

HALLGARTEN & COMPANY

Corporate Actions

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Galane Gold (TSX-V: GG) Strategy: SHORT

| Key Metrics | | | | |
|-------------------------------|----|------------------|--------------|--------------|
| Price (CAD) | \$ | 0.085 | | |
| 12-Month Target Price (CAD) | \$ | 0.030 | | |
| Upside to Target | | -65% | | |
| High-low (12 mth) | | \$0.025 - \$0.18 | | |
| Market Cap (CAD mn) | \$ | 6.06 | | |
| Shares Outstanding (millions) | | 71.3 | | |
| Fully diluted (millions) | | 82.4 | | |
| | | 2014 | 2015e | 2016e |
| Consensus EPS | | | n/a | n/a |
| Hallgarten EPS (est.) | | | (\$0.064) | (\$0.013) |
| Actual EPS | | (\$0.57) | | |
| P/E | | n/a | n/a | n/a |

Galane Gold

Legal Disputes Compound Problems

- + The gold price is ticking up
- + The company has managed to persuade Samsung and the Botswanan government to accept delayed payment terms due to the company's financial problems
- ✘ There is a legal dispute related to land on which key elements of the South African mine are located
- ✘ The new South African is not Black Economic Empowerment (BEE) compliant
- ✘ Earnings have slumped into a loss with the company running gross losses in some quarters of this year
- ✘ Production is down heavily from the average of previous years
- ✘ Beyond the assets the company currently holds there is almost nothing in the general vicinity that would make sense as a bolt-on to the production schedule
- ✘ This has resulted in a move into South Africa which is not being well-viewed
- ✘ Debt taken on in this deal is doubles the company's liabilities
- ✘ There has been substantial dilution due to the Galaxy purchase
- ✘ Samsung will be warier of doing deals with gold producers after this unfortunate first transaction
- ✘ A move to London may be haunted by the exploits of other companies in the corporate grouping

Cobbling Together an African Gold "Empire"

Our oft-repeated mantra is that "Production is King", however if the production is chronically unprofitable then no amount of production will satisfy regal aspirations.

Galane Gold back in 2014 was an un-hedged gold producer and explorer with mining operations and exploration tenements in Botswana. It has an array of small mines that function with a centrally placed mill. Many of these mines have historical antecedents, but in the latest iteration the "complex" has been operating for most of the last decade, firstly under Gallery Gold, then IAMgold and latterly Galane Gold.

The company's shares are quoted on the TSX Venture Exchange and the Botswana Stock Exchange under the symbol GG. It acquired the Mupane complex from IAMgold in the second half of 2011.

The main part of the company's asset base is the Mupane concessions, which have their roots in the historic Monarch mine, from which activity spread forth across the whole of the Tati Greenstone Belt.

Despite a veteran team of skilled operators, things have not been going well in 2015 with spiraling

losses, a forced renegotiation of offtake and royalty deals and now an entry into South African gold mining. Then to try and pull the company out of its dive it announced last year a move into South African gold mining, not an activity that has proven propitious (or profitable) for Canadian listed gold miners in the past).

The recent publication of a NI43-101 on the new mine gives us a chance to review here whether this will be the salvation of Galane.

Purchase of Galaxy Gold – Compounding the Problem?

As if Galane did not have enough financial problems it has potentially compounded the situation with the merger between Galane and Galaxy Gold. Under share purchase agreements dated April 28, 2015 (and amended on Aug. 31, 2015, and Sept. 30, 2015) between five arm's-length parties and one non-arm's-length party, Galane shall acquire approximately 78% of the issued and outstanding shares of Galaxy, which is an operating and producing gold mining company located in Mpumalanga province in South Africa. One of the majority vendors of Galaxy Shares is Wayne Hatton-Jones , the Chief Operating Officer of Galane Gold . The proposed acquisition of 8,581,752 Galaxy Shares from him constitutes a "related party transaction".

In addition, the company indicated that it would acquire the remaining 22% of Galaxy's outstanding shares from the minority shareholders.

In consideration, the company shall issue a total of 24,641,625 common shares and 5,478,964 share purchase warrants (each exercisable into one common share at a price of 17.5 cents for a two-year period) to the shareholders of Galaxy.

