

# Farallon Mining Ltd. (FAN-T, \$0.445 Intraday)

## Recommendation: Buy

Steve Parsons, P. Eng (416) 640-4950; sparsons@wwcm.com  
Ryan Walker, M.Sc. Geol. (416) 640-4971; rwalker@wwcm.com



All values in C\$ unless otherwise noted.

Current Price	\$0.445
Target Price (12-Month)	\$0.60
Target Return	35%

### Changes

	Old	New
Recommendation	Buy	Unchanged
Target	\$0.60	Unchanged
CFPS 2009E	US\$0.04	US\$0.03
CFPS 2010E	US\$0.10	Unchanged

### Company Profile

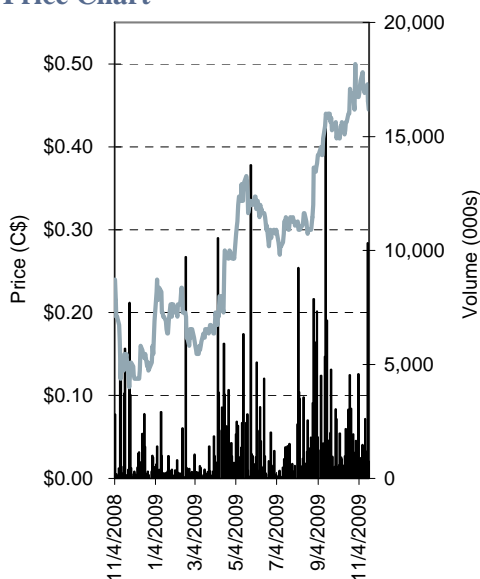
Farallon Resources is a Canadian-listed mineral development company that owns 100% of the Campo Morado zinc-rich volcanogenic massive sulphide (VMS) mine in Mexico.

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

## In-line Q3 Results – October Performance Illustrates G-9's Upside Potential

- Q3 operating results indicative of continued ramp-up at G-9.**  
Q3 mill throughput edges up to 1,270 tpd - toward 1,500 tpd design rate; up to 1,600 tpd in October via enhanced maintenance/capital projects.
- New mill mgmt & 24-hr metallurgical team to boost Q4 recoveries.**  
Zn recovery back up to 79% from 77% in Q2 but conc. grade slips; Cu production up 4.5% to 1.8mm lbs on 33% higher grade, lower recovery.
- FAN plans mill expansion to 2,000 tonnes per day by July 2010.**  
We model 2,000 tpd in 2011 to produce 117.6mm lbs zinc at TCC (net of by-products) of US\$0.22/lb and 12mm lbs copper for ~US\$5mm capex.
- Maintain Buy rating and \$0.60 target price.**  
Target ascribes an equal weighting to 0.85x our NAV est. of \$0.77/share (\$0.78/share old) and 5.0x our FY10 CFPS est. of US\$0.10.

### Price Chart



Source: Thomson ONE

### Financial Summary

Shares Out (mm)	461.4	52-Week Range	\$0.105 - \$0.54
Market Cap (mm)	\$209.9	Avg Weekly Volume	6,703,492
Shares, FD (mm)	481.7	Fiscal Year End	Dec-31
Working Capital (mm)	\$13.7	NAV/Share, FD	\$0.77
Enterprise Value (mm)	\$225.9	P/NAV	0.6 x

	2008A	2009E	2010E	2011E
Zinc Price (US\$/lb)	1.17	0.72	0.85	0.95
Payable Zinc Prod. (000 lb)	0	78,846	117,620	132,010
Total Cash Costs (US\$/lb) (1)	0.00	0.38	0.12	-0.11
EPS (US\$)	-0.12	-0.02	0.09	0.17
P/E	(3.6x)	(25.9x)	4.6x	2.5x
CFPS, before W/C Adj. (US\$)	-0.11	0.03	0.10	0.18
P/CF	(3.8x)	16.1x	4.1x	2.3x

#### Key Management:

Dick Whittington	President and CEO
Greg McCunn	Chief Financial Officer
Ronald Thiessen	Chairman and Director

#### Key Shareholders:

Management (5%)

(1) Includes amortization of pre-sold silver.

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 mine in Guerrero State, Mexico. The company's efforts are 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 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 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 \$0.60.** Our target price is based on a blended multiple with an equal weighting assigned to a multiple of 0.85x our NAV estimate of \$0.77/sh (\$0.78 previously) and a 5.0x multiple of our FY10 CFPS estimate of US\$0.09.

