

28 September 2010

Arian Silver

Year End	Revenue (US\$m)	PBT* (US\$m)	EPS* (c)	DPS (c)	P/E (x)	Yield (%)
12/08	0.0	(3.7)	(2.2)	0.0	N/A	N/A
12/09	0.0	(2.1)	(0.8)	0.0	N/A	N/A
12/10e	2.8	0.1	0.0	0.0	N/A	N/A
12/11e	12.8	4.4	1.5	0.0	17.1	N/A

Note: *PBT and EPS are normalised, excluding goodwill amortisation and exceptional items. Exchange rate \$1.508/£.

Investment summary: Production agreement

Arian Silver's announcement that it has signed the necessary contracts to put its San Jose mine into production represents an important milestone in the evolution of the company and advances the expectation of profits, cash-flow and exploration success. As a result of these developments, Arian anticipates becoming cash-flow positive in the fourth quarter of 2010 and allows us to update and crystallise our forecasts and valuation of the company (set out below).

Revenue and costs

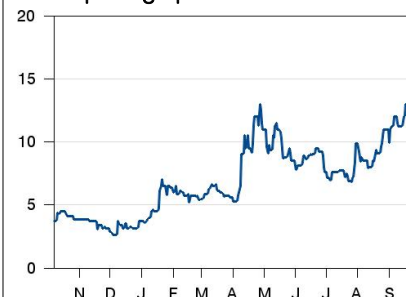
Arian's contractual obligations envisage a 500tpd contract mining operation. Initially, this will feed a 400tpd mill at a cost of US\$26/t. In addition, Arian is to hire a mill at a fixed cost of US\$292,200 per month – equivalent to US\$29.22 per tonne. In terms of revenue, Arian anticipates producing 125t of concentrate per month initially, rising to (we estimate) 156t at a grade of 405oz per tonne. This is possible assuming that its contract miners produce ore with a head grade of 204.49g/t (± 17.68 g/t), which compares to an average grade for the three ore blocks to be mined (Ramal Norte, San Jose 75m Central and Santa Ana) of 185.5g/t and a grade of 300g/t implied by recent (albeit selective) ore sampling by the company.

Valuation: Future value could exceed 47p

On the basis of these contracts, we estimate that Arian will generate revenue of US\$14.2m per annum at a gross cash cost of US\$6.6m. This increases our forecast of the company's profit before tax by 20%, from US\$3.7m previously to US\$4.4m, and our valuation of the company, over the four and a half years of the mine's official life, from 22.56 to 23.87 US cents per share. To this must then be added the likely value of exploration success (which the San Jose mine is specifically intended to fund). Assuming that Arian delineates new resources at the same rate per km of exploration drilling as in the past, we estimate that a US\$10m exploration programme should delineate a resource valued at 47-140p per Arian share in current money terms. Given the terms of the contracts signed, we estimate that Arian will then have an additional US\$8.8m surplus (worth 2.2p per share), which it will have the option to invest into further exploration expenditure if warranted by circumstances at the time.

Price 17p
Market Cap £44m

Share price graph



Share details

Code AGQ
Listing AIM, TSX-V
Sector Mining
Shares in issue 258m

Price

52 week High Low
17.5p 2.2p

Balance Sheet as at 31 March 2010

Debt/Equity (%) N/A
NAV per share (c) 4.0
Net cash (US\$m) 1.5

Business

Arian Silver, listed on AIM and TSX, specialises in Mexican silver deposit exploration and development. Its San Jose mine is expected to enter production soon. Its other three projects are Calicanto and San Celso, located in Zacatecas, and Tepal in Michoacan.

Valuation

	2009	2010e	2011e
P/E relative	N/A	N/A	50%
P/CF	N/A	10.5	3.6
EV/Sales	N/A	5.2	1.1
ROE	N/A	1%	31%

Revenues by geography

	UK	Europe	US	Other
0%	0%	0%	0%	100%

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Investment summary: Important milestone achieved

Arian Silver has announced that “all the necessary contracts are now in place for the proposed silver production operation at its 100%-owned San Jose mine, Zacatecas, Mexico” and that the company is now “moving into production”.