Over and above this the company shall also issue up to \$8.5mn of convertible debentures to certain shareholders/creditors of Galaxy to settle outstanding operating advances provided to Galaxy. These debentures shall carry an interest rate of 4% per year, mature in four years and be convertible into common shares at a price of \$1 per share of principle outstanding. Whether this includes Hatton-Jones was not apparent from the releases we perused. Taking on this debt more than doubles the company's current debt burden.

In a recent press release Galane refers to Galaxy Gold Reefs (Pty.) Ltd. as a wholly owned subsidiary of Galaxy Gold Mining Ltd. It stated that it had acquired a 74% ownership interest in Galaxy pursuant to a share purchase transaction in November, 2015, and will be making an offer to the remaining shareholders of Galaxy to acquire their shares of Galaxy on economically equivalent terms. Interestingly the amount held by minorities has expanded from the original 22% to now 26%.

Some Background

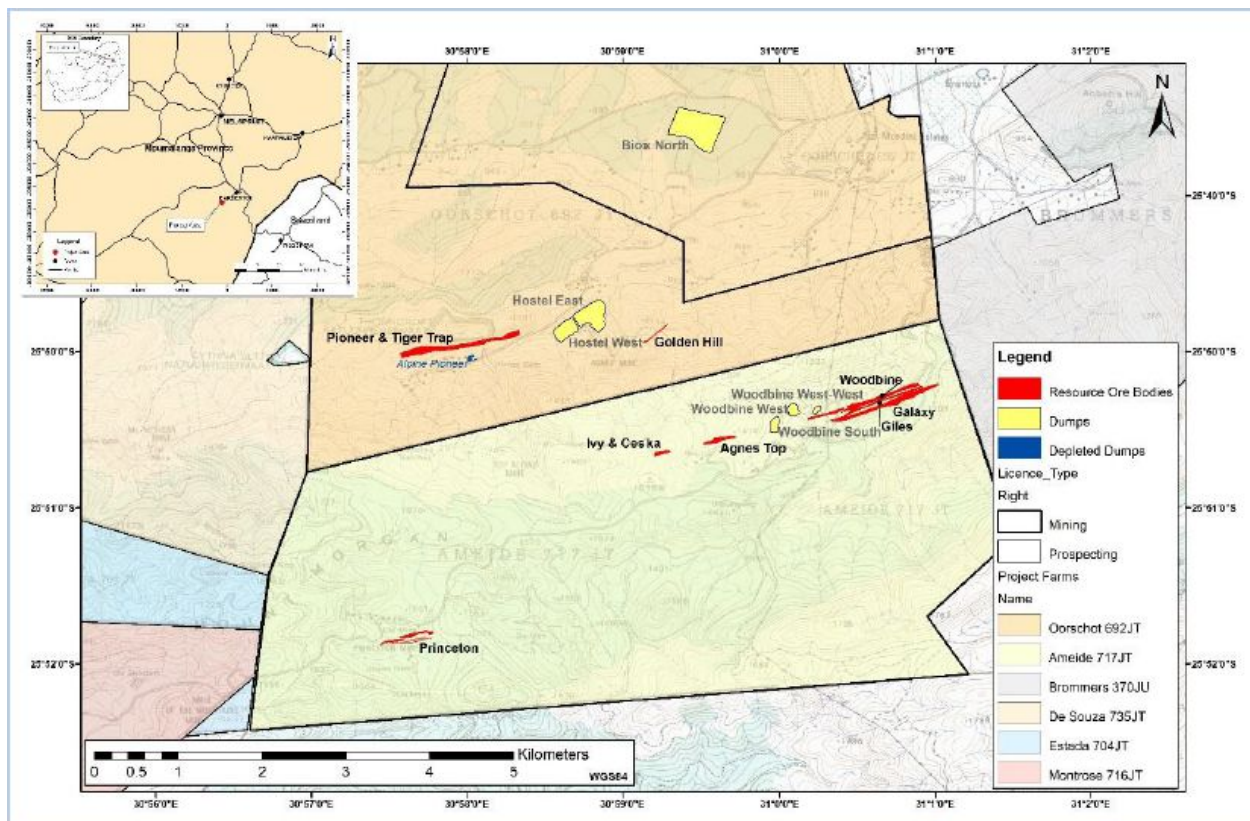
We note that when Galaxy was first mentioned as listing on the Johannesburg Stock Exchange in 2010, it had plans to raise between 250 million-400 million rand through the listing and one or more private placements. Those funds were to be used to meet a production target of 53,000 tonnes per month by December 2011. Obviously the production target has gone the way of all things and a sale of the entity to Galane for debt/equity of slightly over \$10mn shows a fairly massive destruction of value at Galaxy

over the intervening years.

