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Hallgarten & Company

Coverage Update

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Gammon Gold (AMEX:GRS, TSX: GAM)
Strategy: Short

Key Metrics	
Price (USD)	$ 12.20
Price (CAD)	$ 12.80
12-Month Target Price (CAD)	$ 8.00
Upside to Target	-34%
12mth hi-low (CAD)	$2.88-$13.19
Market Cap (CAD mn)	$ 1,734.4
Shares Outstanding (millions)	135.5

	FY08	FY09e	FY10e	FY11e
Consensus EPS		$0.17	$0.73	n/a
Hallgarten EPS		($0.01)	$0.28	$0.27
Actual EPS	$0.33			
P/E	36.9	n/a	43.9	46.0
Dividend	0.00	0.00	0.00	0.00
Yield %	0%	0%	0%	0%

Gammon Gold

A mediocre silver story in golden garb

- ✘ Another quarter of negative results in a booming gold/silver market…ugh!
- + Earnings should return to the black on production/mining process improvements but after so many slip-ups in the past there is no assurance that the company will not be "mugged by circumstances" yet again.
- + A recent capital raising gave the company over $100mn in its war chest, with a price of even further dilution
- + The company recently ousted its President and an associated director
- ✘ Gammon is highly dependent upon silver credits despite a slight gold predominance in its resources and production
- ✘ It has a high cash cost per gold equivalent ounce, in the last reported results, of $500, this is an improvement from the almost incredible $755 of one year ago
- ✘ The price of ousting ineffective management was high with an $8.4mn hit in Q3 to pay off the departing President. This wiped out the company's meager profit for the quarter and sent it to a substantial loss.
- ✘ Gammon lost truckloads of money in recent years and was able to produce its best performance (in 4Q08) only because of forex gains
- ✘ The El Cubo mine is a "minor producer" by anyone's definition with a very small M&I resource
- ✘ Gammon is trading at a P/E of around **41 times** FY10 earnings
- ✘ The company is well-positioned to try another merger but with its poor operating performance it would be hard to make a case that it was bringing anything more than cash to the table.

Interesting projects

Gammon Gold is a Nova Scotia-based mid-tier silver and gold producer. Its flagship property is the Ocampo mine in the state of Chihuahua in Mexico, which began commercial production in January 2007. The company also operates the El Cubo operation in the state of Guanajuato and also has the Guadalupe y Calvo development property in Chihuahua. Originally called Gammon Lakes Resources, it had its origins exploring in Canada. In August 2006 the company merged with Mexgold Resources in a combination that took it to a market cap of CAD$1.8bn (at that time). This transaction brought on board the El Cubo mine and the development property.

At the time the company expected to reach 400,000 gold equivalent ounces at full production (currently just over 200,000 ozs with little prospect of nearing the larger number) and a cash cost per equivalent oz of around US$200 (a pipedream indeed in light of subsequent experience).

Attempts at further expansion have been thwarted with the failed Capital Gold bid being the most recent attempt.

Gammon Gold is 100% unhedged.

Mutton Dressed up as Ham

The foolhardy rush in the direction of anything that has the word "gold" in its name these days. Mexico is a gold producer but for hundreds of years it has been better known as a silver producer and most of the major mines in Mexico are silver plays. Dare we say it but Gammon also fits into that category.

The table below shows the total resource at the current time for Gammon. Frankly the gold equivalent measured and indicated of well under a million ounces is not what one would expect from a company with a market capitalization of CAD$1.5bn. And when it comes with such a problematic and unprofitable past profit (and high cash cost) profile it looks even more underwhelming.

Mineral Category	Gold (g/t)(6)	Silver (g/t)(6)	Gold Equivalent (g/t)(6)	Tonnes (000's)	Gold Ounces (000's)	Silver Ounces (000's)	Gold Equivalent Ounces (000)(2)
Summary - Measured & Indicated							
Total Measured	0.30	14	0.54	12,728	121	5,604	223
Total Indicated	0.57	15	0.84	17,901	329	8,461	483
Total Measured & Indicated	0.46	14	0.72	30,629	450	14,065	706
Summary - Inferred							
Total Inferred	1.85	81	3.33	47,888	2,854	125,274	5,130

Gammon is clinging onto its "gold" moniker by the fingernails. The ratio of gold ounces to silver ounces in the inferred resource is 44 times while the current gold/silver ratio is 64 times. Not quite dominated by silver but Gammon's gold production is not high enough, and its cash costs not low enough for the company not to be silver dependent. It is also interesting to note that the Inferred grades are way above the M&I grades which might suggest that the company will never be able to extract anything like the amount of the Inferred resource if the production grades continue to undershoot the theoretical Inferred grades.

