Mining & Minerals

Farallon Resources Ltd. (FAN-T, $0.175)

Recommendation: Buy

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WELLINGTON WEST Capital Markets Inc.

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All values in C$ unless otherwise noted.

Current Price	$0.175
Target Price (12-Month)	$0.55
Target Return	214%

Changes

	Old	New
Recommendation	Buy	Unchanged
Target	$0.65	$0.55
CFPS 2009E	US$0.09	US$0.04
CFPS 2010E	US$0.13	US$0.11

Company Profile

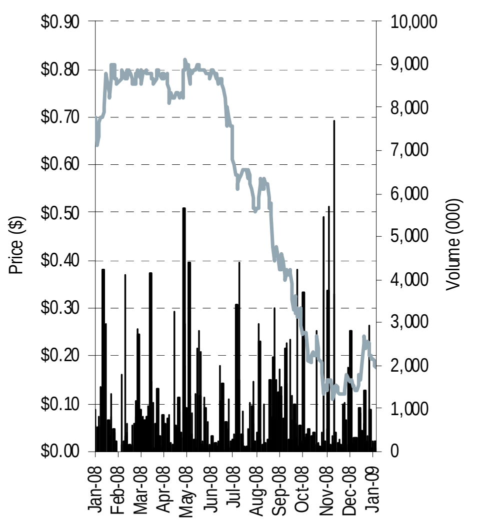
Farallon Resources is a Canadian-listed mineral development company that owns 100% of the Campo Morado zinc-rich volcanogenic massive sulphide (VMS) mine in Mexico.

www.farallonresources.com

Polymetallic Metallurgy Can Be Tricky in the Early Days of Operation, G-9 is No Exception

- **Operating update for the newly-started G-9 delivers mixed results.** 61,300 tonnes milled in Nov and Dec in line with expectations, but metallurgical challenges with lead and copper are proving more difficult.
- **Design recoveries possible for Cu and Pb, but more time required.** Near-design recoveries achieved over short periods. This implies no fatal flaws in the ore. More consistent feed rates and more training required.
- **Low metal prices and Cu/Pb recoveries to strain balance sheet in '09.** Combined effect of low metal prices and slower-than-expected ramp-up of Cu/Pb circuits may necessitate ~$15-$20mm of additional funding.
- **Lowering target to $0.55 from $0.65; maintain Buy rating.** Target derived using an equal weighting to 0.8x our NAV estimate of $0.77/sh ($0.93 old) and 4.0x our FY10 CFPS estimate of US$0.11.

Price Chart



Source: Thomson ONE

Financial Summary

Shares Out (mm)	370.4	52-Week Range	$0.1 - $0.84
Market Cap (mm)	$64.8	Avg Weekly Volume	4,829,089
Shares, FD (mm)	385.4	Fiscal Year End	Jun-30
Working Capital (mm)	$12.5	NAV/Share, FD	$0.77
Enterprise Value (mm)	$78.8	P/NAV	0.2 x
Key Properties:		Status:	
	Campo Morado, Mexico (100%)	Annual Zn production - payable (000 lbs)	76,603
	Polymetallic zinc-rich VMS deposit	Annual Au production - payable (oz)	9,702
		Total Cash Costs (US$/lb, after credits) (1)	0.22
		Total Cash Costs (US$/lb, after credits) (2)	0.31
Key Management:		Key Shareholders:	
Dick Whittington	President and CEO	Management (5%)	
Greg McCunn	Chief Financial Officer		
Ronald Thiessen	Chairman and Director		

(1) Life of mine average - includes amortization of pre-sold silver.
(2) Life of mine average - includes Ag at US$3.90/oz

Source: WWCM Estimates, Company Reports

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Investment Summary and Outlook

Building 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. Mine commissioning is complete and full steady-state production of 1,500 tonnes per day (tpd) is expected in early Q1/09.

Low cash cost potential of G-9 should allow Farallon to weather the depressed metal price environment, but additional funding likely required in the interim while the processing plant is being troubleshot and optimized. 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 metal price assumptions, 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. Even at current metal prices, our analysis suggests that for the first three years Farallon could report total cash costs of approximately US$0.32/lb of zinc – still well within the lowest quartile for zinc producers.

We use a discounted cash flow (DCF) analysis and P/CF multiples to arrive at a 12-month target price of $0.55 ($0.65 previously). Our target price is based on a blended multiple with an equal weighting assigned to a multiple of 0.8x our NAV estimate of $0.77/share ($0.93/share previously) and a 4.0x multiple of our FY10 CFPS estimate of US$0.11 (US$0.13 previously). We reiterate a Buy recommendation, but are lowering our target price to $0.55.

Operating Update for G-9 Delivers Mixed Results, Processing Remains the Key to Success

In aggregate, 61,300 tonnes of ore were milled in November and December, in line with expectations, but metallurgical challenges with lead and copper are proving more difficult. On January 22, 2009, Farallon Resources provided an operational update for the company's newly commissioned 100%-owned G-9 mine in Mexico. By a wide margin, the salient feature of the press release relates to the challenges in stabilizing and optimizing the copper and lead processing circuits. While it is still early days in the ramp-up and production disturbances are par for the course, copper and lead recoveries and concentrate grades are well off forecasted rates. Lead, in particularl, shows little improvement month-over-month. We present the monthly data for November and December in Exhibit 1.

