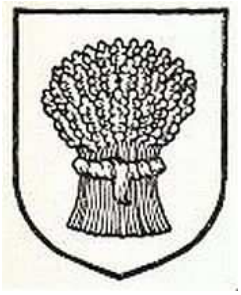
Monday, June 14, 2010



Hallgarten & Company

Initiating Coverage

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Malaga (MLG.to)
Strategy: Long

Malaga - Key Metrics				2009	2010e	2011e
Price (CAD)	$	0.14	Consensus EPS		n/a	n/a
12-Month Target Price (CAD)	$	0.40	Hallgarten EPS		($0.01)	$0.01
Upside to Target		196%	Actual EPS	($0.05)		
High-low (12 mth)	$0.09-	$0.19	P/E	n/a	n/a	11.0
Market Cap (CAD mn)	$	19.9				
Shares Outstanding (millions)		147.7	Dividend	n/a	n/a	n/a
			Yield	0.0%	0.0%	0.0%

Malaga

Breaking the Chinese Stranglehold

- + Malaga is the only Tungsten producer listed on a public market, most other players are private or, if public, on care and maintenance at the current time
- + Tungsten is most commonly used in so called “hard steels” and is best known though for providing the filaments in lightbulbs.
- + All the company’s output is pre-sold to GTP, a major player in the Tungsten space, at market prices
- + The company has just signed on Resource Capital as a core investor via a significant financing
- + The company has secured its own electricity supply by buildings its own hydroelectric facilities
- + Production is rising, prices are rising and investments are lowering the cash cost per MTU signaling strong EBITDA growth over the next two years
- ✘ The Chinese have 90% of the production of Tungsten at the current time
- ✘ The only thing that Malaga is vulnerable to is the Tungsten price, which has shown itself to be highly volatile in recent years. The Chinese as both the largest producer and one of the main users have a vested interest in higher prices but that does not mean that they may not push prices down to achieve other policy or strategic goals

Background

Malaga (which some may know under its previous guise as Dynacor) is a tungsten miner operating in the North of Peru. It acquired the Pasto Bueno mine in Peru in 2005 and has made significant investments in refurbishment and production expansion. It re-started production early in 2009 and is now reaching its current capacity of 500 tpd. A 25% expansion of production in 2010 by tweaking current equipment and medium-term plans for further refurbishment of on-site plant to reach 1,000+ tpd of throughput, shows that there is a lot of revenue expansion potential available at Malaga. Demand for product is guaranteed, as MLG signed a three-year off-take agreement with GTP (formerly Osram-Sylvania) that pays a premium to world spot prices for its high quality tungsten.

In late 2007, Malaga spun off its gold assets into a vehicle called Dynacor Gold) and thus Malaga is now exclusively devoted to tungsten production. It also holds a stake in a nearby electricity generator, so power supply problems, which bedevil so many miners, are not a consideration.

Tungsten

Tungsten takes its name from the Swedish words, *tung sten*, or heavy stone. Its symbol in the periodic table though is W which are from the name of its discoverer, Peter Woulfe, who in 1779 investigated the mineral now known as wolframite and concluded it must contain a new substance. Scheele, in 1781,

found that a new acid could be made from tungsten (a name first applied about 1758 to a mineral now known as scheelite). Scheele and Berman suggested the possibility of obtaining a new metal by reducing this acid. The de Elhuyar brothers found acid in wolframite in 1783 that was identical to the acid of tungsten (tungstic acid) of Scheele, and in that year they succeeded in obtaining the element by reduction of this acid with charcoal. Tungsten occurs in wolframite, scheelite, huebnerite, and ferberite.

Tungsten – where and how

All tungsten deposits are of magmatic or hydrothermal origin. During cooling of the magma, differential crystallization occurs, and scheelite and wolframite are often found in veins where the magma has penetrated cracks in the earth's crust. Most of the tungsten deposits are in younger mountain belts, i.e. the Alps, the Himalayas and the circum-Pacific belt (i.e. the Andes). The concentration of workable ores is usually between 0.3 and 1.0% WO3 with Malaga's mine having a grade of 0.7%.

Applications

Because it retains its strength at high temperatures and has a high melting point, tungsten is used in many high-temperature applications, such as light bulb, cathode-ray tube, and vacuum tube filaments, heating elements, and rocket engine nozzles. Due to its conductive properties, as well as its relative chemical inertia, tungsten is also used in electrodes.

Its high melting point also makes tungsten suitable for aerospace and high-temperature uses such as electrical, heating, and welding applications, notably in the gas tungsten arc welding process (also called tungsten inert gas -TIG- welding).

The hardness and density of tungsten are applied in obtaining heavy metal alloys. High-speed steel, may contain as much as 18% tungsten. Superalloys containing tungsten are used in turbine blades and wear-resistant parts and coatings. In its defense applications, tungsten, usually alloyed with nickel and iron or cobalt to form heavy alloys, is used in kinetic energy penetrators as an alternative to depleted uranium but may also be used in cannon shells, grenades and missiles to create supersonic shrapnel.

Tungsten compounds are used in catalysts, inorganic pigments, and as high-temperature lubricants. Tungsten carbide (WC) is used to make wear-resistant abrasives and cutters and knives for drills, circular saws, milling and turning tools used by the metalworking, woodworking, mining, petroleum and construction industries and accounts for about 60% of current tungsten consumption. Tungsten oxides are used in ceramic glazes and calcium/magnesium tungstates are used widely in fluorescent lighting, while tungsten halogen bulbs are frequently used to light indoor photo shoots, and special negative films exist to take advantage of tungsten's unique disentangling properties. Crystal tungstates are used as scintillation detectors in nuclear physics and nuclear medicine. Other salts that contain tungsten are used in the chemical and tanning industries

Supply

Over the last few years, sources of supply have shifted totally. In 1986, the USSR was the world's largest consumer but, by 1992, the reformed CIS was exporting tungsten and by 1996 was the world's second largest supplier. In the late 1990s and at the beginning of the new millennium, China had risen to

dominate production with 90% of world market for tungsten production and supply. This was despite China having about 75% of the world's tungsten resources.

The other principal producing countries were Austria, Bolivia, Peru and Portugal, whilst mines had closed in the last decade in Australia, Brazil, Canada, France, Japan, South Korea, Sweden, Thailand and the USA. Production in the recent past in the US has been in California and Colorado.