Ocampo –technically challenging

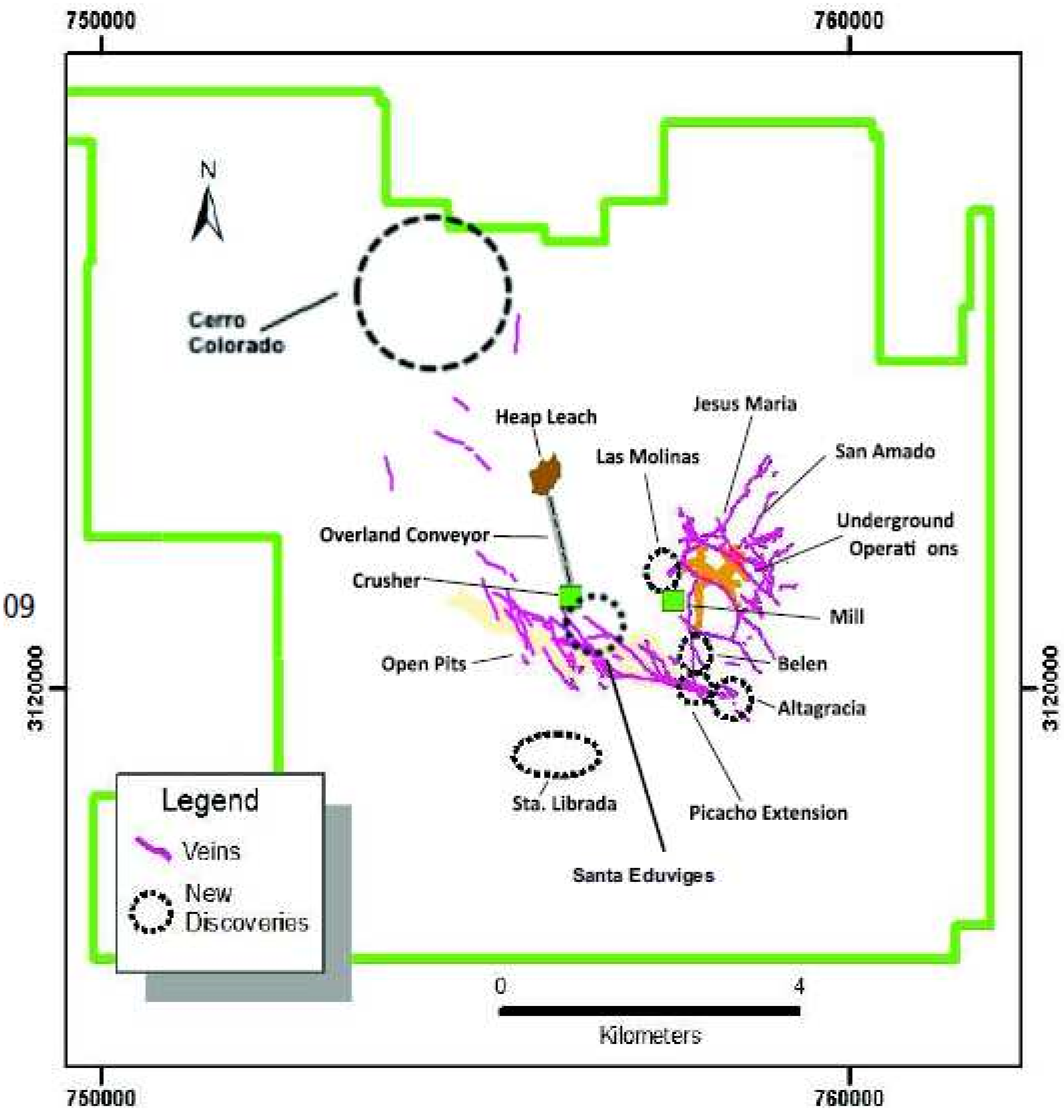
Gammon's main asset is it 100% interest in the Ocampo gold-silver project, located in the historically prolific Sierra Madre Occidental.

The Ocampo mining district has been producing old and silver for over 150 years. Gammon first became active in the area when foreign ownership restrictions were lifted in the late 1990's and has been actively exploring the area since 1999.

The property covers more than 12,000 hectares. Gammon's mine is currently one of the largest operating gold/silver mine in the state of Chihuahua and is comprised of both an open pit and an underground mine with milling and crushing/heap leach processing facilities.

The project area is dominated by Lower Volcanic Group rocks, consisting of massive andesitic flows and tuffs. Localized beds of volcanoclastic sediments are also present. Toward the top of this group, the volcanics become more felsic. This group of rocks is host to the majority of the silver and gold deposits exploited thus far in the SMO. UVG rocks are comprised of felsic ignimbrites, tuffs, flows and volcanoclastics. Overall, there is a northwest trending structural fabric best evidenced by the alignment of the numerous mining districts found in the SMO.

Ocampo is a classic gold-silver epithermal mining district. In general, Ocampo can be broken into two major structural areas, the Northeast area ("Northeast Area") and the Plaza de Gallos Refugio trend ("PGR Trend") that extends from Altagracia in the southeast to beyond La Estrella in the west. The mineralogy and alteration present in both the PGR and the Northeast Ocampo project area are indicative of low sulphidation, quartz-adularia type epithermal systems.



The Ocampo property is shown in the map above. The facilities are strewn over quite a wide area and this is one of the shortcomings of the project. The underground operations are shown in orange and they exploit the spiderweb of veins to the northeast. The open pit is along the network of purple veins more to the south. Curiously the company is talking of the Sta Eduviges find in the pit area being an underground mine while it is talking of the Las Molinas find in the underground mining area being an open it. More on these later.

Ocampo Measured, Indicate & Inferred Resources(3)(4)(5)(7)(8)(10)

Mineral Category	Gold (g/t)(6)	Silver (g/t)(6)	Gold Equivalent (g/t)(6)	Tonnes (000's)	Gold Ounces (000's)	Silver Ounces (000's)	Gold Equivalent Ounces (000)(2)
Open Pit Area(9)							
Measured	0.18	7	0.30	12,174	72	2,625	119
Indicated	0.22	7	0.35	15,285	107	3,684	173
Total Open Pit Area Measured & Indicated	**0.20**	**7**	**0.33**	**27,460**	**178**	**6,309**	**293**
Inferred	**0.62**	**16**	**0.91**	**27,734**	**553**	**14,278**	**812**
Underground Area							
Measured	2.94	197	6.52	393	37	2,495	83
Indicated	2.16	84	3.68	301	21	810	36
Total Underground Measured & Indicated	**2.60**	**148**	**5.29**	**694**	**58**	**3,305**	**118**
Inferred	**4.44**	**258**	**9.12**	**5,573**	**796**	**46,166**	**1,634**
Summary - Total Measured & Indicated							
Total Measured	**0.27**	**13**	**0.50**	**12,568**	**109**	**5,120**	**202**
Total Indicated	**0.25**	**9**	**0.42**	**15,586**	**127**	**4,494**	**209**
Total Measured & Indicated	**0.26**	**11**	**0.45**	**28,154**	**236**	**9,614**	**411**
Summary - Total Inferred							
Total Inferred	**1.26**	**56**	**2.28**	**33,307**	**1,349**	**60,443**	**2,447**

The table above shows the resource at Ocampo, which is not NI 43-101 compliant. Key takeaways here are that the company is talking about producing 80,000 ozs of gold equivalent per quarter and only has a measured and indicated resource of around 400,000 ozs, implying a mere five quarters of production.

