

**Newcrest**

A Division of TD Securities Inc.

# Action Notes

June 18, 2010  
Equity Research

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**Metals & Minerals****Recommendation:** BUY**Risk:** HIGH**12-Month Target Price:** C\$0.70**12-Month Total Return:** 75.0%**Market Data (C\$)**

Current Price	\$0.40
52-Wk Range	\$0.25-\$0.65
Mkt Cap (f.d.)(\$mm)	\$201.6
Float Cap (\$mm)	\$188.6
Dividend per Share	--
Dividend Yield	--
Avg. Daily Trading Vol. (3mths)	1,669,696

**Financial Data (C\$)**

Fiscal Y-E	December
Shares O/S (f.d.)(mm)	504.0
Shares O/S (basic)(mm)	472.7
Float Shares (mm)	471.5
Net Debt (\$mm)	\$9.8
Net Debt/Tot Cap	--
Cash (\$mm)	\$20.9

**Estimates (US\$)**

Year	2008A	2009A	2010E	2011E
EPS (basic)	(0.21)	(0.03)	0.07	0.11
CFPS (basic)	(0.19)	(0.01)	0.07	0.12

**EPS (basic) Quarterly Estimates (US\$)**

Year	2008A	2009A	2010E	2011E
Q1	--	--	0.01	--
Q2	--	--	0.02	--
Q3	--	--	0.02	--
Q4	--	--	0.02	--

**Supplemental Data**

Year	2008A	2009A	2010E	2011E
Zn (US\$/lb)	0.86	2.34	0.94	1.10
Zn Prod. Mlb	14.2	81.9	112	122.5
Cons EPS	--	--	0.12	0.16

All figures in US\$, unless otherwise specified.

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## Farallon Mining Ltd. (FAN-T) C\$0.40

### A New Zinc Producer in Mexico

**Event**

We are initiating coverage on Farallon Mining Ltd. (FAN-T) with a BUY rating and a 12-month target of C\$0.70/share.

**Details**

The company's only operating asset, the G-9 mine, exploits fine-grained, polymetallic volcanogenic massive sulphide mineralization containing economic payable concentrations of zinc, copper, gold and silver, and currently, un-payable concentrations of lead.

*Please refer to full Initiating Report with the same title for more details.*

**Financed Without a Feasibility Study** – Construction of a 1,500 tpd mine and mill began in late 2007, and the first concentrates were produced in Q3/08 during the commissioning stage; commercial production was declared in Q2/09. In an unorthodox move, management decided to finance and build the mine without completing a feasibility study. This meant financing and advancing the project to production without having customary reserves, capex or operating cost estimates that the market is accustomed to. Also, the recession began before all the financing and construction were completed. The project was financed through a combination of debt, equity and forward sales of silver.

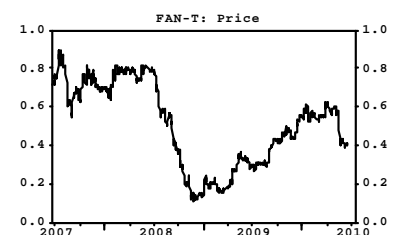
The company moved to construction on the basis of a 2007 Preliminary Economic Assessment (PEA) from which it established a 20-month mine plan to get going. While this novel approach accelerated the timeline to production, we believe it contributed to the high level of share dilution in 2006-2008.

**Large Share Count Reduces Leverage** - At the end of Q1/10 Farallon, had 472.7 million basic shares issued and outstanding along with options and warrants for another 30.7 million shares. Our net asset value per share estimates use 489.3 million fully diluted, in-the-money shares. The combination of a large share count and short mine life reduces leverage to metal price changes.

