

# Farallon Mining Ltd. (FAN-T, \$0.61)

## Recommendation: Buy

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All values in C\$ unless otherwise noted.

Current Price	\$0.61
Target Price (12-Month)	\$0.70
Target Return	15%

### Changes

	Old	New
Recommendation	Buy	Unchanged
Target	\$0.70	Unchanged
CFPS 2010E	US\$0.13	US\$0.12
CFPS 2011E	US\$0.18	US\$0.20
CFPS 2012E	US\$0.19	Unchanged

### Company Profile

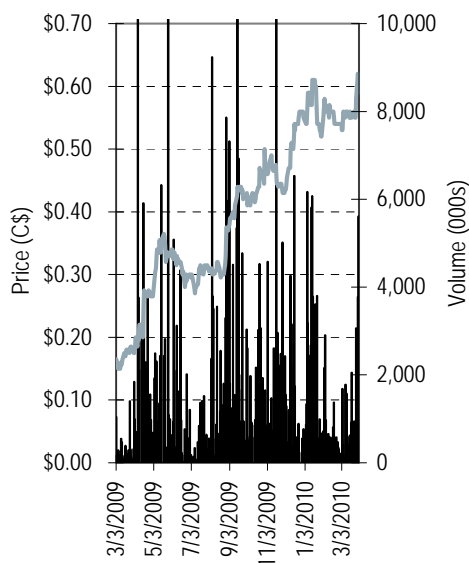
Farallon Resources is a Canadian-listed mineral development company that owns 100% of the Campo Morado zinc-rich volcanogenic massive sulphide (VMS) mine in Mexico.

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

## Q4/09 Financial Results Reflect Continuing Metallurgical Fine-Tuning at G-9 Mine

- Q4/09 financials miss the mark - indicative of continued ramp-up.**  
 Adj. Q4/09 EPS of US\$0.00 & CFPS of US\$0.00 below our forecasts of US\$0.01 & US\$0.03 - reflect continued metallurgical tweaking at G-9.
- Methodical metallurgical & prod'n improvements continue into '10.**  
 Encouragingly, Zn & Cu recoveries climbed to 83% & 67% during first half of March. We model 83% & 65% in 2010; 84.5% & 69.5% in 2011.
- Mill expansion to drive CF growth in '10; higher Zn/Cu prices in '11.**  
 Three levers for CF growth – (1) mill exp'n in '10; (2) incr. Cu recoveries; & (3) higher metal prices. Fully taxed in 2012 moderates CF growth.
- Maintain Buy rating and \$0.70 target price.**  
 Target employs an equal weighting of a 0.85x multiple of our NAV<sub>8%</sub> estimate of \$0.78/sh and 4.5x avg. of our FY10 & FY11 CFPS estimates.

### Price Chart



Source: Thomson ONE

### Financial Summary

Shares Out (mm)	472.7	52-Week Range	\$0.170 - \$0.65	
Market Cap (\$, mm)	\$288.3	Avg Weekly Volume	8,403,346	
Shares, FD (mm)	496.6	Fiscal Year End	Dec-31	
Working Capital (mm)	\$14.9	NAV/Share, FD	\$0.78	
Enterprise Value (mm)	\$267.3	P/NAV	0.8 x	
	2009A	2010E	2011E	2012E
Zinc Price (US\$/lb)	0.74	0.85	0.95	1.15
Payable Zinc Prod. (000 lb)	77,838	119,397	149,543	137,486
EPS (US\$)	-0.04	0.11	0.18	0.17
P/E	nm	5.2x	3.0x	3.2x
CFPS (1)	-0.02	0.12	0.20	0.19
P/CF	nm	4.7x	2.7x	2.9x

#### Key Management:

Dick Whittington President and CEO  
 Greg McCum Chief Financial Officer

#### Key Shareholders:

Management (5%)

(1) Excl. deferred revenue from pre-sold Ag. FAN pre-sold 75% of the G-9 Ag stream for US\$80mm.

