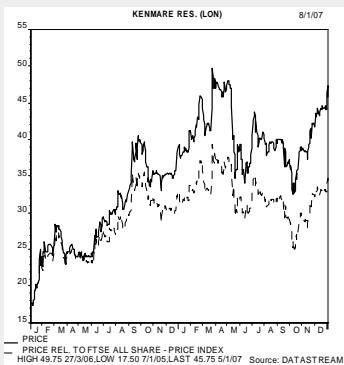


# Kenmare Resources

## BUY

## A market opportunity

Bloomberg	KMR LN
Price	45p
Target Price	60p
12mth high/low	51/32p
Shares outstanding	686.5m
Fully diluted	807.8m
Market Cap	£309 m
Enterprise Value	£421m



Kenmare Resources plc is about to enter production with its Moma titanium-minerals project in Mozambique. Moma's output will represent about 6% of the world market for titanium dioxide, which is growing at around 3% per annum with limited new capacity coming on stream in the next few years and significant closures scheduled. Kenmare also has the option of a low-cost, 50% expansion, which we believe is likely to go ahead early in the project's life. The problems recently encountered by the Kwale project in Kenya – an obvious marketing competitor to Moma – have increased the likelihood of a Moma expansion. We reinstate coverage with a Buy recommendation and target price of 60p per share.

### Key financials

End-Dec	Sales US\$m	EBITDA US\$m	Net profit US\$m	EPS USc	Chg %	P/E X	EV/EBITDA X
2005A	0.0	4.7	4.7	0.7	n/m	n/m	n/m
2006E	0.0	-6.8	-6.8	-1.0	n/a	n/a	n/a
2007E	93.2	65.4	22.0	3.2	n/a	27.4	12.5
2008E	126.3	91.9	44.8	6.5	103	13.5	8.9
2009E	129.5	96.9	51.0	7.4	14	11.8	8.5

Source: Kenmare Resources, Mirabaud Securities estimates

£1 = US\$1.95

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- **Expansion potential drives valuation:** Our target price of 60p is based on an NPV valuation of the 20-year mine plan and an assumed mine-life extension (together our base case), plus a 50% expansion early in the project's life (we model a likely expansion go-ahead decision after two years of operation).
- **Long-life reserve and resources:** The 20-year mine plan is based on a reserve of 496Mt of mineral sands at a grade of 4.3% (combined heavy minerals). The expansion potential comes from the total reserves and resources of 3,540Mt, with a significant increase expected to come from an imminent audit. Even before the audit, the resource gives a life of over 100 years.
- **Resource adds value:** The 20-year mine life is thus very conservative: ten years' additional life on the current mine plan accounts for 9p of our base-case valuation of 39p per share. Our target price of 60p per share assumes a likely expansion go-ahead decision after two years.
- **Low tax regime:** Moma benefits from an industrial free-zone status for its processing facility, and low tax terms for its mining facility (which will sell to the processing facility at the mine operating cost plus 15%).
- **Good geography:** Moma is located on the coast of northern Mozambique, offering immediate access for sea transport to markets. Mozambique has a good record of political stability in the past decade and a half.
- **Low-cost power:** Kenmare has secured grid power (based on hydroelectricity) at USc2.4/kWh – cheap by international standards.

The expansion potential of Moma is key. A decision after two years of operation to expand output by 50% would drive our NPV valuation to 67p per share

## Valuation

We calculate a very basic value of 30p per share, based on discounted cash-flow analysis of the project on the 20-year reserve life and our estimated net-debt position at the end of December 2006. However, adding ten years to the mine life – easily supportable by the resource – raises the valuation to 39p.

We use a weighted average cost of capital of 10.6%, derived from a two-thirds/one-third debt/equity ratio, and a cost of debt at 7.8% and of equity at 16.0%.

Kenmare estimates the whole operation could be increased by 50% to 1.2Mtpa of ilmenite (plus proportionate increases in the co-products) for further capital expenditure of about US\$25m. This presupposes off-take contracts for the additional output can be secured – an assumption with which we are comfortable.