While both the contained gold and silver bottom line numbers look substantial the grades are not and therein lies the rub. Low grades mean higher cash costs for extraction and there is almost no other way around that tough reality. One could work up some sort of argument that the silver grade doesn't matter but in reality it does, because the gold would not be worthwhile without the sheer proliferation of silver at the site. The gold grade is not enough to justify a meaningful mine on its own. There is also a very strong preponderance towards the inferred resort at the current time.

The underground mine

The company is in the midst of a seven-month development program, which has brought two more longhole drills into operation. The mine is currently producing from eight working stopes a substantial increase from the three working stopes at the start of the current year. This will bring the underground mine to an expected output of 1,200 tonnes per day by year-end.

The result of this expansion in stoping is that it claims to now have access to a drill ready inventory of 245,000 tonnes of ore versus inventory of only 70,000 tonnes at the beginning of 2009. It expects to have access to 345,000 tonnes by year-end. The upshot of all this is that the increased production will augment existing mill feed grades and heap leach stacking grades.

This underground mine should be put into a broader context though for in September production per day was running at 676 tonnes per day compared to 96,677 tonnes per day from the open pit mine. This scarcely makes the underground pit worth the effort particularly when the company reports that the grades at the underground mine are even lower than those of the open pit.

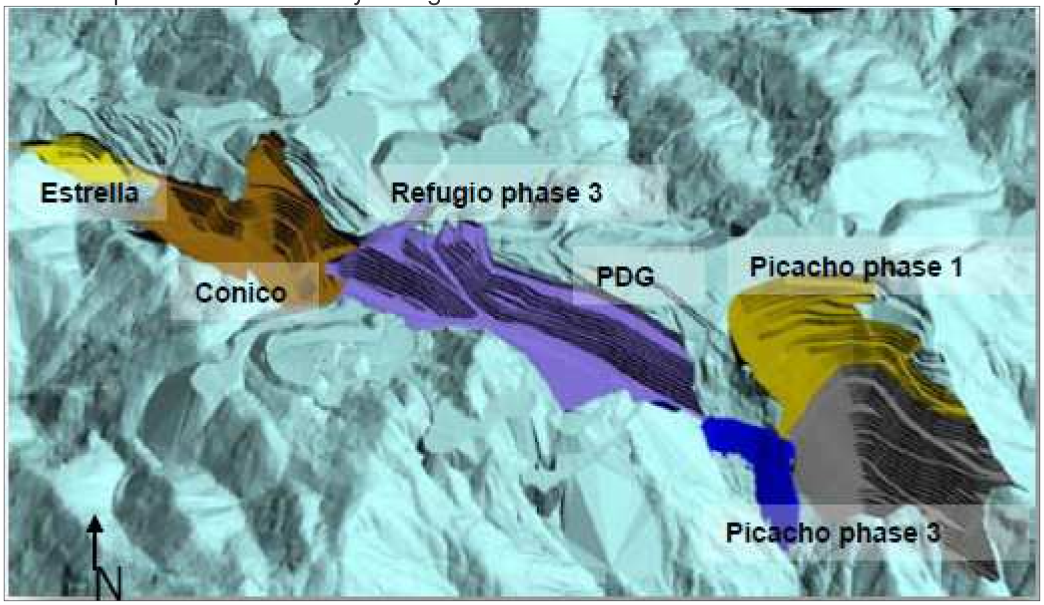
The company claims that exploration at the Santa Eduviges target indicates strong potential for second underground mine. The drilling program at this target included one hole reporting over 9.0 metres of 14.57 grams per tonne gold equivalent. The company feels that, given the ongoing drilling success to date, an additional 5,900 metres of drilling has been added to the original 4,380 metre program and an additional diamond drill was mobilized in October.

The open pit operation

This is the principal mining mode at the project. The nature of the vein systems have lent themselves to elongated open pits which shall eventually become one long open pit. The map on the following page shows the various pit regions.

Investment in recent quarters is claimed to have produced a more than 50% improvement in daily tonnage mined with 20% haulage fleet on standby. In cash cost terms one of the most tangible developments is that Ocampo is now connected to 20 megawatts of electrical grid power (as of July 15, 2009) and thus is now powered off the Mexican grid network. The access to grid power is expected to provide significant energy savings of approximately US$20-25 per gold equivalent ounce

The Refugio Phase 1 is currently in production with more than 80% of ore is mined from this phase. Recent improvements have led the company to project that production in Q4 of 2009 will be around 80,000 ozs of Au equivalent (compared to 51,000 ozs in 3Q09). This is a substantial boost. Time will tell though we suspect it will be closer to 65,000 ozs. To put this into perspective it takes the company back to where production was one year ago.



The company is also projecting a cash cost per oz of $380-$400 (compared to $500 in the preceding quarter). This is a quantum reduction and also remains to be seen. It is not clear from the minor improvements the company has made as to why such a dramatic improvement in costs should be the outcome.

The evolution plan for the pit sequence is that the Plaza de Gallos pit will connect Refugio and Picacho, thereby reducing the distance to the crusher by the end of 2009. The Picacho Phase 1 and 2 pits lie to the west of the structure.