Galaxy Gold's Asset

Galaxy's mining assets are located on the Barberton Greenstone Belt, approximately 10 km to the west of Barberton and 45 km west of the provincial capital of Nelspruit (Mbombela), in the Mpumalanga Province of South Africa. The concession covers an area of 5,863 ha. The mine comprises 21 east-west trending gold ore bodies and four prospects at 600 – 2,000 m depth. The main targets are the following ore bodies:

- Woodbine, Giles, Galaxy, Golden Hill, Agnes Top, Pioneer & Tiger Trap and Princeton ore bodies
- Ivy and Ceska Shaft Pillars
- Woodbine (East, North and South), Alpine Pioneer, Hostel (East and West) and Biox North historical dumps



Its assets include several historical mining operations, as well as tailings storage facilities comprised of previously mined and processed material.

Gold has been prospected at the Galaxy Gold Mine since the 1880s and Agnes has been exploited as an established mine since 1908. Currently, over 75 historical adits exist within the mining area, as well as tailings storage facilities comprised of previously mined and processed material. To date, the mining assets have produced over one million ounces of gold. For the period 1983 to 2001, production totalled

about 351,590 oz gold for the sections Woodbine/Giles, Princeton, Pioneer and Golden Hill.

Galaxy's existing processing plant is in need of refurbishment and seems to be non-functioning at the current time. It consists of a crushing, milling, flotation, thickening, biological oxidation of flotation concentrate (Biox), carbon in leach, elution and tailings disposal set-up designed to treat 16,000 tonnes per month. Statistics in the latest report show that production never exceeded the peak of 12,900 in the month of October 2010. The average between January 2010 and September 2011 never exceeded 6,000 tpm.

Galane claims that this facility can be expanded through refurbishment and the introduction of larger mills and flotation equipment. After hearing similar claims about the Botswanan assets in 2014, we now are sceptics.

It might also be noted that Galaxy has rights to the land in their area of interest, however, a dispute regarding the servitude with Upper Moodies Estate, upon whose properties the slimes dams and expansion plans are located, is ongoing.

Exploration

No exploration work has been carried out subsequent to the 2011 Mineral Resource declaration.

In 2011, exploration work was carried out on the Galaxy properties in the form of structural analysis carried out by Dr R Harris to identify the structural controls of mineralisation in the area. Harris generated exploration targets based on the vergence of D2 and D3 structures.

The NI43-101 on Barberton

In January the company published a mineral resources report for the Galaxy Gold Mine. These were calculated using USD/oz. = 1,130 and Exchange rate of ZAR11.70/US\$1.00.

| Galaxy Mine - Resource Estimate | | | |
|---------------------------------|------------------|-----------------|------------------|
| (August 2015) | | | |
| Category | Tonnes | Grade Au g/t | Contained ozs |
| Measured | 1,876,126 | 3.37 | 203,435 |
| Indicated | 4,350,781 | 2.85 | 399,261 |
| Measured & Indicated | 6,226,907 | 3.01 | 602,696 |
| Inferred | 8,095,521 | 3.4 | 886,199 |

Mineral resources were declared at cut-offs:

- Galaxy, Woodbine, Giles, Golden Hill, Princeton, Pioneer & Tiger Trap, Ivy shaft Pillar, Ivy to Agnes 3-11 Level = 1.8 g/t
- Agnes Top = 1.00 g/t

- Surface dumps = 0.30 g/t

There was also included the Galaxy Gold Mine Mineral Reserve Statement as at 31 August 2015

| Galaxy Mine - Mineral Reserve Estimate | | | |
|--|-----------|-----------------|------------------|
| Category | Tonnes | Grade Au g/t | Contained ozs |
| Probable Mineral Reserves | 1,457,322 | 3.37 | 169,586 |
| Total Mineral Reserves | 1,457,322 | 3.37 | 169,586 |

We are afraid to admit but the mineral reserve look like very thin gruel indeed.

