Tuesday, January 10, 2017

# HALLGARTEN & COMPANY

## Results Note

Christopher Ecclestone
cecclestone@hallgartenco.com

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

**Key Metrics**

| | | |
|---|---|---|
| Price (CAD) | $ | 0.080 |
| 12-Month Target Price (CAD) | $ | 0.03 |
| Upside to Target | | -63% |
| High-low (12 mth) | $0.03 - $0.19 | |
| Market Cap (CAD mn) | $ | 11.41 |
| Shares Outstanding (millions) | | 142.6 |
| Fully diluted (millions) | | 162.1 |

| | 2015 | 2016e | 2017e |
|---|---|---|---|
| Consensus EPS | | n/a | n/a |
| Hallgarten EPS (est.) | | ($0.04) | ($0.02) |
| Actual EPS | ($0.155) | | |
| P/E | n/a | n/a | n/a |

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# Galane Gold

## Financial Waterboarding for Shareholders

- + Company manages to squeeze some residual production out of its Botswanan assets
- ✘ Results statement has fallen back into hefty losses Negative $1.54mn in 3Q16)
- ✘ Gold price has slumped back with no sign of an imminent recovery
- ✘ German prime time TV is investigating matters at sister-company, Feronia
- ✘ The debt mountain is already having cashflow consequences as delayed payments from last year kicked in from October 2016 onwards
- ✘ The company is claiming to fund the Galaxy reboot out of cashflows from Botswana without explaining how this meshes with debt repayment requirements
- ✘ Negotiations on buying yet another troubled asset in South Africa have come to our attention

**Tumbling Dominos**

Immediately after the end of the June quarter the company came out with a surprising announcement of its production numbers for that quarter. This is not something it had done in recent memory and it was clearly an attempt to juice up the stock in light of numbers that were ostensibly better than many had been expecting. When the end of the September quarter passed and there was an ominous silence that dragged on and on, shareholders started to believe that production had taken a turn for the worse. For the third quarter there was no production announcement until investors got to see the Management Discussion & Analysis in recent weeks. Their fears were justified with a 20% plunge in production and operating losses soaring again.

We could see now why the company did not want these numbers in circulation any earlier than they are legally obliged to release them as a perilous confidence house of cards is built upon the premise that the trend has turned for the better. The sequence is:

- ➢ With South African expansion being funded out of cashflow, investors and the market need to think cashflow is rising, which as we have seen it is not

- ➢ If there is not enough cashflow to complete the Galaxy Mine then management will need to tap shareholders

- ➢ Even worse though, investors have been told that the company can both fund expansion AND meet the resurgent debt repayment schedule that reactivated from early Q4 of 2016

- With losses on the rise and gold in decline (and production in Botswana clearly past its peak) the company is staring at a cashflow crunch that requires either a financing, stopping mine development or a further debt restructuring/moratorium