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, exploration sizzle revisited.** Farallon's principal asset is the 100%-owned G-9 mine on the Campo Morado zinc-rich polymetallic property in Guerrero State, Mexico. Farallon recently resumed exploration at Campo Morado, following a hiatus as efforts focused on mine ramp-up. The company is in the midst of a \$4mm-\$5mm 10,000-15,000-metre exploration drill campaign aimed at adding resources.

**Low cash costs and poised to go lower still.** 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.

**We use a discounted cash flow (DCF) analysis and P/CF multiples to arrive at a 12-month target price of \$0.70/share.** Our target price is based on a blended multiple with an equal weighting assigned to a multiple of 0.85x our NAV estimate of \$0.78/sh and a 4.5x multiple of the average of our adjusted FY10 & FY11 CFPS estimates of US\$0.12 and US\$0.20, respectively.

## Q4 CFPS Belies Q1/10 Operational Improvements

**EPS & CFPS both lower than expected.** On March 30, 2010 Farallon Mining reported weaker-than-expected Q4/09 financial results (the company pre-released operational results on January 21, 2010). After adjusting for a US\$1.2mm foreign exchange loss, we estimate adjusted net earnings of US\$0.00/share, below our forecast of US\$0.01/share. Likewise, operating cash flow before working capital adjustments was US\$0.00/share, below our forecast of US\$0.03/share. We contend that the financial results reflect that G-9 mine's metallurgical performance is still in transition, with copper recovery still tracking towards steady-state rates, as shown in Exhibit 2.

### Exhibit 1: Q4/09 EPS & CFPS both Below Our Expectations

US\$ mm, except where noted	Q3/09A	Q4/09A	WWCM est.	Consensus
Net income	-0.58	0.04		
EPS, f.d.	0.00	0.00		
Foreign exchange loss	1.90	1.16		
Loss on extinguishment of notes	0.00	0.00		
Adj net income	1.33	1.21		
<b>Adj EPS, f.d.</b>	0.00	0.00	0.01	0.02
Operating cash flow	0.30	0.92		
Working capital adj.	-0.57	2.77		
Cash flow before w/c adj.	0.87	-1.85		
<b>CFPS, f.d.</b>	0.00	0.00	0.03	n/a
One time items	0.00	0.00		
<b>Adj CFPS, before w/c adj</b>	0.00	0.00		
Shares outstanding, mm (basic)	443.59	472.56		

Source: Company Reports, WWCM Estimates

**On the production front, G-9 produced a record 23.4mm lbs of zinc in concentrate and 2.4mm lbs of copper in concentrate during Q4/09 (Exhibit 2).** The record production reflects increased mill throughput and improved recoveries offsetting lower feed grades that reflect the mining of significantly lower grades during ~3 weeks in December. Zinc recoveries averaged 80% up from 79% in Q3/09, and are still working toward design rates, while copper recovery climbed to 56% after slipping to 46% in Q3/09.

### **Exhibit 2: Q4/09 G-9 Mine Operating Results – Improved Mill Throughput & Recoveries Offset Lower Feed Grades**

	Q4/09A	Q3/09A	Q2/09A	Q1/09A
Tonnes Milled	142,752	117,318	114,644	106,265
Mill head grade				
Zn	9.3%	10.8%	11.0%	9.2%
Cu	1.4%	1.5%	1.3%	1.1%
Pb	1.10%	1.16%	1.16%	0.88%
Gold	3.0	2.7	2.3	1.7
Silver	182.0	203.0	165.0	166.0
Recovery				
Zn	80.0%	79.0%	77.0%	79.0%
Cu	56.0%	46.0%	55.0%	45.0%
Pb	0.0%	0.0%	20.0%	16.0%
Gold	32.0%	34.0%	52.0%	43.0%
Silver	47.0%	39.0%	47.0%	40.0%
Concentrate grade				
Zn	49.1%	49.1%	52.1%	51.7%
Cu	15.4%	16.5%	14.1%	17.8%
Pb	n/a	n/a	20.9%	22.9%
Metal production (mm lbs or oz for Au and Ag)				
Zn	23.4	22.1	21.3	16.9
Cu	2,443	1.8	1.7	1.2
Pb	0	0	0.6	0.3
Au	4,224	3,355	4,400	3,300
Ag	382,120	301,202	284,350	229,500
On-site costs (US\$/t milled)				
	81.5	77.3	76.3	70.6
C1 Costs (\$US/lb Zn), net of by-product credits				
	0.44	0.45	0.39	0.44