**Please see the final pages of this document for important disclosure information.**

**Company Profile**

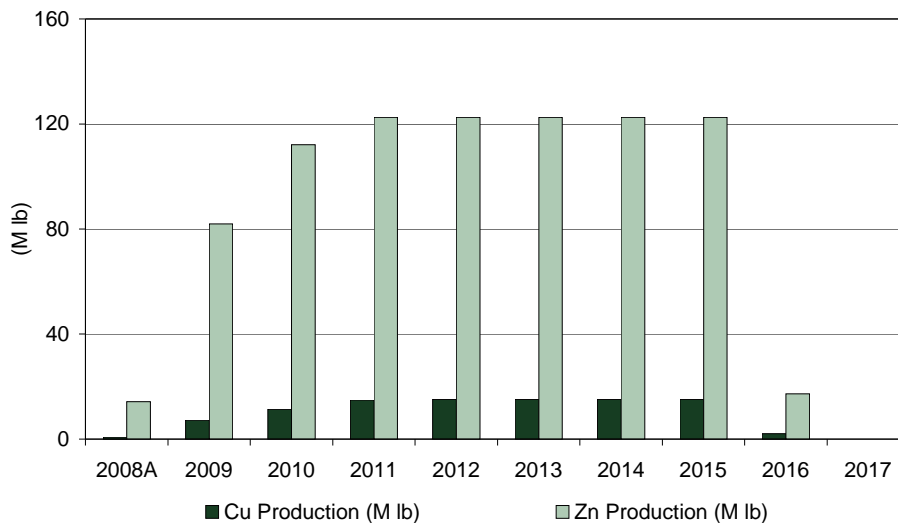
Farallon Mining Ltd. became a producing company in 2009 at its G-9 mine at the Campo Morado project in Guerrero State, Mexico. The G-9 deposit consists of fine-grained, polymetallic volcanogenic massive sulphide mineralization containing economic payable concentrations of zinc, copper, gold and silver.





**Production is Rising** - Concentrate production began in Q3/08 during the commissioning phase, and commercial production was declared in Q2/09. The initial mill throughput capacity was 1,500 tonnes per day (tpd, or 135,000 tonnes per quarter), but the company is now ramping that up to a nominal 2,000 tpd (180,000 tonnes per quarter). **Our life of mine operating scenario for the G-9 deposit shown in Exhibit 1 includes all the reserves plus all the additional resources in the measured, indicated and inferred categories.** For the resources, we added a mining dilution factor of 10% (i.e., tonnes were increased by 10%, and grades were reduced 10%).

### **Exhibit 1. Farallon Mining Ltd. Life of Mine Production Estimates**



Source: TD Newcrest

**Balance Sheet is Strengthening** - At the end of Q1/10, Farallon had working capital of \$18.2 million (including cash of \$20.9 million) and long-term debt of \$21.9 million. The debt came from a US\$30 million four-year loan agreement with a financial institution in May 2009 to pay off two promissory notes totaling \$25.3 million due in September and October 2009. With steady cash flows now expected from operations in the order of \$35 million in 2010 and \$55 million in 2011, the cash squeeze experienced during the construction period appears to have ended, and the company has resumed discretionary exploration activity.

**Reserves and Resources** – G-9 reserves (Exhibit 2) are small, but the potential is high to find additional resources and reserves, in our opinion. Since exploration drilling resumed in late 2009, three new gold rich base metal zones have been defined adjacent to the G-9 mine workings. An initial resource estimate (not shown) for these deposits was announced in April. Additional resources (not shown) exist on the Campo Morado property, but they have metallurgical challenges to overcome to become economic.

### **Outlook**

We expect mill throughput, concentrate production and metal sales to gradually increase over the remainder of 2010 before reaching an average annual production rate in 2011 of about 122 million pounds of zinc, 15 million pounds of copper, 1.9 million ounces of silver, and 20,000 ounces of gold. Life of mine average production costs are expected to average \$0.25/lb Zn net of by-products at our metal price forecasts.

### **Valuation**

Farallon shares are trading at a discount of 43% to our 10%NAVPS estimate of C\$0.71. Our net asset value estimates at different discount rates are shown in Exhibit 3.

**As mentioned above, our valuation is based on a cash flow model for the G-9 deposit that includes all the reserves plus all the remaining resources in the measured, indicated and inferred categories.**



We have also given nominal values to the resources contained within the other Campo Morado base metal deposits as well as the resources within the new gold rich zones announced in early April. The gold zones are valued at 10% of their in situ value using our long-term metal price forecasts; the other Campo Morado deposits are valued at 3.5%.

**Exhibit 2. Farallon Mining Ltd. Reserve and Resource Estimates**

Cut-Off % Zn	Tonnage (M tonnes)	Grade				Contained				
		Cu %	Zn %	Ag g/t	Au g/t	Cu M lb	Zn M lb	Ag M oz	Au M oz	
<b>Measured and Indicated</b>										
5.0%	Measured	1.418	1.23	8.65	239	3.64	38.5	270.4	10.9	0.17
5.0%	Indicated	1.606	1.39	10.04	185	2.72	49.2	355.5	9.6	0.14
	<b>Sub-Total</b>	<b>3.024</b>	<b>1.31</b>	<b>9.39</b>	<b>210</b>	<b>3.15</b>	<b>87.7</b>	<b>625.9</b>	<b>20.5</b>	<b>0.31</b>
<b>Inferred</b>										
5.0%	Inferred	0.930	1.14	9.17	187	2.50	23.4	188.0	5.6	0.07
<b>5.0%</b>	<b>Total (M+I+I)*</b>	<b>3.954</b>	<b>1.27</b>	<b>9.34</b>	<b>205</b>	<b>3.00</b>	<b>111.0</b>	<b>813.9</b>	<b>26.1</b>	<b>0.38</b>
<b>Reserves</b>										
5.0%	Proven	0.525	1.28	10.36	274	3.69	14.8	119.9	4.6	0.06
3.0%	Probable	1.425	1.37	9.87	187	2.77	43.0	310.1	8.6	0.13
5.0%	Sub-Total	1.950	1.34	10.00	211	3.03	57.6	429.9	13.2	0.19
	Percent of Total Resources	49.3%					51.9%	52.8%	50.8%	49.8%