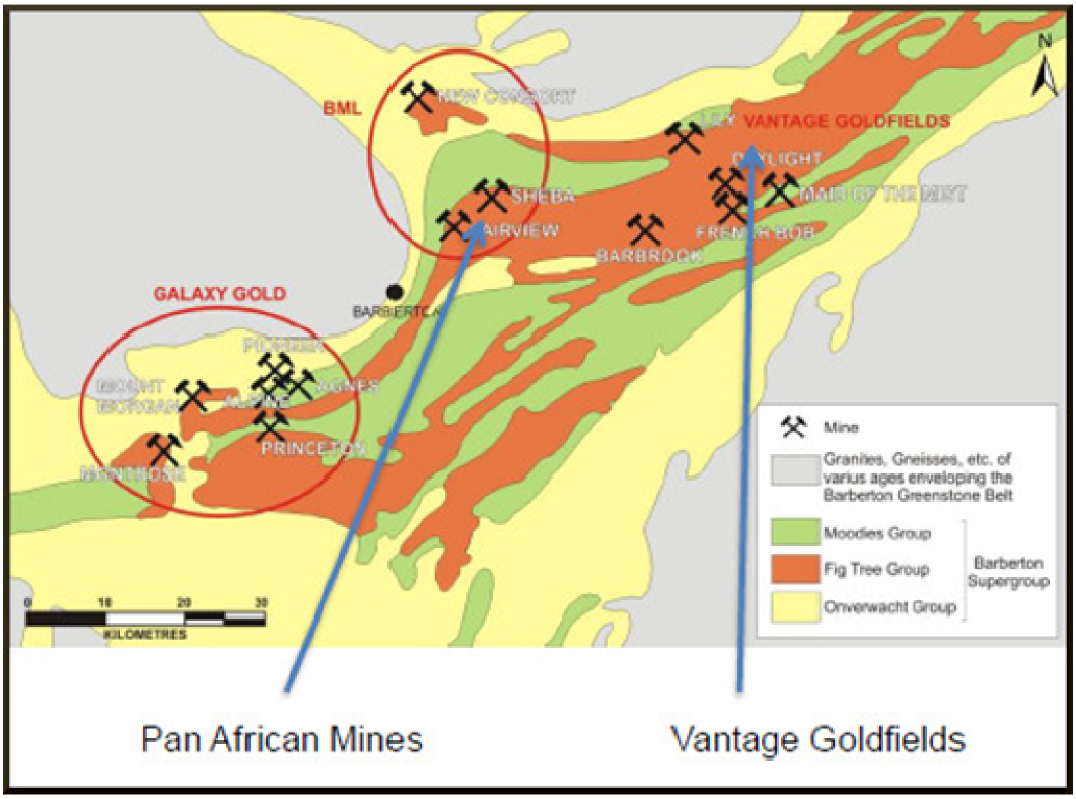
- Then the question is begged of how the company would fund taking on another troubled mine in South Africa (see later in this note)

- Any of these three outcomes has the potential to knock the share price closer to our three cent target price

To add to the misery in the share price a director departed and dumped his stock on the market. Not being an insider he no longer was required to hold off from selling and massive volume knocked the stock from its recent highs, sending it to its recent lows.

**Vantage Goldfields**

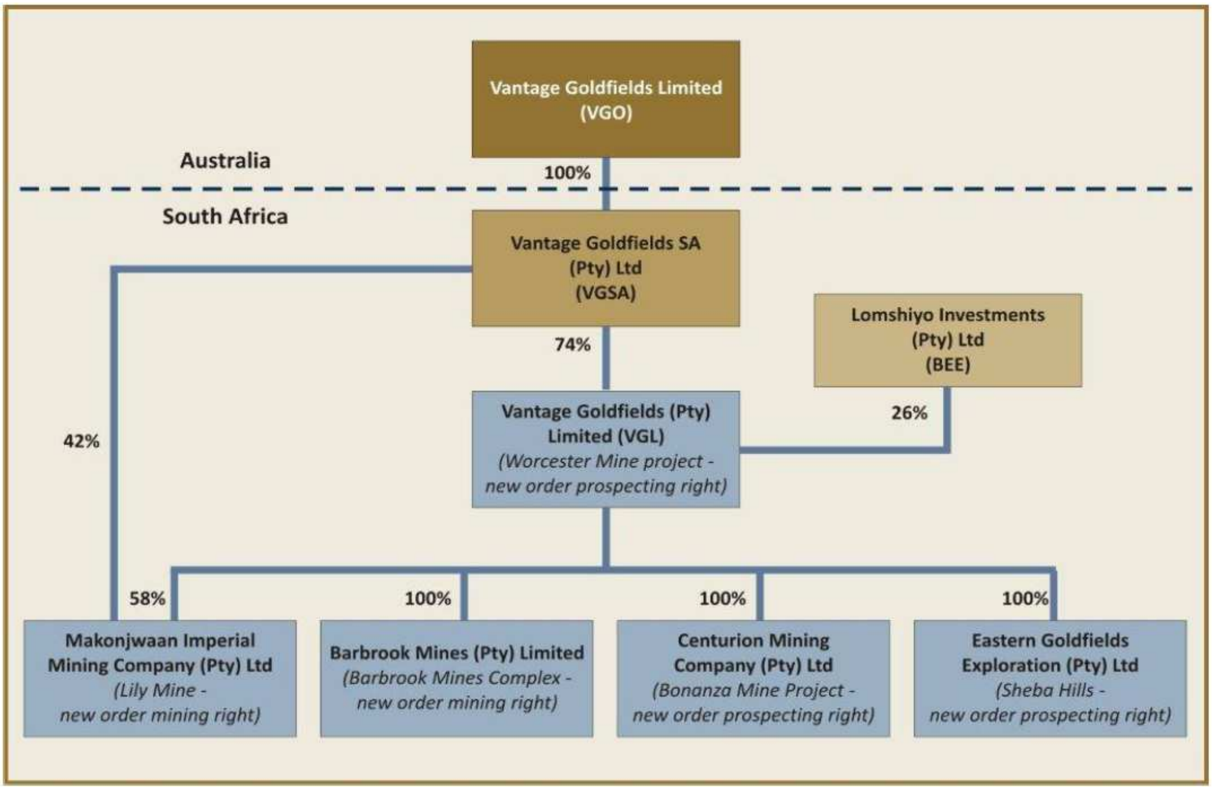
Jungle drums are rarely heard in Barberton, because it's not jungle in any case. However, whatever the source, vibrations are suggesting that a stealth takeover of a delisted ASX entity called Vantage Goldfields is being contemplated. This ill-starred entity (a Galane specialty – as it is ill-starred itself) was delisted from the ASX in late 2014 through a strange selective capital return to shareholders which left a core group of pre-existing shareholders in what was now a delisted entity.



