

PATAGONIA GOLD

09 February 2009

Nearing the Starting Line

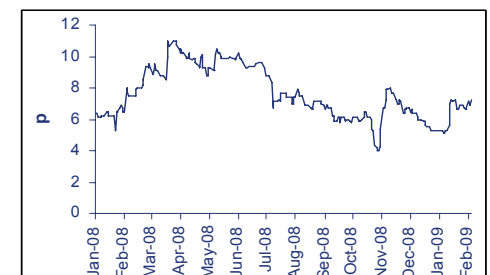
Patagonia Gold has brought its Argentinean gold projects to the brink of production. It has announced an accelerated development schedule that could see small-scale production by the end of 2009. We have raised our target price from 15p to 28p to reflect the NPV impact of this production, currency movements and the gold price.

- Patagonia Gold has announced that it plans to proceed with a small-scale trial heap leach operation at its Lomada project, which could see the company becoming a gold producer by the end of 2009. We believe this trial operation has the potential to generate gross profit of up to US\$8m over 2009E and 2010E and thus to contribute to the anticipated US\$8.5m capex requirement for a larger 21,000oz pa leach plant at Lomada.
- We have remodelled a possible development scenario on the basis of this accelerated development, which, when coupled with an approximate 5p per share contribution from recent depreciation of the GBP, and another 4p per share lift from an increase in our gold price assumption, sees our NPV-based valuation increase from 15p to 28p per share.
- Following Lomada, the company then proposes to continue drilling and development at its much larger and higher-grade Cap Oeste project to the south. While Lomada may provide proof of concept, we see Cap Oeste as possibly a company maker; a high-grade project with resource potential of upwards of 2Moz Au equivalent, capable of supporting a +200,000oz pa operation.
- The company has, historically, raised money on an annual basis, the most recent occasion being in October 2008. With accelerated development at Lomada and a focus on moving the larger Cap Oeste project forward as quickly as possible, we see the need for a possible equity raising of cUS\$12m in early 2009. In our view, these funds, when coupled with projected cash flow from the Lomada trial, should see the company through 2010, until a larger project at Cap Oeste can be considered in 2011. By this point, the company should, by its own projections, be a cash-positive gold producer; this, in turn, should make it possible to access the debt market.
- We compare PGD with its nearest geographical and geological peer, Andean Resources, with a market cap of £230m, some 8x that of PGD. We see the latter's Cerro Negro deposit being very similar in style and size to Cap Oeste, but some two years ahead in drilling and resource definition. On the basis of resources defined to date, we believe PGD warrants a share price of 14p to bring it into line with Andean, with further uplift if we consider a more-than-doubling of the company's resource base that we expect by the middle of 2009.

Rating	Corporate
Target price (12m)	28
Price (6/02/09) (p)	6.9
Market Cap (£m):	30
Sector	Mining and Metals
Reuters/Bloomberg	PGD.L/PGD.LN
AIM	402

PGD £'000s	2008E	2009E	2010E
Year end Dec			
Gold price \$/oz	850	800	800
EBITDA	(6,000)	(4,992)	(1,692)
Net Earnings	(5,889)	(4,734)	(1,810)
EPS p	(1.35)	(0.85)	(0.29)
Cash flow before financing	(5,889)	(5,618)	(6,985)
Cash from share issue	6,095	8,400	
Cash from debt			10,000
Cash at hand	868	3,649	6,665

52 week range	4.00-11.75
Free float (%)	40
Number of shares (m)	40.2
Daily volume (m)	0.23



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Summary

Gold producer by year end

We favour Patagonia Gold (PGD) not simply because of its defensive exposure to gold (Au) and silver (Ag), but because it has taken the decision to move to production as quickly and cheaply as possible, and to then grow incrementally. The company has announced that it plans to develop a small trial heap leach operation at its Lomada project that could produce 2,500oz of Au by the end of the year and then an additional 6,000oz in 2010, for a very low capital and operating cost of US\$1.9m. Cash flow from this trial plant could be up to US\$8m, sufficient to make a significant contribution to the projected US\$8.5m capex for a 21,000oz pa leach plant at Lomada that could be operating by the end of 2010. This larger project could then, in turn, provide cash flow to develop what we consider to be the company-making project at Cap Oeste.