## Metallurgical Performance Remains the Focus

**While mining and milling rates (albeit the latter intermittently) have met or exceeded design capacity, mill optimization remains paramount at G-9.** Farallon Mining recently reported Q3/09 results essentially in line with our expectations. During the quarter, inconsistent mill availability resulted in generally lower-than-expected metallurgical recoveries largely offsetting another slight q/q increase in mill throughput (up 2.3%) to 117,318 tonnes (Exhibit 1). The company reported metal production of 22.1mm lbs of zinc, 1.8mm lbs of copper, 3,355 oz of gold, and 301,292 oz of silver. Zinc recoveries averaged 79% up from 77% in Q2/09, and are still working toward design rates. Improved zinc recoveries offset lower grades to yield improved metal production while copper production improved on 33% higher feed grades; production of both metals also improved on higher mill throughput. Confirming our long-held contention, copper and lead separation continue to present challenges, typical of early goings at operations producing multiple concentrate streams, and the company did not produce a separate lead concentrate during the quarter, preferring to produce a bulk copper-lead concentrate, with lead representing a penalty element. This helps partly explain the increase in C1 costs to US\$0.45/lb of zinc from US\$0.39/lb in Q2 (net of by-products).

### Exhibit 1: Q3/09 Operating Results – Throughput on the Rise but Inconsistent Metallurgical Performance – Improvements seen in October and November

	Units	Q1/09A	Q2/09A	Q3/09A	%Chg (q/q)	<i>new</i> FY2009E	<i>old</i> FY2009E
<b>Tonnes Milled</b>	tonnes	106,265	114,644	117,318	2.30%	464,200	470,000
<b>Head grade</b>							
Zn	%	9.2	11	10.9	-0.90%	10.6	10.0
Cu	%	1.1	1.2	1.6	33.30%	1.4	1.6
Pb	%	0.9	1.2	1.2	0.00%	1.1	1.2
Au	g/t	1.7	2.3	2.2	-4.30%	2.3	2.3
Ag	g/t	166	165	205	24.20%	165	165.0
<b>Recovery</b>							
Zn	%	79	77	79	2.60%	79.0	81.0
Cu	%	45	55	46	-16.40%	50.0	67.0
Pb	%	16	20	0	-	na	32.0
Au	%	43	52	34	-34.60%	47.0	47.0
Ag	%	40	47	39	-17.00%	47.0	47.0
<b>Concentrate grade</b>							
Zn	%	51.70%	52.10%	49.10%	-5.80%	52.0	52.0
Cu	%	17.80%	14.10%	16.50%	17.00%	20.0	20.0
Pb	%	22.90%	20.90%	0.00%	-	20.0	20.0
<b>Metal Production</b>							
Zn	mm, lbs	16.9	21.3	22.1	3.90%	85.702	90.042
Cu	mm, lbs	1.2	1.7	1.8	4.50%	7.164	9.118
Pb	mm, lbs	0.3	0.6	0	-	0	0
Au	oz	3,300	4,400	3,355	-23.80%	16,134	16,335
Ag	oz	229,500	284,350	301,292	6.00%	1,157,453	1,171,847

Source: Company Reports, WWCM Estimates

**Mining in full swing.** During the quarter, mining continued to target the high-grade Southeast zone as well as the North and West Extension zones. Development in the Southeast zone has established 9 mining faces, with 13 active faces in all. Additionally, the company completed an ore pass, significantly improving ore hauling efficiency from the Southeast zone to the mill. Backfilling with cemented rock was also initiated in the lower portion of the North zone to allow for mining of high-grade pillars.

**Q3/09 operating results belie potential – demonstrated in October performance.** While the design capacity of 1,500 tonnes per day (tpd) was intermittently achieved during Q3, extra maintenance and various capital projects

limited mill availability to below design rates with a quarterly average processing rate of 1,270 tpd, up slightly from 1,260 tpd in Q2. The low availability rates reflect continued ramp-up at the G-9 mine. Still, it is important to note that after dipping to 73% in August, availability increased to 85% in September and 87% in October. Additionally, the abovementioned maintenance and capital projects saw the mill process some 49,600 tonnes (1,600 tpd) of ore during October, representing 107% of initial mine design. During the quarter, Farallon also approved an expansion of the mill to 2,000 tpd from 1,500 tpd. The company estimates the expansion's capex at US\$5.3mm, with completion slated for July 2010. We already model ramp-up to 2,000 tpd starting in mid-2010.