The company would no doubt claim "nothing to do with us" but a glance at a map in the company's April 2016 presentation (on preceding page) shows that Vantage Gold's holdings are highlighted in a map despite the fact that they neither border the Galaxy assets nor are they particularly near (over 50kms away). The point being?

Vantage's mining rights cover the Lily Mine and Barbrook Mines Complex (including the Taylors Mine). Its prospecting rights cover some 16,000 ha of greenstone terrain containing known gold deposits and other exploration targets. These mineral rights surround the central core of the Barberton Goldfield where Pan African Resources plc currently produces some 100,000 oz/annum from three mines (Sheba, Fairview, New Consort).

When we refer to this as ill-starred we primarily are referring to the mine accident at the Lily mine and then subsequent collapses, including a fatal sinkhole, which was topped off by the subsidiary going into administration. From what we can gather Galane is not in pursuit of all of Vantage but rather trying to get its hands on the assets in receivership.




The Lily Mine started as an open pit operation in 2000 and continued as such until 2008, when underground operations commenced. An extensive drilling program identified a Mineral Resource of 1.9 million oz. of gold in a shallow wide ore body. The independent bankable feasibility study completed in 2008 identified mineable ore reserves of 0.35 million oz. of gold.

Gold production was quickly ramped up to 25,000 oz. pa with 27,231 oz. produced last year in 2015. Future production is estimated at 30,000 oz. per year for the next 11 years.

Unlike most labour intensive mines in South Africa, the Lily Mine is a fully mechanised operation employing some 500 skilled and semi-skilled personnel. This is possible because of the wide nature of the ore body which allows large trackless mining machinery to be utilized underground.

Virtually the entire labour force is sourced from the local community and most people reside within 20 km of the mine. The labour force is unionised and AMCU has 100% representation at the semi-skilled and unskilled level. There has, according to Vantage, long been a good working relationship between management and the union.

The underground ore (approximately 30,000 tonnes per month when functioning) was hauled to the Central Metallurgical Complex (CMC) for processing. The processing plant is a conventional gold process using crushing, milling, CIP and gold recovery to produce bullion bars. Gold is transported by helicopter on a regular basis to Rand Refinery in Germiston for sale.

**The Disaster**

On 5 February 2016 a *force majeure* event occurred at the Lily Mine forming a massive sinkhole. It is thought that a portion of the crown pillar on 4 Level failed causing a collapse which occurred at the upper western portion of the mine and adjacent to the main entrance to the mine. All employees working underground at the time of the incident were evacuated according to normal mine safety procedures, however three surface employees were buried in the sinkhole (pictured below) and are still missing.