We have remodelled PGD on the basis of this accelerated cash flow. When coupled with an approximate 5p per share contribution from depreciation of the GBP against the dollar, plus a 4p contribution from our increased long-term gold price assumption from US\$750/oz to US\$800/oz, this results in our NPV-based valuation increasing from 15p to 28p. The case for this short-term value could also be argued by comparing PGD with its nearest peer, Andean Resources, which is developing the Cerro Negro deposit nearby. We take the view that both Cerro Negro and Cap Oeste have the potential to be of similar size; however, Andean began work on Cerro Negro in 2005 and so has benefited from an additional two years of drilling to expand its resource.

The company's flagship project at Cap Oeste is currently the subject of an ongoing drilling campaign that continues to produce bonanza Au and Ag grades. The resource at Cap Oeste currently stands at 304,099oz Au and 6.9Moz Ag. However, we have stated previously that on the basis of recent results, we would expect to see this resource advance past 1Moz Au equivalent by mid-year, and to have an ultimate potential of several times that, as only 1,200m of a total identified strike length of 6km has been drilled, to date. The Cap Oeste structure is very similar in size and style to the nearby Cerro Negro project of Andean Resources that has been the subject of feasibility studies, suggesting a production potential of upwards of 200,000oz pa. We believe Cap Oeste offers the same ultimate potential.

Leap-frog approach to growth

In our note of 6 May 2008 (There will be gold), we discussed the potential of a small mine at Lomada to provide cash flow that could be used to develop a larger mine at Cap Oeste. We felt that such an approach provided a leveraged entry into gold production that reduced the risk profile and the level of external funding required. Since that time, the company has reached all the necessary milestones and is now proposing to follow exactly this course of action.

In our view, this incremental approach to growth – with a focus on small-scale, near-term production – reduces the risk profile of the company, as it provides evidence of the company's ability to develop a mining operation in Argentina. In the past PGD has suffered from permitting issues in Argentina, when the neighbouring Chubut province placed an embargo on all mining operations, including the company's Huemules project. Reaching the production milestone at Lomada should remove any lingering concerns related to Argentinian political risk.

Lower half of the cost curve

The global average cash cost for gold reached a peak of approximately US\$450/oz last year, but has since come back to roughly US\$400/oz owing to reductions in fuel and steel prices, and depreciation of most gold-producing currencies. Scoping studies to date have indicated that Lomada could be operated at a cash cost of roughly US\$300/oz, while recently released studies by Andean suggest that Cerro Negro (and thus by extension Cap Oeste) could be sub-US\$200/oz. This is well below the global average; therefore it not only offers a substantial margin of error during the development phase, but also makes any subsequent operation less sensitive to the gold price and therefore offers a buffer against revenue volatility.

We view PGD as a low-risk entry into the gold space for the following reasons:

- Leveraged production. Rather than developing its operation in one “big bang”, with the associated risk of capital, incremental growth offers a lower risk approach.
- Low cost. Recent pricing reductions in the base metal sector have shown us the benefits of operating in the bottom half of the cost curve.
- Low liquidity risk. PGD's major shareholder has, to date, shown a willingness to support the company during difficult markets. While we would view dilution of this major shareholding as a positive, the company has demonstrated that it has a funding source of last resort.
- Heavy discount to nearest peer. On the basis of current in-situ resources, PGD is trading at a 50% discount to its most comparable peer, Andean Resources, with a greater discount being applied if the potential resources are taken into account.

Concrete milestones

Our valuation is based upon our operating assumptions being met. However, the company has now, in effect, set a series of distinct milestones over the next 12 months that should provide a regular flow of news and offer uplift triggers towards our target price. We would expect such milestones to include:

- A possible capital raising in Q1 2009
- Final metallurgical testing, Q2 2009
- Lomada sterilisation drilling, Q2 2009
- Environmental impact study for Lomada, Q2 2009
- Upgraded resource statement for Cap Oeste, Q2 2009
- Purchase of trial plant equipment, Q3 2009
- Commencement of ground works for Lomada trial plant, Q3 2009
- Loading of pad, Q4 2009
- Lomada base-line environmental study, Q4 2009
- First gold production from trial plant, Q4 2009
- Full Lomada feasibility, end-2009

Resources

Resource size

To date, the company has published two compliant resources, 237,000oz Au at Lomada de Leiva; and 304,099oz Au plus 6.9Moz Ag at Cap Oeste. However, in both cases we regard these resources as preliminary and open to expansion.