**Copper and lead metallurgical challenges remain a focus – new management and technical support team installed.** On the metallurgical front, zinc recovery improved to 79% from 77% in Q2, with further improvement to 83% seen during the month of October. Meanwhile copper recovery slipped to 46% from 55%, but jumped back up to 55% during October. The company did not produce a lead concentrate during the quarter. During the quarter, Farallon also installed a technical support team (including 24-hour on-site mill coverage and off-site test work support) to help improve recoveries in the mill.

**Quarterly financial results remain less relevant than operational data during ramp-up phase.** We calculate Farallon's Q3/09 adjusted net earnings at US\$1.3mm or \$0.00 per share versus our expectations of US\$3.33mm in net adjusted earnings or US\$0.01 per share (US\$0.02 consensus). Operating cash flow before working capital came in at US\$0.9mm or US\$0.00 per share versus our expectations of US\$4.94m or US\$0.01 per share.

#### **Exhibit 2: Q3/09 EPS & CFPS In-Line with Our Expectations**

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

Source: Company Reports, WWCM Estimates

**Cash reserves of US\$11mm and internal cash flow should be sufficient to navigate ramp-up.** At quarter end, Farallon had some US\$11mm of cash on the balance sheet. We contend that this, coupled with our expectation of modest cash flow through year-end, should be sufficient now that the bulk of the development capex has been spent.

## Slightly Trimming FY09 EPS & CFPS

**Copper and lead concentrate production challenges remain.** In Q3/09, variability in copper recovery continued, slipping to 46% from 55% in Q2 (and 45% in Q1) - still well below our previous 2009 full-year expectation. Accordingly, we have adjusted our model to reflect lower copper recovery in Q4 (50%) On the flip side, zinc recovery rebounded to 79% from 77% (79% in Q1) - in line with our full-year expectation. Gold and silver recoveries also slipped q/q. In the end, the changes to our model trim our FY09 EPS estimate by US\$0.02 to (US\$0.02) and our CFPS estimate slips by US\$0.01 to US\$0.03.

## Maintain Buy Rating and \$0.60 Target Price

**With production and metallurgical performance expected to improve substantially in the coming quarters, we are leaving intact our earnings and cash flow estimates for 2010 and beyond.** Our target price is based on a blended multiple with an equal weighting assigned to a multiple of 0.85x our NAV estimate of \$0.77/sh (\$0.78 prev.) and a 5.0x multiple of our FY10 CFPS estimate of US\$0.09.

## Appendix: Summary Cash Flow Statement

	Units	FY08A	FY09E	FY10E	FY11E
Zn Price (calendar)	US\$/lb	0.86	0.72	0.85	0.95
Zn Price (fiscal)	US\$/lb	1.17	0.72	0.85	0.95
US\$/C\$ (fiscal)	US\$/C\$	0.94	0.89	0.90	0.90
Payable Zn sales	mm lbs	na	78.8	117.6	132.0
Total cash costs (1)	US\$/lb	na	0.38	0.12	-0.11
Total cash costs (2)	US\$/lb	na	0.46	0.22	0.01
Net Income	US\$, mm	(41.1)	(6.9)	42.8	80.1
Depreciation	US\$, mm	0.0	23.3	16.8	23.4
Amort. of Ag sales	US\$, mm	0.0	(6.3)	(11.7)	(15.8)
Deferred income tax	US\$, mm	0.0	0.0	0.0	0.0
Other	US\$, mm	2.0	1.0	0.0	0.0
Operating cash flow	US\$, mm	(39.0)	11.1	47.9	87.6
EPS, f.d.	US\$/sh	(0.12)	(0.02)	0.09	0.17
CFPS, f.d.	US\$/sh	(0.11)	0.03	0.10	0.18
P/E		nm	nm	4.6 x	2.5 x
P/CF		nm	16.1 x	4.1 x	2.3 x
Target P/E		nm	nm	6.5 x	3.5 x
Target P/CF		nm	22.6 x	5.8 x	3.2 x
Basic shares out		327.7	422.0	461.4	461.4
F.d. shares out		348.1	442.3	481.7	481.7

(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

## Disclaimers

The particulars contained herein were obtained from sources that we believe to be reliable, but are not guaranteed by us and may be incomplete or inaccurate. The opinions expressed are based upon our analysis and interpretation of these particulars and are not to be construed as a solicitation of offer to buy or sell the securities mentioned herein. Wellington West Capital Markets Inc. (“WWCM”) may act as financial advisor, fiscal agent or underwriter for certain of the companies mentioned herein, and may receive remuneration for its services. WWCM and/or its principals, officers, directors, representatives, and associates may have a position in the securities mentioned herein and may make purchases and/or sales of these securities from time to time in the open market or otherwise. This report may not be reproduced in whole or in part, or further distributed or published or referred to in any manner whatsoever nor may the information, opinions or conclusions contained herein be referred to without in each case the prior written consent of WWCM.