Mine Rescue Services were deployed and the employees of Vantage's subsidiary, with the assistance of the proto teams, spent the next eight days in a desperate attempt to rescue the missing employees. Rescue operations were conducted from the emergency outlet shaft but were suspended when ground conditions were declared unsafe. A new rescue hole was drilled in an attempt to provide a safer second outlet. A decision was later made to permanently suspend rescue operations in the interest of safety.

A comprehensive assessment of the entire mine was undertaken and, given that the main entrance to the mine was totally inaccessible, the mine came to a complete standstill and thus was unable to access its ore reserves. This state of things is what forced the operating subsidiary into administration in April of 2016.

The last news out of the company on this situation was in September when the receivers issued a press release stating that, after a frustrated inspection attempt of the state of the underground workings, a collective decision was made, between Mine Management, the Union and Mine Rescue Services to abort the attempts to inspect the localised geological conditions underground. A plan to develop a new decline remains in place. This is sited 400m from the disturbed area and, according to the receiver, represents the best option to access the underground workings safely. Plans to implement this were said to remain on track. In the short term some reworking of old mine dumps was going on but the vast bulk of employees had departed.

**Reading the Tealeaves**

If the intelligence from South Africa is good then Galane is "up to something" with Vantage. Donald Trump may be famous for the "art of the deal", but we (and investors) have seen precious little evidence that Galane management is artful in their deals, nor are they much good when they stick to their knitting, i.e. mining.

Galane would not be the first party to have kicked the tyres here since the disaster. In October the Receivers made mention of their frustration with Vancouver group, Afrocan, which were to have injected R11 million into the troubled entity.

The grapevine claims that now Galane might be engaged in an attempt to snap up the debt of either Vantage or, more likely, its stricken subsidiary. That begs the question of "with what money?". Galane scarcely has cashflow to meet its current obligations let alone be funding new ones.

**Latest Results**

It is typical of the "luck" of Galane that it's best recent quarter for production volume coincided with a high gold price. While gold held up in Q3 production did not. Now with gold off the boil and volumes tumbling, as always, the combination accentuates the negative at this hapless company.

The company's small net result for the June quarter turned out to be a flash in the pan with the third quarter showing a plunge to a loss of $1.59mn. Considering how strong gold was in that period, this is disappointing and a reflection of the steep drop-off in ounces produced (and sold).

