sign a number of offtake agreements currently under negotiation such that the entire output - under a base case scenario - is already pre-contracted for sale, it will take the formal decision to expand the capacity of the separator plant at Moma within the next nine months. However it would only undertake that expansion when the mine had been up and running at full capacity for a number of months. The process of expanding capacity at the separator plant would not disrupt production.

The total cost of building the base case (703,000 tonne project) is \$220 million (plus banking fees, finance costs and owners costs of another \$90 million). The operating costs, per Kenmare's feasibility study, of this project will be around \$23 million per annum. Following a rise in petroleum prices, this may have increased. The additional cost of ramping up the separator plant would be around \$50 million and the larger project will have annual operating costs of \$32 million.

Once it is up and running the tax regime for Kenmare in Mozambique is generous - the country is understandably keen to attract foreign investment. For fiscal purposes the project is treated as two separate entities: a mining company and a processing company. The latter pays a 1% sales royalty but only after six years of production have been completed and is exempt from all import and export duties, corporation tax and VAT. The mining company pays a 3% sales royalty from year one and its profits are taxed at 16% for the first ten years of output and 32% thereafter. The revenues from the mining company are calculated as costs plus a 15% margin so it is clear that the vast bulk of the profits will be made by the (fiscally blessed) processing company.

Construction & Partners

On April 8th 2004 Kenmare announced that it had agreed a fixed price development contract to build the mine and facilities with a joint venture between Multiplex Ltd and Bateman Ltd - two highly respected international contractors. The two parties provided guarantees for this joint venture and Kenmare's lending banks approved the agreement.

The fixed price contract is for \$220 million with provisions for cost over-runs which bring the maximum price up to \$240 million at which point the Bateman/Multiplex joint venture shoulders the entire burden of any overruns. However between \$220 million and \$240 million Kenmare should show a decreasing proportion of the overruns meaning that the contractors are incentivised to build this plant on time and that Kenmare's maximum exposure is \$236.75 million. If there are time over-runs the contractors are charged a penalty of \$400,000 a week so once again there is a real incentive for them to proceed as quickly as possible with the project. There are also clauses in the contract guaranteeing

significant performance damages should the plan not meet Kenmare's standards.

On 21st September 2005, Kenmare announced that the project was 41% complete and running four weeks ahead of schedule. Most of the components for the plant, including the giant plant purchased from BHP Billiton which used to operate at Beenup in Western Australia have arrived on site. The construction of a workers village and airstrip is complete. It is likely that the entire plant will be ready for commissioning in the fourth quarter of 2006.

Offtake Agreements

The agreements signed by Kenmare with potential purchasers of its ilmenite, zircon and rutile are confidential as is standard practice in this industry. so we do not know its partners for certain. However the agreements have been scrutinised by the lender banks and so there is no concern that they may be anything other than real. One might speculate that major users such as DuPont are among those who have signed up.

We believe that Kenmare has now signed offtake agreements covering almost two thirds of the anticipated base case annual output. A portion of the planned ilmenite output - around 20% - has been sold on fixed price contracts which, because they were signed as early as 2000-2001, will not reflect recent increases in market prices. However the bulk of contracts signed since for ilmenite - and all the rutile and zircon contracts - will benefit from the upswing in prices. They have been signed on a fixed volume, variable price basis - that is to say if prices increase Kenmare will issue an additional invoice post shipment, if they fall it will rebate the customers on the following shipment.

The fixed price contracts mean that - whatever happens to market prices - Kenmare will generate sufficient cashflow from Moma to cover its operating costs and bank interest charges. This gives Kenmare clear exposure to any above trend increase in titanium minerals prices while ensuring that it will not default on its loans.

We understand that negotiations are underway which will see further offtake agreements signed during the final quarter of 2005 and into 2006 and expect that by mid-2006 all of the output under the base case scenario will be contracted for sale. It is at this point that Kenmare will, we expect, announce the expansion of the mine and its facilities.

Management

Between 1999 and late 2004 Kenmare was run by CEO Michael Carvill and finance director Tony McCluskey. The duo work from Kenmare's Dublin office and are supported by a strong non-board team responsible for marketing and planning the construction of Moma. This team arranged all of the offtake deals for Kenmare as well as its enormous debt and equity funding. With its financing complete Kenmare set about recruiting a Chief Operating Officer. From a strong list of applicants it selected, in November 2004, Dr Chris Gilchrist who has 25 years experience in mining management, principally in South Africa with De Beers and Anglo Gold.

It is Gilchrist who is overseeing the operations at Moma although at a PLC level it is still very much Carvill and McCluskey who retain control.

The executive team is completed by Dr Alistair Brown, the exploration director who is still engaged in increasing the size of the resource at Moma. One might envisage that when Moma is fully operational he will appraise new projects for Kenmare within the ilmenite sector.

The Kenmare board is not short of non-executive directors. Whilst this means that it should have no problems with corporate governance issues we question whether a company of this size really needs the services of 5 non-executive directors plus a non-executive chairman: Charles Carvill, the father of Michael.