At Lomada, the company is discouraged from expanding the resource as it is required to make a US\$1.5m payment to Barrick once the indicated component of the resource exceeds 200,000oz. We have previously stated that we see the potential for 400,000oz here, and we maintain this view.

1Moz by mid-year and growing

At Cap Oeste, the current resource is based upon drilling undertaken to the end of last year's field season. Later drilling has continued to intersect high-grade Au and Ag, and we have previously stated that we see Cap Oeste surpassing 1Moz by the end of the first half of 2009, with the potential to ultimately be a multi-million-oz deposit once the full 6km strike length of the main structure is drilled. However, we also note that PGD's ability to expand the Cap Oeste resource is restricted by a buy-back clause held by Barrick Gold, once the resource exceeds 2Moz. We have stated previously that we consider the most likely scenario could see PGD ceasing further exploration work once the resource exceeds 1Moz, to concentrate instead on development, with further resource expansion coming in later years.

Resource nature

Size notwithstanding, the most salient point about these resources, in our view, is their amenability to being brought into production quickly and cheaply.

While low grade, the Lomada deposit is a surface deposit on top of a hill in an intensely fractured breccia zone where the gold is in the friable matrix material. The economic significance of this is that the development of the deposit is likely to require no pre-strip and no drilling and blasting, with all mined material then being transported a short distance downhill.

The company's proposal for a Run of Mine (ROM) leach pad is therefore an extremely cheap and fast route to production, by virtue of the technical ease with which it could be mined.

Cap Oeste, in contrast, is larger and high grade, and should be amenable to low-cost production by grade, by-product credits and economies of scale.

Development scenario

The company has announced that it intends to pursue an accelerated development programme at its Lomada project, based around a ROM heap leach operation. The operation is scheduled to be developed in stages:

Trial plant

Start small

As the first plank of its development at Lomada, PGD has proposed to develop a small trial plant, which we understand can be constructed under the current exploration licence.

The company has announced that the forecast cost for testing, permitting, construction and operation of a small ROM leach pad to produce 2,500oz of Au, would be of the order of US\$1.9m and could see this gold produced by the end of 2009. In addition, once the initial pad was exhausted, three more 6m loads could be added to produce an additional 6,000oz during 2010.

ROM means that ore is mined and then placed directly on the leach pad, with no crushing or grinding. This is possible because tests have shown that the gold at Lomada is contained within the loose and friable matrix of the breccia zone, and can be freed up sufficiently by the earth-moving process to allow the leaching liquor to penetrate. The benefit of this is a significant reduction in both capex and opex, as no crushing or grinding plant is required.

Full development

Once the trial plant is operational, the company has then proposed to use this cash to contribute to the development of a larger operation at Lomada, according to the specifications of a scoping study that was released in November 2008.

This study calls for the development of a larger ROM heap leach operation, developed at a capital cost of US\$8.5m, and producing 21,000oz per year at a cash cost of US\$299/oz for a minimum seven-year mine life.

We anticipate PGD being able to develop this larger operation largely from cash flow from its proposed trial mine, and therefore expect this operation to reach production by early 2010.

Longer term – Cap Oeste

We have stated previously our view that Lomada is merely the stepping stone to larger-scale production that could come from the Cap Oeste project to the south. We see Cap Oeste ultimately having the potential to be a multi-million-oz deposit that, in several years' time, could offer the scope for PGD to move towards annual production of more than 200,000oz Au pa.

We had originally modelled a large hard-rock mine and plant being developed here, with production commencing in 2013. However, given that the vein comes to surface and has been heavily weathered, and that a heap leach operation is to be developed nearby at Lomada, we now see the potential for a small heap leach to be developed at Cap Oeste as well, in advance of the main project. Much like Lomada, therefore, we could see Cap Oeste being brought to production more quickly than previously anticipated, thus offering the potential for an additional leverage effect.

We have therefore adjusted our model to include a small level of production from Cap Oeste being brought in during 2011.