## Galane Gold

**In Millions of USD**

| | FY17e | FY16e | 4Q16e | 3Q16 | 2Q16 | 1Q16 | FY15 | 4Q15 | 3Q15 | 3Q15 | 1Q15 | FY14 | FY13 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Mine Revenue | 47.75 | 32.64 | 7.55 | 8.40 | 9.34 | 7.35 | 26.23 | 6.76 | 8.533 | 5.173 | 5.76 | 40.46 | 53.82 |
| Cost of Mine Revenue | 43.67 | 32.77 | 8.10 | 8.39 | 8.12 | 8.16 | 34.45 | 11.04 | 8.565 | 7.744 | 7.10 | 35.98 | 60.28 |
| Gross Profit | 4.08 | -0.14 | -0.55 | 0.01 | 1.22 | -0.82 | -8.22 | -4.28 | -0.032 | -2.571 | -1.34 | 4.49 | -6.46 |
| Selling/General/Admin. Expenses | 2.90 | 2.14 | 0.52 | 0.64 | 0.47 | 0.51 | 2.26 | 0.62 | 0.516 | 0.547 | 0.59 | 2.51 | 2.81 |
| Exploration | 0.18 | 0.028 | 0.008 | 0.006 | 0.007 | 0.007 | 0.115 | 0.01 | 0.029 | 0.045 | 0.036 | 0.12 | 0.17 |
| Depreciation/Amortisation | - | - | | | | - | - | - | - | - | - | - | - |
| Interest Expense (Income) | 1.16 | 0.59 | 0.26 | 0.23 | 0.22 | -0.12 | 0.69 | 0.53 | 0.17 | 0.14 | -0.14 | -0.58 | - |
| Unusual Expense (Income) | 0.00 | 0.00 | | | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 17.82 |
| Forex costs (gain) | 1.50 | 1.73 | 0.35 | 0.91 | 0.00 | 0.47 | -3.02 | -2.52 | -0.38 | 0.01 | -0.13 | | |
| Other Operating Expenses | 1.23 | 0.53 | -0.15 | -0.197 | 0.421 | 0.45 | 0.245 | -0.02 | 0.271 | -0.005 | 0.00 | 0.56 | 1.08 |
| Total Operating Expense | 50.64 | 37.79 | 9.09 | 9.98 | 9.24 | 9.49 | 34.74 | 9.64 | 9.17 | 8.48 | 7.45 | 38.58 | 82.15 |
| Operating Income | -2.89 | -5.16 | -1.54 | -1.58 | 0.10 | -2.14 | -8.51 | -2.88 | -0.64 | -3.31 | -1.69 | 1.88 | -28.33 |
| Gain (Loss) on Sale of Assets | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0.02 |
| Income Before Tax | -2.89 | -5.16 | -1.54 | -1.59 | 0.10 | -2.14 | -8.51 | -2.88 | -0.64 | -3.31 | -1.69 | 1.88 | -26.97 |
| Tax | 0.00 | 0.00 | 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 | -2.89 | -5.16 | -1.54 | -1.59 | 0.10 | -2.14 | -8.51 | -2.88 | -0.64 | -3.31 | -1.69 | 1.88 | -28.78 |
| Minorities | -0.26 | -0.56 | -0.26 | -0.30 | | | | | | | | | |
| Diluted Weighted Average Shares | 142.63 | 142.63 | 142.625 | 142.618 | 112.065 | 71.314 | 54.90 | 53.4 | 52.837 | 52.823 | 52.82 | 54.584 | 50.36 |
| Diluted EPS | -0.020 | -0.036 | -0.011 | -0.011 | 0.001 | -0.030 | -0.155 | -0.054 | -0.012 | -0.063 | -0.032 | 0.034 | -0.571 |
| | | | | | | | | | | | | | |
| Estimated Av. Au Price | $1,275 | $1,280 | $1,240 | $1,328 | $1,260 | | $1,148 | | | | | $1,190 | |
| Ounces Au produced | 38,200 | 25,896 | 5,970 | 6,243 | 7,855 | 5,828 | 24,321 | 6,825 | 7,637 | 4,829 | 5,030 | 30,791 | 31,586 |
| Ounces Au sold | | | | 6,326 | 7,378 | 6,191 | 24,205 | 6,484 | 7,483 | 5,098 | 5,140 | | |

Our earning model is showing a similar loss in the fourth quarter with lower gold and lower ounces. This augurs for a net loss of $1.54mn though it could actually go higher. For FY16 the net loss would be $5.16mn or 3.6cts per share. This is equivalent to more than half the current price per share.

In a most charitable scenario the company might lose $2.89mn in FY17, but as the company has shown in the past such a propensity for SNAFUs this might be be an overly generous prediction as South Africa is reputedly already having problems in the pre-operation phases.

**Conclusion**

Not having delivered profitable production in Botswana and still to get the Galaxy Mine working, the company is seemingly now off after a third mine, and a troublesome one at that. Shareholders here are sure getting a punishing ride. The brutal dilution of the rights issue suited some people, then Galaxy diluted the shares on issue further. Is it no coincidence that the stock price wallows in the single digits and is headed lower? With any luck the Lily Mine will prove to be the “one that got away”.

The mania to “expand out of its problems” has not worked for Galane so far and shall now be compounded by the low gold price and the debt mountain and the immediacy of its repayment.

A rising gold price can cover a multitude of sins but when the price of the yellow metal dropped below $1,200 it left Galane’s management stripped of their last figleaf and that it is not a pretty sight.

The debt issue is the most critical though. The company told markets that it was in good shape to meet the resumption of a fairly hefty repayment (and interest) schedule from the beginning of the fourth quarter of this year. Then the gold price fell, its production slipped, its revenues tumbled and problems ensued at Galaxy (raising costs of reviving that out of “cashflow”). This must raise questions now about the potential for a cash-flow crisis.

We repeat our dim view of this story and we have a **Short** position in Galane Gold in the Model Mining Portfolio and reiterate our 12-month target price of CAD$0.03.

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## Important disclosures

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60 Madison Ave, 6th Floor, New York, NY, 10010