Sources of Production over the last 10 Years	
Primary	55-60,000 tpa
Recycling	20-25,000 tpa

In 2008, Goodall (GBRM), the leading consultants in the tungsten space, predicted that global consumption would rise from 81,000 tpa to around 109,000 tpa by the end of 2012. This projection has probably now a longer time span due to the lost years of global growth in 2008 and 2009.

Not only have the sources of supply altered but so have the tungsten compounds traded, as fluctuating price differentials between concentrate and upgraded products and governmental restrictions played their part in the market. The table below shows the way these shifts have effected product mix over recent decades.

International Trade in Tungsten Compounds

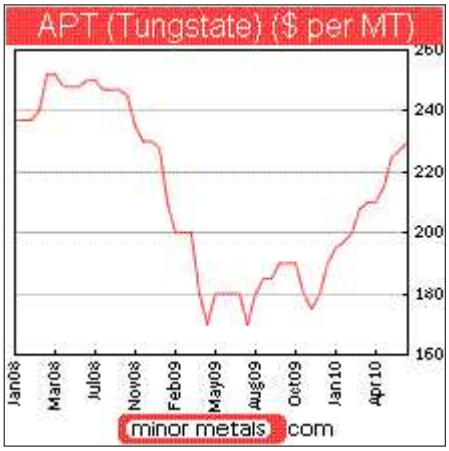
Year	1986	1996
Concentrates:	84%	29%
Intermediate Products:	16%	71%

Intermediate products include tungstates, tungsten oxides and hydroxides, W and WC powders, and ferrotungsten.

Pricing

The average annual price of tungsten since 1950 has fluctuated between a nadir of US$10 per metric ton unit in 1963 and a peak of US$175 in 1977. After that point it sagged back to trade in a $50-75 band for several decades before its revival in the new century. During the last five years, trade in concentrates has diminished and the market has relied more and more upon the APT quotation as a price guide since APT is the product traded in the largest quantity. Prices are mainly based on the quotations published twice a week by London’s "Metal Bulletin", although other trade journals also publish quotations or indicative prices.

The chart at the right shows the recent price trends for APT, with a clear recovery being evident over recent quarters.



The China Factor

We see in tungsten the same dynamic that other specialty metals have experienced over recent decades. During the 1980s and the 1990s China, with the world's largest reserves and lowest cost of production, flooded the world market. This drove down the price of both APT and WO3 concentrates to below the production cost of most other producers. Amongst the distortions this produced was that APT prices, driven downwards by Chinese processors, were only marginally above the price of concentrates at about USD$50 per MTU (metric ton unit = 10kg).

The distressed price in the world market quickly drove many tungsten mines and APT producers in the Americas, Asia and Europe out of business and led to their closure. Moreover, outside of China, exploration and mine development programs were quickly abandoned.

However, the distressed market price for tungsten concentrates and its products began to change in 2003 and more markedly in 2004-2005 propelled by the rapid growth and emergence of the Chinese economy in the world marketplace. As in other metals the rapid growth of Chinese demand for tungsten products for its domestic market triggered a tightening of the availability outside of China which was coupled with the Chinese government's policy curtailing mining projects and taxing the export of tungsten concentrates in order to conserve resources for future domestic needs. This led to a price surge in 2005. Just as in Rare Earths and other specialty metals the Chinese government is curtailing mining programs and strongly "encouraging" downstream processing of concentrates to higher value added products such semi-finished and finished tungsten products. We might also note that before the 2008 clump China had become a net importer of tungsten concentrates and scrap.

This produced a flurry of activity with companies outside of China realizingd that they urgently needed to find and secure long-term supply of tungsten and its products from sources outside China. This led to increased investment in exploration and mine development activities outside of China, particularly in Viet Nam, Australia and the Americas. Three former tungsten mines were reopened: CanTung in Canada in 2005, Pansequira in Portugal in 2005 and Malaga's Pasto Bueno in Peru in 2006.

Factors militating against a ramp up in production included:

- long lead times between exploration and new mine openings are long
- the rapid increase in mine development and operating costs
- the very limited availability of high grade deposits (i.e. greater than 0.6% WO3)

The result is that the pipeline of new projects is empty and even if potential mines were identified there would be no new significant supply can be expected before 3-4 years. Moreover further price advances for tungsten concentrates and products would be necessary before any new major mining programs could stand a chance of gaining funding. As we have seen APT prices again went off a cliff with the global slump of 2008 and any miners with aspirations to get into production ended up shelving plans for the duration of the slump. This only served to accentuate the China-dependency of the industrial users of Tungsten.

The Process: Mining to concentrating

Tungsten is usually mined underground. Scheelite and/or wolframite is frequently located in rather narrow veins which are slightly inclined and often widen with the depth. Open pit mines exist but are rare.

Most tungsten ores contain less than 1.5% WO3 and thus ore dressing plants are always in close proximity to the mine. The ore is first crushed and milled to liberate the tungsten mineral crystals. Scheelite ore can be concentrated by gravimetric methods, often combined with froth flotation, whilst wolframite ore can be concentrated by gravity, sometimes in combination with magnetic separation.
Pricing

Most tungsten concentrates are processed chemically to ammonium paratungstate (APT). Secondary raw materials like (oxidized) scrap and residues are another important feed for chemical tungsten processing. However, wolframite concentrates can also be smelted directly with charcoal or coke in an electric arc furnace to produce ferrotungsten (FeW) that is used as alloying material in steel production. Pure scheelite concentrate may also be added directly to molten steel.

Pasto Bueno – a Long History of Production

The long history of Pasto Bueno can be divided into three different periods of mining operations. Originally called the Consuzo mine it began operations in 1910 and was active through to the early 1990s, under the operatorship by Minera Malaga.

The second operator in the late 1990s was Avocet Resources from about 1995 to 1998. Production peaked in 1980-1981, at a rate of 1000 tons/day. From 1982, production decreased due to low tungsten prices. The property was generally idle from 1998 until 2005 when it was purchased by the current operator, Malaga, Inc (then called Dynacor) in November of 2005. Thus the mine has been active, more or less continuously, for the past nearly 100 years producing a reported six million tonnes of ore and 42,000 tonnes of concentrate grading at 75% WO3.

