

HALLGARTEN & COMPANY

Initiating Coverage

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Donner Metals (TSXV:DON) Strategy: Long

Key Metrics				
Price (CAD)	\$	0.225		
12-Month Target Price (CAD)	\$	0.45		
Upside to Target		100%		
12mth hi-low CAD		\$0.165 -0.37		
Market Cap (CAD mn)	\$	33.8		
Shares Outstanding (mns)		150.3		
Fully Diluted (mns)		163.0		
		FY10e	FY11e	FY12e
Consensus EPS			n.a	n.a
Hallgarten EPS			(\$0.07)	(\$0.04)
Actual EPS		(\$0.130)		
P/E		n/a	n/a	(5.2)
Dividend		0.00	0.00	0.00
Yield		n/a	n/a	n/a

Donner Metals

Entwining Its Fortunes With Xstrata

- + The company has a top drawer majority partner in Xstrata in development of the Matagami polymetallic mining camp of Quebec
- + Early 2013 should see production commence from the already advanced Bracemac-Macleod deposit
- + The presence of the Perseverance mill complex nearby is a massive capex saving for the JV partners
- + The capex commitment from Donner towards the new mine is now less than \$15mn
- + The new mine will be a cash bonanza almost from the first day of production and development of the PD1 mine should follow swiftly on its heels
- ✗ Zinc has come in for another period of self-doubt, which only goes to exacerbate the future crisis by deferring investment now
- ✗ As effectively a junior partner of Xstrata, Donner will be an exciting cash generating play but needs to get some properties that are exclusively its own to create its own personality for investors

Rare as Hen's Teeth

Zinc mining plays are rarer than one might imagine. Very few independents have made it to production in recent times and those that have tend to have been devoured rather quickly by majors. This is a sign to us that rather than the sector being blighted it is one in which the cognoscenti (mining majors, refiners/smelters and trading houses) are positioning themselves while the general investing public and institutions remain rather blithely unaware of the space's attractions.

In our hunt for "fresh meat" in the zinc and lead space, a lot of effort is expended for the discovery of precious few pearls. In itself this is a sign that there is a much more severe supply shortage coming down the pike in these two metals than in copper, where there is no dearth of junior and mid-tier names. One of the names we have come across in recent times and adopted as our champion is Donner Metals, a Toronto Venture Exchange-listed development and exploration company focused on base and precious metal projects in Abitibi region of central Québec. Its flagship project is a partnership with Xstrata's Canadian subsidiary in the Matagami Mining Camp encompassing both the current development of a new mine and on-going exploration activities. The project is supported by Xstrata's existing mine infrastructure, a highly experienced workforce and an operating 2,950-tonne per day mill. As well, the area is serviced by highway, power, airport, railroad and town site infrastructure.

The Matagami Project(s)

The Matagami Mining Camp is a mining district which hosts 18 known VMS deposits, including ten past producing mines of varying sizes. One of these was the sizable Matagami Lake deposit (25.64 million tonnes of 8.2% Zn, 0.56% Cu, 20.91 g/t Ag and 0.41g/t Au) discovered in 1957 and mined from 1963 to

1988. The first discovery at Matagami was made in 1957 and continued exploration has yielded timely new discoveries. The Perseverance deposit, wholly owned by Xstrata, is currently producing. Mineral concentrates produced in Matagami are processed and refined at Xstrata's facilities in Rouyn - Noranda and Montreal.



The Matagami Project is an almost district-sized complex and has an area of mutual interest of 4,737 square kilometres that is governed by the Matagami Joint Venture Agreement signed in 2006 between Donner Metals Ltd and Falconbridge Limited, now Xstrata Canada Corporation.

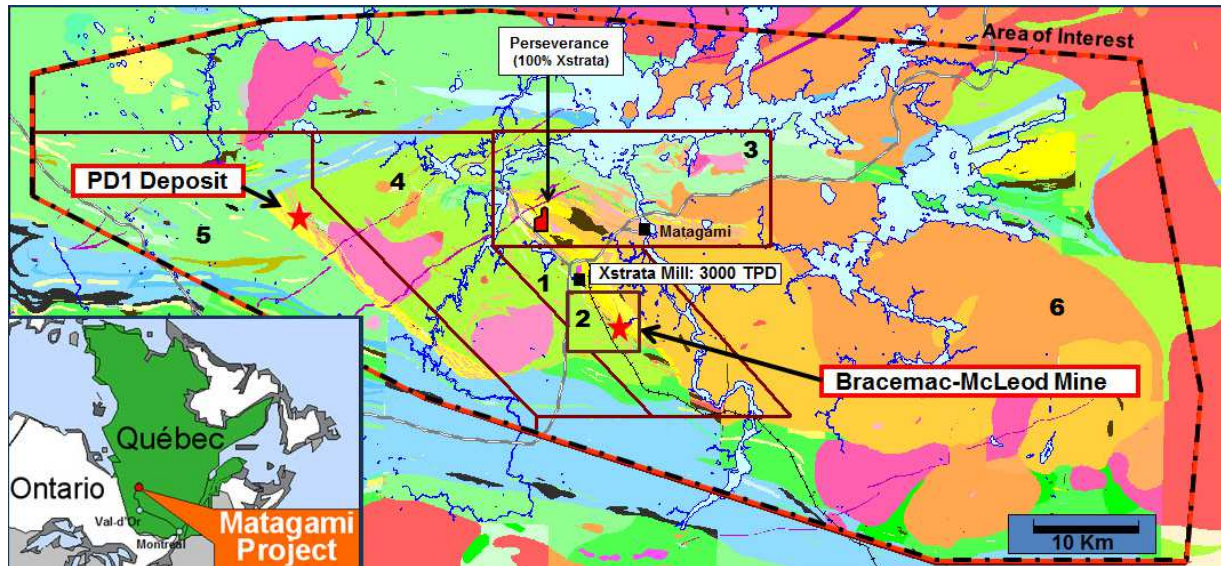
The area of mutual interest is divided into five separate joint ventures areas that cover claims in which Donner holds an interest with Xstrata. Under the joint venture agreement, Xstrata Canada Corporation - Xstrata Zinc Canada Division is the project operator for the Matagami Project and its relative joint ventures.

This almost district-sized complex consist of five properties in the sway of Donner or which one is fully backed in by Donner and the other four have potential for Xstrata to increase its stake through further work. The state of ownership of these concessions currently is:

- ✓ South Flank JV (Xstrata 65% - Donner 35%) - No further Back-in
- ✓ North Flank JV (Xstrata 50% - Donner 50%) - Xstrata Back-in option (15%)
- ✓ Central Area JV (Xstrata 50% - Donner 50%) - Xstrata Back-in option (15%)
- ✓ West Camp JV (Xstrata 50% - Donner 50%) - Xstrata Back-in option (15%) – Xstrata has elected

- to back-in
- ✓ East JV (Xstrata 50% - Donner 50%) - Xstrata Back-in option (15%)

The five concession areas are shown on the map below.



The objective for Donner and Xstrata is to explore for, and discover zinc-copper-silver-gold deposits in the Matagami Camp in order to supply the Matagami Mill over the long term. Production from Xstrata's Perseverance mine will be replaced by production from the Xstrata/Donner Bracemac-McLeod mine. New discoveries will leverage the general infrastructure and existing processing facilities within a known and well-established cost structure for developing deposits.

