

Cerro Grande Mining Corporation (TSX: CEG / OTCQX: CEGMF) - Production Beats Expectations

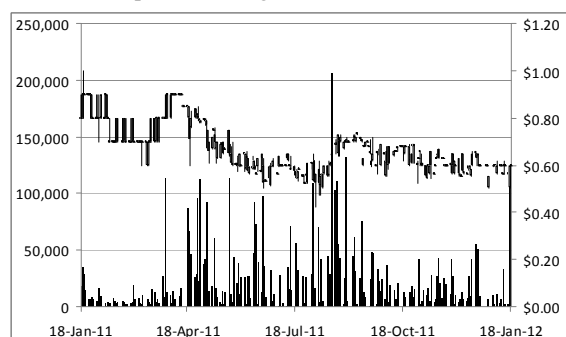
Sector/Industry: Junior Exploration/Mining

www.cegmining.com

Market Data (as of January 20, 2012)

Current Price	CS0.60
Fair Value	CS1.10 (↑)
Rating*	BUY
Risk*	4 (Speculative)
52 Week Range	CS0.42 - CS0.95
Shares O/S	94.19 mm
Market Cap	CS\$6.51 mm
Current Yield	N/A
P/E (forward)	5.6x
P/B	2.7x
YoY Return	-33.33%
YoY TSX	-7.9%

*see back of report for rating and risk definitions



FY2011 Highlights

- Gold production in FY2011 was 15,717 ounces, higher than our estimate of 15,012 ounces.
- Throughput at the end of FY2011 was 100-110tpd. Management indicated throughput is currently at ~121 tpd.
- At the time of our previous report in September 2011, management was expecting to increase throughput to 200 tpd by the end of 2012 - which might not be possible now as the permit application process to increase throughput to up to 500tpd is not expected to be completed before June 2013. The current permits allow production of only up to 166 tpd.
- Revenues were \$24.29 million in FY2011, which were slightly below our estimate of \$25.31 million. Reported net profit was \$3.43 million (EPS: \$0.04), and cash flow from operations was \$6.04 million in FY2011. Our net income forecast for FY2011 was \$4.36 million (EPS: \$0.04).
- Gross margins improved from 10.3% in FY2010, to 44.8% in FY2011 (the industry average is 50.5%). Net margins improved from -47.9% to 14.1% (the industry average is 24.0%).
- Balance sheet improves - debt to capital ratio decreased from 21.0% at the end of FY2010, to 3.9% at the end of FY2011.
- We have raised our revenue and net income forecasts for FY2012 due to higher gold sales and price forecasts. Our revised revenue and net profit forecasts for FY2012 are \$36.11 million, and \$10.01 million (EPS: \$0.11), respectively.
- Drilling on the company's porphyry deposits at Pimenton have recommenced. Drilling at the Santa Cecilia property has started. The company expects to drill 7,200 meters at Santa Cecilia during the drilling season.

Key Financial Data (FYE - Sept 30)

(US\$, 000's)	2009	2010	2011	2012E	2013E
Cash	855	1,470	1,750	6,034	13,830
Working Capital	490	(1,093)	2,647	7,607	15,970
Total Assets	22,035	21,850	26,904	38,045	54,158
Revenues	10,316	10,959	24,289	36,111	44,015
Net Income	104	(5,248)	3,425	10,011	14,394
EPS	0.00	-0.01	0.04	0.11	0.15

Cerro Grande Mining corporation is focusing efforts on increasing production at the Pimenton Gold Mine, Chile. The Pimenton Mine property has Proven and Probable reserves of 132,000 tonnes containing 13.5 g/t Au and 1.47% Cu. Current exploration aims to define economic grade reserves of a potentially large deep-seated porphyry deposit at the Pimenton Mine Property and the near by Tordillo project.

***FY2011
Performance***

Revenues

CEG's FY2011 revenues increased YOY from \$10.96 million to \$24.29 million (our estimate was \$25.31 million), reflecting a 121.6% increase. Q4-2011 revenues were \$5.57 million versus our estimate of \$6.59 million. Revenues were slightly below our estimate due to the following reasons:

- Lower ounces sold in Q4-2011 - our estimated gold sales for FY2011 were 15,012 ounces versus the actual sales of 14,083 ounces. Note that actual gold production for FY2011 was 15,717 ounces, which was higher than our 15,012 ounces estimate.
- **Gold sales were significantly lower than production due to the timing difference in the shipments of gold dore to the buyer, Argor-Heraeus S.A. in Switzerland.**
- Lower than expected gold price - we had used a gold price of \$1,500/oz for Q4 versus the actual gold sales price of \$1,470/oz.

