

Farallon Mining Ltd. (FAN-T, \$0.56)

Recommendation: Buy

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All values in C\$ unless otherwise noted.

Current Price	\$0.56
Target Price (12-Month)	\$0.70
Target Return	25%

Changes

	Old	New
Recommendation	Buy	Unchanged
Target	\$0.75	\$0.70
CFPS 2010E	US\$0.15	US\$0.11
CFPS 2011E	US\$0.23	US\$0.19
CFPS 2012E	US\$0.20	Unchanged

Company Profile

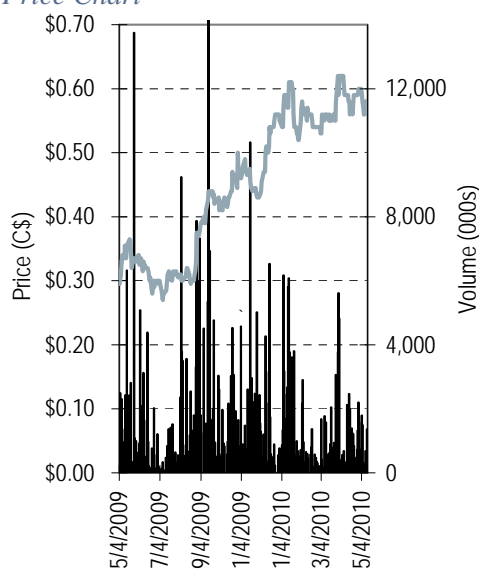
Farallon Resources is a Canadian-listed mineral development company that owns 100% of the Campo Morado zinc-rich volcanogenic massive sulphide (VMS) mine in Mexico.

www.farallonresources.com

Cash Flow Growth in the Offing, But Tempering Forecasts Following Q1 Results

- Q1 CF below forecast, prod'n gains deliver only modest CF growth.**
Q1/10 EPS & CFPS of US\$0.01 below our forecast of US\$0.02. While prod'n gains capture headlines, cash flow growth below expectations.
- Prod'n gains & lower op. costs should drive CF growth into 2011...**
W/ prod'n avg +1,900 tpd & ops costs abating, Q2 results should provide a clearer picture on CF pot'l; may be insufficient to support consensus est.
- ...However, we are trimming our CF & NAV ests on higher op costs.**
Application of higher off-site costs & lower Zn grade in '11 decreases our '10 CFPS to US\$0.11 from US\$0.14 & NAVPS to \$0.78 from \$0.81.
- Maintain Buy rating, but lowering target to \$0.70/sh from \$0.75/sh.**
Target employs an equal weighting of a 0.85x multiple of our NAV_{8%} 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)	\$264.7	Avg Weekly Volume	7,946,951	
Shares, FD (mm)	494.4	Fiscal Year End	Dec-31	
Working Capital (mm)	\$18.2	NAV/Share, FD	\$0.78	
Enterprise Value (mm)	\$265.7	P/NAV	0.7 x	
	2009A	2010E	2011E	2012E
Zinc Price (US\$/lb)	0.74	0.95	1.05	1.20
Payable Zinc Prod. (000 lb)	77,838	119,397	134,156	137,486
Total Cash Costs (US\$/lb) (1)	0.60	0.25	-0.01	0.01
EPS (US\$)	-0.03	0.10	0.17	0.19
P/E	nm	5.4x	3.2x	2.9x
CFPS (US\$) (1)	-0.02	0.11	0.19	0.20
P/CF	nm	4.9x	2.9x	2.8x

Key Management:

Dick Whittington President and CEO
Greg McCunn Chief Financial Officer

Key Shareholders:

Management (5%)

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

Source: WWCM Estimates, Company Reports

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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. While production and cost figures are generally trending in the right direction, the improvement has yet to translate into improved operating cash flow at the rate we had expected. We look to Q2/10 to provide a clearer picture on Farallon's cash flow potential, with a full quarter of higher production rates.

We use a discounted cash flow (DCF) analysis and P/CF multiples to arrive at a 12-month target price of 0.70/share (\$0.75/share 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 \$0.78/sh (\$0.81/sh old) and a 4.5x multiple of the average of our adjusted FY10 & FY11 CFPS estimates of US\$0.11 (US\$0.15 old) and US\$0.19 (US\$0.23 old).