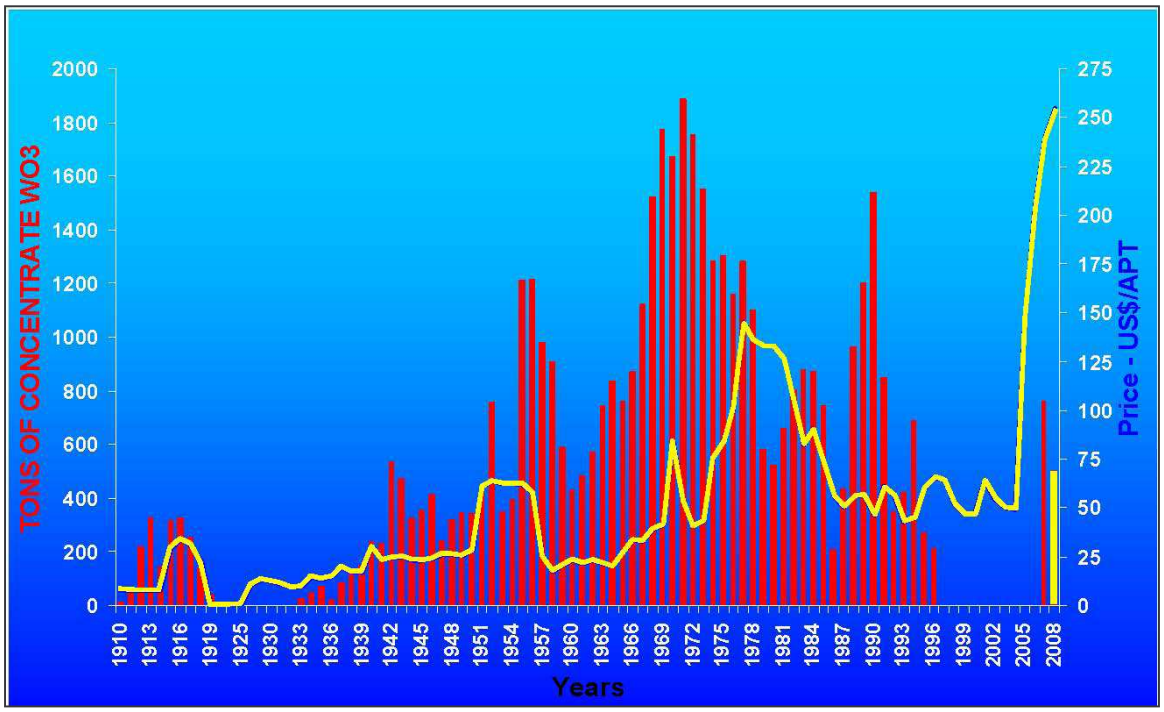
The Nature of the Mine

Firstly it should be noted that the company's mine is at very high altitude lying at between 3,200 and 4,200 metres with the concession covering a relative small area of 690 hectares. The ore has a grade of 0.7% WO3 while the quality of the tungsten concentrate produced at Pasto Bueno, at 75% WO3, is one of the best in the world since it has very low levels of impurities and does not have even trace levels of radioactivity that can be a problem with some other concentrates. Between 1941 and 2002, some six million tons of tungsten were produced from the mine, and this was from only five veins.

The company terms the deposit as a Greisen-type of deposit, a type of hydrothermal wall-rock alteration and a class of tin-tungsten deposits. Hydrothermal wall-rock alteration is the process whereby rocks on the margins of hydrothermal flow channels are changed from an original assemblage of minerals to a different one. This change occurs because of heat and mass exchange between water and rock. These deposits usually contain, on average around 20 mn tonnes of Tungsten. Many of the tungsten deposits of Yunnan in southeast China, the richest tungsten province in the world, occur in greisenized granite.

Historically, the previous owner had identified 31 veins, mining ore solely from five of these structures. Malaga, having completed surface exploration, has been able to identify to date, 75 veins, 25 of which are major structures. In the company's opinion the Pasto Bueno property still has extensive unknown potential.

The chart that follows shows the historical production of the mine compared to the prevailing price of APT. The main conclusion that can be drawn from this is that the price very rarely drove the production trend.



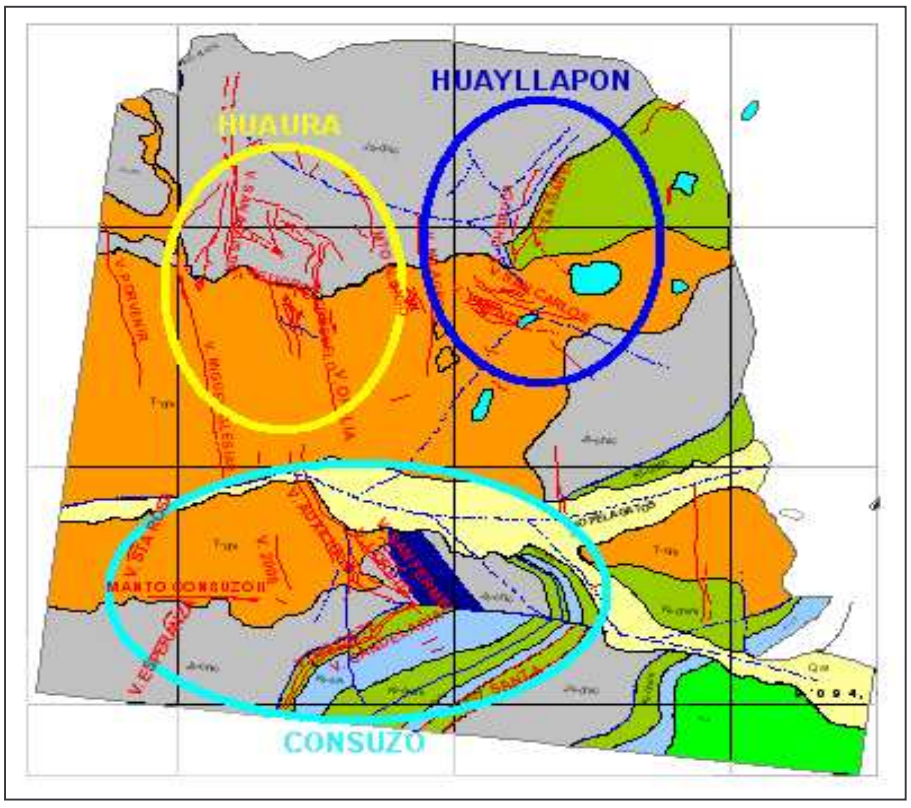
Reactivation of the mine

Beginning in about 1995, Avocet Mining invested considerable time and money to try and restart the operation. They completed the development of the No. 12 level along the Consuelo vein and built the new Huaura mill near the No. 12 level adit. In 2005, Malaga, Inc. purchased the majority of the property (24 concessions) from Minera Malaga. Malaga refurbished the Huaura mill, built by Avocet, and began producing mill feed from several of the veins. The initial pre-production operations goal was 250 Tpd which was achieved at the beginning of 2007 and continues to the present.