Source: Company Reports

**Increased mill throughput, but unit costs too...** Despite an increase in the mill throughput rate, on-site costs also continued their steady climb, increasing to US\$81.42/tonne milled, from US\$77.29/tonne in Q3/09 (Exhibit 2). Typically, pushing the mill throughput rate has the added benefit of economies of scale (i.e. lower unit production costs). This was not the case for Farallon in 2009; however, we believe this is poised to change in 2010. The higher unit costs in Q4/09 reflect higher labour and contract services costs and the installation in Q3/09 of a technical support team to help train personnel to improve recoveries.

These higher costs were partially offset by improved recoveries and increased byproduct credits owing to metal price appreciation.

### *Flashes of Potential Brighten Prospects for 2010.*

**Subsequent to year end, enhancements to the original processing plant were made to increase production and to improve zinc and copper recovery to 84% and 68% during the first half of March.** We currently model zinc recovery of 83% to yield a zinc concentrate grading 54% zinc in 2010, increasing to 84.5% recovery for a 54% zinc concentrate in 2011. Likewise our model currently contemplates 65% copper recovery in 2010 for a copper concentrate running 17% copper, with recovery climbing to 69.5% for a concentrate grade of 18% copper in 2011. These estimates are unchanged. Farallon's ultimate goal is for recoveries of 85% zinc and 75% copper; currently, our modeled zinc and copper recoveries conservatively top out at 84.5% and 70.5%, respectively.

### **Exhibit 3: Q1/10 Operational Statistics – Recoveries Climb as Tonnes Milled Soars (Concentrate Grades Trending Lower)**

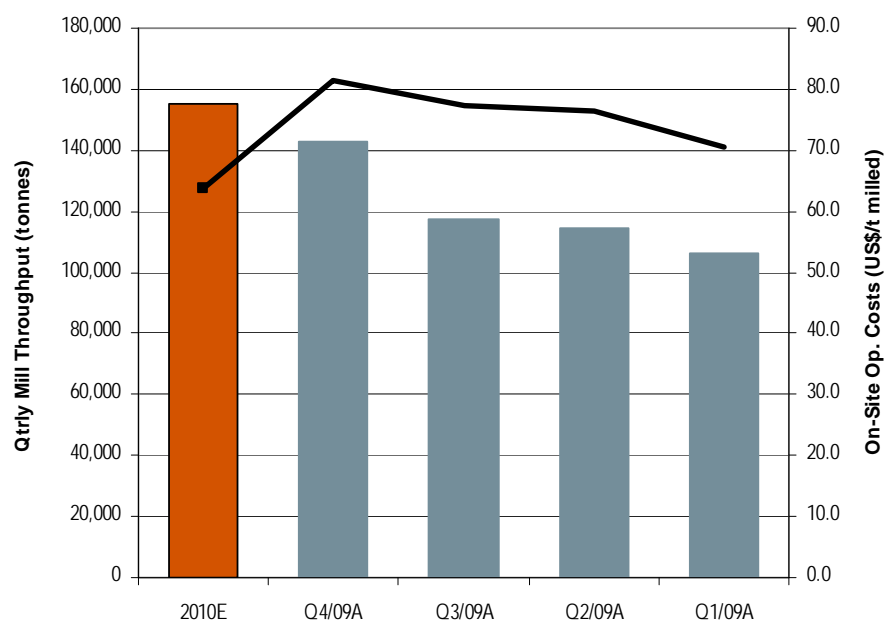
Period	Throughput <i>tpd</i>	% of Design <i>(1,500 tpd)</i>	Zinc <i>Recovery</i>	Copper <i>Recovery</i>	Zinc Con. <i>% Zn</i>	Copper Con. <i>% Cu</i>
Q1 2009	1,190	79%	79%	45%	52%	18%
Q2 2009	1,260	84%	77%	55%	52%	14%
Q3 2009	1,275	85%	79%	46%	49%	17%
Q4 2009	1,552	103%	80%	56%	49%	15%
Q1 2010(1)	1,672	111%	82%	60%	49%	14%
Mar.2010	1,910	127%	84%	68%	49%	13%