G-9 Production on the Right Track

G-9 turned in another record quarter of production, with 25mm lbs of zinc in concentrate during Q1/10... The record zinc production reflects increased mill throughput and improved recoveries (82% v. 80% in Q4/09) offsetting lower feed grades (9.1% v. 9.3% in Q4/09). Meanwhile, copper production slipped by ~12% to 2.14mm lbs on lower head grade (1.1% v. 1.4%) while recovery improved to 59% from 56% q/q. By comparison, we currently model zinc recovery of 83% in 2010, increasing to 84.5% in 2011. Our model also accounts for 65% copper recovery in 2010, climbing to 69.5% in 2011. Total cash costs continued their downward trend, amounting to US\$0.38/lb during Q1/10, and hitting US\$0.31/lb in March 2010.

...but operational improvements translate into only modest CF growth. Despite the encouraging operational improvements, Farallon delivered weaker-than-expected Q1/10 financial results. After adjusting for a US\$1.1mm foreign exchange gain, we estimate adjusted net earnings of US\$0.01/share, below our forecast of US\$0.02/share and the Bloomberg consensus estimate of US\$0.015. Likewise, operating cash flow before working capital adjustments was US\$0.01/share, below our forecast of US\$0.025/share (consensus n/a). We contend that the financial results reflect continued operational transition at G-9.

Q2/10 poised to be a defining quarter in terms of demonstrating cash flow potential. In this regard we note the improved throughput rate in March, which averaged 1,926 tpd, and continued at 1,900 tpd to 2,000 tpd into mid-May. Assuming that results similar to Q4/09 (CF of US\$0.00/sh) continued into

January and February would mean US\$0.01/sh of cash flow was generated in March alone (for Q1/10 CF of US\$0.01/sh). Extrapolating this would see Farallon report CF of US\$0.03/sh in the subsequent quarters of 2010 for full-year cash flow of US\$0.10/sh, not including any potential upside via remaining incremental mill throughput benefits and operating cost savings.

Exhibit 1: Q1/10 EPS & CFPS Both Below Our Expectations

<i>US\$ mm, except where noted</i>	Q1/10A	Q4/09A	Q3/09A	WWCME	Consensus
Net income	6.202	0.04	-0.58		
EPS, f.d.	0.01	0.00	0.00		
Foreign exchange loss (gain)	-1.10	0.26	-1.90		
Adj net income	5.10	0.30	-2.48		
Adj EPS, f.d.	0.01	0.00	-0.01	0.02	0.015
Operating cash flow	-0.52	4.41	0.30		
Working capital adj.	-6.53	2.16	-0.57		
Cash flow before w/c adj.	6.01	0.87	0.87		
Adj .CFPS, f.d.	0.01	0.00	0.00	0.025	n/a
Shares outstanding, mm (basic)	472.7	469.9	437.9	496.6	
Shares outstanding, mm (f.d.)	483.1	496.6	496.6	496.6	
Zinc production (mm , lbs)	24.95	23.4	22.1	26.9	
Total cash costs (US\$/oz) (1)	0.38	0.44	0.45	0.30	

(1) Incl. deferred revenue from pre-sold Ag (pre-sold 75% of Ag stream for US\$80mm).

Source: Company Reports, WWCM Estimates

Exhibit 2: Q1/10 G-9 Mine Operating Results - Improved Mill Throughput & Recoveries Offset Lower Feed Grades