Source: TD Newcrest

**Exhibit 3. Farallon Mining Ltd. Net Asset Value Estimates**

Estimated Shares Used in DCF	489,291,117	Recent Price	\$0.405					
Forex C\$/US\$	0.9764	Target Price	<b>C\$0.70</b>					
		Upside Potential	72.8%					
	8%		10%		12%		15%	
	Amount (\$000)	Per Share	Amount (\$000)	Per Share	Amount (\$000)	Per Share	Amount (\$000)	Per Share
<b>MINING ASSETS (tax adjusted)</b>								
Campo Morado - G-9 Mine (100 %)	\$ 283,088	\$0.58	\$ 268,741	\$ 0.55	\$ 255,399	\$ 0.52	\$ 237,088	\$ 0.48
<b>TOTAL PROJECT NAV</b>	<b>\$ 283,088</b>	<b>\$0.58</b>	<b>\$ 268,741</b>	<b>\$ 0.55</b>	<b>\$ 255,399</b>	<b>\$ 0.52</b>	<b>\$ 237,088</b>	<b>\$ 0.48</b>
<b>OTHER TANGIBLE ASSETS</b>								
HEDGE BOOK	\$ 0	\$0.00	\$ 0	\$ 0.00	\$ 0	\$ 0.00	\$ 0	\$ 0.00
G-9 Gold Zones	\$ 21,200	\$0.04	\$ 21,200	\$ 0.04	\$ 21,200	\$ 0.04	\$ 21,200	\$ 0.04
Campo Morado Other Deposits	\$ 51,765	\$0.11	\$ 51,765	\$ 0.11	\$ 51,765	\$ 0.11	\$ 51,765	\$ 0.11
INVESTMENTS	\$ 0	\$0.00	\$ 0	\$ 0.00	\$ 0	\$ 0.00	\$ 0	\$ 0.00
<b>TOTAL OTHER ASSETS</b>	<b>\$72,965</b>	<b>\$0.15</b>	<b>\$72,965</b>	<b>0.15</b>	<b>\$72,965</b>	<b>0.15</b>	<b>\$72,965</b>	<b>0.15</b>
<b>NET DEBT</b>								
	Q1/10							
WORKING CAPITAL	\$16,938	\$0.03	\$ 16,938	\$ 0.03	\$ 16,938	\$ 0.03	\$ 16,938	\$ 0.03
LONG TERM DEBT	-\$21,900	-\$0.04	-\$ 21,900	-\$ 0.04	-\$ 21,900	-\$ 0.04	-\$ 21,900	-\$ 0.04
CONVERTIBLE DEBENTURE	\$ 0	\$0.00	\$ 0	\$ 0.00	\$ 0	\$ 0.00	\$ 0	\$ 0.00
IN THE MONEY OPTIONS & WARRANTS	\$ 4,116	\$0.01	\$ 4,116	\$ 0.01	\$ 4,116	\$ 0.01	\$ 4,116	\$ 0.01
ESTIMATED WRK. CAP. ADDITIONS	\$ 0	\$0.00	\$ 0	\$ 0.00	\$ 0	\$ 0.00	\$ 0	\$ 0.00
ESTIMATED DEBT ADDITIONS	\$ 0	\$0.00	\$ 0	\$ 0.00	\$ 0	\$ 0.00	\$ 0	\$ 0.00
<b>NET DEBT</b>	<b>-\$ 847</b>	<b>\$0.00</b>	<b>-\$ 847</b>	<b>\$ 0.00</b>	<b>-\$ 847</b>	<b>\$ 0.00</b>	<b>-\$ 847</b>	<b>\$ 0.00</b>
<b>TOTAL NAV (US\$)</b>	<b>\$ 355,207</b>	<b>\$0.73</b>	<b>\$ 340,859</b>	<b>\$ 0.70</b>	<b>\$ 327,517</b>	<b>\$ 0.67</b>	<b>\$ 309,206</b>	<b>\$ 0.63</b>
<b>TOTAL NAV (C\$)</b>	<b>\$346,824</b>	<b>\$0.74</b>	<b>\$332,815</b>	<b>\$ 0.71</b>	<b>\$319,788</b>	<b>\$0.69</b>	<b>\$301,909</b>	<b>\$0.65</b>
PREMIUM (DISCOUNT) to NAV		-46%		-43.2%		-41%		-37%
P/NAV		0.54		0.57		0.59		0.63