- Picacho Phase 1 is currently pre-stripping waste
- Picacho Phase 2 will access the VHG area with a switchback connection
- The pits that have not been mined in 2009 include Conico/Estrella/Refugio Phase 3 (final pit) and Picacho Phase 3 (final pit)

The main hope for extension of mine life is that early exploration indicates that Las Molinas could be a sixth open pit at the complex, this would not be part of the super-pit as it is located away to the northeast.

El Cubo – the second mine

The El Cubo-Las Torres Mine complex is located in the village of El Cubo, which is approximately 10 kilometers east of the city of Guanajuato and is the capital city of the State of Guanajuato, Mexico. El Cubo is located in an arid, mountainous region at an elevation of 1,996 meters above sea level.

This underground mine is a legacy of the Mexgold takeover as that company has acquired, in 2004, a 100% interest in the property, consisting of 58 exploitation and exploration concessions that cover 8,500 hectares. El Cubo leases the Las Torres Mine complex, that is adjacent to the El Cubo Mine, from a subsidiary of Industrias Peñoles.

El Cubo is situated in the Guanajuato mining district, an area encompassing 20 kilometers x 16 kilometers. The eastern part of the Guanajuato mining district, where El Cubo is located, is underlain by a volcano-sedimentary sequence of Mesozoic to Cenozoic age rocks.

The veins at El Cubo are not rock type specific. The principal host rocks for the ore shoots are the Guanajuato Conglomerate for the lower ores and the Bura Rhyolite for the upper ores. The mineral deposits in the El Cubo area are all related directly to faults. The deposits occur as open-space fillings in fracture zones or impregnations in the locally porous wall rocks. The veins formed in relatively open spaces are the main targets for mining.

Source: Gammon Gold

In early October Gammon announced that it had reached agreement, with Peñoles on the lease renewal for an additional three-year term. This lease provides Gammon with the mining rights and use of the Las Torres processing and administration facilities located at Gammon's El Cubo Mine. In 2008, all processing and administration at our El Cubo mine was consolidated to the lower cost, higher capacity Las Torres mill.

The renewal of the Peñoles lease, combined with the adoption of a 7-day continuous work schedule will allow Gammon to continue to benefit from the enhanced economics of the Las Torres mill. As the Company drives improved productivities at its El Cubo operations it can leverage the additional processing capacity available at Las Torres.

The table below shows the resource at the El Cubo property and the leased Las Torres property. Its is not clear from information available if the Las Torres mining resource is actually at the disposal of Gammon under the lease agreement which appears to be more oriented towards utilization of the processing facilities. In any case the M&I resource at El Cubo is the main thing to focus upon and it is not exactly inspiring. This appears to be another of those “mine it and be surprised”-type of operations where drilling or further exploration is combined with the mining effort. This is sometimes a felicitous strategy with open-cut mining but underground, as here at El Cubo, it can be very hit-and-miss (quite literally). Somewhat akin to looking for a light-switch in the dark in a house one has never been in before.

The measured and indicated resource is feeble indeed. It is only on the basis of the inferred resource that anyone would continue with this effort. Even then the Inferred resource does not exactly look packed with potential either. No wonder Peñoles are happy to leave this asset to others to dither around with.

El Cubo Measured, Indicate & Inferred Resources(3)(4)(5)(7)(10)

Mineral Category	Gold (g/t)(6)	Silver (g/t)(6)	Gold Equivalent (g/t)(6)	Tonnes (000's)	Gold Ounces (000's)	Silver Ounces (000's)	Gold Equivalent Ounces (000)(2)
El Cubo							
Measured	2.38	94	4.09	160	12	484	21
Indicated	2.61	95	4.34	215	18	659	30
Total El Cubo Measured & Indicated Resources	**2.51**	**95**	**4.23**	**375**	**30**	**1,143**	**51**
Inferred	**4.84**	**220**	**8.84**	**2,343**	**364**	**16,605**	**666**
Las Torres							
Measured	-	-	-	-	-	-	-
Indicated	-	-	-	-	-	-	-
Total Las Torres Measured & Indicated Resources	-	-	-	-	-	-	-
Inferred	4.53	186	7.91	438	64	2,626	112
Phoenix Pit							
Measured	-	-	-	-	-	-	-
Indicated	2.72	49	3.61	2,100	184	3,308	244
Total Phoenix Pit Measured & Indicated	**2.72**	**49**	**3.61**	**2,100**	**184**	**3,308**	**244**
Inferred	-	-	-	-	-	-	-
Summary - Measured & Indicated							
Total Measured	**2.38**	**94**	**4.09**	**160**	**12**	**484**	**21**
Total Indicated	**2.71**	**53**	**3.68**	**2,315**	**202**	**3,967**	**274**
Total Measured & Indicated	**2.69**	**56**	**3.70**	**2,475**	**214**	**4,451**	**295**
Summary - Inferred							
Total Inferred	**4.79**	**215**	**8.70**	**2,781**	**428**	**19,231**	**778**

The company claims that the renewal of the lease of the Las Torres mill allows the El Cubo operations to benefit from the lower processing costs while Gammon gains operational benefits from a continuous work schedule. As it gains additional production at the El Cubo mine, the company will be able to process this ore at the Las Torres plant. Moving towards this continuous work schedule (i.e. seven day work week) has been an uphill struggle as the company ran into strike action back in late April (which ran to mid-June) with the miner's union. The company decided to tough it out as El Cubo was substantially higher cost to operate than Ocampo (yet represented 21% of the company's forecast 2009 production).

Eventually this strike was settled and the miners agreed to the new schedule but the company also agreed to an 8% increase in basic wages and a 3% increase in benefits representing, approximately, a 3.5% increase in total payroll costs.