Polymetallic VMS deposits often present metallurgical challenges at start-up – G-9 is no exception. At present, Farallon is producing three separate concentrates. The metallurgical performance in the zinc circuit is tracking well and is approaching the recoveries and concentrates we use in our production model. As is the case for most VMS deposits, favorable results in the copper and lead circuits tend to be more difficult since the circuit response can by hyperactive until such time that upstream bottlenecks are removed, enabling steady flow rates. In November and December, the mill was running on an on-off basis due to constraints on the mining side. According to company management, the on-off cycling as well as certain mechanical issues in the grinding circuit caused erratic flow to the flotation circuit, which exacerbated an already metallurgically complex situation.

Exhibit 1: Lead and Copper Well Off Design Rates and the Typical Recoveries and Grades We Use in Our Production Model

	Actual		WWCM Est	Variance from
	Nov-09	Dec-09	at steady-state	Steady-state
Recovery				
Zn	78.00%	81.00%	85.00%	5%
Cu	33.00%	42.00%	75.00%	44%
Pb	21.00%	11.00%	40.00%	73%
Concentrate grade				
Zn	49%	51%	54%	6%
Cu	14%	18%	25%	28%
Pb	14%	20%	30%	33%

Source: Company Reports, WWCM Estimates

Better metallurgical recoveries on the horizon? We believe so, but it may take another six months. While mining is no longer a constraint, as development is now well into the Southeast zone, we still believe that production disturbances will be frequent through the ramp-up period, making it difficult for mill operators to stabilize and then optimize the copper and lead circuits. Importantly, much improved metallurgical performance has been achieved over short periods, which suggests to us that the challenges are more operational than they are related to the mineralogy. Operational challenges can be overcome; problematic mineralogy can be a show-stopper.

FAN tables updated production plan for 2009 – below previous guidance, but mostly in line with our more conservative estimates. The plan envisages the mining of 550,050 tonnes grading 11.7% zinc, 1.57% copper, 1.23% lead, 206 g/t silver and 2.95 g/t gold starting in January 2009. In Exhibit 2, we compare FAN's revised plan with our and the company's previous estimates. We now model the mining of 520,000 tonnes (unchanged) grading 11.0% zinc, 1.6% copper, 1.2% lead, 2.95 g/t gold, and 206 g/t silver.

Fluid numbers reflect the realities of commissioning, but also in FAN's case, an evolution of the mine plan. We highlighted as far back as our initiating coverage piece (June 26/08) the higher level of potential risk introduced by Farallon's decision to forgo a feasibility study at G-9 in return for an accelerated development timeline. We contend that the recent revision to the mine plan (grades and tonnages) highlights this risk, and justifies our adherence to more conservative assumptions than we would otherwise apply.

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Exhibit 2: WWCM and FAN Production Estimates for FY09E; We Remain More Conservative on Tonnes Mined and Zinc Grades

	FAN new Jan-09	FAN old Nov-08	Variance (%)	WWCM new Jan-09	WWCM old Nov-08	Variance (%)
Tonnes	550,050	547,500	0.50%	520,000	520,000	0.00%
Zinc (%)	11.70%	12.00%	-2.80%	11.00%	11.50%	-4.35%
Copper (%)	1.57%	1.72%	-8.90%	1.60%	1.65%	-3.03%
Lead (%)	1.23%	1.20%	2.50%	1.20%	1.20%	0.00%
Silver (g/t)	206.2	222.3	-7.20%	206.0	220.0	-6.36%
Gold (g/t)	2.95	2.99	-1.20%	2.95	2.95	0.00%

Source: Company Reports, WWCM Estimates

Valuation: More Conservative Assumptions for Copper and Lead Circuits Weigh on EPS and CFPS

Incorporating more conservative metallurgical results for copper and lead through 2010 and beyond weigh on earnings and cash flow. For copper, we are lowering our FY09 and FY10 recoveries to 50% and 60%, from 75% previously. For lead, we are cutting our recovery estimates for FY09 and FY10 to 20% and 32% from 37% and 38%, respectively. We have also adjusted our calculation for DD&A. In Mexico, for tax purposes miners are allowed to apply 75% depreciation in year 1. We note that this does not carry over to year 2, as previously modeled. If taxable earnings are insufficient to apply the full 75% in year 1, then DD&A estimates approximate units of production in year 2 and beyond. Our model has been adjusted accordingly. The net result is a boost to earnings, with no impact on cash flow.