The key features of the contracts are:

- i) Ore will be contract mined at 500 tonnes per day for 20 days per month (ie 10,000tpm or 120,000tpa). There is potential to triple the contract mining production rate from 500tpd to 1,500tpd, subject to mill capacity being available. Total costs to deliver ore to the mill are estimated to be US\$26/t.
- ii) The milling operation will initially handle 400tpd, with plans to increase throughput with an upgraded crusher. Mill hire costs are a fixed MXP3.7m per month (equal to US\$292,200 at MXP12.664/US\$), including all operating costs, maintenance and repair costs and consumables and subject to adjustment for any operating downtime. This equates to US\$29.22 per tonne of ore processed at 500tpd, falling to US\$9.74/t at 1,500tpd.
- iii) At a milling rate of 400tpd, Arian expects to produce 125t of silver (Ag) concentrate at a grade of 370-440oz Ag per tonne.
- iv) A net smelter royalty of 2% of concentrate value is payable by Arian to the vendor of the San Jose property.
- v) Initial mill feed will be taken from surface dump material at Arian’s Los Campos property until the Santa Ana resource block is accessed.
- vi) Positive cash flow is expected from Q410 onwards.

These contractual terms and conditions differ from those assumed in our note of 29 July, as follows:

Exhibit 1: Current and previous contract assumptions

Note: * Incurred by mill operator.

Parameter	Previous assumption	Current assumption
Throughput rate	120,000tpa	96,000tpa rising to 120,000tpa
Silver price	US\$21.35/oz	US\$21.35/oz
Ore Silver Grade	300g/t	
Mining Rate	500tpd	400tpd rising to 500tpd
Silver recovery	77%	
Contract Mining Cost	US\$22.70/t	US\$26.00/t
Processing costs (flat)		US\$292,167 per month
Unit processing costs	*US\$15.00/t	US\$29.22/t (at 500tpd)
Dilution	10%	
Positive cash-flow	Q310	Q410
Output	74,269oz Ag per month	125t concentrate at 370-440oz per tonne containing 50,625oz Ag ($\pm 4,375$ oz) per month rising to 156.25t concentrate at 370-440oz per tonne containing 63,281oz Ag ($\pm 5,469$ oz) per month.

Source: Edison Investment Research

By comparing the silver content of the concentrate produced with the tonnes mined, it is possible to calculate a yield of 157.46g/t (± 13.61 g/t) and, by applying the same silver recovery factor of 77%, we can deduce that Arian anticipates mining ore at an average head-grade of 204.49g/t

(±17.68g/t). This compares with an average grade for the three ore blocks to be mined (Ramal Norte, San Jose 75m Central and Santa Ana) of 185.5g/t (see Exhibit 2).

Exhibit 2: Current value of total San Jose resource and that of the three ore blocks to be mined

Ore blocks		Tonnes	Ag (g/t)	Total oz
Ramal Norte	Indicated	82,461	209.7	555,944
	Inferred	24,523	161.9	127,645
S.J. 75m C	Indicated	65,542	155.9	328,511
	Inferred	7,290	110.1	25,805
St Ana	Indicated	208,332	192.3	1,288,009
	Inferred	63,380	180.4	367,597
Total		451,528	185.5	2,693,578

Source: Edison Investment Research, ACA Howe and Arian Silver

The first 18 months of mining, however, will be conducted on the Santa Ana ore block, where in-house work, including sampling and re-modelling of the Howe resource model (less tonnage in lieu of higher grade), indicates a potential grade of around 300g/t (at a 170g/t Ag cut-off, assuming US\$18/oz Ag).

As a result of the contractual changes, relative to our previous assumptions, we have adjusted our scoping economics for the four and a half years of the San Jose mine's formal life as follows:

Exhibit 3: Current and previous scoping economics for San Jose mine

Note: * Estimated.