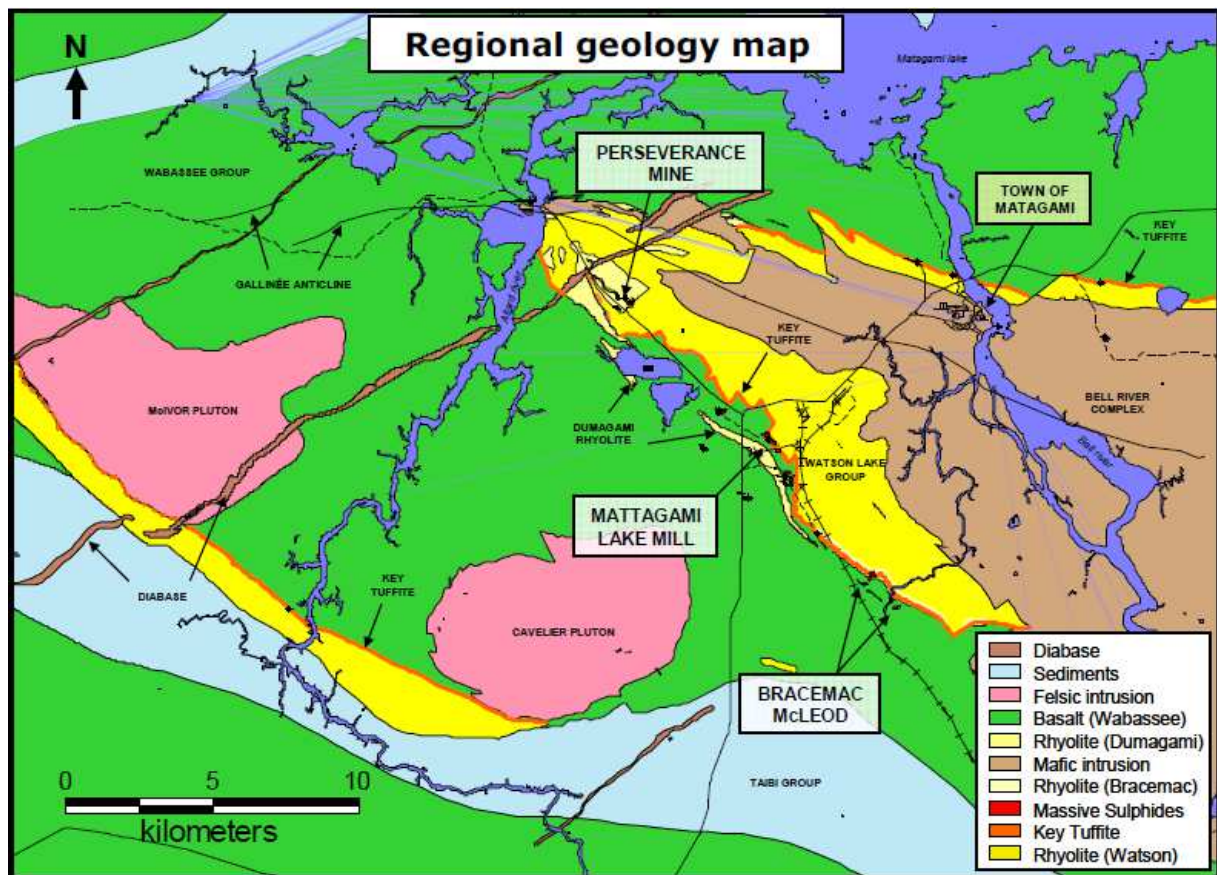
Geology

The Matagami VMS Camp is located in western Quebec in the Abitibi Greenstone Belt of the Superior Province. The district's deposits are classic examples of Archean volcanogenic massive sulfide deposits that have been generated by syngenetic processes on the seafloor (in this case the primeval Watson Lake) and subsequently subjected to a regional metamorphism of greenschist-facies grade. There is an excellent animation of how the deposit evolved on the company's website.

The Matagami camp is typified by extensive volcanic rocks that pass upward from felsic rocks (Watson Lake Group) to volumetrically more abundant mafic rocks (Wabasse Group). The transition between these two groups occurs in three belts, the South Flank belt, North Flank belt and West Camp belt. The volcanic successions were synvolcanically intruded by the large Bell River layered complex (which drove hydrothermal processes), gabbro sills and dykes and lesser intermediate to felsic dykes and sills. Stratigraphy in the Matagami region is relatively layer-cake and typically progresses from a lower sequence of felsic volcanic rocks (rhyolite/dacite – Watson Lake Group) to a very thick upper sequence of mafic volcanic rocks (andesite/basalt – Wabasse Group). The map below shows the regional geology.

Interlayered with the volcanic rocks are tuffite beds, some of which can be laterally extensive and act as

stratigraphic marker horizons. The sequence is intruded in all areas by synvolcanic, gabbro sills and dykes. The impact of intrusion of the gabbro sills is to inflate the stratigraphic succession as much as 30-40%. Felsic intrusions, generally dykes, occur locally and tend to cluster around areas of VMS activity. Both of these intrusion sets clearly post-dated the hydrothermal activity responsible for sulphide deposition.



The Matagami Lake region has a mining history that dates back to the late 1800's when Robert Bell first conducted exploration in the area. The first discovery of zinc and copper-bearing massive sulphides was made in 1956 at what became the Mattagami Lake Mine. Production began in 1963.

Additional discoveries (Iles Dieu and Norita East - 1985, Bell Allard - 1992) supported continuous production until October 2004 when the last ore was drawn from the Bell Allard Mine and operations ceased due to depleted resources. The Perseverance Deposit was discovered in 2000 and put into production in 2008.

The table on the following page details production at the various mines, grades and depths. The players in the zone now are obviously Xstrata and Donner but also MDN Inc (TSX:MDN) which holds 100% of the past producing Isle Dieu property.

Past Producers in the Matagami Camp							
Deposit	Production	Mt	%Zn	%Cu	Ag g/t	Au g/t	Depth
South Flank							
Matagami Lake	1963-1988	25.64	8.2	0.56	20.91	0.41	30-228
Orchan	1963-1982	4.51	9.84	1.02	37.03	0.51	31-366
Isle Dieu	1989-1997	3.05	17.85	1.01	76.63	0.46	320-610
Bell Allard South	1968-1970	0.23	9.24	1.14	37.03	0.51	18-70
Bell Allard	1999-2004	3.59	13.67	1.25	40.55	0.69	950-1025
North Flank							
Norita	1976-1997	3.89	3.94	1.83	25.84	0.59	10-689
Norita East	1992-1996	1.08	10.21	0.8	41.42	0.74	600-900
New Hosco	1963-1970	1.83	1.73	1.73	10.29	0.34	09-305
Garon Lake	1968-1970	0.47	2.17	1.46	10.29	0.34	15-305
Radiore 2	1979-1980	0.14	1.34	1.57	8.57	0.31	Surface

Bracemac-Macleod – the Focus of Attention

In the wake of the signing of the Donner/Xstrata agreement, the Bracemac-McLeod deposit was discovered in 2007. This deposit has been under development since April 2010 and production is anticipated in early 2013. Rather conveniently the Bracemac-McLeod deposit is located only six kilometres from Xstrata's Matagami mill complex, which shall become fully available for processing when the Perseverance deposit runs out in the next two years.

