

# Farallon Resources Ltd. (FAN-T, \$0.20)

## Recommendation: Buy

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All values in C\$ unless otherwise noted.

|                         |        |
|-------------------------|--------|
| Current Price           | \$0.20 |
| Target Price (12-Month) | \$0.45 |
| Target Return           | 125%   |

### Changes

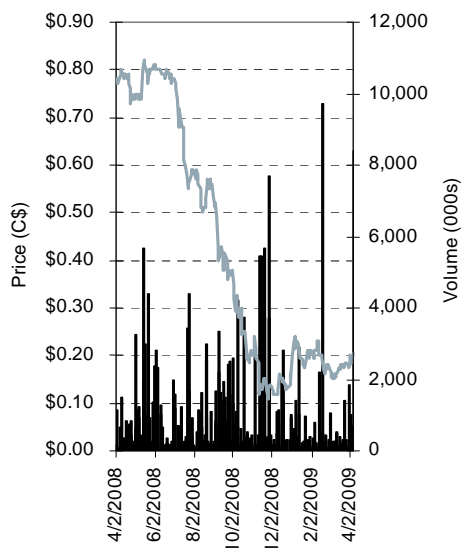
|                | Old        | New       |
|----------------|------------|-----------|
| Recommendation | Buy        | Unchanged |
| Target         | \$0.50     | \$0.45    |
| CFPS 2009E     | (US\$0.01) | Unchanged |
| CFPS 2010E     | US\$0.08   | US\$0.07  |

### Company Profile

Farallon Resources is a Canadian-listed mineral development company that owns 100% of the Campo Morado zinc-rich volcanogenic massive sulphide (VMS) mine in Mexico.

[www.farallonresources.com](http://www.farallonresources.com)

### Price Chart



Source: Thomson ONE

## Equity Issue Establishes a Path to Debt Management; Share Re-Rating Likely in '09

- FAN raises \$8.3mm in equity to extinguish \$7.75mm promissory note.**  
Proceeds reduce \$32.75mm in total promissory notes by \$7.75mm & establishes a path to debt management; issue at \$0.20/sh limits upside.
- De-risked balance sheet improves visibility on production re-rating.**  
Debt reduction helps ensure FAN navigates production ramp-up, but full share re-rating awaits improved metallurgical performance.
- Share dilution trims FY10 EPS & CFPS Estimates & target price.**  
Issuance of 41.7mm shares lowers our FY10 EPS estimate to US\$0.05 from US\$0.06 and FY10 CFPS to US\$0.07 from US\$0.08.
- Lowering target to \$0.45 from \$0.50; maintain Buy rating.**  
Target ascribes an equal weighting to 0.85x our NAV est. of \$0.60/sh (\$0.64 prev.) and 5.0x our FY10 CFPS est. of US\$0.07 (US\$0.08).

### Financial Summary

|                       |        |                   |                 |
|-----------------------|--------|-------------------|-----------------|
| Shares Out (mm) (1)   | 405.3  | 52-Week Range     | \$0.10 - \$0.84 |
| Market Cap (mm)       | \$70.9 | Avg Weekly Volume | 4,829,089       |
| Shares, FD (mm) (1)   | 422.2  | Fiscal Year End   | Jun-30          |
| Working Capital (mm)  | \$12.5 | NAV/Share, FD     | \$0.60          |
| Enterprise Value (mm) | \$77.1 | P/NAV             | 0.3 x           |

| Key Properties:                    | Status:                                       |        |
|------------------------------------|---|--------|
| Campo Morado, Mexico (100%)        | Annual Zn production - payable (000 lbs)      | 75,094 |
| Polymetallic zinc-rich VMS deposit | Annual Au production - payable (oz)           | 9,702  |
|                                    | Total Cash Costs (US\$/lb, after credits) (2) | 0.22   |
|                                    | Total Cash Costs (US\$/lb, after credits) (3) | 0.31   |

| Key Management:  | Key Shareholders:       |                 |
|------------------|-------------------------|-----------------|
| Dick Whittington | President and CEO       | Management (5%) |
| Greg McCurn      | Chief Financial Officer |                 |
| Ronald Thiessen  | Chairman and Director   |                 |

(1) Assumes conversion of promissory notes at \$0.33 for 25mm shares.

(2) Life of mine average - includes amortization of pre-sold silver.

(3) Life of mine average - includes Ag at US\$3.90/oz

Source: WWCM Estimates, Company Reports

**Please see disclaimers on the last two pages of this report.**

## Investment Summary and Outlook

**Ramping up a mine at G-9.** Farallon's principal asset is the 100%-owned Campo Morado zinc-rich polymetallic project in Guerrero State, Mexico. The company's development effort is focussed on the high-grade G-9 deposit. Commercial production was declared at G-9 on April 1, 2009, after steady-state production of 1,500 tonnes per day (tpd) was maintained from March 5, 2009.

**Low cash cost potential of G-9 and partially de-risked balance sheet should allow Farallon to weather lower metal price environment.** The combined effect of G-9's high grades and substantial by-product credits from copper, gold, silver, and lead, should result in steady-state total cash costs that fall well within the lowest quartile among zinc producers, thereby enabling the company to weather the current weak metal price environment. At our recently adopted metal price assumptions (See our Mining Sector notes dated Mar. 26/09 and Apr. 8/09), we estimate average total cash costs for the next three years of US\$0.25/lb, net of by-product credits using silver prices of US\$3.90/oz, pursuant to the sale-purchase agreement with Silver Wheaton.

**We use a discounted cash flow (DCF) analysis and P/CF multiples to arrive at a 12-month target price of \$0.45 (\$0.50 previously).** Our target price is based on a blended multiple with an equal weighting assigned to a multiple of 0.85x our NAV estimate of \$0.60/share (\$0.64 previously) and a 5.0x multiple of our FY10 CFPS estimate of \$0.07 (\$0.08).