Expansion would naturally bring a reduction in unit operating costs, but the low incremental capital expenditure makes a very significant impact on NPV. After conservatively allowing a year to execute the necessary work, we have modelled the company at different expansion timings on a project NPV basis (also assuming the 30-year, extended life) plus net debt:

### Sensitivities to expansion timing

Decision after years of operation	1	2	3	4
Total valuation per share (p)	70	67	65	63

Source: Mirabaud Securities estimates

£1 = US\$1.95

We believe Kenmare is more likely than not to decide to expand Moma after two years of operation which, after allowing a year for the necessary work and for ramp-up, raises our value to 53-67p per share. This is calculated from the base-case 30-year NPV plus 50-100% of the NPV effect of the expansion (ie a better-than-even probability the expansion will be added). For the sake of deriving a single target price, we have taken the mid-point of this range – 60p.

### Kenmare – summary valuation

Moma project (post-tax DCF basic 20-year reserve life)	US\$618.9m
Moma project basic NPV per share (p)	46.2
Net debt	US\$218.4m
Net debt (p)	-16.4
<b>Basic valuation (p)</b>	<b>29.9</b>
NPV of additional ten years' life (p)	8.9
<b>Base-case valuation (30-year life) (p)</b>	<b>38.8</b>
NPV of expansion decision after two years – 28.3p per share	
Assume 75% chance of above expansion (p)	21.2
<b>Total valuation (p)</b>	<b>60.0</b>
Current share price (p)	45.0
Premium (%)	33.3

Source: Mirabaud Securities estimates

£1 = US\$1.95

## Moma project

Mozambique is one of Africa's success stories, offering a very positive investment environment in the Sub-Saharan context

### Location

Although all of Kenmare's significant assets are in a single, developing country, Mozambique has a good record of political stability in the past decade and a half. Mozambique is one of Africa's 'success stories'. The political violence of the 1980s is now well in the past, and the country is used by the World Bank as an example of economic reform and investment-friendly policies.

### Sector background

Moma will produce ilmenite (~55% titanium dioxide –  $TiO_2$ ), the basic feedstock for pigments. Moma's production will be suitable for processing by the main routes used by the world's pigment producers. Moma's co-products are rutile (almost pure titanium dioxide) and zircon (used in ceramics), both of which command much higher prices than ilmenite.

The titanium dioxide feedstock industry is dominated by a small number of major players, including Rio Tinto, Exarro (of South Africa) and Iluka Resources (of Australia) – the top three control 60% of production. This means that any market weakness is unlikely to persist long before provoking a supply-side response. Correctly executed, the titanium dioxide business can be both high margin and stable.

Moma's output will represent just 6% of the world market for titanium dioxide, which is growing at 3% per annum with limited new capacity coming on stream in the next few years and significant closures scheduled.

The titanium dioxide markets have no terminal exchanges, and there is no public price discovery. Commercial information is closely guarded, but indicative prices are ilmenite US\$80-100/t, rutile US\$450/t and zircon US\$775/t. We are assuming US\$85/t for ilmenite, US\$450/t for rutile and US\$775/t for zircon, which collectively tally with the company's guidance on anticipated revenue at full output.

### Sales

Kenmare has secured off-take contracts for 70% of Moma's initial production, and the project's expansion potential is poised to exploit any shortfall in the market

Kenmare has secured off-take contracts for over 60% of the planned production for the first five years. Of the production covered by these contracts, 25% is under fixed volumes at fixed prices (with inflation adjusters, mainly the US PPI). The 75% balance is also at fixed volumes but at market prices. These market-price contracts will be priced provisionally, with subsequent adjustments once historical prices are available (up to 12 months later).

Moma's natural competitor for markets – at least those customers using the sulphate route to produce feedstock – is the Kwale project near the coast of Kenya (operator: Tiomin Resources Inc – TIO TSX). Tiomin secured finance in mid-2006 but recently (December 2006) halted construction and withdrew personnel pending government resolution of land issues.

Another regional 'competitor' is Rio Tinto's Mandena project in Madagascar, which was given the go-ahead just over a year ago. Capital expenditure is US\$585m for first production in the September quarter of 2008, with full output of 750,000tpa from 2012. Mandena will produce a 60%  $TiO_2$  ilmenite for smelting at Rio Tinto's operations at Sorel in Quebec. Rio is reactivating a mothballed furnace for the purpose.