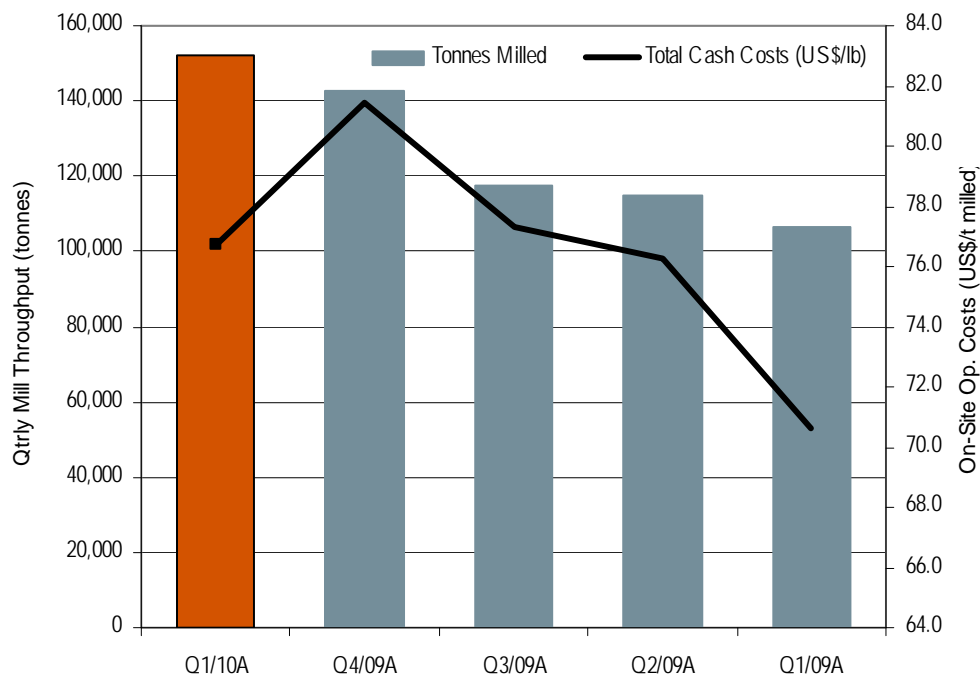
	Q1/10A	Q4/09A	Q3/09A	Q2/09A	Q1/09A	WWCM 2010E	
						old	new
Tonnes Milled	152,178	142,752	117,318	114,644	106,265	656,750	656,750
Mill head grade							
Zn	9.10%	9.3%	10.8%	11.0%	9.2%	10.80%	10.80%
Cu	1.10%	1.4%	1.5%	1.3%	1.1%	1.34%	1.34%
Pb	n/a	1.10%	1.16%	1.16%	0.88%	1.40%	1.20%
Gold	2.50	3.0	2.7	2.3	1.7	2.50	2.50
Silver	174.00	182.0	203.0	165.0	166.0	190.00	175.00
Recovery							
Zn	82.0%	80.0%	79.0%	77.0%	79.0%	83.0%	83.0%
Cu	59.0%	56.0%	46.0%	55.0%	45.0%	65.0%	65.0%
Pb	0.0%	0.0%	0.0%	20.0%	16.0%	29.5%	29.5%
Gold	39.0%	32.0%	34.0%	52.0%	43.0%	34.0%	34.0%
Silver	49.0%	47.0%	39.0%	47.0%	40.0%	47.0%	47.0%
Concentrate grade							
Zn	48.4%	49.1%	49.1%	52.1%	51.7%	54.0%	54.0%
Cu	14.0%	15.4%	16.5%	14.1%	17.8%	17.0%	15.0%
Pb	n/a	n/a	n/a	20.9%	22.9%	30.0%	30.0%
Metal production (mm lbs or oz for Au and Ag)							
Zn	24.95	23.4	22.1	21.3	16.9	129.78	129.78
Cu	2.139	2.443	1.8	1.7	1.2	12.61	12.61
Pb	0	0	0	0.6	0.3	n/a	n/a
Au	4,322	4,224	3,355	4,400	3,300	17,948	17,948
Ag	420,911	382,120	301,202	284,350	229,500	1,885,570	1,736,709
On-site costs (US\$/t milled)							
	76.7	81.5	77.3	76.3	70.6	67.2	67.2
C1 Costs (\$US/lb Zn), net of by-product credits							
	0.38	0.44	0.45	0.39	0.44	0.10	0.25

Source: WWCM Estimates, Company Reports

Unit costs show initial signs of responding to increased mill throughput.

Encouragingly, on-site costs fell ~6% to US\$76.7/tonne milled from US\$81.42/tonne in Q4/09 as mill throughput increased by 6.6% to 152,178 tonnes. We contend that the lower unit costs reflect the elimination of expat labor and contractor services in the mill and improved proficiency of mill staff.

Exhibit 3: 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 Q1/10, Farallon had US\$20.9mm in cash and equivalents and working capital of US\$18.2mm. 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 EPS & CFPS Slightly Trimmed...But Growth on the Horizon

2010 & 2011 EPS & CFPS estimates trimmed on the application of higher costs and slightly lower zinc grade. We have adjusted our model to reflect higher costs and a lower assumed zinc mill feed grade (10.5% versus 11.7% previously) in 2011. The net effect is a US\$0.04 drop in each of our 2010 EPS and CFPS estimates to US\$0.10 and US\$0.11, respectively; likewise our 2011 EPS and CFPS estimate have been trimmed by US\$0.04 each to US\$0.17 and US\$0.19, respectively. Looking ahead we see the potential for CF growth via production gains and reducing operating costs during the balance of 2010, with the effect amplified by higher assumed zinc prices in 2011.