Source: TD Newcrest

**Justification of Target Price**

Our target price of C\$0.70 is based on a weighted blend of multiples: 1xP/NAVPS (40% weight), 5xEV/EBITDA (5% weight), 8xP/E and 6xP/CF multiples for 2010 and 2011 (55% combined weight) as shown in Exhibit 4.



**Exhibit 4. Farallon Mining Ltd. Target Price Calculation**

	Criteria Value	Multiple		Implied Target	Criteria Weighting	Target Contribution
		Current	Target			
Price/10% NAV	0.70	0.57	1.00	\$0.70	40.00%	\$0.28
EV/EBITDA - 2010	0.10	3.53	5.00	\$0.51	5.00%	\$0.03
P/E 2010	0.07	6.11	8.00	\$0.57	10.00%	\$0.06
P/E 2011	0.11	3.56	8.00	\$0.88	17.50%	\$0.15
P/CF 2010	0.07	5.84	6.00	\$0.44	10.00%	\$0.04
P/CF 2011	0.12	3.35	6.00	\$0.70	17.50%	\$0.12
Calculated Target Price (US\$)					100.00%	\$0.68
Calculated Target Price (C\$)						\$0.70
<b>Target Price (Rounded to nearest \$0.05)</b>						<b>\$0.70</b>
Current Price (C\$)						\$0.405
Potential Upside to Target						72.8%

Source: TD Newcrest

**Key Risks to Target Price**

Relative to other companies in our equity coverage universe, we believe that an investment in Farallon Mining Ltd. is subject to a HIGH level of risk. Our recommendation is subject to forecast, financial, technical political risks and deposit size risk. Among other things, these include risks related to copper, gold, silver, zinc, lead, and fuel prices, the governing fiscal and legislative regimes, the timing of key developments, market conditions, capital and operating costs, foreign exchange rates, resource estimates, operating parameters, permitting, environmental issues, indigenous peoples, and staffing and key personnel retention.

**Investment Conclusion**

Farallon became a low-cost zinc-copper producer in 2009 from its G-9 mine in Guerrero State, Mexico. Production is growing from recent mill improvements, and the larger Campo Morado property has better than average potential to add to resources and reserves. The balance sheet is strong and improving now that operating cash flows exceeds debt servicing and capex requirements. However, the mathematics associated with large share count and a relatively short mine life results in the company not having much leverage to changes in metal prices or operations. We believe that Farallon is a company that should be bought on weakness, like the period we are in now. The upside should come from the higher zinc prices we are forecasting in 2011 and beyond.

**Site Visit Information**

On July 9, 2009 we visited Farallon's G-9 mine and mill in Mexico. The project contributes 100% of the company's metal production and metal sales revenues. Transportation to the project site by helicopter from Mexico City, and accommodation were both provided by the company during this visit of its material operation.



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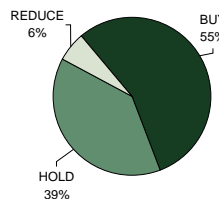
<b>Company</b>	<b>Ticker</b>	<b>Disclosures</b>
Farallon Mining Ltd.	FAN-T	n/a

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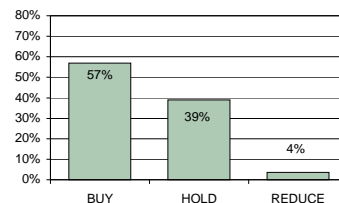
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Distribution of Research Ratings<sup>^</sup>



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Current as of June 3, 2010

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**ACTION LIST BUY:** The stock's total return is expected to exceed a minimum of 15%, on a risk-adjusted basis, over the next 12 months and it is a top pick in the Analyst's sector.

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**SPECULATIVE BUY:** The stock's total return is expected to exceed 30% over the next 12 months; however, there is material event risk associated with the investment that could result in significant loss.

**HOLD:** The stock's total return is expected to be between 0% and 15%, on a risk-adjusted basis, over the next 12 months.

**TENDER:** Investors are advised to tender their shares to a specific offer for the company's securities

**REDUCE:** The stock's total return is expected to be negative over the next 12 months.

**Overall Risk Rating in order of increasing risk:** Low (8.6% of coverage universe), Medium (28.5%), High (52.6%), Speculative (10.3%)

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