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HALLGARTEN & COMPANY

Results Note

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

Key Metrics

Price (CAD)	$	0.065
12-Month Target Price (CAD)	$	0.030
Upside to Target		-54%
High-low (12 mth)		$0.025 - $0.18
Market Cap (CAD mn)	$	5.33
Shares Outstanding (millions)		82.0
Fully diluted (millions)		173.4

	2015	2016e	2017e
Consensus EPS		n/a	n/a
Hallgarten EPS (est.)		($0.05)	($0.07)
Actual EPS	($0.155)		
P/E	n/a	n/a	n/a

Galane Gold

From Bad to Worse

- + The gold price is ticking up
- ✘ The results for FY2015 and the last quarter thereof showed soaring losses
- ✘ Revenues declined further from Q3 and the company showed a substantial gross loss
- ✘ Cash has plunged and debt has risen steadily
- ✘ Dilution of the share base has ballooned due to the Sth African deal
- ✘ The current deep discount issue doubles shares on issue
- ✘ Cashflow is deteriorating rapidly and the funds from the rights issue are a mere financial figleaf and will not staunch the outflow
- ✘ There is a legal dispute related to land on which key elements of the South African mine are located
- ✘ The new South African asset is not Black Economic Empowerment (BEE) compliant
- ✘ Production is down heavily from the average of previous years

Bad to Worse

It is difficult to be more negative about this stock than we are, but we were even surprised at the dire results the company posted for the December quarter and FY2015. It is no surprise though that they waited until after the market close on the very last day for filing as the company is also in the throes of a right issue. However, sooner or later, the inevitable filing was going to weigh upon the outcome of the financing as the close date in within the first week of May. In effect shareholders of the company have been asked to stump up cash (or be brutally diluted) whilst they did not know how the company was doing in the last fiscal year.

The Back-Story on an African Gold "Empire"

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

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

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

Despite a veteran team of skilled operators, things have not been going well in 2015 with spiraling losses, a forced renegotiation of offtake and royalty deals and now an entry into South African gold mining, via the acquisition of Gallery Gold, with its mothballed mine.

Earnings Outlook Unchanged

The results for the December quarter of 2015 and FY2015 have come in even worse than we had expected. And this was despite the company having “cushioned” the bad news with a novel forex gain on an asset that had only just acquired.

To summarise the results in short we would note:

- Declining revenues
- Burgeoning gross loss
- Higher GS&A
- Higher debt
- Strongly negative cashflow
- Deteriorating bottom line
- Greater dilution due to the Galaxy Gold transaction, which shall shortly be further compounded by the rights issuance (on a 1:1 basis)

Indeed it is apparent that without a very sizeable foreign exchange gain of $2.52mn in the fourth quarter the losses would have been substantially higher.

The extent of the decline is best shown by the halving of top-line revenues from 2013 to 2015. This was made worse by a return to gross losses. While the company would probably argue that a manoeuvre involving the treatment of stripping costs accentuated the mining costs, even discounting this (and we shall discuss it anon) still has the company making a gross loss. More disturbingly the results continued to decline into the fourth quarter from pervious quarters of FY15. They were down QoQ and YoY.

Beyond this we would note (also discussed anon) that the kicker that non-US gold miners have enjoyed from the USD strength in recent years is now in full reverse and thus margins will probably not be as high as they were in FY15 (if one can call a negative gross result a “margin”).

While one might argue that GS&A was lower than FY14, the number for Q4 was higher than any other quarter in FY15 (probably due to transaction costs relating the South African purchase).

We would also note that interest costs were steep upward trajectory, a trend that is likely to be exacerbated now that debt is massively higher due to the South African deal.

Exploration costs are almost non-existent and had evaporated by the fourth quarter came around.

One component in the cost of mine revenue that is worth noting is that during the fourth quarter of 2015 Galane’s management concluded that future mining operations at its Golden Eagle resource would use underground mining methods.