Even though revenues were slightly below our expectations, we were pleased with the company's performance as CEG has made significant improvement in FY2011 compared to FY2010. Revenues increased YOY due to the following reasons:

- Increase in gold sales from 8,598 ounces to 14,083 ounces (YOY: 64% increase).
- Increase in silver & copper sales - revenues from silver & copper were \$3.58 million in FY2011, versus \$0.95 million in FY2010. Our estimate was \$3.68 million.
- Increase in gold and silver prices.

Gold recovery rates, and grades for FY2011, were 92% and 12.2g/t, respectively. Management indicated that the current gold recovery rate, and grade, are ~95%, and ~12.1g/t.

CEG's throughput rate was 100 to 110 tpd at the end of FY2011 (September 2011). Management indicated that the current throughput rate is ~121 tpd and expects to increase to 150 tpd by the end of June 2012. The company indicated that the application for a permit to increase throughput to above 166 tpd (discussed in our initiating report) will not be completed until June 2013.

We have raised our revenue forecast for CEG to \$36.11 million (previous estimate: \$30.43 million) for FY2012, and \$44.01 million (previous estimate: \$42.41 million) for FY2013. We revised the following assumptions; which resulted in the increase in our forecasts:

- Increase in gold price forecasts.
- Adjusted throughput rates due to the delay in the permit application process.
- Included unsold gold production in 2012 sales.

The table below shows our previous and revised assumptions

	2012	2013
Gold Price (Revised)	\$ 1,600	\$ 1,500
Gold Price (Previous)	\$ 1,500	\$ 1,300
Ore Production (Revised)	47,085	66,795
Ore Production (Previous)	43,800	73,000

Source: Company & Fundamental Research

Production Cost

Net cash costs for the year, we estimate, were \$698 per ounce sold versus \$1,032 per ounce sold in FY2010. Our cash cost estimate for FY2011 was \$638/oz. In Q4-2011, the cash cost was \$976 per ounce versus our estimate of \$666 per ounce.

The higher than expected cash cost was due to a mechanical failure of the ball mill at the Pimenton mine, which resulted in a production shutdown for 14 days. CEG has replaced the ball mill and production is back on schedule.

EBITDA & Earnings

EBITDA improved from -\$1.76 million in FY2010, to \$6.88 million in FY2011. Net income also improved from -\$5.25 (EPS: -\$0.01) last year to \$3.43 million (EPS: \$0.04) this year. The table below shows that EBITDA and net income were below our estimates. This was due to the combination of lower revenues and higher production costs than what we had expected. Other operating expenses, including SG&A expenses, were in line with our estimates.

(\$ mm)	2009A	2010A	2011A	2011E
EBITDA	1.76	(1.76)	6.88	7.78
EBIT	0.30	(3.27)	4.68	5.61
Net Income	0.10	(5.25)	3.43	4.36
EPS	\$ 0.00	\$ (0.01)	\$ 0.04	\$ 0.05

Source: Company & Fundamental Research

Despite the lower than expected EBITDA, and net income, CEG's FY2011 performance was significantly better than FY2010, as evidenced from the table above. The table below shows that all the margins turned positive in FY2011. CEG is expected to continue to improve its margins to the 'Gold Producers' industry average.

	2009A	2010A	2011A	2011E	Ind. Avg
Gross	33.2%	10.3%	44.8%	54.5%	50.5%
EBITDA	17.1%	(16.0%)	28.3%	38.1%	38.8%
EBIT	2.9%	(29.8%)	19.3%	32.9%	31.0%
Net	1.0%	(47.9%)	14.1%	32.7%	24.0%

Source: Company & Fundamental Research

Cash Flows Summary

Cash flow from operations increased in FY2011 to \$6.04 million, up from \$0.78 million in FY2010, due to the higher net income.

Cash flow from investing was negative \$6.84 million in FY2011, due to the investments on the Pimenton mine and on other properties.

Cash flow from financing for the year was \$1.09 million, which constituted \$3.26 million from equity financing, and negative \$1.94 million from debt repayments.