The company's executives claim that the Technical Report shows an all-in sustainable cost of \$688 per ounce at an exchange rate of ZAR11.70/US\$1.00 (currently approximately ZAR16.5/US\$1.00) and a net cash positive position at the end of the first year.

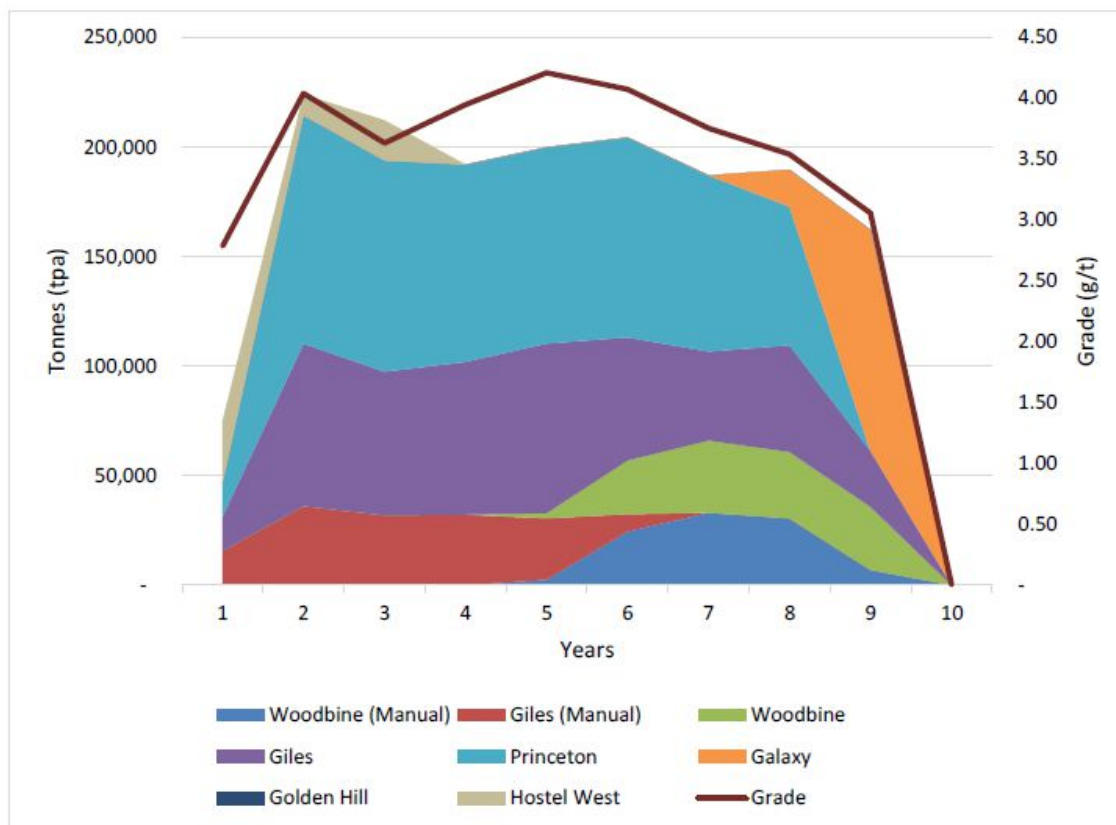
Its next step will be the refurbishment of the plant, mining facilities and construction of a 25,000 tonnes per month tailings retreatment plant. The tailings dumps are very low grade indeed. Admittedly they come with no mining cost but how lucrative they can be must be limited. How this will be funded is not made clear. Will Samsung cough up more money or will it be a case of "once bitten, twice shy" for the Koreans?

After this, Galane claims it will commence a new pre-feasibility study for the expansion of the underground mine and the processing plant to take production to over 50,000 ounces of gold per year and "materially increase the life of mine". With the current reserve that provides only a three year outlook for the mine.

The latest NI43-101 report estimates that the initial capital amounts to ZAR17.9 million. Some 82% of the initial capital expenditure to return the mothballed operation to full production gets spent during Year One. There are two plants at the site and Galane aims to refurbish the south plant only in order to produce and sell a flotation concentrate. The flotation plant has a total RoM capacity of approximately 15,000 tpm. Capital of ZAR6.4 million will be required to refurbish and re-commission the Galaxy flotation plant. Approximately four months will be required for the plant refurbishment and commissioning. With consistent operation, the consultant claims that a flotation gold recovery of approximately 90% can be achieved.