The Donner - Xstrata team discovered the Bracemac-McLeod deposit with its deposit containing NI 43-101 compliant, proven and probable mining reserves of 3.73 million tonnes grading 9.60% zinc, 1.26% copper, 28.25g/t silver and 0.43g/t gold that support an initial 4 year mine plan. In close proximity to these reserves are inferred resources of 2.63 million tonnes grading 8.78% zinc, 1.31% copper, 38.83g/t silver and 1.06g/t gold. The company claims that mineralization is open in many parts of the deposit and thus exploration potential is considered excellent.

In addition to the construction of the Bracemac-McLeod mine, a second deposit called PD1 is currently under feasibility study. We shall discuss this later.

Xstrata Zinc – a behemoth

One of the eye-popping numbers that came to light in the IPO process of the major metals trader Glencore in early 2011 was that the company claimed to control a market share of around 60% of the openly traded zinc in the world. When one combines this with the knowledge that Xstrata (in which Glencore owns a 34% stake) is also one of the world's largest zinc miners, there emerges a pattern of control and domination.

Xstrata Zinc is headquartered at Madrid in Spain (ironically a country in which Rio Tinto also has its roots in zinc). Xstrata is one of the world's largest producers of zinc with zinc and lead operations and exploration projects located in Australia, Canada, Germany, Peru, Spain and the United Kingdom.

Xstrata Zinc's operations in Spain comprise the San Juan de Nieva zinc smelter and the Arnao zinc semis plant in Asturias, and the Hinojedo roasting plant in Cantabria.

In Australia, operations comprise: the Mount Isa, George Fisher underground, Handlebar Hill open cut and Black Star open cut zinc-lead mines, zinc-lead concentrator, lead smelter and Bowen Coke Works in north Queensland; the McArthur River open pit zinc-lead mine, processing and loading facility in the Northern Territory; and 75% of the Lady Loretta zinc lead deposit in north-west Queensland.

In Canada, operations and exploration projects include the Brunswick zinc-lead mine and lead smelter in New Brunswick; 25% of the CEZ zinc smelter near Montreal; and the Perseverance zinc deposit (adjoining Donner's Bracemac McLeod) in Quebec.

Xstrata Zinc also operates the Nordenham zinc smelter in northern Germany; the Northfleet lead refinery in the United Kingdom; and owns 33.75% of the Antamina mine in Peru.

Zinc – potential unappreciated

At the risk of sounding eternally optimistic we reiterate our enthusiasm for zinc. Around half of all zinc currently consumed is used for galvanizing steel, which is an environmentally friendly method of protecting steel against corrosion. Zinc also finds application in the manufacture of die-cast alloys, brass and the production of zinc oxides and chemicals.

The zinc equation is rather simple. At a price per pound of under 70 cts most producers of zinc are losing money. Some were sustained, when zinc first turned turtle in the 2008 rout, by their by-product credits from silver or lead but then those too slipped beneath the waves and some of the classic Ag-Pb-Zn mines were losing money on all three product lines. Some others, most particularly the Australians, got some brief relief by the Australian dollar plunging in late 2008 from 92cts to the USD to a nearly 60 cts in the space of a month. However, not to be outdone, the zinc price lost 40% in the same time, largely negating the currency move. The net result was a swathe of mine closures and mothballing across the globe. Some have reopened, some have gone for good.

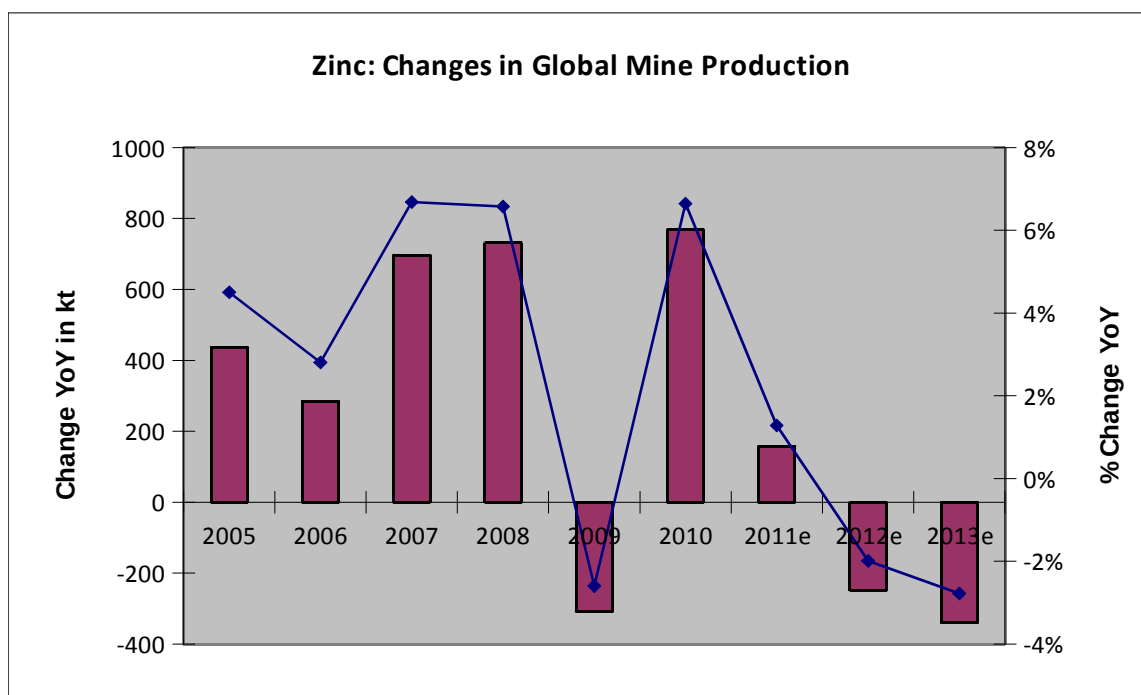
Steel production rebounded, at least in China, during 2010 and with it lifted the iron ore price making for a fevered market again in that metal. Zinc responded in a more muted fashion largely because Western demand was still way off the boil and Chinese consumption was insufficient to make up for the broader weakness. In 2009, sharp falls in zinc demand of 25% in Europe, 10.5% in the United States, 23% in Japan and 22% in the Republic of Korea were partially balanced by an increase in Chinese apparent usage of 17.8% resulting in an overall reduction in global demand of 5.3%.

World Refined Zinc Supply and Usage 2006 - 2011 000 tonnes											
	2006	2007	2008	2009	2010	2010 Jan-Jun	2011 Jan-Jun	Mar	2011 Apr	May	Jun
Mine Production	10,431	11,128	11,860	11,552	12,320	6,005	6,212	1,029.7	1,056.2	1,116.1	1,140.8
Metal Production	10,629	11,345	11,766	11,281	12,860	6,266	6,451	1,104.2	1,055.6	1,079.2	1,105.0
Metal Usage	11,000	11,276	11,559	10,845	12,571	6,081	6,228	1,073.5	1,017.9	1,037.0	1,103.6

Source: ILZSG

The table above shows mine production crawling upwards over the last six years before a small retreat in 2009. Both metal usage and production turned down in 2009 and production of refined zinc exceeded usage by 445,000 tonnes, the largest surplus since 1993. This should have been enough to send zinc even lower but the Chinese surged into the marketplace and vacuumed up the surplus, clearly stashing it away for a rainy day.