The table below shows the improvement in cash flow from operations as stated above.

Cash Flows (\$, mm)	2009	2010	2011	2012E	2013E
Cash Flow from Operations	\$3.31	\$0.78	\$6.04	\$12.29	\$17.51
Cash Flow from Investing	(\$2.34)	(\$2.31)	(\$6.84)	(\$7.55)	(\$9.50)
Cash Flow from Financing	(\$0.29)	\$2.15	\$1.09	(\$0.46)	(\$0.21)
Foreign Exchange Rate Adj.	\$0.02	\$0.00	(\$0.01)	\$0.00	\$0.00
Net Change in Cash	\$0.70	\$0.62	\$0.28	\$4.28	\$7.80
Free Cash Flows	\$1.46	(\$1.26)	(\$0.47)	\$4.87	\$8.07

Free cash flows are expected to significantly improve to \$4.87 million, and \$8.07 million, in FY2012, and FY2013, respectively, up from negative \$0.47 million in FY2011.

Improved Liquidity and Capital Structure

At the end of FY2011, CEG had a much stronger balance sheet compared to FY2010. As shown in the table below, CEG had \$1.75 million in cash, and \$2.65 million in working capital at the end of FY2011, a huge improvement from FY2010, when the working capital was negative \$1.09 million. The improvement in working capital was due to a reduction in short-term debt and an increase in inventory (due to the increase in unsold gold production).

	2009A	2010A	2011A	Ind. Avg
Cash & Cash Equivalent (\$ mm)	0.86	1.47	1.75	
Working Capital (\$ mm)	0.49	(1.09)	2.65	
Current Ratio	1.14x	0.80x	1.80x	0.80x
Debt / Capital	20.8%	21.0%	3.9%	16.3%
LT Debt / Capital	15.4%	7.3%	1.2%	3.7%

Source: Company & Fundamental Research

The debt to capital ratio at the end of the year was 3.9%, below both last year's 21.0%, and the Gold Producers' industry average of 16.3%.

Stock Options and Warrants

At the end of FY2011, the company had 2.21 million warrants (weighted average exercise price - \$1.04) and 7.69 million options (weighted average exercise price - \$0.60) outstanding. 1.61 million warrants and 2.83 million options are currently in-the-money. CEG will be able to raise up to \$1.66 million if all in-the-money warrants and options are exercised.

Valuation and Rating

Our valuation on CEG increased from \$0.93/share to \$1.09/share as we raised our near-term cash flow projections and our long-term gold price forecast from \$1,100/oz to \$1,200/oz. We have not made any other significant changes in our valuation models.

Valuation Summary (C\$)		
	Revised	Previous
Pimenton Gold Mine	\$0.76	\$0.60
Pimenton Porphyry	\$0.30	\$0.30
Working Capital - LT Debt	\$0.02	\$0.02
Average	\$1.09	\$0.93

Source: Fundamental Research Corp.

The following table shows that CEG is trading significantly below the average valuation metrics of its peers.

Ticker	Company Name	P/E	EV/EBITDA	EV/Revenue
TSX:PTQ	Petaquilla Minerals Ltd.	19.5x	6.6x	1.9x
TSX:WDO	Wesdome Gold Mines Ltd.	67.0x	9.4x	1.9x
TSX:CRJ	Claude Resources, Inc.	37.6x	8.8x	3.3x
TSXV:MMY	Monument Mining Limited.	3.1x	0.4x	0.3x
TSX:DNG	Dynacor Gold Mines Inc.	6.4x	2.1x	0.4x
TSX:OYM	Olympus Pacific Minerals Inc.	22.9x	7.4x	5.1x
TSX:ND	New Dawn Mining Corp.	14.2x	6.6x	1.1x
TSX:MDN	MDN Inc.	30.5x	13.8x	4.3x
TSX:CAL	Caledonia Mining Corporation	5.3x	2.4x	1.1x
TSXV:GAL	Galantas Gold Corp.	19.8x	5.8x	1.6x
	Average	22.6x	6.3x	2.1x
	Median	19.7x	6.6x	1.7x
TSX: CEG (forward multiples)		5.6x	4.7x	1.5x
Comparables Valuation		\$2.38	\$0.79	\$0.81

Source: Fundamental Research Corp.

CEG is currently trading at a 5.6x forward P/E, 4.7x forward EV/EBITDA and 1.5x forward EV/Revenue - these ratios are significantly lower than its peer average ratios of 22.6x, 6.3x and 2.1x, respectively.

