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## King Island on the ascent

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King Island, it turns out, doesn't just produce cheese

Right now, small cap managers are looking to contribute to a \$3 million to \$5 million equity raising of a small tungsten mining company, King Island Scheelite (**KIS - share price 26 cents**) in order for it to do further drilling.

With a current market cap of \$16 million, King Island Scheelite is not going to be another Lynas Corp overnight, but its fundamentals look similar and its share price has been heading in the right direction, being up 44 per cent over the past six months.

They could do worse than emulate Lynas. **Shares of the local producer of rare earths** - a variety of materials vital for production of some electronic products - have risen from 15 cents in January 2009 by a factor of almost 15 to their current level of \$2.22, implying a market capitalisation of \$3.7 billion.

Rare-earths producers have enjoyed a massive surge in late 2010 thanks to China's move to limit supplies of rare earths, which it can do since it accounts for close to 96 per cent of the world's supply. Similarly, China produces 80 per cent of the world's tungsten and has said it will reduce the rate at which it supplies this increasingly valuable mineral to the rest of the world.

Tungsten, which is a derivative of the ore scheelite, is used for cutting tools, such as drill bits. Its demand is forecast to grow from 62,000 tonnes in 2010 to 90,000 tonnes in 2015 due to increasing industrialisation, particularly in Asia.

China's tight grip on tungsten supplies reflects its desire to control as many inputs into the production process as possible. Such dominance may help Chinese manufacturers sharpen their competitiveness against rivals in other countries.

### Tungsten price surge

The tungsten price has increased by more than five-fold between 2005 when it was around US\$50 a tonne. The period happens to coincide with the timing of King Island's purchase of the Tasmanian mine from Rio Tinto. Today, the metal's price is over US\$250 a tonne.

On the basis of the value of its existing reserves, or the amount of tungsten it can mine economically, King Island is worth \$1.26 a share. Its steep discount is because it needs to raise more money. After its current raising, it will need to raise \$20 million in October and then \$40 million to \$50 million after that to go into full production.

One of the factors that has made Lynas so attractive to investors is its high grades, or the concentration of rare earths in every tonne of ore mined. A higher grade means that even if other producers come along, your mine can still be economic.

King Island has an average grade of 1.3 per cent, which is at the top of the range for those (few) tungsten producers that are outside China.

Tony Haggarty, the founding director of Excel Coal, whose fortune is estimated at \$450 million is on the board. As a small investor, it's always good to know you are alongside industry heavyweights.

### Season's end

We are getting to the end of a period where small-cap fund managers can stop complaining about not seeing their families.

But before that, many of these self-described workaholics will go to the Euroz Small Caps Conference, located in usually sunny Rottneest Island in WA. This place has, "some of the world's finest beaches and bays", according to its website (your scribe has never been). A hard life for some.

One question asked in a topsy-turvy reporting season has been how long the upward momentum will continue for companies that are the flavour of the month?

Outside of mining, these include those businesses that rely on business spending, like recruitment company **Talent2 (TWO)** and computer services groups SMS Management (**SMX**) and Data3 (**DTL**).

For example, trading at \$1.66 a share, Talent2 is trading on a current year price/earnings ratio of almost 16 times, compared with the small cap industrial average of 13.

On the flip side, retailers and other consumer related stocks like Specialty Fashion (**SFH**), Pacific Brands (**PBG**), the Solomon Lew vehicle Premier Investments (**PMV**) have been under notable pressure, as have labour hire businesses like Programmed (**PRG**). These stocks are trading on single digit PEs.

One fund manager, David Aylward of Tribeca Investment Partners, thinks that there are signs in smallville that investors are again in the hunt for value:

"A few stocks that have performed well and had good results, but were then sold off heavily..."

Stocks that stood out in this category included Flight Centre (**FLT**) and drilling company Imdex (**IMD**).

Elsewhere, he said, "It's been a disappointing earnings season, but some (share prices) popped in stocks where investors are keen to look for signs that things have bottomed out and that downgrades are a thing of the past."

Companies in this category include furniture retailer, Fantastic (**FAN**), although we note its share price has come back after its initial spike, accommodation booking provider Wotif.com (**WOT**), rural company Australian Agricultural Company (**AAC**), and would-be pulp mill operator Gunns (**GNS**).

I know which category of company I prefer to be in.

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