Below can be seen our projections for the YoY change in production over the next few years. Production continued to rise in both Zn/Pb output due to the strong silver price and new production in the Ag/Zn/Pb polymetallic category. However, under this frothy layer primary base metal sources of Zn/Pb will be heading down as mines expire and no new production appears. This is where the real crisis is brewing. The production falls in 2012 and 2013 are due to mine closures not demand issues.



Source: Hallgarten

The problem for Zinc users going forward is going to be mine closures. The capacity departing is much more substantial than the volume coming on stream. For example, in Australia the Century zinc mine owned by Minmetals has historical production in excess of 500,000 tonnes per year of metal but is currently expected to close in 2015. Minmetals has suggested it could remain active for another year before being exhausted. The company is studying development of a second Australian mine, called Dugald River, for which a feasibility study completed in 2008 confirmed a resource of 53 million tonnes

at 12.5% zinc, 1.9% lead and 36 g/t silver. This project might be capable of producing approximately 200,000 tonnes of zinc, 25,000 tonnes of lead and 900,000 ounces of silver for a period of 23 years. Thus one large mine is being replaced by another

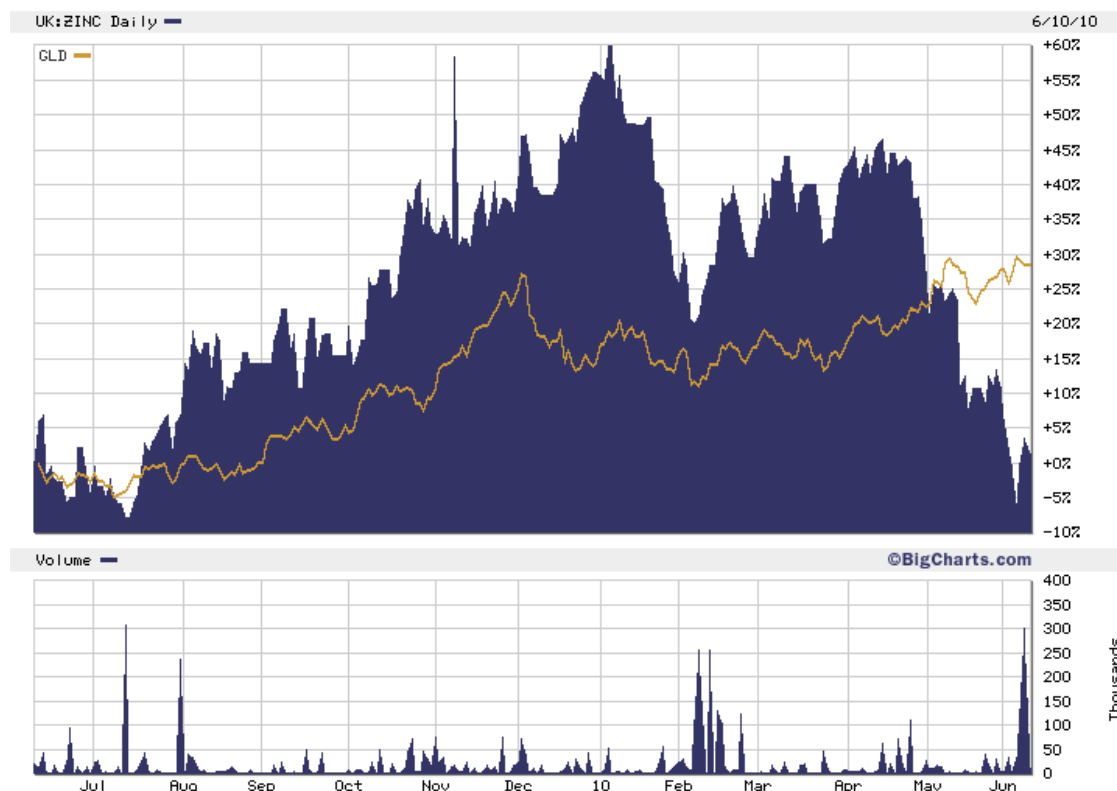
In Canada, the aforementioned Xstrata-owned Brunswick and Perseverance mines are destined to close in 2013. This is after Brunswick has already been stretched beyond its original LOM. A shutdown of the two mines would remove a combined 350,000 tonnes of annualised metal capacity.

To counter these closures we have new mines like Glencore's Perkoa in Burkina Faso (90,000 tpa) and Talivivaara in Finland at slightly over 25,000 tpa. Thus mega-mines that lasted for decades are being replaced by much smaller mines with more limited mine lives.

Zinc trends – more industrial than monetary

There seems to be more relationship between the S&P and zinc than between gold and zinc. The inflation school of thought that supports unbridled gold buying would hold that rising commodity prices is a sign of inflationary outbreak and thus a reason to buy gold as zinc and others rise. However the gold bugs changed their tune when Europe started to go to the dogs with inflation being put on the backburner and "flight from risk" being the new mantra. This allowed gold to rise when there was decreasing inflation risk, particularly from commodities.

The following chart shows the Zinc ETF versus the Gold ETF.



Zinc Price Outlook

Since its depths in 2008 zinc has rebounded to over \$1 per pound only to slip back in May 2010 on the first wave of Euro travails and then again on the recent global market weakness. However the metal seemed to have found a band between 90 cts and \$1.10 per lb over the last year. This relative stability is good but not much consolation to anyone in the space. This includes end-users. The zinc complex has needed a sustained recovery in prices to tease projects off the drawing boards and into the financing phase. While some transactions went through during the recovery phase most of these were on existing producing assets. The zinc end users need to feel that there is some new production coming on three or more years out. Short of silver mines with strong zinc/lead by-product credits there is very little between here and the horizon in terms of new production. This then implies that a shortage bubble is coming along and prices will spike again as they did in 2006/2007.

While producers or prospective producers were rightly wary when Zinc and Lead first shot up to the \$1.20 per lb level in December 2009 (suspecting they might be being led into a bear trap by the Chinese or hedge funds or whoever) the fact that both metals were able to hold themselves above the \$1 mark for a sustained period of time since then (except in the recent turbulence) has emboldened hard-core Lead and Zinc fans to dare to consider that some projects on the drawing boards may actually be moved forward. The rise of the Trading Houses as a source of financing through offtakes has partly negated the generalised disinterest of the equities markets in the sub-space.