Since 2005, Malaga has invested CAD$14.2 million for the rehabilitation of the mine and the 250 tpd plant. In September 2006, it began pre-production at a level of 50 tons/day. The mine reached the mill's maximum capacity in June 2007, and has been producing at a steady level of 250 tons/day. Malaga has also substantially increased the WO3 recovery rate from a historical level of 50-60% to more than 80% in current operations. Work in underway on upgrading daily production at the plant, in order to reach a daily capacity of 500 tons/day in 2010.

The mine consists of three sectors, Consuzo, Huara and Huayllapon. These are shown on the cross-section that follows. The only sector in operation until recently was Huara but Huayllapon (marked HDD at the right) has just started to be mined in 2010. The company's goal is to get all three major areas into operation.

The map below shows the three zones in relation to each other.



The table below shows the current state of the resource at Pasto Bueno taken from the NI43-101 compliant technical report from March 2010. Interestingly the Pasto Bueno mine is akin to a pie that can be served continually without ever diminishing. For example when GTP signed its offtake agreement with Malaga (discussed later) the company signed a five-year agreement although the company at that time (in 2009) only officially had 14-months worth of reserves at the then production rate. Pasto Bueno gives new meaning to the words "bottomless pit".

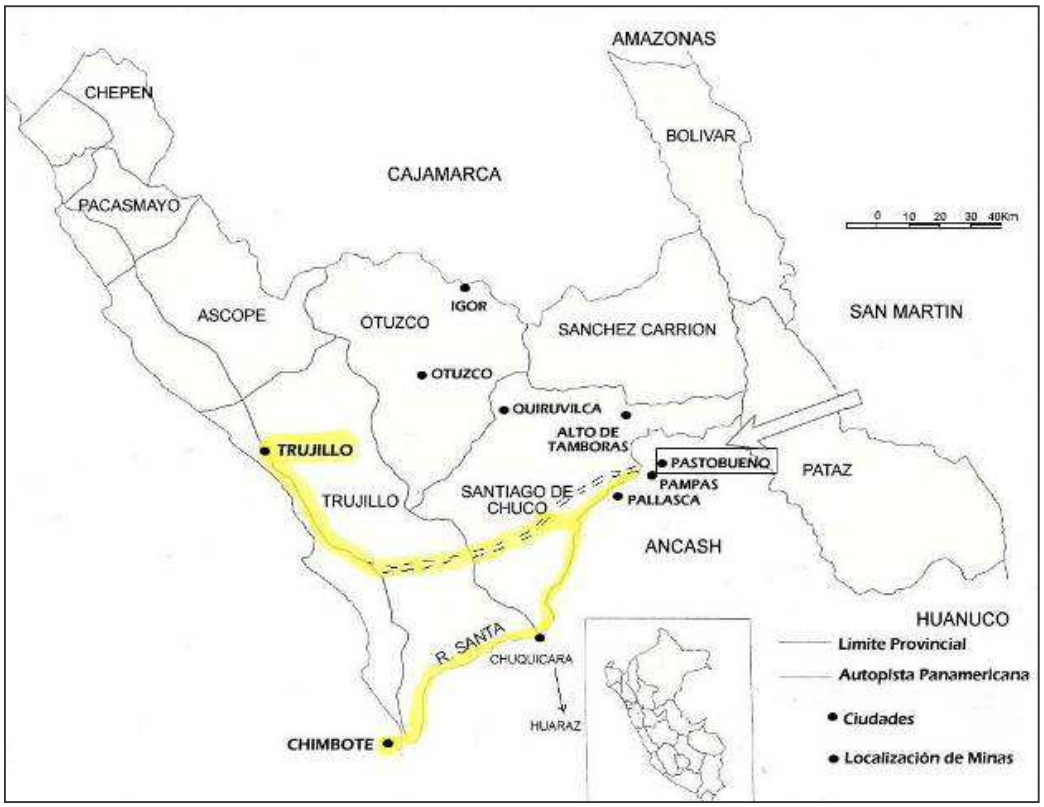
Category	Metric Tonnes	$W_{O3\ grade}$
Reserves		
Proven	81,686	0.71%
Probable	87,731	0.68%
Total Reserves	169,417	0.70%
Resources		
Measured	64,757	0.81%
Indicated	334,088	0.73%
Total Measured & Indicated	398,845	
Total Inferred	1,820,641	0,70%

Production Expansion

The company has recently been in the throes of a throughput expansion and efficiency drive. The goal is to reach milling capacity up to 700tpd some time in 2011. In the interim the goal is to increase production capacity to 500 tpd during the second quarter of 2010 and then 600 tpd by the end of the year 2010. We might note that 700 tpd is not some chimera as the mine was operating at 1,000tpd in the 1970s.

A new rod mill will be installed in June 2010 with a further rod mill to follow thereafter. The addition of vibration tables and the mine development will add to installed capacity.

The target is to further reduce its cash cost of sales beyond the reduction from US$135 to US$105 per MTU achieved in the first quarter of 2010, the cash cost of sales was US$124 per MTU. Malaga have stated that, in the remaining part of the year, the increase in production capacity, with resultant improvement in the recovery rate as a result of the increased capacity, and the implementation of certain operational process changes, should reduce the cash cost per MTU to US$105 by the end of FY10.



Infrastructure

As the Pasto Bueno mine has been in operation, in one form or another, for so long it is almost a given that it has the access and services required to operate a mine in its location. The map above shows that the mine has good access to ports with a choice of two outlets to marine transport.

Water for the process facility is supplied from one of the alpine lakes approximately 2.5 km east of the processing plant as well as from surface water and the underground workings.

Hydro-electric power – self-sufficiency as the goal

The bemoaning by mining companies of their electricity supply situation is so common as to no longer evince a yawn from us. We must confess to have been stunned to come upon a photo of a rather substantial hydro-electric dam in Malaga's presentation and then realize that the dam was actually funded and built by the company itself to ensure its access to supplies.