The Exploration Play

Gammon's main exploration prospect consists of five mining titles totaling around 669 hectares in the formerly producing Guadalupe y Calvo district located high in the Sierra Madre Occidental. This asset was inherited with the Mexgold acquisition in 2006. Historic production at the Guadalupe Project has been estimated at 2-million ounces of gold and 28-million ounces of silver, grading 37g/t gold and 870 g/t silver. A report on the project was prepared by Pincock Allen & Holt in November 2002. The inferred mineral resource at this project currently stands at 1.08 million ounces gold and 45.6 million ounces of silver from immediately accessible zones.

Mexgold undertook, in early 2004, an initial ten-hole drill program at Guadalupe. In this program, seven out of ten wide-spaced drill holes bracketing the project area returned significant gold/silver results. This included drill hole GC-6 grading 11,092 grams (11.09 kilograms, or 357 ounces) of silver per tonne over two metres (6.5 feet). This interval was contained in a larger zone of 25.5 metres grading 1.16 grams per tonne gold and 961 grams per tonne silver for a gold-equivalent grade of 15.9 grams per tonne. Other results included gold-equivalent grades of up to 9.1 g/t over five metres, and 39.6 g/t over one metre, for an average gold-equivalent grade of 21.4 g/t over intervals averaging 3.3 metres at a +3.0 g/t cut-off.

Guadalupe y Calvo Estimate of Inferred Resources(3)(4)(5)(7)(10)

Deposit Location	Gold (g/t)(6)	Silver (g/t)(6)	Gold Equivalent (g/t)(6)	Tonnes (000's)	Gold Ounces (000's)	Silver Ounces (000's)	Gold Equivalent Ounces (000)(2)
Rosario Bulk Tonnage (at 75% of available tonnes)	1.60	96	3.39	10,700	566	33,100	1,167
Rosario Underground (at 33% of available tonnes)	18.50	435	24.89	700	393	9,200	560
Rosario							
Total Rosario Inferred	**2.64**	**117**	**4.71**	**11,400**	**959**	**42,300**	**1,727**
Nankin Underground (at 33% of available tonnes)	9.25	260	13.84	400	118	3,300	178
Nankin							
Total Nankin Inferred	**9.25**	**260**	**13.84**	**400**	**118**	**3,300**	**178**
Summary - Inferred							
Total Rosario and Nankin Inferred	**2.84**	**120**	**5.02**	**11,800**	**1,077**	**45,600**	**1,905**

The resource as it stands on the development property does not inspire great confidence. One almost wonders why a company of Gammon's market capitalisation is fooling around with assets like this when it is now cashed up and its stocks price (for better or worse) gives it a currency to acquire stressed players. The Nankin underground resource is of such diminutive size that reminds us of Linda Evangelista's purported comment that she "didn't get out of bed for less than $10,000 per day". Any respectable miner with Gammon's market capitalisation should say the same of Guadalupe y Calvo. This project is very silver dependent because the gold is almost not worth talking about and certainly not viable without heavy silver credits.

The aforementioned renewal of the lease on the Las Torres processing facilities provides Gammon with the flexibility to consider moving the other El Cubo mills that are currently on care and maintenance to the Guadalupe y Calvo exploration property to accelerate the development strategy. At least this would represent a saving in kick-starting this operation. Interestingly a scoping study was supposed to be ready in 1Q09 and is now talked about as "resuming in 2010". What is so difficult about getting a scoping study done?

Production – non-linear

The table below if given to a non-mining investor who was then asked to comment upon it would most probably generate an analysis of terminal decline and mediocre cost management. We all know the gold and silver prices fluctuate and there is virtually nothing the companies can do about this, but Gammon Gold's cost controls are a totally different matter. They are quite literally all over the place. The recent $500 per oz cash cost was lauded by the company but frankly puts the company back to where it was six quarters before. Costs are seemingly out of control at the company and no adequate explanation can be given for this. In fact is there another "major" gold miner that operates under such a wildly oscillating cost structure?

Gammon Production	3Q09	2Q09	1Q09	Q408	3Q08	2Q08	1Q08	Q407	3Q07	2q07	1Q07
Gold ozs	31,537	31,115	36,829	43,768	34,096	43,465	33,099	27,571	26,444	32,246	35,126
Silver ozs	1,265,645	1,116,067	1,351,300	1,649,893	1,372,123	1,484,763	1,310,971	1,140,797	1,115,233	1,357,708	1,421,966
Gold equivalent ozs	51,047	47,123	54,480	64,889	57,521	71,154	57,946	48,184	47,091	59,312	64,147
cash cost per au oz.	$500	$453	$430	$384	$757	$501	$491	$676	$764	$702	$575

The production levels of gold have deteriorated since early 2007. In two quarters since then they were able to beat the starting production but gold output has been all over the place, like the cash cost. There is little linearity to Gammon's business. Silver production is likewise highly irregular. Well may we ask whether the latest expenditure of capex in expanding production at the mill, pad and pits will do any more than take the company back to its recent peak production. That is a rather disappointing prospect as the company has scarcely made money, and frequently lost money, in some of its best quarters.

Hold onto your Tin-Foil Hats..

We should add a few words on silver, one of our personal *bêtes noires* when it dares to rise above $15. At the moment the Holy Grail for silver "bugs" is to see silver back at the ratio that was "established" when gold crossed $1000 in early 2008 and silver briefly hit $22. It was like all their Christmases had come at once. Since then disappointment has been their daily meal. When gold retreated to $650 last October silver was back under $10 which was like being blasted back to the Dark Ages for a silver "bug". The ratio at its peak was a tad under 50 to one while at the darkest hour it was back at the dreaded 70 to one. Ever since the rally in gold began in late 2008 the silver crowd have been rubbing their lucky rabbits' foot, lighting candles to Macumba deities and dancing naked by the full moon to try and get their ratio down to its true destiny (i.e. 50 to one).