Beyond that, we have obtained guidance from recently released feasibility studies from Andean Resources, which is expanding its Cerro Negro deposit in the same region as PGD. Cerro Negro is a similar geological feature to Cap Oeste, of similar size and grade, and although PGD is several years behind in resource definition, we see the two projects as roughly similar in size and scope. Andean has indicated that cash costs of roughly US\$200/oz could be achieved at Cerro Negro, with the potential for this to be less now, owing to recent cost reductions across the industry. Cash cost is, to an extent, a factor of the size and scale of plant that is constructed, and so we cannot draw a direct analogue. However, this low figure does give us comfort that Cap Oeste could be operated towards the bottom of the cost curve.

Possible US\$8m contribution from trial plant

Cap Oeste could also be started cheaply

Capex and opex guidance offered by Andean

Financial

We have adjusted our model to reflect the company's modified plans to bring Lomada into production via a trial mining route.

On the basis of the cost estimates provided by the company, and our gold price assumption for 2009 of US\$850/oz we could see a US\$2.2m gross operating profit realised by this trial by the end of 2009E, with an additional US\$6.4m contributed in 2010E if the three further layers are added to the trial heap leach. Increasing our gold price assumption to the current spot price of US\$900/oz could see these cash flows increase to US\$2.3m and US\$6.8m, respectively.

We have then modelled Lomada ramping up toward the end of 2010 to make a contribution to an estimated 2010 production of 9,000oz and then to full production of 21,000oz pa from Lomada in 2011E. The scoping study completed for Lomada has defined a seven-year mine life, based on the small resource that currently exists. However, we have previously stated that we see the potential for 400,000oz here, and have therefore pushed our production out to 12 years.

We have noted that we see the potential for Cap Oeste to also be brought forward to production via the ROM leach pad route and have allowed for a contribution of 15,000oz in 2011E, ramping up steadily from there to 200,000oz pa by 2016E.

On these assumptions, we have forecast positive EBITDA by 2011 of £8m, increasing quickly from there to almost £28m in 2012 and £35m in 2013. Translation through to net earnings, however, is less certain, owing to the potential for the company to claim accelerated depreciation concessions that could significantly reduce taxable earnings in the major capex years of 2011 and 2013.

Funding requirements

PGD has, to date, followed a policy of funding its exploration requirements by raising money on an annual basis, the most recent being £1.85m in October 2008.

Capital raising in early 2009

In addition to the US\$1.9m flagged by the company for the Lomada trial operation, we see the need for a ramp-up of drilling and other activities at Cap Oeste to increase this resource and move it closer to production. We have therefore modelled an equity raising of US\$12m in early 2009 at the current share price. This is based on our assumptions of what may be required to bring these projects forward:

US\$2m for development and operation of the Lomada heap leach.

US\$4m for continued drilling and assay at Cap Oeste and La Manchuria.

US\$4m for overhead and technical studies related to further development of Lomada and Cap Oeste.

US\$2m for contingencies.

We concede this amount is somewhat arbitrary, but feel that such a raising, if combined with cash flow from the Lomada trial heap, should see PGD becoming self sufficient through development of the full Lomada project. The need for further funding to develop a much larger operation at Cap Oeste will be based on the size and timing of such an operation; however, we feel that credit markets may have loosened by then, to allow a significant debt contribution to be added.

Valuation

NPV increase as a result of three factors

NPV

Our primary valuation methodology is based on a discounted cash flow analysis of our assumed development scenario. Using a discount rate of 12%, over a 12-year operating life, we arrive at an NPV per share of 28p, an increase of some 85% from our previous NPV valuation of 15p per share.

This 13p per share increase stems from a combination of three factors:

- Gold price (4p). Our initial modelling used a gold price going forward of US\$750. We have increased our assumption to US\$850/oz for 2009, decreasing to a steady US\$800/oz going forward.
- Currency (5p). Depreciation of the GBP against the USD has added approximately 5p to our valuation. In addition, we raise the possibility of operating-cost reductions owing to depreciation of the Argentine peso; however, we have not factored these into our model.
- Accelerated production (4p). The likelihood of bringing revenue forward by way of the trial plant at Lomada and potential trial plant at Cap Oeste.