In the past, two hydroelectric plants were in operation: an 800 kW unit and a smaller 150 kW unit exploiting the hydrological resources of Pelagatos River in the creation of the Pelagatos reservoir (with a capacity of 12-million cubic metres) guaranteed the continuous operation of these two plants throughout the year independently of the seasonal changes in the flow of water. These hydroelectric plants were originally built by the Malaga Santolalla Corporation were gravitational units, that is to say: the kinetic energy of water undergoing a 170 meter drop is converted by a turbine into mechanical energy which is in turn converted into electrical energy by an alternator. This project was built to run the

Consuzo (was later renamed the Pasto Bueno) tungsten mine. Unfortunately these units were regarded as totally obsolete and thus out of use.

A new hydroelectric plant, owned by Hidro Electrica Pelagatos (Hidropesac), was commissioned in December 2008. The hydroelectric plant is currently providing 80% of the mine's power requirements. Hidropesac was formed in January 2006 as a joint venture between Malaga (with 44% ownership), Emerging Power Developers Ltd., (EPD), a Swiss company (having 51% ownership), and ElectroKraft SA, a Peruvian hydropower construction company (the remaining 5% ownership). The hydroelectric plant has a current capacity of 600 kW. The remaining power continues to be provided by the Hidrandina grid.

The hydroelectric plant uses the river flow directly without any additional hydrological infrastructure. The hydroelectric power generated is directly used by the Pasto Bueno mine and its ore processing plant resulting in a significant reduction in energy operating costs. Up until now they have used on-site diesel generated power.

The building of the new hydroelectric plant was financed through the Clean Development Mechanism by the sale of carbon credits under the Kyoto Protocol that is implemented by the United Nations Framework Convention on Climate Change (UNFCCC).

When Malaga purchased the Pasto Bueno property from its previous owners in addition to all the mineral rights, all the hydroelectric rights were also transferred to Malaga. These rights were originally obtained by the Malaga Santolalla Company in the 1950s from the Government of Peru. As a first step in the development of Pasto Bueno, Malaga through its joint venture with EPD, Hidropesac, began building the new hydroelectric plant to replace

Hidropesac has invested more than US$3mn in this project and has successfully built and commissioned a 600 kW hydroelectric plant at Pasto Bueno. This plant includes two hydroelectric generators – one 150 kW vertical unit and one 450 kW horizontal unit both coupled to Pelton turbines as well as state of the art operational electronic controls. A 22.9 kV/400 V transformer and 15 km power transport line have also been built and installed at Pasto Bueno. EPD, Malaga's partner in Hidropesac, has worked on this project with STUCKY S.A. a Swiss company that has more 80 years of international experience in the building and commissioning of hydroelectric projects from mega-sized projects to much smaller projects throughout the world.

Since early 2009, following a series of operational and conformity tests that were finished in late 2008, the 600 kW hydroelectric plant was put into commercial production and now provides more than 90% of Pasto Bueno's energy requirements. Thus, Malaga is now apart from certain occasional peak power requirements, basically energy independent from the national power grid.

In phase II of the hydroelectric development ,Malaga intends to install a 2nd hydroelectric plant that will not only cover all of its future power needs but will also allow Hidropesac to generate additional electricity that will be sold to the national power grid and generate further income for the joint venture.

Offtake

In sharp contrast to the bemoaners of the REE space the end users in the Tungsten space are acutely aware of their vulnerability in the supply chain. Not unsurprisingly the major users have moved to try and secure their upstream (as per our mantra in specialty metals "Secure Thy Upstream"). In one case Sandvik, the major toolmaker, has acquired a mine in Australia. This company is particularly vulnerable to supply disruptions as it is up against China, making a major push into the tool space and thus we might tactfully say that it would be to the benefit of Chinese toolmakers to have foreign competitors experience supply problems from the Chinese tungsten mines. If any investors doubt that that might happen then they would be naive indeed.

Then there is Malaga's symbiotic relationship with Global Tungsten & Powders Corp (GTP). In February 2009 Malaga signed a five-year agreement for the provision of Tungsten. The main terms of this deal were:

- a $1.2mn cash advance without interest
- a $3.8mn loan (first year without interest and afterwards at LIBOR)
- Reimbursement terms over four years with conversion in shares at market price less a discount
- Selling price of Malaga tungsten in line with market price
- Right of first refusal for excess capacity above 700 tpd

This arrangement not only financed Malaga's expansion plans but gives it a guaranteed outlet for product up to the 700 tpd level. It is important to note the market price provision because usually these offtake agreements can end up being onerous with fixed prices or big discounts.

GTP was created in August 2008 as Global Tungsten & Powders Corp. It was the former Materials & Components division of Osram Sylvania, the world's largest lighting firm. The materials group has its roots in the old GTE Sylvania's manufacturing operations that were taken over by the German lighting major, Osram in 1993. GTP is headquartered in Towanda, Pennsylvania and is a leading, producer of tungsten, molybdenum, other refractory materials and phosphors produced in the form of ammonium paratungstate, powders, rod, wire and other fabricated products. Its plants are in PA and the Czech Republic. GTP is now part of the Plansee Group, a German private company that is a leading supplier of powder metallurgically manufactured products, with experience in refractory materials dating back to 1921.

The terms for the conversion of shares are that GTP has the right to convert its debt holdings to shares at any time for a maximum of 19.99% of outstanding shares. They would exchange at a 15% discount to the average 10-day price preceding the transaction.

However while GTP has the right to convert but they have made it clear to Malaga that this is not their intention. Malaga had offered to finance with shares but GTP preferred debt as they don't consider themselves miners.

Recent financings

In early May 2010, Malaga undertook a two tranche non-brokered financing from which it received, in the first tranche, gross proceeds of CAD$2.75mn through the issue of 18,321,667 common shares at $0.15 and 18,321,667 warrants with an exercise price of $0.25 that expire two years after the closing date. There is a second tranche (consisting of 21,666,667 Subscription Receipts at a price of $0.15 each) that entitle, under the same terms, the holder to redeem for one Unit following the shareholder approval at the annual general meeting. The funds raised for the second tranche resulting in gross proceeds of up to $3.25 million were in escrow pending approval.

Investors in the private placement include Resource Capital Fund V LLP, which took 16.66mn units (and the same number of Subscription Receipts) for a total investment of $5mn. Resource Capital, based in Denver is one of the most prominent PE investors in the mining space in the US and an interesting endorsement of Malaga's strategy.