Exhibit 3: Slower Ramp-Up to Design Recoveries Weighs on CFPS Est. Adjustments to DD&A Calculation Tighten Spread Between EPS and CFPS

	FY09E	FY10E
EPS, f.d.		
-new	US$0.01	US$0.10
-old	(US$0.02)	US$0.05
CFPS, f.d.		
-new	US$0.04	US$0.11
-old	US$0.09	US$0.13
NAV, f.d.		
-new	$0.77	
-old	$0.93	

Source: WWCM Estimates

Balance sheet likely to be strained in 2009. At December 31, 2008, the company had approximately US$14.1mm in cash reserves. Our analysis suggests that should current metal prices persist through year-end and should the copper and lead circuits take time to stabilize and ultimately optimize, as we expect, FAN's cash position could get whittled down to untenably low levels in 2009, even before consideration for repayment of high-yield notes that total US$25mm. To address the shortfall, we believe the company may either: secure a term loan to bridge the gap or look to renegotiate with current noteholders for a further extension of the US$25mm notes.

Sensitivity of FY10 CF and Total Cash Costs to Changes in Metal Prices

Low cash cost potential of G-9 should allow Farallon to weather the depressed metal price environment. Given the current low metal price environment, we felt it prudent to stress test our FY10 CFPS estimates against zinc and copper prices. Our analysis suggests that at current metal prices, FAN's cash flow should amount to US$0.04/share, compared with our estimate of US$0.11 and total cash costs, net of by-product credits (with silver at US$3.90.oz, pursuant to the sale-purchase agreement with Silver Wheaton) should approximate US$0.28/lb.

Exhibit 4: FY10E Cash Flow Sensitivity to Changes in Copper & Zinc Prices

Cu Assumption - US$/lb	Zn Price Assumption - US$/lb							
	0.40	0.50	0.60	0.70	0.80	0.90	1.00	1.10
1.40	0.03	0.04	0.06	0.08	0.10	0.11	0.13	0.15
1.60	0.03	0.05	0.07	0.08	0.10	0.12	0.13	0.15
1.80	0.04	0.05	0.07	0.09	0.10	0.12	0.14	0.15
2.00	0.04	0.06	0.07	0.09	0.11	0.13	0.14	0.16
2.20	0.04	0.06	0.08	0.10	0.11	0.13	0.15	0.16
2.40	0.05	0.07	0.08	0.10	0.12	0.13	0.15	0.17
2.60	0.05	0.07	0.09	0.10	0.12	0.14	0.15	0.17

Source: WWCM Estimates\

Exhibit 5: FY10E Total Cash Costs (US$/lb Zn) Sensitivity to Changes in Copper and Gold Prices

Cu Assumption - US$/lb	Au Price Assumption - US$/oz							
	650.00	700.00	750.00	800.00	850.00	900.00	950.00	1000.00
1.40	0.29	0.29	0.28	0.28	0.27	0.27	0.26	0.26
1.60	0.27	0.27	0.26	0.26	0.25	0.25	0.24	0.23
1.80	0.25	0.25	0.24	0.24	0.23	0.22	0.22	0.21
2.00	0.23	0.22	0.22	0.21	0.21	0.20	0.20	0.19
2.20	0.21	0.20	0.20	0.19	0.19	0.18	0.18	0.17
2.40	0.19	0.18	0.18	0.17	0.17	0.16	0.15	0.15
2.60	0.17	0.16	0.15	0.15	0.14	0.14	0.13	0.13

Source: WWCM Estimates

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Lowering Target to $0.55; Maintain Buy Rating

We reiterate a Buy rating, but lower our target price to $0.55. In response to downward revisions to both our NAV and FY10 cash flow estimates, we are lowering our target price to $0.55, while maintaining a Buy rating. Our target price is based on a blended multiple with an equal weighting assigned to a multiple of 0.8x our NAV estimate of $0.77/share ($0.93/share previously) and a 4.0x multiple of our FY10 CFPS estimate of US$0.11 (US$0.13 previously).

Appendix: Summary Cash Flow Statement

	Units	FY08A	FY09E	FY10E	FY11E	FY12E
Zn Price (calendar)	US$/lb	0.86	0.65	0.80	1.00	1.20
Zn Price (fiscal)	US$/lb	1.17	0.65	0.80	1.00	1.20
US$/C$ (fiscal)	US$/C$	0.94	0.90	0.90	0.90	0.90
Payable Zn sales	mm lbs	na	96.3	104.1	106.5	106.5
Total cash costs (1)	US$/lb	na	0.29	0.07	0.10	0.19
Total cash costs (2)	US$/lb	na	0.40	0.19	0.18	0.27
Net Income	US$, mm	(41.1)	1.9	36.9	53.6	62.4
Depreciation	US$, mm	0.0	23.3	18.3	18.1	18.1
Amort. of Ag sales	US$, mm	0.0	(10.8)	(12.4)	(8.6)	(8.6)
Deferred income tax	US$, 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)	15.4	42.9	63.1	71.9
EPS, f.d.	US$/sh	(0.13)	0.01	0.10	0.14	0.17
CFPS, f.d.	US$/sh	(0.13)	0.04	0.11	0.17	0.19
Basic shares out		302.5	370.4	370.4	370.4	370.4
F.d. shares out		310.1	378.0	378.0	378.0	378.0

(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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Company Name	Ticker Symbol	Applicable Disclosure
Farallon Resources	FAN-T	11

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11) The research analyst(s) has viewed Campo Morado in May 2006.
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