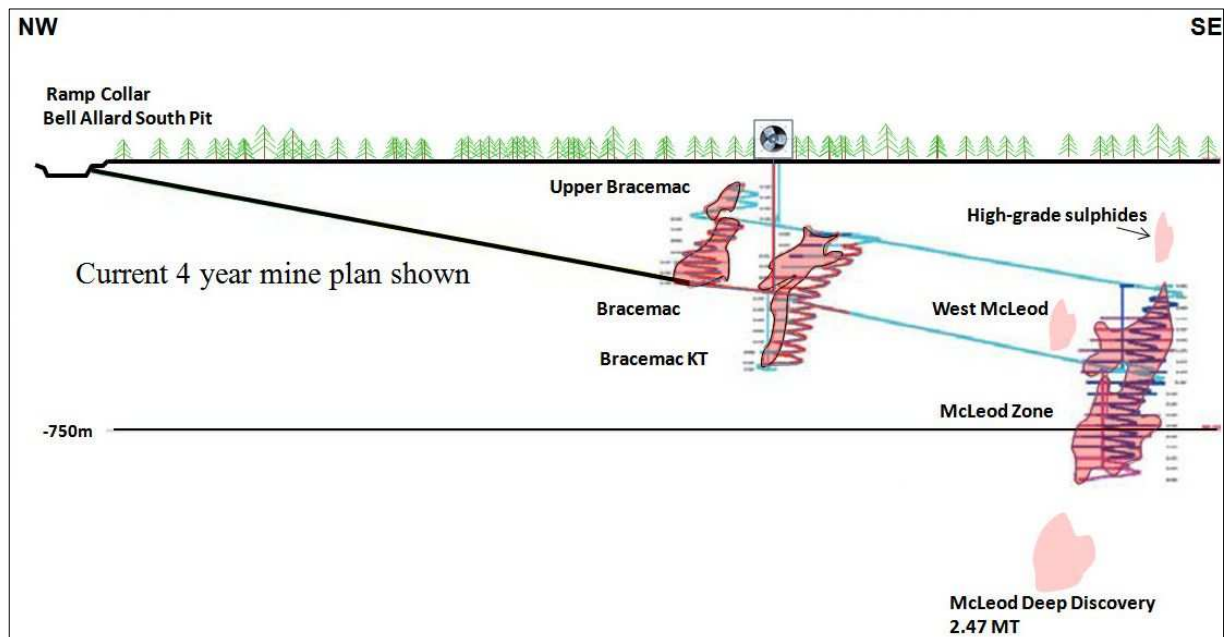
Thus the perspective for stocks in the space to firm up again as zinc and lead crawl back into the daylight looks good and we feel that Zinc and Lead should be trading soon back above the above \$1 per lb consistently. Our twelve month outlook is for Zn to again reach \$1.10 or slightly higher. Our two to three year view is for Zinc to breach the \$1.50 per lb mark. Thus the aforementioned Zinc ETF looks a great way to play this potential move. Even better there is a leveraged ETF, from the same originator, that gives double effect to any up (or down) move.

Advancing to Production

With our view on Zinc shared by the management's enthusiasts at Donner it is no surprise that they are charging full speed ahead towards production. Xstrata Zinc had a feasibility study prepared by GENIVAR (with Xstrata Zinc) in September 2010.

The orebody is comprised of four distinct ore zones: Bracemac Upper, Bracemac Main, Bracemac KT and McLeod. The cross-section on the following page shows the four year mine with the decline currently nearing the first part of the deposit. This access ramp will be 2.3km in total.

The feasibility study recommended using a longhole mining method with either a transverse or a longitudinal access to the orebody. For economic reasons and to maximize productivity, it was decided to utilize the transverse mining method where the orebody thickness is greater than 6 meters.



When it reaches Bracemac it will be spiraled up as a ramp while the decline continues towards the Bracemac KT deposit. Ramps will then spiral up and down in that deposit and an airshaft will be sent up to the surface. Stope production is scheduled to begin in January 2013 and will end in December 2016. In total, 250 stopes will be mined between January 2013 and the end of 2016.

It is expected in the feasibility study that metal production will total 606 Mlbs of payable zinc, 83 Mlbs of payable copper, 1.5 Moz of payable silver and 13 koz of payable gold over the LOM.

Donner-Xstrata Matagami Agreement

Current Mine Plan - Proven and Probable Reserves

	Deposit	Production	(Mt)	% Zn	% Cu	Ag g/t	Au g/t	Depth (m)
South Flank	Bracemac-McLeod	Scheduled	3.73	9.60	1.26	28.25	0.43	35-900
		2013 4 yr LOM						

Expansion

	Deposit	Resource Classification	(Mt)	% Zn	% Cu	Ag g/t	Au g/t	Depth (m)
South	McLeod Deep	Inferred	2.47	9.20	1.22	40	1.10	600-1200
Flank	McLeod West	Inferred	0.16	2.20	2.60	24	0.20	400-600
	McLeod Copper zone	Indicated	0.24	0.96	1.25	7.80	0.19	600-700

In total, 250 stopes will be mined between January 2013 and the end of 2016.

Cemented rockfill will be poured in longitudinal stopes and in transverse primary stopes, while

unconsolidated rockfill will be used in transverse secondary stopes. This approach fits with the relatively small tonnage of the deposits and the waste rock management program (development waste rock used as rockfill in underground stopes).

Considering the difficulties anticipated with excavating a shaft and building the related infrastructure in a clay-based soil of over 13-meter in thickness, as well as to reduce the environmental footprint of the mine, the deposit will be accessed via an underground ramp from a portal located in the old Bell-Allard South (BAS) pit.

Combined Proven and Probable Mineral Reserves (diluted) stand at 3.73 Mt, grading 9.60% Zn, 1.26% Cu, 28.25 g Ag/t and 0.43 g Au/t. Average daily production rate will initially be 2,300 tpd, for the first two years of production. Then, it will reach 2,800 tpd for the last two years of the LOM, for a LOM average daily production rate of 2,500-tpd.

At this rate, the LOM of the Bracemac-McLeod Project will be 6.5 years: two and a half years of preproduction for developing the underground mine, and four years of production. The company however feels that the LOM could be up to seven years by bringing in the inferred resource and considering that the Macleod Deep is open in various directions.

The development rate for the main ramp was set to 4.5 m/day. Once several working faces are available, the advance rate can reach 17.6 m/day based on 4 rounds excavated at a rate of 4.4 m/round. When the main ventilation system is operational (main fan and raise), the advance rate can reach 22 m/day based on 5 rounds excavated at a rate of 4.4 m/round.

Capital costs for the Bracemac-McLeod Mine, including a 10% allowance for contingencies, are estimated at \$159 million. This amount, quoted in 2010 Canadian dollars, excludes taxes, duties and inflation. Of this amount, almost \$110 million will be disbursed before the start of production in 2013; the remaining \$49 million, incurred during the production phase, is considered as an ongoing investment and thus paid out of cashflow.

Capital Item	Total CAD\$
Surface	26,521,070
U/G Construction	13,776,626
U/G Vertical Development	9,138,179
U/G Lateral Development	45,485,305
U/G Stoping	738,647
U/G Mobile Equipment	4,836,000
Mill & Tailings	3,400,000
Environment	1,395,500
Indirect	32,924,208
Diamond drilling U/G	6,528,000
Total Mine	144,743,536
General contingencies (10%)	14,474,354
Total Mine with contingencies	159,217,889

Average direct operating costs for the Bracemac-McLeod Mine are estimated at \$72.27/t milled. This includes mining, mineral processing, maintenance, administration and human resources. Below we present a summary breakdown of the operating costs estimate.

Operating Costs Summary

Mining	\$37.51/t milled
Maintenance	\$7.06/t milled
General & Administration	\$9.70/t milled
Milling	\$18.00/t milled
TOTAL	\$72.27/t milled

The Feasibility Study contained a model for the NPV and IRR at different metals price points. At our favoured price targets for 2013 (i.e. Zinc at \$1.50 and copper at \$3.50) the NPV is \$385mn for the project and the IRR is 74%. These are healthy numbers by any estimation.