(1) Includes operational results up to Mar. 29/10

Source: Company Reports

**We highlight the potential for unit costs to decrease in 2010 as mill employees become better trained and as expat labor and contractor services are paired back.** Longer-term, an ongoing mill expansion to 2,000 tonnes per day (tpd) from 1,500 tpd slated for completion in July 2010 should help further reduce unit costs. Indeed we expect the associated economies of scale to deliver a step-change in cash flow from 2010 to 2011 concurrent with a higher zinc price and further improvements in metallurgical performance (recoveries and concentrate grades).

### Exhibit 4: Mill Expansion Coupled with Phase-out of Expat Technical Support Team Bodes Well for Lower Op Costs in 2010



Source: Company Reports, WWCM Estimates

## Balance Sheet

**Well funded through 2010.** At the end of 2009, Farallon had US\$21.6mm in cash and equivalents and working capital of US\$14.9mm. The company's long-term debt comprises a US\$30mm term loan with Credit Suisse. A portion of the loan was used to repay 15% per annum promissory notes due in September 2009. The debt is payable in installments with US\$5mm due in each of 2010 and 2013, and US\$10mm in each of 2011 and 2012. We estimate that Farallon's cash position is more than sufficient to cover 2010 capital expenditures.

## FY10 & FY11 CFPS Slightly Trimmed

**2010 CFPS trimmed on the application of lower zinc and copper mill grades pursuant to the updated reserve estimates offset by increased tax shielding.** We have adjusted our model to lower mill feed grades for both zinc and copper (10.8% and 1.34%, respectively, versus 11.7% and 1.5% previously). This is partially offset by increased tax shielding through mid 2011 related to Farallon's accumulated operating losses. The net effect is a US\$0.01 drop in our 2010 CFPS estimate to US\$0.12 and US\$0.02 increase in our 2011 estimate to US\$0.20; our FY12 CFPS estimate remains US\$0.19.

**Exhibit 5: Modest Revisions to FY10 & FY11 EPS & CFPS**

	FY10E	FY11E	FY12E
EPS, f.d.			
- new	US\$0.11	US\$0.18	US\$0.17
- old	US\$0.00	US\$0.19	US\$0.20
CFPS, f.d.			
- new	US\$0.12	US\$0.20	US\$0.19
- old	US\$0.13	US\$0.18	US\$0.19
NAV			
- new	C\$0.78		
- old	C\$0.78		

Source: WWCM Estimates

**Exhibit 6: NAV Sensitivity to Long-Term (2013+) Zinc and Copper Prices**

		Zinc (US\$/lb) 2013+						
		0.75	0.85	0.95	1.05	1.15	1.25	1.35
Copper (US\$/lb)	1.75	0.74	0.77	0.79	0.82	0.84	0.86	0.89
	2.00	0.75	0.78	0.80	0.82	0.85	0.87	0.90
	2.25	0.76	0.78	0.81	0.83	0.86	0.88	0.90
	2.50	0.77	0.79	0.82	0.84	0.86	0.89	0.91
	2.75	0.77	0.80	0.82	0.85	0.87	0.90	0.92
	3.00	0.78	0.81	0.83	0.85	0.88	0.90	0.93
	3.25	0.79	0.81	0.84	0.86	0.89	0.91	0.93