Galane Gold

In Millions of USD

	FY16e	FY15	4Q15	3Q15	3Q15	1Q15	FY14	4Q14	3Q14	2Q14	1Q14	FY13
Mine Revenue	28.70	26.23	6.76	8.533	5.173	5.76	40.46	7.79	9.46	10.77	12.44	53.82
Cost of Mine Revenue	31.76	34.45	11.04	8.565	7.744	7.10	35.98	7.09	8.48	10.55	9.86	60.28
Gross Profit	-3.06	-8.22	-4.28	-0.032	-2.571	-1.34	4.49	0.22	0.98	0.22	2.58	-6.46
Selling/General/Admin. Expenses	2.10	2.26	0.62	0.516	0.547	0.59	2.51	0.79	0.639	0.61	0.47	2.81
Exploration	0.18	0.115	0.01	0.029	0.045	0.036	0.12	0.04	0.02	0.03	0.03	0.17
Depreciation/Amortisation	-	-	-	-	-	-	-	0.00	-	-	-	-
Interest Expense (Income)	1.80	0.69	0.53	0.17	0.14	-0.14	-0.58	-0.50	-0.08	0.00	0.00	-
Unusual Expense (Income)	0.00	0.00	0.00	0.00	0.00	0.00	0.00	-0.61	0.608	0.00	0.00	17.82
Forex costs (gain)	1.50	-3.02	-2.52	-0.38	0.01	-0.13						
Other Operating Expenses, Total	0.05	0.245	-0.02	0.271	-0.005	0.00	0.56	0.39	0.00	0.09	0.08	1.08
Total Operating Expense	37.39	34.74	9.64	9.17	8.48	7.45	38.58	7.19	9.67	11.27	10.44	82.15
Operating Income	-8.69	-8.51	-2.88	-0.64	-3.31	-1.69	1.88	0.60	-0.21	-0.50	1.99	-28.33
Gain (Loss) on Sale of Assets	0	0	0	0	0	0	0	0	0	0	0	0.02
Income Before Tax	-8.69	-8.51	-2.88	-0.64	-3.31	-1.69	1.88	0.60	-0.21	-0.69	2.12	-26.97
Tax	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	1.81
Post- Tax Income	-8.69	-8.51	-2.88	-0.64	-3.31	-1.69	1.88	0.60	-0.21	-0.69	2.12	-28.78
Diluted Weighted Average Shares	173.40	54.90	53.4	52.837	52.823	52.82	54.584	52.54	52.677	52.54	51.53	50.36
Diluted EPS	-0.050	-0.155	-0.054	-0.012	-0.063	-0.032	0.034	0.011	-0.004	-0.013	0.041	-0.571
Estimated Av. Au Price	$1,280	$1,148					$1,190					
Ounces Au produced	26,210	24,321	6,825	7,637	4,829	5,030	30,791	6,044	8,206	7,195	9,346	31,586

Galane had historically operated Golden Eagle as an open pit and had recorded an asset of $3,893,479 in relation to stripping costs. As it now no longer intends to operate an open pit at Golden Eagle it made the decision that the change in mining method required a de-recognition of the stripping costs. As a result, it recorded a charge of $3,893,479 within mining costs in the consolidated statement of earnings.

This sounds reasonable until one ponders that it is charging off an "asset" as a mining cost even though we presume that sunk stripping costs had occurred in previous mining periods. Surely this should instead have been an asset write-off?

Therefore, what should one look for in FY16? More of the same, we expect, with a reversal in the forex effects (see anon). We do NOT expect the South African assets to be contributing in FY16 therefore the company will be entirely dependent upon Botswana. There is no sign that this is going to be positive for while the gold price has risen slightly in the first few months of 2016, the US dollar has weakened and oil prices have rebounded. On top of this interest costs should soar. We are factoring these in at $18mn for the full year.

This gives us an estimate of a loss of nearly $8.7mn for the next fiscal year or an EPS of negative 5 cts per share on the massively expanded share base (presuming full take-up of the rights issue (on which we are dubious).