Clearly, any delay in Madagascar could make Moma's 60%  $TiO_2$  ilmenite product attractive to Rio Tinto as an alternative supplier to replace/supplement supplies from

Mandena. This would be particularly true if production ramp-up at Mandena is running behind the ramp-up feed requirements of the restarted furnace at Sorel – with smelted chloride-grade slag worth around 7-8 times the ilmenite feed and the smelter restart costing a further US\$190m, Rio Tinto would not want the smelter to run at under its capacity.

### Mining & processing

The Moma mine plan is based on the Namalope and Tupuito deposits, which have a mineable reserve of 469Mt at 4.3% heavy minerals. The product suite comprises ilmenite (81% of the total and amounting to 16.4Mt contained), rutile (0.5Mt contained) and zircon (1.3Mt contained).

The facilities are designed to produce 800,000tpa of ilmenite (post a debottlenecking investment of US\$6.5m), 21,000tpa of rutile and 56,000tpa of zircon. Ilmenite and rutile are both forms of titanium dioxide, the raw material for making the pigments that go into paints, paper and plastics etc. Zircon (zirconium silicate) is used in ceramics and refractory applications.

### Moma project – Ten years' key operational highlights (based on 20-year reserve life and no expansion, money of the day)

End-Dec		2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E
Throughput	Mt	20.0	26.9	26.9	26.9	26.9	26.9	26.9	26.9	26.9	26.9
Ilmenite grade	%	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5
Ilmenite produced	t	595,000	800,000	800,000	800,000	800,000	800,000	800,000	800,000	800,000	800,000
Rutile produced	t	19,000	21,000	21,000	21,000	21,000	21,000	21,000	21,000	21,000	21,000
Zircon produced	t	41,500	56,000	56,000	56,000	56,000	56,000	56,000	56,000	56,000	56,000
Ilmenite price received	US\$/t	87	89	92	94	96	99	101	104	106	109
Rutile price received	US\$/t	461	473	485	497	509	522	535	548	562	576
Zircon price received	US\$/t	794	814	835	856	877	899	921	944	968	992
Total sales revenue	US\$m	93.6	126.8	130.0	133.2	136.6	140.0	143.5	147.1	150.7	154.5
Total operating costs	US\$m	29.3	37.8	38.8	39.7	40.7	41.7	42.8	43.9	45.0	46.1
Operating profit	US\$m	63.9	88.5	90.7	93.0	95.3	97.7	100.1	102.6	105.2	107.8
Operating profit margin	%	68	70	70	70	70	70	70	70	70	70
PBT	US\$m	26.6	47.5	51.0	54.9	58.9	62.9	67.0	71.1	75.2	79.4
Tax/processing royalty	US\$m	-	-	-	-	-	1.4	1.8	1.9	1.9	2.0
Net earnings	US\$m	26.6	47.5	51.0	54.9	58.9	61.5	65.2	69.2	73.3	77.4
Capex	US\$m	51.5	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
Free cash flow	US\$m	-8.9	61.2	65.0	69.1	73.5	76.4	80.4	84.9	89.4	94.0

Source: Mirabaud Securities estimates

The ilmenite has a grade of around 55% TiO<sub>2</sub>, but this will be processed such that about half will be upgraded to 60%, making it suitable for customers using the chloride process (customers would first smelt the ilmenite to chloride-grade slag) to produce pigment feedstock. The other half will be suitable for customers using the sulphate process (again requiring smelting to slag) or those with facilities to upgrade it to synthetic rutile (which can be used directly in the chloride process without smelting).

Ilmenite for the chloride process (common in the West) commands a roughly 3-4% price premium over ilmenite for the sulphate process (the process used in all new-build

Moma's 2007 production target is based on a very conservative ramp-up

capacity in China in recent years). Moma's rutile can be sold to customers using the chloride process (for use directly without the need for smelting).

Mining will be carried out in artificial ponds by two dredgers, each with a rated capacity of 2,500tph. The mine plan calls for production of 3,000tph, meaning that 40% of the mining capacity is redundant and available for expansion.

Moma's production in 2007 is targeted at 446,000t of ilmenite, 14,000t of rutile and 31,000t of zircon, which means that the recent six-week delay in the handover of the facilities by the contractor should not impact the production profile. Handover of the mineral separation plant is scheduled for next month, which will essentially complete the project's major works.