We expect solid earnings by 2012

PE

First-tier gold producers such as Barrick and Newmont have performed well in recent months, and are currently trading at forward PE ratios of between 15x and 20x. We do not argue that PGD deserves such valuation; however, for the purposes of illustration, our financial model suggests the potential for EPS of more than 4p per share by 2012E if production ramps up as we have assumed. A more conservative 10x PE would therefore equate to an ultimate target price of 40p per share, if milestones are reached.

EV/Resource oz

In general, we do not favour valuations based on a simple assessment of in situ resources, as such comparisons take no account of the wide differences in development and mining costs. However, in instances where a geographically and geologically similar example is available, we believe the comparison is instructive.

Trading at significant discount to nearest peer

Andean Resources is advancing its Cerro Negro deposit in Santa Cruz province that is geologically very similar to Cap Oeste, in similar terrain and in the same political jurisdiction. The resource picture here is developing, but currently stands at approximately 2.2Moz Au equivalent, compared with only 400,000oz at Cap Oeste. However, Andean has been drilling for an additional two years and so it is likely to have tested a greater proportion of the Cerro Negro potential. We take the view that both deposits are likely, ultimately, to be similar in size and thus be able to support operations of similar scale.

We therefore have two companies with assets of similar scale in close proximity to each other that may, in time, develop into gold operations of similar size; but both are proposing to reach that objective via a different path – PGD proposes to start mining on a small scale as quickly as possible and use cash flow to grow incrementally, while Andean is proposing the “big bang” approach of a larger development from scratch. PGD plans to be producing well in advance of Andean (albeit on a small scale); in our view, this offers significant risk benefits over Andean, primarily as it offers the company a mechanism to develop its understanding of the various deposits, and offers the market an opportunity to observe the company’s ability to move to producer status, both without huge risk of capital.

The enterprise value (EV) of Andean is roughly US\$350m, therefore suggesting an EV/oz valuation of US\$160/oz. PGD, in contrast, has a current EV of approximately US\$45m on a resource base of approximately 600,000oz, for a valuation of US\$80/oz.

Given the close similarity between Cap Oeste and Cerro Negro, we think it is not unreasonable to argue that both companies deserve a similar EV valuation. On this basis, it could be argued that PGD, even on its preliminary resource figure, should be trading closer to 14p – twice its current price – simply to bring it into line with Andean. However, should we consider the probability that recent drill results have already more than likely doubled its resource base, then we believe a case could be made for an EV valuation of 28p, to match its peer and neighbour.

Figure 1. Income statement

Profit and Loss £m	2006	2007	2008E	2009E	2010E	2011E	2012E	2013E
Gross operating profit				1,158,950	3,802,500	12,090,000	33,637,500	42,575,000
Less royalty				(34,769)	(114,075)	(362,700)	(1,009,125)	(1,277,250)
Less export tax				(115,895)	(380,250)	(1,209,000)	(3,363,750)	(4,257,500)
Admin and exploration	(2,798,990)	(6,235,534)	(6,000,000)	(6,000,000)	(5,000,000)	(2,500,000)	(2,500,000)	(2,500,000)
Amortisation of goodwill	(15,054,025)							
Impairment of goodwill								
Barrick payment	(17,853,015)	(6,235,534)	(6,000,000)	(4,991,714)	(1,691,825)	8,018,300	26,764,625	34,540,250
Operating profit	(17,853,015)	(6,235,534)	(6,000,000)	(4,991,714)	(1,691,825)	8,018,300	26,764,625	34,540,250
Share of operating loss in associate	(17,853,015)	(6,235,534)	(6,000,000)	(4,991,714)	(1,691,825)	(4,040,400)	(1,411,800)	(32,871,800)
Total operating profit EBITDA	(17,853,015)	(6,235,534)	(6,000,000)	(4,991,714)	(1,691,825)	3,977,900	25,352,825	1,668,450
Depreciation		(1.98)	(1.44)	(0.94)	(0.29)	0.67	4.27	0.28
EBIT		48,297	110,861	257,532	232,076	113,774	90,201	1,658,609
EBIT per share		(75.629)						
Interest receivable	52,295							
Finance costs	(75,629)	(2,097)						
Interest payable - project debt				0	(350,000)	(712,250)		
Net earnings after interest	(17,876,349)	(6,189,334)	(5,889,139)	(4,734,182)	(1,809,749)	3,379,424	25,443,026	3,327,059
Tax charge								
Profit from disposal of associate	873,595							
Net earnings	(17,002,754)	(6,189,334)	(5,889,139)	(4,734,182)	(1,809,749)	3,379,424	25,443,026	3,327,059
EPS	(6.30)	(1.84)	(1.35)	(0.85)	(0.29)	0.55	4.14	0.54