The Exchange Rate Kicker

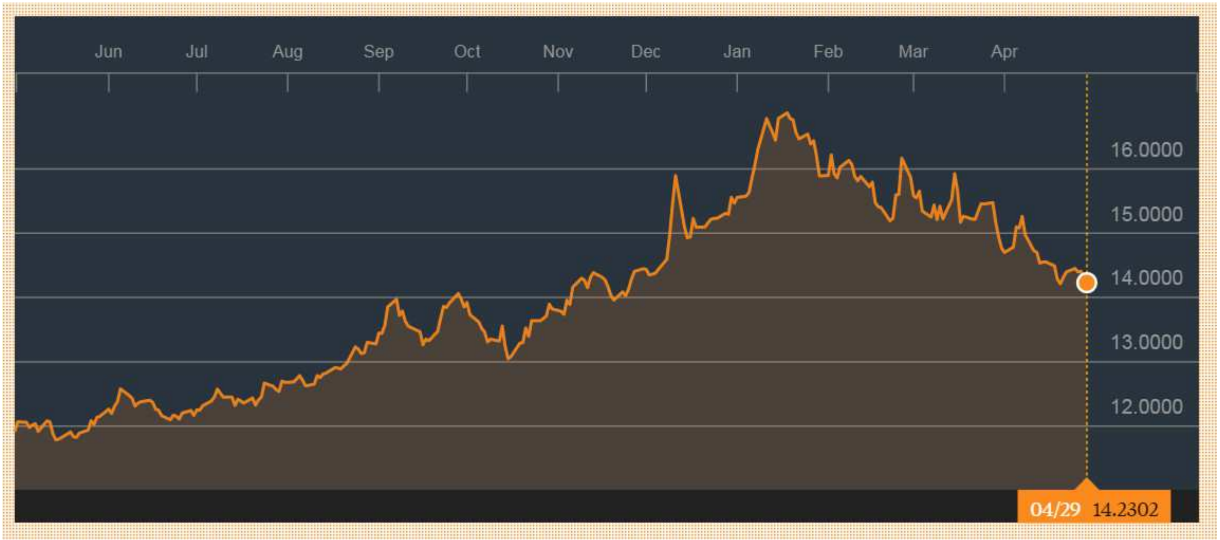
Rarely can it be said that the South African Rand has done so many favours to a company that actually has not operating assets in the country! Indeed the company managed to book a $3.02mn gain from forex effects in FY2015, of which $2.52mn was in the last quarter and this helped the bottom line from looking even more dire than it already does.

Moreover, when one looks at the exposure to the various currencies in the table below, one can surmise that the company booked the gain on the South African acquisition even though it is not operating and that it was only brought into the company's sphere of influence at the very end of the fiscal year.

Exposure in USD to Currency Risk

	As at Dec 2015	As at Dec 2014
South African Rand	(4,656,447)	(506,038)
Botswana Pula	(5,301,334)	(10,351,469)
Canadian Dollar	(1,001,837)	(701,012)
	(4,654,432)	(504,024)

Currency moves and booking profits therefrom can be a two-edged sword. As is well-known the US dollar has, in recent months, reversed its strength of recent years. Below can be seen its move against the South African Rand.



Source: Bloomberg

The company admits in its latest accounts that, not taking into account interest rate moves, the following effects would occur in relation to a USD move:

- A 10% strengthening of the U.S. dollar against these foreign currencies at year-end would have resulted in an increase in the Galane's earnings for the year of $996,329 (2014 – $1,050,774).

- A 10% weakening of the U.S. dollar against these currencies at year-end would have resulted in a decrease in the Galane's earnings for the year of $1,217,735 (2014 – $1,284,280).

This begs two questions. The first is how the currency effect in the FY2015 accounts could have been more than three times larger than the 10% strengthening scenario when one considers that the South African assets only appeared on the scene at the very end of the fiscal year? Then the more poignant question is what happens if the quite obvious weakening of the USD continues against commodity currencies through all of 2016? Surely this will be a big negative hit against the already heavily negative earnings statement of Galane.

Production

Gold production in 4Q15 was 6,825 ounces compared to 6,044 ounces in 4Q14 and yet the results for the period were diabolical. We know gold was lower than at the same time as last year, but so were oil prices and there was the positive of the weaker currencies against the USD. The grade and recovery in Q4 2015 of 1.30 g/t and 75.5% was lower than the grade and better than the recovery in 4Q14. In 4Q15, a higher proportion of the ore milled was from the low grade stockpiles.

The Balance Sheet

The balance sheet of the company at the end of December is shown below. There is no reason to believe that this may have shown any improvement since that time except for the conversion of some debt owed to Traxys related to unfulfilled deliveries from the Galaxy mine property in South Africa.

As can be noted, cash on hand has deteriorated seriously over the last twelve months. Moreover in light of the large and escalating losses the negative cashflow is likely to consume (or to have already consumed) the cash on hand. The current financing is estimated to bring in around $700,000 (if fully taken up) which will scarcely make a dent in the size of the cash shortfall.

During 2015 an amount of $5,911,946 was reclassified from long term assets into inventories. However these were run down to $4,818,576 by year end.