## Farallon Eases Balance Sheet Pressure; Prudent Decision in Light of Metal Price Weakness

**Balance sheet strengthened at the cost of further dilution, helps to underpin downside.** On April 6, 2009, Farallon announced that the company raised gross proceeds of \$8.3mm via a private placement of 41.7mm common shares at \$0.20/share. The proceeds are earmarked to pay off the \$7.75mm in promissory notes issued in October 2008 and extendible into October 2009. In conjunction with the repayment, Farallon will also pay a \$581,250 bonus fee and issue 620,000 bonus shares. The debt elimination would leave Farallon with a \$25mm promissory note (bearing 15%) due on Sep. 9, 2009. We currently assume that Farallon will renegotiate and repay a portion of the note, with approximately US\$16mm extended by one year, which we estimate would leave US\$7mm on Farallon's balance sheet at the end of 2009.

**Share re-rating draws nearer, awaits sustained metallurgical improvements.** We contend that, albeit at the price of extra dilution, the extinguishment of a portion of the company's debt has partially relieved the pressure on Farallon's balance sheet, thereby increasing the probability of (and timeframe for) Farallon's shares benefitting from a re-rating on the transition to production at G-9. While this potential re-rating may also be driven in the relative near-term by increased producer and market chatter regarding potential near-term merger and acquisition activity (mostly confined to the copper space so far), we contend that the far more material driver for share price appreciation remains sustained

demonstration of improved metallurgical performance at the G-9 mine, something we expect over the course of 2009. The partial debt elimination should also allow the company to better manage the remaining debt repayments and help ensure that the company emerges from ramp-up at G-9, which has been made more challenging by the current poor metal price environment.

**Dilution results in modest downward adjustments to earnings and cash flow.**

The net result of the latest equity issue is a modest dilution of our NAVPS, EPS and CFPS estimates in 2010 (as presented below), despite the application of higher precious metal prices, as described on our Sector Report dated Apr. 8/09.

**Exhibit 1: 2010 EPS & CFPS Trimmed on Share Dilution**

|            | FY09E      | FY10E    |
|------------|------------|----------|
| EPS, f.d.  |            |          |
| -new       | Unchanged  | US\$0.05 |
| -old       | (US\$0.03) | US\$0.06 |
| CFPS, f.d. |            |          |
| -new       | Unchanged  | US\$0.07 |
| -old       | US\$0.01   | US\$0.08 |
| NAV, f.d.  |            |          |
| -new       | \$0.60     |          |
| -old       | \$0.64     |          |

Source: Company Reports, WWCM Estimates

**Lowering Target to \$0.45; Maintain Buy Rating**

**Slight risk reduction no cause for changes to our multiples, discount rate.** In response to the downward revisions to both our NAV and FY10 cash flow estimates, we are **lowering our target price to \$0.45**, while **maintaining a Buy rating**. Our target price is based on a blended multiple with an equal weighting assigned to a multiple of 0.85x our NAV estimate of \$0.60/share (\$0.64 previously) and a 5.0x multiple of our FY10 CFPS estimate of \$0.07 (\$0.08).

## Appendix: Summary Cash Flow Statement

|                      | Units    | FY08A  | FY09E  | FY10E  | FY11E  | FY12E  |
|----------------------|----------|--------|--------|--------|--------|--------|
| Zn Price (calendar)  | US\$/lb  | 0.86   | 0.55   | 0.65   | 0.80   | 1.10   |
| Zn Price (fiscal)    | US\$/lb  | 1.17   | 0.55   | 0.65   | 0.80   | 1.10   |
| US\$/C\$ (fiscal)    | US\$/C\$ | 0.94   | 0.85   | 0.85   | 0.85   | 0.85   |
| Payable Zn sales     | mm lbs   | na     | 96.3   | 104.1  | 106.5  | 106.5  |
| Total cash costs (1) | US\$/lb  | na     | 0.33   | 0.11   | 0.05   | 0.12   |
| Total cash costs (2) | US\$/lb  | na     | 0.43   | 0.22   | 0.14   | 0.22   |
| Net Income           | US\$, mm | (41.1) | (11.6) | 23.3   | 42.1   | 59.5   |
| Depreciation         | US\$, mm | 0.0    | 23.3   | 18.3   | 18.1   | 18.1   |
| Amort. of Ag sales   | US\$, mm | 0.0    | (9.0)  | (11.2) | (10.1) | (10.1) |
| Deferred income tax  | US\$, mm | 0.0    | 0.0    | 0.0    | 0.0    | 0.0    |
| Other                | US\$, mm | 2.0    | 1.0    | 0.0    | 0.0    | 0.0    |
| Operating cash flow  | US\$, mm | (39.0) | 3.7    | 30.4   | 50.1   | 67.6   |
| EPS, f.d.            | US\$/sh  | (0.12) | (0.03) | 0.06   | 0.10   | 0.14   |
| CFPS, f.d.           | US\$/sh  | (0.12) | 0.01   | 0.07   | 0.12   | 0.16   |
| Basic shares out     |          | 327.7  | 405.3  | 420.2  | 420.2  | 420.2  |
| F.d. shares out      |          | 329.7  | 407.3  | 422.2  | 422.2  | 422.2  |

(1) Total cash costs, net of by-product credits & amortization of pre-sold silver

(1) Total cash costs, net of by-product credits with Ag at US\$3.90/oz

Source: Company Reports, WWCM Estimates

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|--------------------|---------------|-----------------------|
| Farallon Resources | FAN-T         | 11                    |

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