Another sideline

Pasto Bueno is not just a tungsten resource for there is also silver and copper in its output though this has not been a focus until recent times. During 2009, Malaga invested in a small pilot plant to concentrate the mine tailings and succeeded in producing a tailing concentrate enriched in copper and silver.

Obviously this impacts positively the operational cash flow. In March the company announced that it had sold 1,000 tonnes of copper/silver concentrate in the months of January and February of 2010. This concentrate was extracted from the mine tailings, a by-product accumulated from tungsten ore processing. It was expected that an additional 1,000 tonnes will be sold in March, generating an expected US$1mn during the 1Q10. The company anticipated selling 5,000 tonnes of accumulated material for at least US$2.5mn in the first half of FY10.

An agreement has been signed with a Peruvian company to process 5,000 tonnes of the enriched tailings and it expects to expand this arrangement further in the future.

Earnings Outlook

In coming up with earnings estimates for Malaga over the next couple of financial years we have used the company's projections of output, costs and APT prices. These are as shown in this table:

	FY11e	FY10e	FY09
Tons per day	700	490	267
Annual Production MTU	143,500	105,000	63,358
Cash cost/MTU	97	103	133
Gross Margin per MTU	83	66	21
Av price APT per MTU	235	219	197

These do not seem a stretch in light of the current market price and the progress on increasing the milling throughput. The projection of $103 in cash cost per MTU is still some way off as 1Q10 cash costs were $124 per MTU.

We would note that amortization and depreciation run at very high rates for Malaga, possibly reflecting the need to amortize the costs of improvements over what is ostensibly a rather short mine-life horizon. The horizon being so short because of the limited official reserves. This is ironical in light of the "limited" reserves being upon a mine that has been functioning for the best part of a century in one form or another. However, be that as it may, the amortization/depreciation number was running at around 40% of revenues in FY09 and then at over 25% in 1Q10. We have resolved to use a 26% relationship to revenues for the next two FY estimates.

Thus in working up estimates (shown on the following page) for FY10 and FY11 based upon these parameters we feel that the company has the potential to:

- Produce sales of around $20.7mn in FY10 or nearly double that of the previous FY
- This would produce a pre-tax loss of $820,000
- However, EBITDA would be around $5.3mn due to the high amortization number of $5.3mn
- In FY11 sales could be as high as $30.3mn, thus a YoY increase of 50%
- This would produce a pre-tax gain of $1.85mn or around one cent per share
- EBITDA in this year would exceed $10mn due to the hefty $7.9mn in amortization and depreciation

Quite clearly cashflow has taken a major turn for the better in this scenario, enabling the payback of the GTP loan as well as facilitating improvements to the daily throughput that would push FY12 earnings even higher. Clearly the ideal scenario for shareholders would be for the amortization rate to be lowered and a dividend flow initiated out of the money that would sink down to the bottom line.

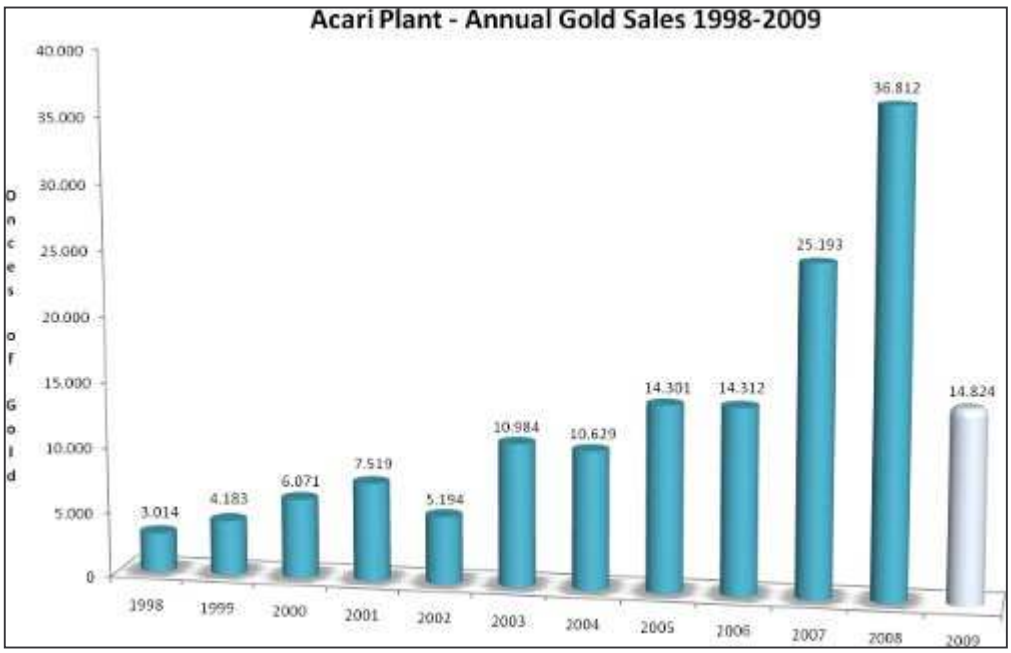
Malaga

(CAD mn)	FY11e	FY10e	1Q09	FY09	4Q09	3Q09	2Q09	1Q09	FY08	4Q08	3Q08	2Q08	FY07
Revenue	30.35	20.70	3.78	11.20	2.47	2.78	2.49	3.44	10.62	3.06	3.16	2.46	8.03
Cost of Revenue, Total	16.01	12.44	2.75	9.58	2.70	2.53	1.96	2.38	8.54	2.42	2.33	2.21	5.36
Gross Profit	14.34	8.26	1.03	1.63	-0.23	0.25	0.53	1.05	2.09	0.65	0.82	0.25	2.67
Selling/General/Admin. Expenses	3.30	3.10	0.83	2.76	0.523	0.69	0.70	0.75	3.06	0.77	0.73	0.86	3.72
Depreciation/Amortization	7.89	5.38	1.01	4.09	1.071	1.01	1.15	0.88	1.9	0.51	0.51	0.34	0.65
Interest Expense(Income)	0.80	0.80	0.20	0.72		0.20	-	-	0.338	-0.09	-	-	
Forex loss (gain)	0.50	-0.20	0.32	-0.76	-1.12	0.18	0.09	0.10					
Unusual Expense (Income)	0.00	0	0.00	-0.03			0.02	0.02	-0.04	0	-0.09	0.02	0.07
Total Operating Expense	28.50	21.52	5.11	16.36	3.17	4.62	3.82	3.99	13.75	4.03	3.57	3.48	10.74
Income Before Tax	1.85	-0.82	-0.56	-5.16	-0.70	-1.84	-1.33	-0.56	-3.13	-0.96	-0.41	-1.02	-2.75
Dynacor Gold effect	0.0	0.0	0.00	-2.38	-2.43	-0.13	0.07	0.11	0.21	0	0	0.06	-0.67
Tax	0.0	0.0	0.00	0.00	0.00	0.00	0.00	0.00	0	0	0	137.06	123.06
Net Income	1.85	-0.82	-0.69	-7.60	-3.776	-1.98	-1.33	-0.56	-3.13	-0.96	-0.41	-0.96	-3.42
Diluted Weighted Average Shares	151	149	147.686	140.77	140.77	138.99	137.12	137.117	137.12	137.12	137.12	137.12	122.39
Diluted Normalized EPS	0.01	-0.01	0.00	-0.054	-0.027	-0.014	-0.01	0.00	-0.023	-0.01	0	-0.01	-0.028
Tons per day	700	490		267					250				240
Production MTU	143,500	105,000	18,108	63,358					57,500				46,100
Cash cost/MTU	97	103	124	133					144				109
Gross Margin per MTU	83	66		21					34				54
Av price APT per MTU	235	219	220	197					248				237