Historically though the ratio was closer to 15 to one over the years when bimetallic currencies ruled (essentially until the end of the 19th century). The hot button issue of US elections in the 18880s and 1890s was the gradual eclipse of silver. Curiously one might even speculate that silver's relative decline coincidentally (or maybe not) dates back to when it became an industrial metal in the photographic applications. Silver bugs rather ironically are constantly touting new applications for silver (the latest being biocides) while gold's advocates feel no need to underpin demand with industrial applications, beyond jewellery.

Capital Gold's Narrow Escape

It is useful to briefly dwell on this transaction earlier this year because was the cause of CapGold's fall from grace and ultimately the latest boardroom revolution therein. We detailed these events in our recent note on the company and its various attractions. On March 12, 2009 CapGold announced that it had agreed to be taken over by Gammon Gold in an all-share transaction.

Capital Gold Corporation is a gold production and exploration company with listings in Toronto (CGC.to) and the Bulletin Board (CGLD.ob). Through its Mexican subsidiaries and affiliates, it owns 100% of the El Chanate open-pit gold mine in Sonora, Mexico. Capital Gold began gold production in July 2007 with 40,000 ounces of gold in its first year of operation.

The offer consisted of 0.1028 Gammon Gold shares for each Capital Gold common share outstanding. At that time the offer represented a value for each Capital Gold share of US$0.76 (a premium of 29% to Capital Gold shareholders based on the respective 10-day volume weighted average trading prices of Gammon Gold's and Capital Gold's common shares closing on March 11, 2009). As Capital Gold had approximately 198 million shares outstanding the offer valued CGC at around $150mn. Gammon's price was US$7.50 at the close before the announcement and then it promptly dived 13% lower to around

$6.53, shaving $18 mn off the amount offered to CapGold holders. Even without this price deterioration the transaction was odorous.

The deal was being pushed through with an almost indecent haste. The Letter of Intent stated that the parties planned to complete their respective technical, operating and financial due diligence and negotiate the terms of a definitive agreement by March 31st. Capital Gold had agreed to a non-solicitation period expiring on March 31, 2009, subject to fiduciary outs, and both parties agreed to the payment of a break fee to the other party in the amount of US$4 million payable only under certain circumstances. This was a case of marry in haste and repent at leisure.

The key factor, which we pointed out at the time, was that the gold cost per oz at Gammon was $655 while their gold equivalent cost was $755. Gammon looked like a very over-priced company in light of its paltry earnings. Frankly we suspected that this deal looked best for a certain Toronto asset manager that had more than 20% of the stock and had pledged their support (seemingly before the public were told of the deal and in time to add to their CapGold position). We can only presume that this manager (which also held a position in Gammon was looking to average down Gammon's cash cost per oz to underpin its "out there" valuation.

In any case the Gammon merger fell apart on the eve of the final closing with Gammon withdrawing for unspecified reasons. In retrospect one can see good reasons why adding CapGold's John Brownlie to the Gammon team might have made eminent sense as the poor showing of El Cubo and the seeming inability of Gammon to control costs across its mines might have benefited from Brownlie's acute cost control skills.

Precipitate (and Expensive) Action

On the 22nd of September Gammon announced the retirement and rescission of all existing compensatory retirement entitlements with Fred George as President, Chairman and member of the Board of Directors with effect from the 13th of October 2009. René Marion, the Chief Executive Officer, was subsequently appointed as President and remains as Chief Executive Officer. Ron Smith, an independent director temporarily assumed the position of interim Chair of the Board of Directors. Also on September 22 the resignation of Canek Rangel as a member of the Board of Directors was announced. The board then set about the task of finding replacements to "strengthen" the board. We find it hard to load the blame for the poor production performance on these two as the CEO of the company, whoch theoretically should be responsible for the day to day performance is still ensconced in power and in reality now is even more powerful.

This decision may have been made for very good reason, but what this "very good reason" might be was not shared with shareholders or the authorities. It had better be a very good reason because the cost of this action was a charge of $8.4mn (for accrued severance and stock-based compensation charge related to Fred George's departure) against the September accounts that sent the positive EPS of one cent per share for the quarter down to a loss of 6 cents per share.

Recent Financing Moves

There have been two financing events at Gammon in recent months. On November 9th the company announced that it had restructured and replaced its prior syndicated credit facility with a standalone US$30 million revolving line of credit that will be offered 100% through The Bank of Nova Scotia and will mature 24 months from the date of closing. The company claimed at the time that the new credit facility terms are expected to enhance Gammon's net cash flow profile, as there will be no principal repayments, other than a one-time payment on the maturity date equal to the drawn loan balance at that point in time. We are left slightly concerned as to why a company with over $200mn in quarterly revenues should be worried about its "cash flow profile" if everything is going as well as they have claimed. Surely sound financial policies would favour gradual reduction in outstanding debt would be preferable to a one-off maturity.

A prior move was the rather hefty equity issue, which was proclaimed to be a success on the 22nd of October. We cannot fault this move as it signaled to us that things were about as good as they were going to get at Gammon, both in terms of metals prices going their way and their market capitalization being "way out there" in valuation terms. This public offering consisted of 12,926,000 common shares at a price of US$8.90 per common share with gross proceeds of US$115,041,400.

The price of the stock closed at $9.01 on the 6th of October (the eve of the deal announcement) and slumped to $8.60 on the announcement. It then rebounded to the pre-deal levels before tumbling to as low as $7.82 on the 30th of October. Takers of the deal were quite substantially under water. And yet the stock has rebounded since to its current levels. Gammon is a soufflé that has risen twice… investors be wary of tempting fate.