Further, we believe the company's 2007 production target is very conservative and that actual output will be nearer to 600,000t of ilmenite. Our basic valuation is based on this figure, but even if the company's conservative ramp-up is factored in, the base-case valuation falls by only 1p per share.

Kenmare has secured grid power at US\$2.4/kWh. The supply is dependent on Mozambique's national grid bringing the power from the Cahora Bassa hydroelectric dam, about 700km distant. Kenmare has taken appropriate measures, including installing a back-up transformer at the provincial capital and a voltage stabiliser on the power line. It has also installed stand-by, diesel-fuelled generating facilities at the project site, capable of providing sufficient power to run all activities save mining. The working capital projection allows for a three-month run-of-mine stockpile.

The mining method depends on the availability of water, but Moma has three potential sources, a well-field, a lake and a wetland area, each capable of supplying the full requirement.

#### **Taxation regime**

Moma has industrial free-zone status for its processing facility, and low tax terms for its mining facility (which will sell ore to the processing facility at the mine operating cost plus 15%). The processing facility will pay a 1% royalty on external sales from year seven.

The mining company will pay a 3% royalty on its revenue. It is also liable for a tax of 15% of its profits for the first ten years, rising to 30% thereafter. However, the high share of the total capital cost represented by the mining assets (mainly the dredges) means that the mining company will pay no significant tax until year seven.

## Summary Financials

### Profit & Loss

		2005A	2006E	2007E	2008E	2009E
Net revenue	US\$m	-	-	93.2	126.3	129.5
Other income	US\$m	1.8	3.2	2.6	4.5	7.2
Cost of sales	US\$m	0	0	-29.3	-37.8	-38.8
Exploration and evaluation costs	US\$m	-1.5	-1.5	-0.5	-0.5	-0.5
Depreciation & amortisation	US\$m	-	-	-22.2	-24.9	-25.2
Foreign exchange gains/losses	US\$m	4.9	-8.0	-	-	-
G&A expenses	US\$m	-0.5	-0.5	-0.5	-0.5	-0.5
Finance costs	US\$m	-	-	-21.2	-22.3	-20.7
<b>PBT</b>	<b>US\$m</b>	<b>4.7</b>	<b>-6.8</b>	<b>22.0</b>	<b>44.8</b>	<b>51.1</b>
Income tax	US\$m	-	-	-	-	-
<b>PAT</b>	<b>US\$m</b>	<b>4.7</b>	<b>-6.8</b>	<b>22.0</b>	<b>44.8</b>	<b>51.0</b>
Basic no. of shares in issue	m	656.4	676.3	686.5	686.5	686.5
Diluted no. of shares in issue	m	776.4	797.6	807.8	807.8	807.8
Basic	USc	0.7	-1.0	3.2	6.5	7.4
Diluted	USc	0.6	-0.9	2.8	5.6	6.4

Source: Kenmare Resources, Mirabaud Securities estimates

### Balance Sheet

		2005A	2006E	2007E	2008E	2009E
Cash and cash equivalents	US\$m	75.5	31.8	52.9	95.5	143.8
Trade and other receivables	US\$m	1.8	4.4	10.7	14.3	14.7
<b>Total Current Assets</b>	<b>US\$m</b>	<b>77.3</b>	<b>36.2</b>	<b>63.6</b>	<b>109.8</b>	<b>158.5</b>
PP&E	US\$m	187.7	287.9	323.4	309.7	295.7
Exploration and evaluation expenditure	US\$m	104.2	124.2	118.5	112.8	107.1
<b>Total Non-Current Assets</b>	<b>US\$m</b>	<b>291.9</b>	<b>412.1</b>	<b>441.9</b>	<b>422.5</b>	<b>402.8</b>
<b>Total Assets</b>	<b>US\$m</b>	<b>369.3</b>	<b>448.3</b>	<b>505.5</b>	<b>532.3</b>	<b>561.3</b>
Trade and other payables	US\$m	16.2	13.5	3.7	4.4	4.5
<b>Total Current Liabilities</b>	<b>US\$m</b>	<b>16.2</b>	<b>13.5</b>	<b>3.7</b>	<b>4.4</b>	<b>4.5</b>
Long-term debt	US\$m	164.7	249.6	294.6	275.9	253.8
Other debt	US\$m	1.5	4.7	4.7	4.7	4.7
Accrued liabilities	US\$m	7.1	5.9	5.9	5.9	5.9
<b>Total Liabilities</b>	<b>US\$m</b>	<b>189.5</b>	<b>273.8</b>	<b>309.0</b>	<b>291.0</b>	<b>269.0</b>
<b>Net Assets</b>	<b>US\$m</b>	<b>179.8</b>	<b>174.5</b>	<b>196.5</b>	<b>241.3</b>	<b>292.3</b>
Issued capital	US\$m	54.8	55.3	55.3	55.3	55.3
Share premium	US\$m	105.7	106.7	106.7	106.7	106.7
Retained earnings	US\$m	-17.2	-24.0	-2.0	42.8	93.9
Other reserves	US\$m	36.4	36.5	36.5	36.5	36.5
<b>Total Equity</b>	<b>US\$m</b>	<b>179.8</b>	<b>174.5</b>	<b>196.5</b>	<b>241.3</b>	<b>292.3</b>