We maintain our BUY rating and raise our fair value estimate from \$0.95 per share to \$1.10 per share.

Risks

The following risks, though not exhaustive, may cause our estimates to differ from actual results:

- The success of drilling, resource expansion, and development are important long-term success factors for the company.
- The value of the company depends on commodity prices.
- The Pimenton Mine is occasionally subject to severe snow fall which can cause closure of the operations, such as in 2005.
- The availability of infrastructure such as road access and power supply for future operations and development.
- The relatively high cost of narrow vein underground mining.
- CEG's ability to obtain permits for the planned increase in production at the Pimenton Mine.
- The ability to provide sufficient and consistent power for the operations, which are currently provided by diesel powered generators.

We rate the company's shares a RISK of 4 (Speculative).

Income Statement						
<i>USD; in millions, except per share items</i>	2008	2009	2010	2011	2012E	2013E
Revenue						
Gold	-	9.18	10.00	20.71	32.00	39.08
Copper + Silver	-	1.14	0.95	3.58	4.11	4.94
Other	-	-	0.01	-	-	-
Total Revenue	-	10.32	10.96	24.29	36.11	44.01
Operating Cost	-	6.89	9.83	13.42	18.36	20.04
Cost Of Goods Sold	-	6.89	9.83	13.42	18.36	20.04
Gross Profit	-	3.42	1.13	10.87	17.75	23.98
Reclamation and Remediation	-	0.14	0.15	0.16	0.15	0.15
Selling General & Admin Exp.	1.55	1.41	1.78	3.20	4.69	5.72
Stock-Based Compensation	0.40	0.25	1.07	0.57	1.05	1.27
Others	(0.12)	(0.14)	(0.12)	0.06	0.06	0.07
Other Operating Exp., Total	1.83	1.66	2.89	3.99	5.95	7.22
EBITDA	(1.83)	1.76	(1.76)	6.88	11.80	16.76
Depreciation & Amort.	0.02	1.46	1.51	2.21	1.61	2.29
EBIT	(1.85)	0.30	(3.27)	4.68	10.18	14.47
Interest Expense	0.82	0.49	0.33	0.25	0.17	0.08
Interest and Invest. Income	-	-	-	-	-	-
Net Interest Exp.	0.82	0.49	0.33	0.25	0.17	0.08
Other Income	0.02	0.56	0.66	0.10	-	-
Other Expense	0.14	(0.06)	(0.07)	(0.04)	-	-
Write-offs	(6.06)	(0.20)	(2.24)	(1.06)	-	-
EBT Excl. Unusual Items	(8.57)	0.10	(5.25)	3.43	10.01	14.39
Income Tax Expense	-	-	-	-	-	-
Net Income	(8.57)	0.10	(5.25)	3.43	10.01	14.39
Basic EPS	(0.01)	0.00	(0.01)	0.04	0.11	0.15

Balance Sheet*USD; in millions, except per share items*

	2008	2009	2010	2011	2012E	2013E
ASSETS						
Cash And Equivalents	0.15	0.86	1.47	1.75	6.03	13.83
Short Term Investments	-	-	-	-	-	-
Total Cash & ST Investments	0.15	0.86	1.47	1.75	6.03	13.83
Accounts Receivable	0.15	0.47	0.76	1.40	1.68	2.02
Total Receivables	0.15	0.47	0.76	1.40	1.68	2.02
Inventory	0.40	0.48	0.86	2.64	3.17	3.80
Prepaid Exp.+ Others	2.13	2.13	1.41	0.17	0.21	0.25
Total Current Assets	2.83	3.93	4.49	5.96	11.09	19.90
Gross Property, Plant & Equipment						
Accumulated Depreciation						
Net Property, Plant & Equipment	16.94	17.87	17.13	20.55	26.49	33.70
Receivable	0.15	0.24	0.24	0.39	0.46	0.56
Other	0.81	-	-	-	-	-
Deferred Tax Assets, LT	-	-	-	-	-	-
Other Long-Term Assets	-	-	-	-	-	-
Total Assets	20.73	22.04	21.85	26.90	38.05	54.16
LIABILITIES						
Accounts Payable	1.54	2.47	3.34	2.73	3.27	3.93
Lease	0.03	0.03	0.30	0.24	0.21	-
Debt	1.56	0.93	1.94	-	-	-
Amount due to related parties	0.80	-	-	0.35	-	-
Total Current Liabilities	3.93	3.44	5.58	3.32	3.48	3.93
Lease	0.05	0.02	0.24	0.08	-	-
Debt	2.61	1.90	0.13	0.19	0.19	0.19
Amount due to related parties	0.24	0.78	0.83	-	-	-
Reclamation	1.86	2.00	2.15	2.31	2.31	2.31
Total Liabilities	8.68	8.13	8.92	5.89	5.98	6.42
Common Stock	75.88	77.00	81.27	85.92	85.92	85.92
Retained Earnings	(63.83)	(63.09)	(68.34)	(64.91)	(53.86)	(38.19)
Total Common Equity	12.05	13.91	12.93	21.01	32.07	47.74
Total Equity	12.05	13.91	12.93	21.01	32.07	47.74
Total Liabilities And Equity	20.73	22.04	21.85	26.90	38.05	54.16