Two different mining methods have been proposed should Galane be able to get Galaxy Gold Mines back into production: these are a fully mechanised cut and fill mining method and a conventional shrinkage stoping mining method. Furthermore the Tailing Storage Facilities will be mined utilising a truck and shovel operation.

The life of mine plan for Galaxy is based on a production capacity of 15,000 tpm constrained by the processing plant capacity. The life of mine production profile is illustrated in the figure that follows:



A key takeaway comes near the end of the report when the consultant makes the comment: “An expected 30% discount on the price due to selling concentrate has a significant impact on the margin. Galaxy should investigate alternative processing options to be able to upgrade the final product to a dorè instead of receiving a 70% payability on the concentrate”. This then should be read on the light of the claimed AISC because one must discount the current gold price to reflect the much lower price that Galane will be getting for a concentrate over dorè.

The other elephant in the room is the issue of why, if it is so low capex to restart AND the AISC is so attractive and the timeframe is so short, then why did the mine shut when it did with much higher gold prices than is currently the case?

On the Legal Dispute

This dispute relates to aspects of the mining operation that are NOT on the concessions of the company but on a neighbouring farm. These include the 22 Level adit, a tailings dam and explosives depot. In terms of the servitude agreement, the prior owner of the mine (before Galaxy) paid a monthly option fee to the land owner, Upper Moodies Estates CC (UME).

The last payment was made in October 2012 and the agreement expired in December 2012. An agreement for sale of the land was drafted but has not been signed and finalised. A legal dispute, including threat of eviction in early 2014, has since been entered between Galaxy and the land-owner

regarding outstanding option fee payments and access to the property including the servitudes and explosive depot located on that portion.

To make matters worse, UME, as owners of the Ptn 12 Oorschot 692 JT, has government approval for plans to construct a Concession Creek Dam and subsequently declare the land a nature reserve. Should UME decide to implement such, all mining operations within the area boundary will have to be ceased indefinitely.

BEE – That Old Bugbear

The Black Economic Empowerment (BEE) scheme in South Africa is a source of frequent bogglement and annoyance to Canadian mining observers. It is worth noting that currently Galaxy does not comply with its BEE requirement as per the government regulations, whereby a mining company should hold an initial 26% BEE. Such will have to be implemented in order to progress operations.

Earnings Outlook Unchanged

We have left our earnings outlook unchanged despite the Galaxy purchase, except that we have increased the number of shares on issue to take into account the dilution through the acquisition.

