Growth Equities & Company Research

8th July 2004	Editor-in-Chief Stephanie Boutrot stephanie@tisl.co.uk 020 7033 9389

Buy Kenmare at 15.75p

Within the next few weeks Kenmare resources will start work on the construction of a titanium minerals mine at Moma in Mozambique. The company has been working on this project for half a decade and now appears to have all the planks in place - mining and environmental permits, construction contracts, sales agreements, debt funding and - shortly - equity funding. The mine should start production by the second half of 2006. Historically demand for titanium minerals has grown at a steady 3% per annum but a recent surge in Chinese use has increased the demand while from the end of this year major producers start to go into decline. We think that our base case scenario of a steady growth in prices for ilmenite, rutile and zircon (the minerals produced at Moma) will prove to be extremely cautious. On that basis any estimate of the Net Present value of this project appears to have more upside than downside risks.

The other variable in calculating a NPV is output. The current intention is to build a mine that would produce 600,000 tonnes of ilmenite per annum, 60,000 tonnes of zircon and 17,000 tonnes of rutile. At that rate of production the resource could well last 90 years. Such a project should generate base case revenues of $90 million per annum. However, 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 $145 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. It is our view that Kenmare intends to move to 1 million tonnes output by 2009 at the latest and possibly much sooner. On that basis our base case NPV of 35p per share could well increase to

Key Data	
EPIC	KMR
Share Price	15.75p
Spread	15.5-16p
NMS	15,000
Fully Diluted Post Rights Market Cap	123 million pounds
12 Month Range	14.25-20p
Shares Issued (post offer)	781 million
Market	Full
Website	KenmareResources.com
Sector	Mining
Borrowings	269 million dollars
Contact	FD Tony McCluskey 00 353 671 0411

57p per share without making any great assumptions about titanium minerals price inflation. At 15.75p that makes the shares a clear buy.

Background

Kenmare has a long history as one of many Irish mining juniors. However in 1999 Kenmare decided to focus solely on the development of Moma. Kenmare 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 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 scare 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. Hence, even though demand was increasingly strongly last year, production actually went down by 2% resulting in significantly increased prices. This trend is likely to continue as new ilmenite mines being considered for commissioning have lower zircon levels than older mines where production is set to decline.

Historically the consumption of all three commodities has increased by around 3% per annum but over the past year we have seen well above trend growth thanks to the industrialisation of China and India. Unless you believe that the process of industrialisation the world's two most populous economies will go into reverse (which we do not) than that above trend growth should continue.

Meanwhile the world's two largest conventional mines (Enneaba and Richards Bay) are now set to enter a period of declining production. While new projects other than Moma will in due course come onstream this process will not happen overnight and it is hard to identify any projects in the pipeline that could compete with Moma in terms of price. On that basis it is not surprising that Kenmare has already signed contracts with customers prepared to buy a good portion of projected output. On the basis of a 600,000 tonne ilmenite mine we believe that 49% of the ilmenite has been pre-sold under off-take agreements as well as most of the rutile and zircon output. More sales contracts will be put in place before production starts and we are lead to believe that a number of announcements are in the pipeline.

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 replaced at the back of the pond. Since they are mining sand from the front of the pond and replacing it as the pack 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 barges to bulk carriers which then have swift access to world shipping lanes.

The dredge barge, concentrator, conveyor belts and shipping facilities can handle up to 5,000 tonnes of sands an hour which equates to 1 million tonnes of ilmenite produced per annum. The separator plant which Kenmare plans to build can work at only 3,000 tonnes of sands per hour - the rate needed to produce 600,000 tonnes of ilmenite. The total cost of building this base case (600,000 tonne project) is $220 million (plus banking fees, finance costs and owners costs of another $90 million) and the operating costs of such a project would be around $23 million per annum. The additional cost of ramping up the separator plant would be a maximum of $50 million and the larger project would have annual operating costs of £32 million.

Construction & Partners

The negotiations with various contractors that have taken place over the past three years have at times been tortuous. Kenmare managed to purchase both the concentrator and separator plants at a very low price from BHP Billiton. These have been dismantled and moved from their previous location in Western Australia where they are now packed for export ready for onward transport to Moma. Their further transport, re-erection and the guaranteeing of their performance are all part of the scope of work of the fixed price development contract.

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 Batemen Ltd - two highly respected international contractors. The two parties have provided guarantees for this joint venture and Kenmare's lending banks have now 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 Batemen/Multiplex joint venture shoulders the entire burden of any overruns. However between $220 million and $240 million Kenmare should 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 and first works should be starting within weeks. There are also clauses in the contract guaranteeing significant performance damages should the plan not meet Kenmare's standards.

Offtake Agreements

The agreements signed by Kenmare already are confidential 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.

The nature of the offtake agreements, which in total cover 57% of the first five year's production (on the 600,000 tonne ilmenite model) is that 18% of production has been sold on fixed price contracts. That means that Kenmare is guaranteed to have enough income to cover its operating costs and bank interest charges. The rest of the offtake deals signed to date are on a fixed volume, variable price - 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. This gives Kenmare clear exposure to any above trend increase in titanium minerals prices while guaranteeing that it will not default on its loans.

We understand that negotiations are underway which will see further offtake agreements signed during 2004 and 2005 which will ensure that most, if not all, of the base case output already has a customer before the commencement of operations. At a certain stage this process is likely to prompt Kenmare to take the decision to expand output to1 million tonnes of ilmenite. We do not expect to have to wait until 2009 to see that expansion take place.