Cash Flow Statement

<i>USD; in millions, except per share items</i>	2008	2009	2010	2011	2012E	2013E
Net Income	-	0.10	(5.25)	3.43	10.01	14.39
Depreciation & Amort.	-	1.46	1.51	2.21	1.61	2.29
Amort. of Goodwill and Intangibles	-	-	-	-	-	-
Impair. of Assets	-	-	-	-	-	-
Depreciation & Amort., Total	-	1.46	1.51	2.21	1.61	2.29
Non-cash Items	-	2.54	4.14	2.13	1.05	1.27
Change in WC	-	(0.80)	0.38	(1.72)	(0.37)	(0.45)
Cash from Ops.	-	3.31	0.78	6.04	12.29	17.51
Capital Expenditure	-	(2.22)	(2.29)	(6.69)	(7.55)	(9.50)
Other Investing Activities	-	(0.12)	(0.02)	(0.15)	-	-
Cash from Investing	-	(2.34)	(2.31)	(6.84)	(7.55)	(9.50)
Equity	-	0.36	1.54	3.26	-	-
Debt	-	(0.62)	(0.51)	(1.94)	-	-
Related Parties	-	-	0.83	-	(0.35)	-
Lease	-	(0.03)	0.30	(0.23)	(0.11)	(0.21)
Cash from Financing	-	(0.29)	2.15	1.09	(0.46)	(0.21)
Foreign Exchange Rate Adj.	-	0.02	-	(0.01)	-	-
Net Change in Cash	-	0.70	0.62	0.28	4.28	7.80

Fundamental Research Corp. Equity Rating Scale:

Buy – Annual expected rate of return exceeds 12% or the expected return is commensurate with risk

Hold – Annual expected rate of return is between 5% and 12%

Sell – Annual expected rate of return is below 5% or the expected return is not commensurate with risk

Suspended or Rating N/A— Coverage and ratings suspended until more information can be obtained from the company regarding recent events.

Fundamental Research Corp. Risk Rating Scale:

1 (Low Risk) - The company operates in an industry where it has a strong position (for example a monopoly, high market share etc.) or operates in a regulated industry. The future outlook is stable or positive for the industry. The company generates positive free cash flow and has a history of profitability. The capital structure is conservative with little or no debt.

2 (Below Average Risk) - The company operates in an industry where the fundamentals and outlook are positive. The industry and company are relatively less sensitive to systematic risk than companies with a Risk Rating of 3. The company has a history of profitability and has demonstrated its ability to generate positive free cash flows (though current free cash flow may be negative due to capital investment). The company's capital structure is conservative with little to modest use of debt.

3 (Average Risk) - The company operates in an industry that has average sensitivity to systematic risk. The industry may be cyclical. Profits and cash flow are sensitive to economic factors although the company has demonstrated its ability to generate positive earnings and cash flow. Debt use is in line with industry averages, and coverage ratios are sufficient.

4 (Speculative) - The company has little or no history of generating earnings or cash flow. Debt use is higher. These companies may be in start-up mode or in a turnaround situation. These companies should be considered speculative.

5 (Highly Speculative) - The company has no history of generating earnings or cash flow. They may operate in a new industry with new, and unproven products. Products may be at the development stage, testing, or seeking regulatory approval. These companies may run into liquidity issues, and may rely on external funding. These stocks are considered highly speculative.

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