Dynacor Gold Mines (DNG.to)

As previously mentioned Malaga was formerly called Dynacor and several years ago changed its name to Malaga at the point (October 2007) at which it spun off it gold interests into a vehicle called Dynacor Gold Mines. Thus far this experiment has been more pain than gain as mark-downs of the shareholding in Dynacor Gold have proven to be an ongoing drag upon Malaga's earnings statement, even though these are non-cash items. The stock came out of the gates at CAD 70cts and has never seen that level again.

These days Dynacor Gold Mines is active in gold exploration and gold production. It has been operating in Peru since the late 1990s and has operated, since 1998, a custom gold milling plant. In 2008, the custom mill at Acari produced more than 36,000 ounces of gold. The mill buys in gold ore from small miners for processing. During the last two years, the mill's capacity was increased from 90 tons/day to 180 tons/day, which enabled Dynacor to report a net yearly profit in 2008 of USD1.6 mn (5 cents per share). As the graphic below shows production in FY09 plunged due to a reduction in the procurement of gold ore. This reduction was caused by the sales tax withheld by the Peruvian tax authorities, which in turn resulted in a reduction of liquidity.

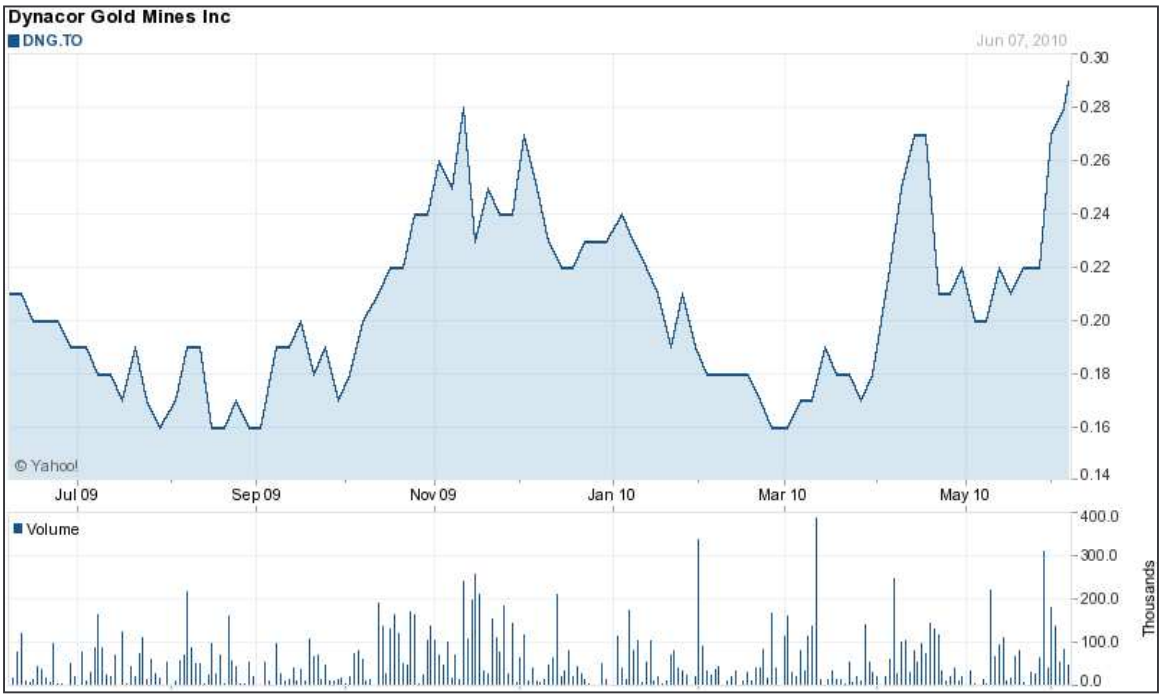


In FY09 these milling operations generated net earnings of $4.6M compared to $4.9M in 2008. Dynacor recorded an impairment in the value of the Acari property in the amount of $3.8M based on Dynacor's market-capitalisation as well as an additional provision of $2.5M for the contingent tax claims. These non-monetary elements resulted in a net loss of $6.5M. However in 1Q10 the earnings turned positive again (a mere $41K) and gold sales were running at 5,342 ozs in the quarter.

It also owns three mining properties – Acari, Tumipampa and Casaden – and has an active exploration and drilling campaign underway on its Tumipampa property. It should be noted that the Acari deposit does not feed the Acari mill at this time.

Interestingly Dynacor has a rather heavy institutional base with over 70% held by institutions with Sprott Asset Management, AGF, Trapeze Asset Management and Caisse de Dépôt et de Placement (Sodemex) figuring prominently.

The current market capitalization is just under CAD$10mn. Malaga retains 13.5% of this company.



Malaga's Management

The board consists of Jean Martineau, Chairman of the Board, who has been President and CEO since August 2007, Chairman of the Board of Directors since 2000 and Director since 1996. He was also a Director of Wesdome Gold Mines (Toronto) from 1999-2007. Prior to this, he has worked for a decade in the pulp and paper industry. He was, in particular, assistant manager for a mill owned by Kruger in Venezuela. During the 1980s, Mr Martineau worked as a stockbroker for a large Canadian brokerage firm, Lévesque, Beaubien & Geoffrion.