Management

The Kenmare management team of CEO Michael Carvill and finance director Tony McCluskey are a low-cost "safe pair of hands" unit based in Dublin. Their job in concluding the numerous agreements with customers, contractors, lenders, the Mozambique Government and investors is now largely complete. Following the fund raising Carvill will continue to negotiate offtake agreements and to liaise with investors. Unlike some of the promoters on junior Irish mining companies the Carvill/McCluskey team have actually delivered on promises of bring a world class mining project to fruition and their City standing is high.

However within Kenmare there is no individual with experience of mine management and the company is now undertaking the hiring of a Chief Operating Officer to be based in Dublin. We understand that it has narrowed its short-list down to four candidates and that an appointment will be made over the summer.

Financing

Kenmare's total funding "requirement" for Moma is $366 million 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 Liability $30 million

You will note that under the terms of the construction agreement it is extremely unlikely indeed that the contingency liability will be needed to be used and the company has made it abundantly clear that it has no intention of sitting on idle bank deposits. On this basis we think it more than likely that it will give the green light to the expansion of the separator facility during 2005 which would allow Kenmare to ramp up to a production level of 1 million tonnes of ilmenite plus co-products per annum from year one.

The funding for this project comes from a mixture of debt and equity. The 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 raised is in two parts. A $55 million institutional placing at 16p per share has already been completed with irrevocable undertakings from the institutions already received. The company is now seeking to raise a further $42 million via an open offer at 16p to existing shareholders on the basis of 13 shares offered for every 27 held. Any shares not taken up in the offer are likely to be placed with institutions and our meetings with the company lead us to believe that investors are already lined up to take any shares not bought in the open offer. The Carvill family has indicated that it will be taking up its full entitlements and may indeed take up a portion of any shortfall in the open offer. We believe that investor response to the open offer has been positive.

An added reason to take up the open offer is that for every four new shares bought investors will receive one warrant allowing them to buy an additional share at 19p - these warrants lapse in July 2009 and will be tradable. The exercise of these warrants will bring in an additional $27 million which - in reality - is unlikely to be surplus to requirements given the probable increase in production capacity.

Should the company fail to find a home for all the shares it has a fallback position of issuing convertible loan notes but we do not anticipate that this will be needed. Following the equity issue the number of shares in issue on a fully diluted basis - in other words including all outstanding warrants and options - will be 781 million.

Risks

The principal risk appears to be political. Mozambique started as a centrally planned Marxist economy but in recent years has 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 (and even Zimbabwean farmers) in order to move forward. At present the regime is stable and is so keen to attract inward investment that the processing facility at Moma will pay no taxes for its first six years and thereafter a royalty payment of just 1% of revenues. There will be no corporation taxes. Fitch, the rating agency, has Mozambique sovereign risk as B+

However this is Southern Africa and as such there must always be some danger of regime change and therefore the company has taken out full political risk insurance.

Metals prices can also vary over time. It is just conceivable that the Chinese and Indian economies will go into reverse although we consider this unlikely. Historically prices of titanium minerals have risen steadily, at least maintaining real value, and over the lifetime of this project we consider this to be the most likely outcome with the risks more on the upside (given the near term supply/demand imbalances) than on the downside.

The final risk is to Carvill's position rather than to investors. The decline of Richards Bay and of Enneaba means that the major producers have obvious gaps in their product portfolio starting to appear from 2005 onwards. Our estimates of the NPV of Moma are based on a funding cost of 8% - clearly the majors could achieve a far lower cost of funding and thus for them, an acquisition at somewhere between the current share price and our estimates of NPV would clearly be financially attractive. Carvill is determined to see Moma through to production but it is possible that he will not see his dreams fulfilled and a the idea of a bid by Rio Tinto or Anglo American cannot be dismissed entirely.

Valuation & Conclusion

The shares could mark time over the next few weeks as the current equity issue is digested but that should not obscure the phenomenal long-term upside. This is a company with a - soon to be strengthened - management team with a track record of delivering on its promises. The company has signed offtake agreements with very real partners that guarantee sufficient revenues to ensure the viability of the project. For the banks to be relaxed enough to lend such large sums to such a small company should provide real comfort for equity investors. The construction partners are well regarded and heavily incentivised to complete their work on time and on budget.

Our base case valuation assumes that there is no further positive macro-economic push on titanium minerals prices. This we think unlikely but in order to be prudent have assumed that the increase in prices returns to long run trend. We assume a fairly speedy exercise of the warrants but in the base case scenario production remains at 600,000 tonnes of ilmenite per annum for 15 years. Again this is highly unlikely. Yet even the base case scenario arrives at a NPV of 35p per share on a fully diluted basis.

Our alternative model assumes that Kenmare uses its $30 million contingency funds plus some warrant money to expand output to 1 million tonnes from 2007. This is not unrealistic although there may be some slippage on timescales and that arrives at an NPV of 57p per share. Again this model takes a cautious view on price increases and given the fixed costs of the Moma project this offers significant upside to both models.

Whatever the basis of ones model the conclusion is the same. Existing shareholders should take up their entitlements in the open offer in full and those not on the shareholder list should consider making an investment well before any stock overhang is cleared and the true value of this project starts to be reflected in the share price. At 15.75p the shares are hugely undervalued.

t1ps.com limited can be contacted at 49 Rivington Street, London EC2A 3QB - email stephanie@tisl.co.uk - fax 020 7033 9387 - tel 020 7033 9389