U.S. Institutions may conduct business through our affiliate Wellington West Capital Markets (USA) Inc. Wellington West Capital Markets (USA) Inc. accepts the contents of this research report, however, the company that prepared this report may not be subject to U.S. rules regarding the preparation of research reports and the independence of research analysts.

This report will be forwarded to our affiliate Wellington West Capital Inc. (“WWCI”). Subject to WWCI management review and approval, this report may be distributed to clients of WWCI. WWCI and WWCM are members of the Canadian Investor Protection Fund (“CIPF”).

### *Wellington West Capital Markets Stock Rating System*

The rating system is based on the stock’s expected absolute total return over the next 12 months. Generally, Strong Buy rating is expected to produce a total return of 25% or more, Buy a total return of 10% to 25%, Market Perform a total return of 0% to 10% and Underperform a negative total return. Speculative Buy rating is expected to produce a total return of 25% or more, but is based on factors and forecasts that have high degrees of uncertainty. The distribution of the recommendations for the last three-month period and their relationship with investment banking business are available on request by emailing to [compliance@wwcm.com](mailto:compliance@wwcm.com).

### *Analyst Compensation*

Research analysts receive compensation based on a number of factors as determined by WWCM’s management. Compensation is affected by all of the firm’s business activities, including revenue generated from capital markets and investment banking. No part of the compensation of the analyst who authored this report is based on the specific recommendation or views expressed in this report.

### *Analyst Trading*

WWCM permits analysts to own and trade in the securities and/or derivatives of those companies under their coverage, subject to the following restrictions: no

trades can be executed in anticipation of the initiation of coverage; no trades can be executed for five days after dissemination of launching coverage or a material change in recommendation; and no trades can be executed against an analyst's recommendation. Exceptions require prior approval of the Head of Research and can only be executed for a reason unrelated to the outlook of the stock.

### *Dissemination of Research*

WWCM endeavors to make all reasonable efforts to provide research, simultaneously and electronically to all eligible clients and potential clients.

Company Name	Ticker Symbol	Applicable Disclosure
Farallon Resources	FAN-T	2, 11

### *Applicable Disclosure Details*

- 1) In the last 12 months, WWCM, or its affiliates, have managed or co-managed an offering of securities by the subject issuer.
- 2) In the last 12 months, WWCM, or its affiliates, have received compensation for investment banking and related services from the subject issuer.
- 3) The research analyst or a member of the research analyst's household, or any associate or individual preparing the report, has a long position in the shares and/or the options of the subject issuer.
- 4) The research analyst or a member of the research's household, or any associate or individual preparing the report, has a short position in the shares and/or the options of the subject issuer.
- 5) WWCM or its affiliates is a market maker, or is associated with the specialist that makes a market in the securities of the subject issuer.
- 6) WWCM or its affiliates own more than 1% of any class of common equity of the subject issuer.
- 7) WWCM has a conflict of interest with the subject issuer.
- 8) The research analyst(s) has a conflict of interest with the subject issuer.
- 9) Over the last 12 months, the research analyst has received compensation based on a specific investment banking transaction relative to the subject issuer.
- 10) The research analyst or a member of the research analyst's household serves as a Director or Officer or Advisory Board Member of the subject issuer.
- 11) The research analyst(s) has viewed Campo Morado in May 2006.
- 12) A portion of the travel expenses of the analyst were paid or reimbursed by the issuer.

### *Analyst Certification*

Each analyst of WWCM whose name appears in this research report hereby certifies that (i) the recommendations and opinions expressed in the research report accurately reflect the research analyst's personal views about any and all of the securities or issuers discussed herein that are within the analyst's coverage universe and (ii) no part of the research analyst's compensation was, is, or will be, directly or indirectly related to the provision of specific recommendations or views expressed by the research analyst in the research report.