Financing

Kenmare's total funding "requirement" for the construction of Moma and the running of the corporate entity until Moma is cash generative is \$366 million (which does not include previous costs) which can be broken down as follows:

* Project Work plus cost over-run facility	\$236.5 million
* Financing Fees plus interest	\$70 million
* Company Costs	\$20 million
* Funding Fees	\$10 million
* Contingency Fund	\$30 million

Under the terms of the construction agreement it is extremely unlikely indeed that the contingency facility will be needed to be used and the company has repeatedly made it abundantly clear that it has no intention of sitting on unused cash. The contingency facility could, however, be used to fund most of the expansion needed to increase production to 1 million tonnes of ilmenite per annum. We assume that if there is a modest shortfall in the funding requirement for plant expansion it will be made up by the cash generated from early production.

The funding for this project came from a mixture of debt and equity. Lender banks have provided \$203 million of senior debt at rates ranging from cost of funds plus 3.4% to cost of funds plus 4.9%. An additional \$66 million of subordinated debt has been arranged at a 10% interest rate resulting in an average cost of debt financing of circa 8%.

The equity was raised in the Autumn of 2004 via a placing and open offer at 16p which brought in \$97 million. Those taking part in the fund raising were also allocated one warrant allowing them to buy an additional share at 19p for every four shares taken up in the offer. Around 80 million of these warrants which have a five year life are still in circulation. Although the warrants are now heavily in the money there is no rush for investors to exercise them and therefore we do not anticipate them providing an additional source of finance until 2008 or 2009 by which stage Kenmare will be cash generative and will not need that cash.

Most Recent Results

On 21st September, Kenmare announced its half calendar year results for 2005. Operating expenses amounted to \$2.85 million and net interest income was \$0.897 million. Thanks to a foreign exchange gain on its bank deposits - which were \$80.53 million at the period end - the company reported a pre-tax profit of \$3.75 million. However this figure is not significant in the greater scheme of things. At the period end, Kenmare had drawn down bank loans of \$119.5 million, having drawn down \$64.5 million during the six months.

Risks & Opportunities

Over the past two years the risks associated with the Moma project have decreased significantly and that is one reason why the discount rate used in our calculation of Net Present Value is 10%, rather than the 12.5% we had used in modelling some years ago. Many within the industry were sceptical about the ability of Kenmare to raise the project finance required for Moma or to conclude the offtake agreements with international producers which were a precondition of that finance. The equity fund raising was the largest ever conducted by an junior resource stock and there were those who had doubts as to whether it would succeed

However the financing risks now appear minimal and the nature of the contract with Kenmare's construction engineers means that the project risks are also minimal. The two remaining major risks are political and related to commodity prices.

Mozambique started its post colonial existence as a centrally planned Marxist economy but in 1983 adopted a UN sponsored Economic Recovery Programme which has included one of the world's most comprehensive privatization programmes. Despite a Civil War sponsored by the old South African regime - which ended in 1991 - Mozambique has successfully attracted Western capital in order to move forward. The regime is stable and the fiscal terms offered to Kenmare indicate its strong desire to attract Western capital to the country. However this is Southern Africa and as such there must always be some danger of regime change. The banks have taken out political risk insurance against bad debts.

The price of titanium mineral sands can also fluctuate. In 1999 zircon traded at \$280 per tonne - today it trades at around \$700 tonne. Ilmenite prices have risen far more steadily. Our models assume that prices of ilmenite, zircon and rutile will increase only marginally in real terms which corresponds to the long-term historic norms within this industry. However given the maturity of major mines such as Richard Bay and the dramatic increases in demand seen in China and India this view may be over-cautious. We regard the risks to our model as being on the upside not the downside.

A possible threat to Kenmare, if not to its shareholders is that of a corporate approach. It is worth noting that a consortium led by Kerry Packer recently purchased a 7.25% in Iluka, a major producer. If the Moma project is potentially worth 70.6p per share to Kenmare which has an average cost of capital of 8%, then to a mining major - all of whom face declining output from their existing facilities - but which operate with a far lower cost of capital, the value will be significantly greater. As far as we are aware, Kenmare has not yet received any approaches but the possibility that one will be made is, in our view, a very real one.

Valuation and Conclusion

Shares in Kenmare have enjoyed a remarkable run since our initiation of coverage at 15.75p last July. The completion of the debt and equity fund-raising removed a large degree of uncertainty over this project and also a potential stock overhang, had the issue not been well supported. Moreover Kenmare is ahead of progress on construction, on strengthening its management team and has provided a regular stream of announcements about new offtake deals. Naturally there will be some investors who wish to take some profits.

However we believe that the stock remains undervalued. In our view the company is almost certain to expand capacity at Moma to 1 million tonnes of ilmenite per annum in the middle of 2007. However using the base case scenario whereby output remains at 703,000 tonnes of ilmenite and assuming that prices increase by just 2% per annum in real terms, our estimate of the Net Present Value of this project, using a 10% discount rate, is 59.1p per share, on a fully diluted basis. If the company decides to enlarge its facility in mid 2007 our estimate of the NPV of Moma rises to 70.6p per share, on a fully diluted basis. The value of this project to a larger corporate player such as Rio Tinto or Anglo American would be significantly higher, given its much lower cost of capital.

Whether Kenmare manages to bring Moma onstream whilst retaining its independence is uncertain. What is now certain is that the project will be brought onstream and at least on time if not ahead of schedule. The risks involved in investing in Kenmare are steadily reducing but there is still significant potential for capital gains for those purchasing this stock at 34.25p. Our stance remains **buy**.

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