Source: Kenmare Resources, Mirabaud Securities estimates

## Cash-flow Statement

		2005A	2006E	2007E	2008E	2009E
PBT profit/loss	US\$m	4.7	-6.8	22.0	44.8	51.0
Less interest income	US\$m	-1.8	-3.2	-2.5	-4.4	-7.2
Add back D&A	US\$m	0.0	0.0	22.2	24.9	25.2
Add back foreign exchange loss	US\$m	2.1	1.2	0.0	0.0	0.0
Add back share-based payments	US\$m	0.2	0.0	0.0	0.0	0.0
Changes in working capital	US\$m	-0.2	-5.3	-16.1	-2.9	-0.3
Add back changes in accrued liabilities	US\$m	15.0	-1.2	0.0	0.0	0.0
<b>Net cash flows from operating activities</b>	<b>US\$m</b>	<b>19.9</b>	<b>-15.3</b>	<b>25.5</b>	<b>62.3</b>	<b>68.8</b>
<b>Cash Flows from Investing Activities</b>						
Interest received	US\$m	1.8	3.2	2.5	4.4	7.2
Addition to exploration and evaluation expenditure	US\$m	-42.6	-20.0	-0.5	-0.5	-0.5
Addition to construction in progress (formerly PP&E)	US\$m	-113.7	-97.0	-51.5	-5.0	-5.0
<b>Net cash generated by (used in) investing activities</b>	<b>US\$m</b>	<b>-154.5</b>	<b>-113.8</b>	<b>-49.5</b>	<b>-1.1</b>	<b>1.7</b>
<b>Cash Flows from Financing Activities</b>						
Proceeds from issues of shares	US\$m	8.0	1.5	0.0	0.0	0.0
Increase in share option reserve	US\$m	1.5	0.2	0.0	0.0	0.0
Proceeds from borrowings	US\$m	109.8	84.9	45.0	0.0	0.0
Repayment of borrowings	US\$m	0.0	0.0	0.0	-18.7	-22.1
<b>Net cash flows from financing activities</b>	<b>US\$m</b>	<b>119.3</b>	<b>86.5</b>	<b>45.0</b>	<b>-18.7</b>	<b>-22.1</b>
<b>Net (decrease)/increase in cash and equivalents</b>	<b>US\$m</b>	<b>-15.2</b>	<b>-42.5</b>	<b>21.1</b>	<b>42.6</b>	<b>48.3</b>
Cash and cash equivalents at beginning of the year	US\$m	92.9	75.5	31.8	52.9	95.5
Effect of forex on cash and cash	US\$m	-2.1	-1.2	0.0	0.0	0.0
<b>Cash and cash equivalents at the end of the year</b>	<b>US\$m</b>	<b>75.5</b>	<b>31.8</b>	<b>52.9</b>	<b>95.5</b>	<b>143.8</b>

Source: Kenmare Resources, Mirabaud Securities estimates

## RECOMMENDATIONS HISTORY

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## RATINGS, CERTIFICATION AND DISCLOSURE

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- NEUTRAL:** The stock is expected to generate absolute price performance of between 10% positive and 10% negative during the next 12 months.
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