| Galane Gold | | | | | | | | | | | |
|---------------------------------|---------|---------|--------|--------|--------|---------|-------|--------|--------|-------|--------|
| In Millions of USD | | | | | | | | | | | |
| | FY16e | FY15e | 3Q14 | 3Q14 | 1Q14 | FY14 | 4Q14 | 3Q14 | 2Q14 | 1Q14 | FY13 |
| Total Revenue | 34.47 | 28.27 | 8.533 | 5.173 | 5.76 | 40.46 | 7.79 | 9.46 | 10.77 | 12.44 | 53.82 |
| Cost of Revenue, Total | 32.76 | 31.30 | 8.565 | 7.744 | 7.10 | 35.98 | 7.09 | 8.48 | 10.55 | 9.86 | 60.28 |
| Gross Profit | 1.71 | -3.03 | -0.032 | -2.571 | -1.34 | 4.49 | 0.22 | 0.98 | 0.22 | 2.58 | -6.46 |
| Selling/General/Admin. Expenses | 2.10 | 2.15 | 0.516 | 0.547 | 0.59 | 2.51 | 0.79 | 0.639 | 0.61 | 0.47 | 2.81 |
| Exploration | 0.33 | 0.13 | 0.029 | 0.045 | 0.036 | 0.12 | 0.04 | 0.02 | 0.03 | 0.03 | 0.17 |
| Depreciation/Amortisation | - | - | - | - | - | - | 0.00 | - | - | - | - |
| Interest Expense (Income) | 0.52 | 0.32 | 0.17 | 0.14 | -0.14 | -0.58 | -0.50 | -0.08 | 0.00 | 0.00 | - |
| Unusual Expense (Income) | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | -0.61 | 0.608 | 0.00 | 0.00 | 17.82 |
| Forex costs (gain) | -0.45 | -0.63 | -0.38 | 0.01 | -0.13 | - | - | - | - | - | - |
| Other Operating Expenses, Total | 0.32 | 0.29 | 0.271 | -0.005 | 0.00 | 0.56 | 0.39 | 0.00 | 0.09 | 0.08 | 1.08 |
| Total Operating Expense | 35.58 | 33.55 | 9.17 | 8.48 | 7.45 | 38.58 | 7.19 | 9.67 | 11.27 | 10.44 | 82.15 |
| Operating Income | -1.11 | -5.28 | -0.64 | -3.31 | -1.69 | 1.88 | 0.60 | -0.21 | -0.50 | 1.99 | -28.33 |
| Gain (Loss) on Sale of Assets | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0.02 |
| Income Before Tax | -1.11 | -5.28 | -0.64 | -3.31 | -1.69 | 1.88 | 0.60 | -0.21 | -0.69 | 2.12 | -26.97 |
| Tax | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 1.81 |
| Post-Tax Income | -1.11 | -5.28 | -0.64 | -3.31 | -1.69 | 1.88 | 0.60 | -0.21 | -0.69 | 2.12 | -28.78 |
| Diluted Weighted Average Shares | 86.70 | 82.40 | 52.837 | 52.823 | 52.82 | 54.584 | 52.54 | 52.677 | 52.54 | 51.53 | 50.36 |
| Diluted EPS | -0.013 | -0.064 | -0.012 | -0.063 | -0.032 | 0.034 | 0.011 | -0.004 | -0.013 | 0.041 | -0.571 |
| Estimated Av. Au Price | \$1,180 | \$1,090 | | | | \$1,190 | | | | | |
| Ounces Au produced | 29,210 | 25,035 | 7,637 | 4,829 | 5,030 | 30,791 | 6,044 | 8,206 | 7,195 | 9,346 | 31,586 |

Risks

When we wrote our last note we listed the prime risks as being:

- ✘ Gold price weakness
- ✘ Technical problems with the mine reopening at the Galaxy site
- ✘ Budget overruns on the capex
- ✘ Cash opex remaining excessively high

- ✘ Adverse currency movements

It would appear that everything that could go wrong has gone wrong in recent times with the added icing on the cake now of South African risk.

Shorting Galane

We instituted a Short position in the Model Mining Portfolio on the 4th of December 2015 at 7.5cts. This position did not take long to bear fruit as we closed the Short on the 23rd of December at 2.5cts. In fact the stock had exceeded our expectations to the downside.

Conclusion

Usually a company with severe operating problems at its existing mines, that is also heavily haemorrhaging cash, focuses on rectifying their existing problems (or they take a plane to Panama). However to the dismay of shareholders the management at Galane decided to “double-down” quite literally in buying Galaxy Gold, with the share price reflecting investor confidence in the management’s ability to handle this new move. Can Galane “walk and chew gum” at the same time? This is a point still to be proven.

Back in 2014, Galane was cashed up (indeed trading at a significant discount to its cash on hand) with a plan to revive a string of pits and work its way through sizeable stockpiles. It even had an offtaker/sugardaddy in the form of Samsung which it had taken on in a novel deal.

A bit over a year later the cash is severely whittled down, losses have ballooned, gold production has slumped and the company has launched itself on a distracting and dilutive absorption of a gold miner in South Africa. That is a real downer for investors that thought they were getting Botswanan risk (i.e. negligible) and instead find themselves in one of the least attractive jurisdictions in the mining world these days. What’s more the latter transaction is being cooked with a non-arm’s length party. To top this off the company had to request a payment standstill with Samsung and a royalty amnesty with the Botswanan government. Debt from the South African deal doubles liabilities while dilution blew shares on issue from 52mn to 71mn (or 82mn fully-diluted).

Attempts to reduce costs have proven rather fruitless with mining/processing costs sometimes even exceeding mining revenues in recent quarters.

In light of the legal problems and uninspiring prospects raised by the NI 43-101 (not to mention the lack of heartening developments in Botswana) and the dead-cat bounce in the stock price, we have reinstated a **Short** position in Galane Gold to the Model Mining Portfolio with a 12-month target price of CAD\$0.03.



Important disclosures

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