Exhibit 4: FY10 & FY11 EPS & CFPS Trimmed...but Growth in the Offing, with a Step-Change in 2011 on a Higher Assumed Zinc Price

	Q1/10A	Q2/10E	Q3/10E	Q4/10E	2010E	2011E
EPS, f.d.						
-new	US\$0.02	US\$0.03	US\$0.04	US\$0.05	US\$0.10	US\$0.17
-old	US\$0.02	US\$0.03	US\$0.04	US\$0.05	US\$0.14	US\$0.21
CFPS, f.d.						
-new	US\$0.02	US\$0.03	US\$0.05	US\$0.05	US\$0.11	US\$0.19
-old	US\$0.02	US\$0.03	US\$0.05	US\$0.05	US\$0.15	US\$0.23
NAV, f.d.						
-new	\$0.78					
-old	\$0.81					

Source: WWCM Estimates

Exhibit 5: NAV Sensitivity to Long-Term (2013+) Zinc and Copper Prices

NAV Sensitivity		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	0.80	0.83	0.86	0.88	0.91
	2.00	0.75	0.78	0.81	0.84	0.86	0.89	0.92
	2.25	0.76	0.79	0.82	0.85	0.87	0.90	0.93
	2.50	0.77	0.80	0.83	0.86	0.88	0.91	0.94
	2.75	0.78	0.81	0.84	0.86	0.89	0.92	0.95
	3.00	0.79	0.82	0.85	0.87	0.90	0.93	0.96
	3.25	0.80	0.83	0.85	0.88	0.91	0.94	0.97

Source: WWCM Estimates

Exhibit 6: 2011E CFPS Sensitivity to Zinc and Copper Prices

2011 CFPS Sensitivity		Zinc (US\$/lb) 2011						
		0.75	0.85	0.95	1.05	1.15	1.25	1.35
Copper (US\$/lb) 2011	2.50	0.19	0.19	0.19	0.19	0.19	0.19	0.19
	2.75	0.19	0.19	0.19	0.19	0.19	0.19	0.19
	3.00	0.19	0.19	0.19	0.19	0.19	0.19	0.19
	3.25	0.19	0.19	0.19	0.19	0.19	0.19	0.19
	3.50	0.19	0.19	0.19	0.19	0.19	0.19	0.19
	3.75	0.19	0.19	0.19	0.19	0.19	0.19	0.19
	4.00	0.19	0.19	0.19	0.19	0.19	0.19	0.19

Source: WWCM Estimates

Maintain Buy Rating, but lowering target to \$0.70 from \$0.75

Production gains & lower operating costs should drive CF growth into 2011.

Our target price is based on a blended multiple with an equal weighting assigned to a multiple of 0.85x our NAV_{8%} estimate of \$0.78/sh (\$0.81/sh old) and a 4.5x multiple of the average of our FY10 & FY11 CFPS estimates of US\$0.11 (US\$0.15 old) and US\$0.19 (US\$0.23 old). **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	0.95	1.05	1.20
Zn Price (fiscal)	US\$/lb	0.74	0.95	1.05	1.20
US\$/C\$ (fiscal)	US\$/C\$	0.89	1.00	1.00	1.00
Payable Zn sales	mm lbs	77.8	119.4	134.2	137.5
Total cash costs (1)	US\$/lb	0.44	0.25	-0.01	0.01
Total cash costs (2)	US\$/lb	na	0.36	0.12	0.13
Net Income	US\$, mm	(17.3)	51.4	86.3	95.1
Depreciation	US\$, mm	11.0	18.1	25.3	21.6
Amort. of Ag sales	US\$, mm	(4.7)	(13.4)	(16.9)	(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)	56.2	94.7	99.9
EPS, f.d.	US\$/sh	(0.03)	0.10	0.17	0.19
CFPS, f.d.	US\$/sh	(0.02)	0.11	0.19	0.20
P/E		nm	5.4x	3.2x	2.9x
P/CF		nm	4.9x	2.9x	2.8x
Basic shares out		470.4	470.4	473.7	487.6
F.d. shares out		496.6	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

(3) 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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- 11) The research analyst(s) has viewed Campo Morado in July 2009.
- 12) A portion of the travel expenses of the analyst were paid or reimbursed by the issuer.

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