The rest of the board, Daniel Danis, Renald Marchand, Gilles Masson and Martin Wong are not particularly notable for their mining experience, except for Masson who is a director of Semafo, a company that we are very well disposed towards and Royal Nickel (a company we do not know of).

The rest of the management consists of Pierre Monet, the Vice President & CFO who was previously Vice President Finance, Administration and Treasurer of Iron Ore Company of Canada (a subsidiary of Rio Tinto), between 2003 to 2006. Ivan Quiroz who is Vice President Operations, Peru and essentially runs the mine. He is a mining engineer and metallurgist, and a member of the Collegio de Ingenieros del Perú, having graduated from the National University of Engineering in Lima, Peru in 1981. From 1996 to

1999, he acted as Technical director of Dynacor Mines Inc., now named Malaga Inc, and now oversees the Pasto Bueno, Acari and Tumipampa properties (the latter two now being part of Dynacor Gold Mines).

The Chief Geologist is Alonso Sanchez who graduated from the Universidad National de Ingeniería in 1995. He worked 11 years for the Peruvian mining major Buenaventura (BVN) of which five years were as a mine geologist and six years as an exploration geologist. He is experienced in epithermal gold, silver, tin, tungsten, and polymetallic deposits, and Skarn-type deposits in Peru and Bolivia.

North American Tungsten (NTC.v)

There is another sometime player in the tungsten space in the Western World. It is North American Tungsten, which owns the CanTung mine in the Northwest Territories of Canada. This mine was put on care and maintenance in June 2009 due to low tungsten prices and is still not back on line despite the APT price rebound and multiple financings that the company has done in the meantime. This may be due to a reputed $250 per tonne production cost at the CanTung mine. Ironically, the CAD$34mn market capitalization is substantially higher than that of Malaga.

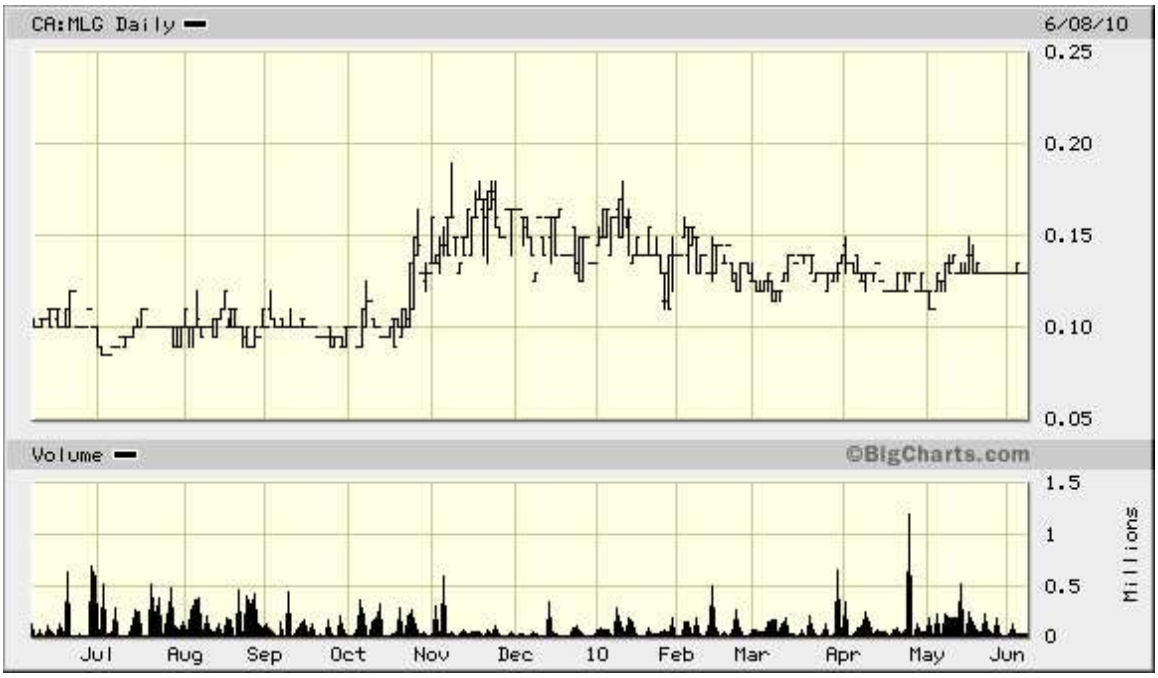
Conclusion

Overall there now exists a window of opportunity for tungsten producers, outside of China, as end users scramble to secure alternative, more reliable sources of supply. Any broader economic recovery (than the current anaemic version) should lead to heated competition for tungsten concentrates in the global market between Chinese and non-Chinese processors and consequently result in an increasing price structure for tungsten and its products in the future. A jump in prices of APT to closer to $300 would not be unthinkable.

Malaga is the great survivor in the space, and then only just…. It has come through the valley of darkness into which the specialty metals fell in 2008 but has still not managed to capture the market's interest due to generalized ignorance of tungsten and its supply/demand dynamics. If investors can get into a lather over Rare Earths and Lithium then we feel that Tungsten is just as deserving of attention, maybe even more so.

Grade and longevity of deposit are both factors that are in Malaga's favour in comparison to another stock in the space like North American Tungsten. Cost control must be stringent to survive the fluctuations in the price of APT. Malaga has the added advantage of having long had its own power supply from hydro sources, an advantage it has reinforced in recent times with its new hydro JV.

The high amortization rate hides the earnings potential but hopefully this non-cash item will be modified. At the current pace of expansion of production with prices of APT where they are or slightly higher, the EBITDA at Malaga could be over $10mn in FY11, representing a P/EBITDA ratio of only three times. Underpinning this is one of the major users (GTP) of Tungsten as a guaranteed off-taker and Resource Capital, a very savvy investor as a key holder. We have added several months back a **Long** position in Malaga to the Model Mining Portfolio and we take this opportunity to reiterate this stance with a 12-month target price of 40 cts.


CA:MLG Daily
6/08/10
0.25
0.20
0.15
0.10
0.05
Volume
©BigCharts.com
1.5
1
0.5
0
Millions
Jul
Aug
Sep
Oct
Nov
Dec
10
Feb
Mar
Apr
May
Jun

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