Zn Price	\$0.80/lb		\$1.0/lb		\$1.25/lb		\$1.50/lb		\$1.75/lb		\$2.00/lb	
Cu Price	NPV,	IRR	NPV,	IRR	NPV,	IRR	NPV,	IRR	NPV,	IRR	NPV,	IRR
\$2.25/lb	10	10	96	30	203	49	311	64	418	77	526	88
\$2.50/lb	24	14	110	33	218	51	325	66	434	79	541	90
\$2.75/lb	39	18	125	36	233	54	341	68	448	80	556	91
\$3.00/lb	54	21	140	39	247	56	356	70	463	82	571	93
\$3.25/lb	69	25	155	41	263	58	370	72	478	84	586	94
\$3.50/lb	84	28	170	44	278	60	385	74	493	85	600	96
\$4.00/lb			275	62								

The Processing Deal with Xstrata

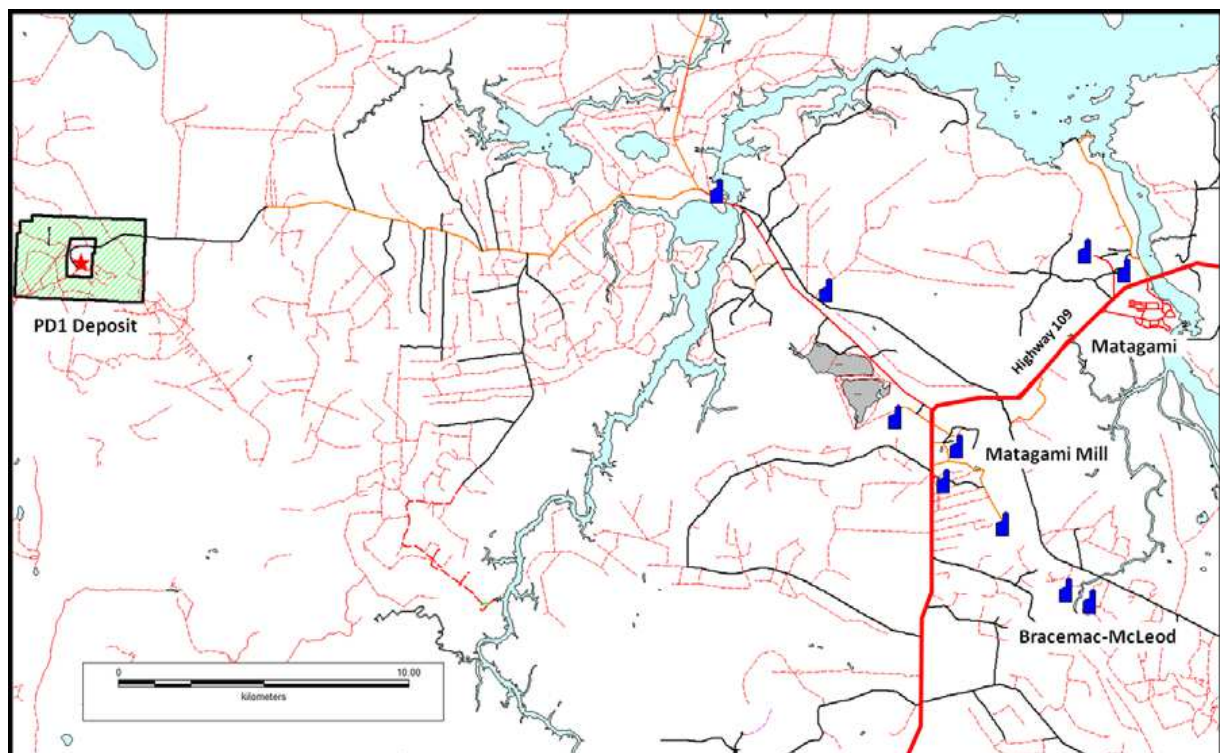
Probably the biggest advantage that this project has is the close proximity of Xstrata's Perseverance mill and the imminent availability of milling capacity there as the Perseverance Mine reaches the end of its producing life. As a result of this all the production of the Bracemac-Macleod operation will go to the mill and thereby eliminate totally any obligation on the part of Donner to invest in capital items such as the mill and tailings facility.

While the per tonne charge pre-agreed with Xstrata looks like a tolling charge the company reassures us that it will not pay a toll as such. It pays its 35% share of the operating cost of the mill plus a capital recovery charge of CAD\$6.75/tonne, based on amortizing the replacement cost of the mill and tailings (CAD\$92.4mn) over 15 years at an average mill throughput of 2500 tpd. The company is currently exploring into ways of feeding the mill at 3000 tpd, the rate at which Xstrata's Perseverance deposit currently feeds the mill. If this plan is successful the capital recovery charge would reduce to C\$5.63/tonne. It should be noted that Donner has a substantially lower capex than one would expect on a *de novo* zinc mine since they are paying a capital recovery charge instead to cover the "rent" in a manner of speaking on Xstrata's pre-existing mill and tailings facility.

For accounting purposes it might be noted that Donner sells the cons to Xstrata at the mill gate net of annual benchmark smelting and refining charges c.i.f. benchmark port of discharge.

Next Cab Off the Rank – PD1

This nondescriptly named second project of Donner started to make sense when we plowed through the historical literature and found references to the “Phelps-Dodge” deposit. The PD1 deposit was discovered in 1974 by Phelps Dodge Corporation of Canada, which subsequently sold the property to Orchan Mines Limited in 1976. The property was included in the MLOJVA in 2007.



A total of 50 historical drillholes were drilled on the PD1 deposit between 1974 and 1984. In 2010 Xstrata Zinc drilled 25 holes in the upper portion of the deposit above 100 metres vertical depth.

Donner earned in its stake of 50% on PD1 which will then be reduced to 35% by Xstrata producing a Feasibility study on the project. Phelps Dodge does have residual rights though. These include:

- ✓ Phelps Dodge holds a 15% *net carried interest** on the first 1.6 million tons mined from the 9 mineral claims. This will increase to a 25% net carried interest after 1.6 million tons are mined.
- ✓ Net carried interest in this case is defined as Net Proceeds less capital expenditures, working capital and carrying charges. (Net Proceeds being defined as gross revenue less operating costs and both transfer and processing charges).
- ✓ Phelps Dodge is entitled to \$400,000 in cash payments, paid in annual installments of \$100,000, during each of the first four years of production from the property.

- ✓ Following production of the first 1.9 million tons from the property, Phelps Dodge may elect, within one year, to participate at 40% in any further development of the property by foregoing its net carried interest from the point of election.

The deposit differs from the typical Matagami sulphide deposits on three fronts:

- ✓ The deposit is a body of dense massive pyrite within which two internal parallel layers are defined on the basis of minimum cut-off grade.
- ✓ The overall grade of the deposit and that of the above cut-off mineralization is lower than camp average for massive sulphides.
- ✓ The grain size is finer than camp average.

In a NI 43-101 resource calculation (shown following) prepared in February 2011 by Zorayda Consulting for Donner and contained a resource was interesting from the copper and zinc grade perspective but not sizable in terms of tonnage. However, PD1 provides a possibility of an extra source of material for the mill after Bracemac-Macleod peaks in its production. PD1 has the big advantage that the bulk of its resource is shallow suggesting to us, maybe an open pit, followed by a move underground. Xstrata is moving ahead with the feasibility study on the deposit.