The offering was a bought deal taken by a syndicate led by BMO Nesbitt Burns and UBS (and including Dundee Securities, Macquarie Capital Markets, Canaccord and Research Capital. The net proceeds of the offering were targeted to fund expanded operations exploration programs at the Ocampo and El Cubo mines, the advancement of the Guadalupe y Calvo project, debt repayment, greenfields exploration and general corporate purposes. Frankly the amount of money raised struck us as being a "never had it so good" decision by the company. The company did not need even vaguely like this amount of money. Debt was relatively unimportant and expansion of the existing mines and projects did not need anything like this sum to be in the war chest. While the hit to the share price was temporary the price soon bounced back (unjustifiably).

The debt profile at the end of the September quarter showed total liabilities of $177mn. Interestingly none of the categories were important except "Future Income Taxes" of $89mn (up from $77.3mn one year prior). This would seem to be a misnomer as one doesn't add taxes that not yet generated by revenues so one suspects that this means "Past Income tax liabilities that we might pay in the future". As the Canadian authorities are unlikely to be so generous in allowing dilatory payment we suspect this money is owed to the Mexican government. At this size it is a not inconsiderable amount and if the Mexican government pressed for payment then most of the company's cash pile would evaporate.

Acquisition Prospects

It is rather hard to conjure what might transpire on this front. The company has a good cash pile now and its currency (i.e. stock price) is overvalued. Ergo it is a perfect time to make an all-stock acquisition offer. Time has moved on though from the bargain basement days of last March when it flirted with CapGold.

Most of the real bargains have seen their stock prices rise. We can think of some that may have passed beneath the radar but it is not our job to give free ideas to clueless managements. The obvious candidates for snapping up are mainly with a silver bias. This is a space the company seems desperate to avoid being categorized in, with good reason.

The danger now is of doing a "dumb deal". We might note also though that the company has a standstill agreement with CapGold and when this expires the most obvious candidate to go after would be "the one that got away" last time.

Forex effects

There are a number of things going wrong for Gammon but a few stick out for extra consideration. While we have highlighted the wildly gyrating production cost equally important for the bottom line has been the foreign exchange losses (or a large gain in Q4 of FY08 that "fixed" an unhealthy looking bottom line). There are a number of millstones grinding together to produce the chaff of this forex number. The debt and the metals the company sells are USD denominated, while the workforce and many of the production costs are in Mexican pesos and then the final accounting and headquarters costs are in Canadian dollars.

The preceding chart shows the cross-rate for the Mexican Peso against the Canadian dollar. Its continuous decline during FY09 should give the company a benefit of lower labour costs. However, forex losses have been escalating, from a negative $700,000 in Q1 through a loss of $7.04mn in Q2 to a loss of $4.45mn in the latest quarter. Thus the losses on converting the output from USD to Canadian dollars must be the big culprit here (or at least as much as we can divine). When gold was at it's lowest in recent years (4Q08) and the Canadian dollar was at its weakest in recent years in the same quarter the company made a forex gain of $16.77mn.

Thus seemingly when things are bad globally, things are good for Gammon. By a process of deduction one might wonder if a recovering economy might not be such a good thing for Gammon then. Recent weeks have seen the Canadian dollar strong but not making quantum leaps against the dollar, the Mexican peso is weak and now is suffering ratings downgrades. Theoretically this should pay off in lower production costs, but what does theory have to do with Gammon's results. Theoretically at over $500 gold it should be profitable but who are we to wonder why?

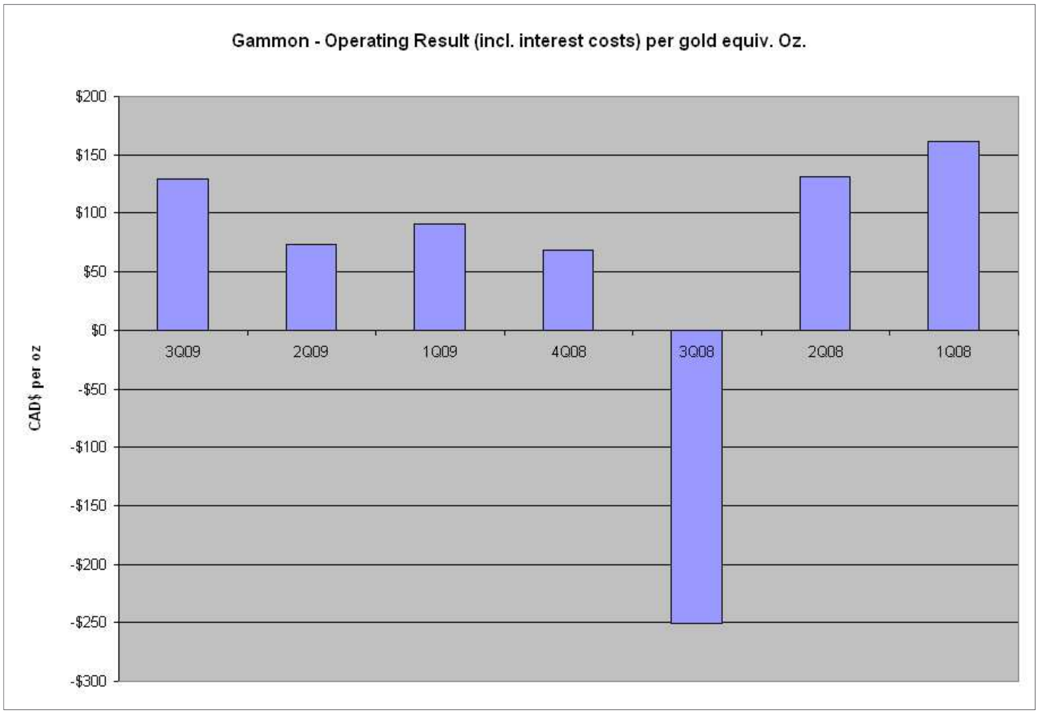
Results and Outlook

As we have mentioned thus far the results of Gammon are woeful. In fact it is impossible to find a more hapless and loss-prone company in the producing gold miner space.