Source: WWCM Estimates

**Exhibit 7: 2011E CFPS Sensitivity to Zinc and Copper Prices**

		Zinc (US\$/lb) 2011						
		0.75	0.85	0.95	1.05	1.15	1.25	1.35
Copper (US\$/lb) 2011	2.50	0.14	0.16	0.18	0.20	0.22	0.24	0.26
	2.75	0.15	0.17	0.19	0.21	0.23	0.25	0.27
	3.00	0.15	0.18	0.20	0.22	0.24	0.26	0.27
	3.25	0.16	0.18	0.20	0.22	0.24	0.26	0.28
	3.50	0.17	0.19	0.21	0.23	0.25	0.27	0.29
	3.75	0.18	0.20	0.22	0.24	0.26	0.28	0.30
	4.00	0.18	0.21	0.23	0.25	0.27	0.29	0.31

Source: WWCM Estimates

**We also note the potential for the Street's CFPS estimates to be trimmed owing to a change in the way Farallon reports operating cash flow; our estimates are unaffected since we had already adopted this approach.** Going forward, Farallon intends to report the US\$80mm received from Silver Wheaton as deferred revenue. The net effect of this is that Farallon's cash flow from operations will more accurately reflect actual pricing received for the metal it produces in the context of the existing sale-purchase agreement with Silver Wheaton. In other words, cash flow from operations will reflect spot silver prices on 25% of the silver produces and US\$3.90/oz on the 75% under contract with Silver Wheaton. Previously, cash flow from operations reflected spot prices for all silver sales.

### **Maintain Buy Rating and \$0.70 Target**

**No change to Buy rating and \$0.70 target price.** Our target price is based on a blended multiple with an equal weighting assigned to a multiple of 0.85x our NAV<sub>8%</sub> estimate of \$0.78/sh and a 4.5x multiple of the average of our FY10 & FY11 CFPS estimates of US\$0.12 and US\$0.20, respectively. **We note that Farallon represents one of precious few ways for investors to gain exposure to zinc production,** with the added feature providing exposure to both ramping up production and substantial exploration potential.

## Appendix: Summary Cash Flow Statement

	Units	FY09A	FY10E	FY11E	FY12E
Zn Price (calendar)	US\$/lb	0.74	0.85	0.95	1.15
Zn Price (fiscal)	US\$/lb	0.74	0.85	0.95	1.15
US\$/C\$ (fiscal)	US\$/C\$	0.89	0.90	0.90	0.90
Payable Zn sales	mm lbs	77.8	119.4	149.5	137.5
Total cash costs (1)	US\$/lb	0.44	0.14	-0.05	0.03
Total cash costs (2)	US\$/lb	na	0.26	0.06	0.15
Net Income	US\$, mm	(17.3)	52.8	89.6	85.8
Depreciation	US\$, mm	11.0	20.8	28.2	24.6
Amort. of Ag sales	US\$, mm	(4.7)	(15.0)	(16.5)	(16.8)
Deferred income tax	US\$, mm	0.0	0.0	0.0	0.0
Other	US\$, mm	2.2	0.0	0.0	0.0
Operating cash flow	US\$, mm	(8.8)	58.6	101.3	93.6
EPS, f.d.	US\$/sh	(0.04)	0.11	0.18	0.17
CFPS, f.d.	US\$/sh	(0.02)	0.12	0.20	0.19
P/E		nm	5.2x	3.0x	3.2x
P/CF		nm	4.7x	2.7x	2.9x
Basic shares out		424.8	469.6	469.6	469.6
F.d. shares out		451.8	496.6	496.6	496.6

(1) Total cash costs, net of by-product credits with Ag at spot prices

(2) 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	2, 11

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