PD1 Deposit – Resource						
Category	Tonnes	Zinc %	Copper %	Silver g/t	Gold g/t	Vertical Depth metres
Measured	596,193	4.34	0.83	19.59	0.12	25 to 100
Indicated	262,387	4.26	0.91	19.95	NS	100 to 200
Indicated	528,925	4.25	1.59	21.13	NS	200 to 300
Indicated	272,211	5.48	1.41	20.27	NS	300 to 400
Indicated	71,895	6.32	0.77	12.44	NS	400 to 500
Indicated	5,762	2.64	0.19	8.14	NS	500 to 515
Total M&I Resource	1,737,373	4.55	1.16	19.88	-	25 to 515

The Sandstorm Deals

The company has done a pair of recent deals to ameliorate the financing burden for Donner as it kickstarts its project on the way to production. Both were done with companies in the Sandstorm group to help Donner pay for its share of the development costs of the Bracemac-McLeod mine. In mid-July 2011 the company announced an agreement with Sandstorm Gold to:

- ✓ buy gold and gold equivalent equal to 17.5% of Bracemac McLeod's project output (thus half of Donner's 35% share of output)
- ✓ to pay Donner \$5 mln in June of 2012

The deal with Sandstorm Gold commits Donner to sell gold to Sandstorm which will pay the lesser of US\$350 per ounce of gold (or gold equivalent) and the then prevailing market price of gold. However

Donner will have the option, for a period of 24 months, to repurchase up to 50% of the gold committed in the agreement by making a US\$3.5 million payment to Sandstorm Gold whereupon the percentage of gold and gold equivalent that Sandstorm Gold is entitled to purchase shall be decreased from 17.5% to 8.75%. Aside from the upfront deposit and per ounce payments, Sandstorm Gold is not required to contribute to any capital, exploration or operating expenditures in respect to the Bracemac-McLeod mine. Sandstorm Gold has received a guarantee that it will receive minimum before tax cash flows of:

- ✓ US\$0.8 million in 2013,
- ✓ US\$1.4 million in 2014,
- ✓ US\$1.4 million in 2015, and
- ✓ US\$1.4 million in 2016,

This provides Sandstorm with a 100% return of capital within approximately five years.

Then in a separate deal later in July 2011, the sister company, Sandstorm Metals & Energy (TSX-V: SND) made a US\$20 million payment to Donner in fulfillment of the copper purchase agreement announced on July 13, 2011. Like the gold agreement, Sandstorm Metals is entitled to purchase an amount equal to 17.5% of the life of mine copper produced from the Bracemac-McLeod mine at a per pound price equal to the lesser of US\$0.80 and the then prevailing market price of copper unless the price of copper falls below US\$2.75 per pound, in which case the per pound price will be equal to the lesser of US\$0.55 and the then prevailing market price of copper.

Sandstorm Metal's payment to Donner consisted of US\$17.75 million as an upfront payment and the remaining US\$2.25 million coming from the purchase of 6,428,571 common shares of Donner at US\$0.35 per share.

A key thing to note here is the trigger measures for lowering the price paid by Sandstorm. The \$350 per oz trigger on gold is fine for anything except the most apocalyptic scenarios, but the 80 ct per lb trigger on Zinc is a lot more like sailing close to the wind for Donner with the price in recent days flirting with that level. Nevertheless, we are looking out towards 2013 production when we feel that Zinc might verily be closer to \$.150 per lb than 80 cts.

On Sandstorm

The first Sandstorm entity appeared on the scene in 2009 and represented an interesting new spin on the model that Silver Wheaton had pioneered. In Sandstorm's case the focus was on VPP, or Volumetric Product Participation, financing. The first vehicle to be launched was sandstorm Gold which came out of the gate at its IPO with metals streams from Luna Gold and Silvercrest. Going was slow for a long while after that as financing improved in the equities markets and miners felt they could raise the money for smaller mine builds rather than resort to VPP-like deals.

Finding themselves somewhat limited in the precious space in the short-term the company decided to replicate itself in the base metal space (presumably also to avoid dilution for those who had bought into the precious metals' entity and didn't want their waters muddied). So the management launched Sandstorm Metals & Energy Ltd. as an entity seeking to complete commodity purchase agreements with companies that have advanced stage development projects or operating projects. A commodity

purchase agreement involves Sandstorm Metals & Energy making an upfront cash payment to its partners and in exchange, Sandstorm Metals & Energy receives the right to purchase a percentage of the commodity produced for the life of the asset, at a fixed price per unit. Sandstorm Metals & Energy helps other companies in the resource industry grow their business, while acquiring attractive assets in the process.

Sandstorm Metals & Energy states its focus as low cost operations with strong exploration potential and strong management teams. To this end, Sandstorm Metals & Energy has completed commodity purchase agreements (beyond that with Donner) with NovaDX Ventures Corp., Royal Coal Corp., Terrex Energy Inc., and Thunderbird Energy Corp.

We suspect Donner was able to drive a hard bargain on gold largely because easy financing in equity markets over the last two years have meant thin pickings for the likes of Sandstorm in bolstering its portfolio of forward purchases. As only marginally seen as a gold producer Donner could never have hoped to leverage its gold production into an equity financing at attractive levels with the *hoi polloi* of the Canadian markets.

Results Outlook

While the nature of management of the project for Donner is pretty simple (in effect they don't manage anything!) the accounting for an arrangement where the mine is not owned by a jointly owned subsidiary but rather a true JV can be fairly boggling.

The key things to remember are that Xstrata has 65% and Donner has 35% but beyond that Donner has pre-committed half its zinc and half its gold output. This provides for a second revenue stream (i.e. Sandstorm payments) over and beyond what it is paid for its output sold at full price.

Then in calculating mine costs, the numbers in the Feasibility study give the guide to what the company will be paying per tonne to Xstrata for what is processed. On top of this comes the Capex surcharge to Xstrata to compensate Xstrata for its sunk costs on the mill and tailings and then an overriding 10% management fee to Xstrata. We have the still unknown factor as to whether the Capex surcharge will be reduced should the mill run at a higher rate. We have not taken this possibility into account.

For depreciation we have followed the company's view that the mine life might be seven years.

We have figured two months of production in the company's FY13 (which ends in February 2013).

We have factored in an expansion of 30 mn in the number of shares on issue before production begins as the company tops up the amount that it contributes to the capex of the mine build.

Our metal price assumptions for FY13 & 14 are:

- ✓ Zinc at US\$1.35 per lb
- ✓ Copper at US\$3.70 per lb
- ✓ Gold at US\$1,350 per oz
- ✓ Silver at US\$30 per oz

Donner Metals

USD mns – FY ending Feb

	FY16e	FY15e	FY14e	FY13e	FY12e	FY11	FY10	FY09
Revenue - Mine	101.73	89.41	88.22	14.70				
Sandstorm Payments	28.74	28.16	24.28	4.05				
Total Revenue	130.48	117.57	112.50	18.75	0.00	0.00	0.00	0
Cost of Revenue -mined	21.64	17.66	18.53	3.09				
Capitalisation fee	2.33	1.90	2.00	0.33				
Gross Profit	106.50	98.01	91.96	15.33	0.00	0.00	0.00	0
GSA on JV	3.36	2.74	2.87	0.48				
Selling/General/Admin. Expenses	1.50	1.50	1.50	1.50	1.50	1.48	1.45	1.19
Stock Based Compensation	0.70	0.70	0.60	0.50	0.50	0.47	0.95	0.03
Management Fee	2.50	2.04	2.14	0.36				
Depreciation/Amortization	18.64	16.80	16.07	2.68	0.03	0.02	0.01	0.01
Exploration	4.00	4.00	4.00	3.00	2.10	3.84	4.39	4.97
Other Operating Expenses	0.50	0.50	0.50	0.20				
Total Operating Expense	55.17	47.84	48.22	12.14	2.63	5.81	6.80	6.20
Operating Income	75.31	69.73	64.28	6.61	-2.63	-5.81	-6.80	-6.20
Interest Income(Expense)	0.00	0.00	0.00	0.00	0.00	0.03	-0.79	-0.55
Other financing costs	0.00	0.00	0.00	0.00	0.00	0.00	0.13	-0.39
Income Before Tax	75.31	69.73	64.28	6.61	-2.63	-5.78	-7.46	-5.26
Tax	21.09	19.53	18.00	1.10	-0.44	-0.79	-1.43	-0.228
Income After Tax	54.22	50.21	46.28	5.51	-2.19	-4.99	-6.03	-5.03
Weighted Average Shares	187	183	180	150.3	150.3	114.299	81.249	47.416
EPS	0.29	0.27	0.26	0.04	-0.01	-0.04	-0.07	-0.13

As can be noted there is a veritable outpouring of cash-flow from the get-go of production. This should produce (in our model) somewhere around 26 cents per share in the first full year of production. To put this in perspective the EPS is higher than the company's current share price. The earnings grow by around 10% in the next year and slightly less into the fourth fiscal year of production.