Galane Gold - Balance Sheet

	Dec End 2015	Dec End 2014
Current assets:		
Cash	1,887,179	9,653,807
Trade receivables and other current assets	859,454	1,837,530
Inventories	8,729,705	6,337,040
	11,476,338	17,828,377
Non-current assets:		
Mining properties	34,196,825	21,594,417
Plant and equipment	2,607,674	1,885,585
Ore stockpiles		5,911,946
	36,804,499	29,391,948
	48,280,837	47,220,325
Current liabilities:		
Accounts payable and accrued liabilities	8,538,785	6,635,834
Interest-bearing loans and borrowings	5,709,605	4,667,416
	14,248,390	11,303,250
Non-current liabilities:		
Interest-bearing loans and borrowings	8,195,566	4,020,218
Warrants denominated in a foreign currency	113,349	
Restoration and rehabilitation provision	3,656,728	3,083,251
	11,965,643	7,103,469
Shareholders Equity	22,066,804	28,813,606
	48,280,837	47,220,325

As can be noted debt has ballooned from $18.4mn to over $26mn while cash has shriveled from nearly $10mn to under $2mn. Shareholders' funds have diminished in accord with the losses despite the all-stock acquisition of Galaxy Gold.

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

The Rights Issue

On March 30, 2016, the announced a deep discount rights issue on a one for one basis at one cent per share. The rights were not tradeable.

The ex-date was April 8, 2016 while the subscription period expires on May 6, 2016. If fully subscribed the offering would generate gross proceeds of approximately CAD$713,000.

We can safely say that the company would not have had a the remotest chance of undertaking a conventional placing, at say 4cts, when the stock was trading at 5-6 cts with the occasional recent dive to 4.5cts and the December quarter results still coming down the pike. Now that the results are in and look so disappointing (even to those not expecting much) then the takeup in the final few days will be interesting to see. We might also note that if half the shares in the company have been acquired at 1 cts, then effectively holders can dump the holding at any point above one cent and assuage their consciences that they "made a profit".

Iamgold Bails

Some shareholders had taken comfort that Iamgold was the largest stakeholder here with around 25% of the diluted capital (after the Galaxy deal). That consolation was withdrawn when in mid-March when Iamgold revealed that it had sold all 21,875,000 common shares of Galane Gold that it held. These shares were sold at 1 ct per share when the company was trading at five times that level. This was closely followed by the rights issue giving a clear sign that Iamgold were consulted on their willingness to stump up for the issue and passed. They also cleared out of the stock in a mode that looked like a desperation exit.

Shorting Galane

We instituted a Short position in the Model Mining Portfolio on the 4th of December 2015 at 7.5cts. This position did not take long to bear fruit as we closed the Short on the 23rd of December at 2.5cts. In fact the stock had exceeded our expectations to the downside. In the last week (28th of April) we reinstituted a Short position again.

Conclusion

These latest results were way worse than even we predicted. Sales have slumped and the company lost a devastating $8.51mn in the year and $2.88mn in just the fourth quarter. To make it worse, without the non-cash *creativity* of an exchange gain of $2.52mn in the December quarter the loss would have been nearly double.

To put it bluntly the company is losing more in a year than its market cap and there is no end in sight.

To make it worse, the negative cashflow is dire and the current financing (if it gets any traction) will raise only around $700K, which is a mere fraction of the amount the company is gushing from its severed financial artery.

Usually a company with severe operating problems at its existing mines, that is also heavily haemorrhaging cash, focuses on rectifying their existing problems. Instead it resolved to double-down with the purchase of a mothballed mine in South Africa with multiple legal complications. We might also mention that South Africa is not a jurisdiction which gives Canadian mining investors a warm inner glow.

All the grand aspirations, expressed in 2014, for a turnaround have been dashed. Attempts to reduce costs have proven rather fruitless with mining/processing costs sometimes even exceeding mining revenues in recent quarters. Therefore some 18 months later the cash is severely whittled down, losses have ballooned, gold production has slumped and the company has launched itself on a distracting and dilutive absorption of a gold miner in South Africa. Debt from the South African deal doubles liabilities while dilution blew shares on issue from 52mn to 71mn (or 82mn fully-diluted). This then doubles again with the rights offering.

We have reinstated a **Short** position in Galane Gold to the Model Mining Portfolio with a 12-month target price of CAD$0.03.

Important disclosures

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