Thus far this year only the first quarter was able to turn a profit and that was thanks in part to a forex gain. The other quarters have been underwater due to various reasons. We envision a small increase in production in the fourth quarter, a more stable USD/CAD exchange rate (and strength of both against the peso) combined with the stronger tendency in gold and silver in recent weeks to help lift the company to a profit of around CAD$11mn in the current quarter. This would take the company to a loss of one cent per share for the full FY.

Somehow the consensus out there is reading a gain of 17 cts for the full year that is well-nigh impossible in light of the embedded losses that the company has. This number may go some way to explaining the unfettered enthusiasm that some investors have for this stock.

The table on the preceding pages shows the rather thin margins that the company has managed in what is theoretically a time of plenty for gold miners. We excluded the forex loss/gain from this number (as the tax authorities also seem to be doing). The key thing here is that Gammon **was more profitable when gold was hundreds of dollars lower and when production costs were higher per ounce.** This really takes some doing.



Looking forward we can merely speculate on how much the company might make as its tendency to make botch-ups means that whatever good intentions there might be can always come to grief.

The table on the following page contains our earnings model. The prime considerations being:

- Shares on issue have risen by 12.2mn due to the recent financing
- Correspondingly net cash has risen o around $100mn, after over $8mn was paid out to the departing President
- Financing costs fall and turn positive due to the large amount of cash on hand
- FY10 profit of CAD$37.83mn or 28 cts per share
- We see revenues being driven higher due to gold prices (we are using $1100 as the average gold price for 2010 and an average price of $16.50 for silver).
- Most of the bottom line gain comes from more stable exchange rates, lower production costs rather than higher volumes produced.
- We see no evidence to persuade us that Gammon can up production meaningfully from these properties
- In FY11 we are looking for a profit of CAD$36.6mn (27 cents per share)
- Production might go into a decline in our opinion in this fiscal year
- There are unlikely to be further improvements in the cost base. These may very well deteriorate again as the mines gets closer to their "use-by" date.

Gammon Gold

In Millions of USD (except for per share items)	FY11E	FY10E	FY09E	3Q09	2Q09	1Q09	FY08	4Q08	3Q08	2Q08	1Q08
Revenue	218.00	223.00	193.59	47.91	43.33	47.35	212.52	48.26	48.34	64.55	51.37
Other Revenue, Total						-	-	-	-	-	-
Total Revenue	218.00	223.00	193.59	47.91	43.33	47.35	212.52	48.26	48.34	64.55	51.37
Production Cost	96.00	97.20	92.49	23.85	22.45	21.90	127.65	24.52	42.44	36.00	27.07
Refining Cost	3.10	3.36	2.99	0.79	0.79	0.56	1.66	0.51	0.36	0.42	
Gross Profit	**118.90**	**122.44**	**98.11**	**24.06**	**20.88**	**24.89**	**83.84**	**23.23**	**6.76**	**27.83**	**24.30**
Selling/General/Admin. Expenses	25.30	24.50	27.52	5.50	6.46	9.46	29.95	9.18	8.18	7.58	5.01
Severance payment			8.40	8.40							
Research & Development						-	-	-	-	-	-
Depreciation/Amortization	44.80	46.00	43.00	11.49	10.20	9.74	40.38	9.00	11.59	10.53	9.93
Operating Income	**48.80**	**51.94**	**19.19**	**7.07**	**4.22**	**5.69**	**12.88**	**5.05**	**-14.23**	**9.72**	**9.36**
Net Interest	2.00	-0.50	-2.20	-0.45	-0.77	-0.75	-1.53	-0.61	-0.18	-0.35	
Forex (loss)/gain	-2.00	-1.00	-11.90	-4.45	-7.04	0.60	18.94	16.77	5.25	-2.01	-
Income Before Tax	**48.80**	**50.44**	**5.09**	**-7.02**	**-4.39**	**5.54**	**30.30**	**21.21**	**-9.15**	**7.49**	**12.21**
Tax	-12.20	-12.61	-6.40	0.00	-3.18	-2.92	9.69	10.35	5.70	-2.64	-3.72
Income After Tax	**36.60**	**37.83**	**-1.31**	**-7.02**	**-7.57**	**2.62**	**39.99**	**31.56**	**-3.45**	**4.85**	**8.49**
Equity In Affiliates						-	-	-	-	-	-
Net Income	36.60	37.83	-1.31	-7.02	-7.57	2.62	39.99	31.56	-3.45	4.85	8.49
Diluted Weighted Average Shares	138	136.2	126.10	123.273	122.83	122.78	120.81	121.149	119.82	120.75	120.83
Diluted EPS	0.27	0.28	-0.01	-0.06	-0.06	0.02	0.331	0.26	-0.03	0.04	0.07

Conclusion

Maybe the simplest way to describe this situation is to see a largish resource that has hitherto been intensively mined without scarcely any profitability. The resource is dwindling as fast as it is mined so some day, a few years off, there will be no mine and no resource and virtually no-one except the miners in Mexico and Gammon's management will have made any money out of this situation. Unless the company comes up with a new rabbit to pull out of its hat, its market capitalization will go into terminal decline. This sounds like a good enough reason to us to avoid this stock. At the current levels, the rationale for calling it a "short" is even more powerful.

Is a rip-roaring gold price the only thing that will get the company into the black? Is merely "getting into the black" good enough for a company that has a $1.6bn market cap? The end of the main mine's life is no longer an "over the horizon" event, but very much a foreseeable event in the next few years if something drastically bigger is not found. Sounds dire. Who are the investors out there who regard this as an annuity, when we would posit it's an annuity with no payout? In fact Gammon Gold looks like a Reverse Tontine where "first one out" exits intact while "last man standing" gets nothing.

We regard Gammon as a **Short** with a 12-month target price of $8.

Important disclosures

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