Management Team

Our interactions with Donner have been exclusively with **David Patterson**, the Chairman (and a director). He has been involved with various exploration companies for over two decades. He has raised in excess of CAD\$150 million for mineral exploration companies, including Donner Metals Ltd.

The CEO (and also a Director) is **Harvey Keats**, who was formerly Vice President of Exploration of Diamond Fields Resources Inc. where he was directly responsible for the exploration program at Diamond Fields' Voisey's Bay nickel-copper-cobalt property in Labrador where reserves were increased dramatically with the discovery of the "Eastern Deeps" zone. Prior to joining Diamond Fields, he spent 25 years with Falconbridge where he held many senior executive positions including Exploration Manager for Falconbridge Chile S.A., General Manager Exploration for Falconbridge International Limited and Director, Nickel Laterite Exploration.

Ken Thorsen, a Director, has over 35 years' experience in the exploration business. He retired after 21 successful years as General Manager of Advanced Projects with Teck-Cominco and was formerly President of Teck Exploration Ltd. During this tenure, he was instrumental in the discovery of the Estrades VMS project in NW Québec. Prior to Teck, he spent two years with SMDC (now Cameco) and, prior to that, over eight years with Selection Trust where he was responsible for the discovery of the Leinster nickel mine in Australia. He is a Professional Engineer and has a degree in Geological Engineering. He has extensive experience in exploration for many commodities, including gold, silver, copper, zinc, nickel, platinum, palladium, diamonds and uranium and has been involved in exploration programs in Mexico, Canada, USA, Peru, Chile, Brazil, Argentina, Venezuela, Australia, China, Africa, Panama and Central Asia. He currently serves as a director of several exploration companies.

Kerry Sparkes, a Director, worked for Noranda Exploration from 1989 to 1994 followed by five years in senior roles up to Exploration Manager with Archean Resources during which time he was instrumental in the discovery and delineation of the Voisey's Bay deposits. In 1997, he was appointed as Senior Geologist at Voisey's Bay Nickel Co Ltd. and subsequently moved to Donner Metals as Exploration Manager in 1999. He became Vice President of Messina Minerals Inc. in 2005 followed by a move to Norwest Corporation as Senior Associate in 2009.

Laurie Sadler, also a Director, is a retired Chartered Accountant with extensive experience as a business advisor to public and private companies. He was a founder and managing partner of the firm Sadler, Weismiller, Spencer, Chartered Accountants from 1984 until 2001.

The other key personnel consist of:

Robin Adair, who is the Vice-President of Exploration since 2006 following a 25-year career with Falconbridge/Noranda where he held senior positions as Exploration Manager for North America for zinc/copper and subsequently nickel/copper/PGEs. During this tenure, he guided exploration, advanced projects, feasibility and evaluation programs and participated in numerous acquisitions. His extensive experience in VMS deposits comprises geology as well as deposit economics and development. In his role with Falconbridge/Noranda, he was responsible for negotiating and managing numerous of the major's business partnerships with senior and junior mining companies.

Ron Tessier is Vice-President of Engineering. His history is linked to the Perseverance Mine which has hitherto been the keystone of the mining district. It was he, who in 2006 managed the positive feasibility study of the Perseverance Mine and extensive experience in the Matagami Camp as former President of R&S Consultants. In 2007, as Mine Manager, he oversaw the construction of the \$160mn Perseverance Project, which was completed on budget and six months ahead of schedule in mid-2008. He has forty

years of experience in a broad range of activities related to research, feasibility studies, construction, commissioning, operation, and maintenance of numerous mining and treatment facilities throughout North America.

Risks

The main risks we can envisage with Donner are:

- ✧ persistently low Zinc prices for an extended period of time (triggering the lower Sandstorm price, amongst other complications)
- ✧ difficulties in raising its share of the mine build costs
- ✧ some breakdown in relations with Xstrata or some attempt by that company to strong-arm Donner into selling out cheaply
- ✧ excessively high production costs

In response to these we would note that Zinc at current prices for an extended period of time would only hasten the demise of several large mines nearing their end of mine life and further stymie future mine plans and scale back production at existing mines. This exacerbates the nightmare scenario for zinc end-users several years out when a supply crunch will hit.

The current straightened financial situation for mine funding is probably the most realistic risk for the company. However, as the company has Xstrata as the controlling management in the mine project, any funder of Donner is making more of a bet on Xstrata's ability to get the mine working profitably and on time than taking a risk on Donner itself.

Meanwhile relations with Xstrata are excellent. There has been ample scope for Xstrata to get tough and force better terms out of Donner but consistently relations have been harmonious and professional. An agreement, as noted earlier, exists on the processing price for Donner's share of the ore output to ensure against transfer pricing to the mill-owner.

Conclusion

Donner finds itself in a peculiar predicament. It has done everything right and got itself one of the best partners in the world, Xstrata, which is building and largely funding its mine (and brings a mill, gratis, to the table). And yet the market does not care one fig and ranks it as if it is a junior zinc explorer. There is good reason to be disappointed with zinc stocks over the last ten years, but when one thinks back over it several of the largest zinc names that have grown up from explorers over that period have been swallowed in recent times by majors, e.g. Farallon and Breakwater. The zinc majors like Nyrstar are stalking the land taking down whatever assets they can get their paws on. While Donner is probably only a target for Xstrata and thus has a sort of force field around it, it does not have to succumb to any price as the initiation of positive cashflows from its share of the mine's production will empower it to get other parts of the deposit into production and possibly venture farther afield.

The Donner story is relatively simple. Virtually all the work is done by Xstrata and Donner collects the money once the mine is operational. This has the seeds of being either a dividend story, a takeover story or building a new zinc company story (if the company finds itself standalone projects).

Tuesday, November 1, 2011

In the wake of our second encounter with Donner this year we added a Long position to the Model Mining Portfolio in September 2011. The addition of this Zinc stock, further bolstered our holdings in that space. While there are a few Zinc wannabes out there in the public markets, a change in the nature of the funding environment (namely the rise of the Trading Houses) is altering the perspectives from some of these potential producers for the better.

Donner is not the main driver of its project, but we can find little to complain about in this when the partner is Xstrata. This liaison has moved Donner from the “maybe” column in Zinc players to one of the “definites.” We have added it to the Model Mining Portfolio with a 12-month price target of 45 cts.



Important disclosures

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