Source: Patagonia Gold, Matrix Corporate Capital estimates

Figure 2. Balance sheet

Balance sheet £m	2006	2007	2008E	2009E
ASSETS				
Non-current assets				
Property plant and equipment	40,214	66,199	66,199	950,199
Financial assets	85,210	146,666	146,666	146,666
Other receivables	227,032	351,316	351,316	351,316
Total non-current assets	352,456	564,181	564,181	1,448,181
Current Assets				
Trade and other receivables	202,682	224,630	224,630	224,630
Cash at hand	966,143	661,793	867,670	3,649,489
Total current assets	1,168,825	886,423	1,092,300	3,874,119
Total Assets	1,521,281	1,450,604	1,656,481	5,322,300
LIABILITIES				
Current liabilities				
Trade and other payables	(301,220)	(534,922)	(534,922)	(534,922)
Total current liabilities	(301,220)	(534,922)	(534,922)	(534,922)
Non-current liabilities				
Total liabilities	(301,220)	(534,922)	(534,922)	(534,922)
Net assets	1,220,061	915,682	1,121,559	4,787,378
Capital and reserves				
Called up share capital	2,731,065	3,579,229	4,735,528	5,935,528
Share premium account	23,389,188	28,400,654	33,339,372	40,539,372
Translation reserve	238,907	103,907	103,907	103,907
Share based payment reserve	13,731	112,600	112,600	112,600
Profit and loss account	(25,152,830)	(31,280,708)	(37,169,847)	(41,904,028)
Equity shareholders funds	1,220,061	915,682	1,121,560	4,787,378

Source: Patagonia Gold, Matrix Corporate Capital estimates

Figure 3. Cash flow statement

Cash flow statement £m	2006	2007	2008E	2009E	2010E	2011E	2012E	2013E
Cash flow from operating activities								
Operating loss	(17,002,754)	(6,189,334)	(6,000,000)	(4,991,714)	(1,691,825)	8,018,300	26,764,625	34,540,250
Adjustment for								
interest received	(52,295)	(48,297)						
Depreciation and impairment	15,072,099	24,279				4,040,400	1,411,800	32,871,800
Profit on disposal	(873,595)							
Decrease in debtors	(158,802)	(146,232)						
Increase in creditors	(629,641)	233,702						
Other provisions								
Share based payments	13,731	98,869						
Settlement of convertible debt	520,000							
Net cash used in operating activities	(3,111,257)	(6,027,013)	(6,000,000)	(4,991,714)	(1,691,825)	12,058,700	28,176,425	67,412,050
Cash flow from investing activities								
Interest received	52,295	48,297	110,861	257,532	232,076	113,774	90,201	1,658,609
Disposal of glass earth shares	893,994							
Purchase of property plant and equipment	22,050	(50,264)		(884,000)	(5,525,000)	(19,825,000)	(32,825,000)	(650,000)
Disposal of HPD	(25,093)							
Net cash from investing activities	943,246	(1,967)	110,861	(626,468)	(5,292,924)	(19,711,226)	(32,734,799)	1,008,609
Cash flows from financing								
Proceeds from issue of share capital	3,020,000	5,859,630	6,095,016	8,400,000	10,000,000		10,000,000	(18,000,000)
Proceeds from debt								
Repayment of debt								
Debt interest								
Net cash from financing	3,020,000	5,859,630	6,095,016	8,400,000	10,000,000		10,000,000	(18,000,000)
Change in cash	851,989	(169,350)	205,877	2,781,818	3,015,251	(7,652,526)	5,441,626	50,420,659
Cash at beginning of period	147,965	966,143	661,793	867,670	3,649,489	6,664,740	(987,785)	4,453,840
Foreign exchange movement	(33,811)	(135,000)						
Cash at end of period	966,143	661,793	867,670	3,649,489	6,664,740	(987,785)	4,453,840	54,874,499

Source: Patagonia Gold, Matrix Corporate Capital estimates

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Company	Disclosure
Patagonia Gold (PGD)	Company Broker

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