Measure	Unit	Previous	Current	Change (%)
Annual ore production	kt	120	120	0.0
Grade	g/t	300		
Recovery	%	77		
Silver output	oz	891,226		
Silver price	US\$/oz	21.35	21.35	0.0
Concentrate production	tpa		1,875	
Concentrate grade	oz per tonne		405	
Contained silver	oz		759,375	
Net smelter return	%		*89	
Vendor net smelter royalty	%		2	
Share	%	50	100	
Revenue	US\$ ('000s)	9,514	14,167	+48.9
Costs	US\$ ('000s)	2,724	6,626	+143.2
Gross profit	US\$ ('000s)	6,790	7,541	+11.1
General and administrative costs	US\$ ('000s)	-3,000	-3,000	0.0
EBITDA	US\$ ('000s)	3,790	4,541	+19.8
Depreciation and amortization	US\$ ('000s)	41	41	0.0
EBIT	US\$ ('000s)	3,749	4,500	+20.0
Net interest	US\$ ('000s)	0	0	0.0
Profit before tax	US\$ ('000s)	3,749	4,500	+20.0

Source: Edison Investment Research

As such, it can be seen that, while costs are higher than those previously expected, so too are revenues to an extent that projected profits also increase. Conversely, whereas we had previously anticipated positive cash flow from Q310, its delay until Q410 means that we have adjusted our analysis such that (hypothetical) dividends are assumed to be payable from FY11 only. Exhibit 4 shows the variation in our valuation of Arian Silver based on the changes discussed.

Exhibit 4: Previous and current Arian Silver valuation, USc (unless stated otherwise)

	Previous	Current	Change (%)
Silver price (US\$/oz)	21.35	21.35	0.0
DDF valuation	8.27	9.48	+14.6
NPV of terminal NAV	1.18	1.28	+8.5
Residual resource valuation	12.48	12.48	0.0
Calicanto valuation	0.63	0.63	0.0
Total valuation (cents)	22.56	23.87	+5.8
Total valuation (pence)	14.96	15.23	+1.8

Source: Edison Investment Research

Exploration potential

Significantly, based on the assumptions above, we estimate that Arian will be able to increase its total, budgeted exploration spend to US\$18.8m. This compares to an estimate of “in excess of US\$10m” previously.

In our previous analysis, we had assumed that a US\$10m exploration budget would be sufficient to enable the company to drill approximately 100,000m across the San Jose property. On the basis that its current resource was delineated at a rate of 1.15Mt for each km drilled, we were thus able to estimate a potential resource from a US\$10m drilling campaign of 128.4Mt (including the 13.4Mt existing resource). Further assuming that these resources would be categorised in line with the industry average of 12.7% in the measured category, 35.51% in the indicated category and 51.79% in the inferred category, and applying industry average valuations to each category of resource ounce, we were able to derive a potential additional value for the SJV of c US\$1,000m, or \$3.76 (£2.49) per share. If the resource estimate were updated by 2016, this would have a value of £1.40 per share in current money terms (after subtracting the drilling cost of US\$10m).

By contrast, an updated exploration budget of US\$18.8m would correlate to 188km of drilling at US\$100 per metre. At 1.15Mt per kilometre drilled, this would translate into 229.4Mt of resources (including the 13.4Mt existing resource) worth US\$1,692m, or US\$7.06 (£4.49) per share, given an industry average split of categorisation and at industry average valuations. Discounting at 10% per annum, this would be worth US\$3.99 (£2.54) per share in current money terms, over six years (after deducting drilling costs).

By contrast, assuming that Arian delineates new resources in the same proportion as those already discovered implies a value of US\$353m, or US\$0.71 (£0.47) per share, after subtracting discovery costs and discounting over six years for a US\$10m drilling campaign. For a US\$18.8m campaign however, it implies a value of US\$581m, or US\$2.43 (£1.55) per share after subtracting drilling costs, which reduces to US\$1.37 (£0.87) when discounted back six years.

As San Jose’s current resource of 13.4Mt was delineated after drilling 10% of the strike length of the vein, it seems likely that drilling over 100% of the strike length of the vein will yield a resource of the order of 134Mt across all categories – ie the additional US\$8.8m of exploration budget may have to be deployed to infill, rather than step-out, drilling as the San Jose vein may not support a resource of 229.4Mt. Given that the total resource may therefore be delineated by a US\$10m drilling programme, we are therefore leaving our valuation of the potential blue-sky upside relating to the San Jose resource unchanged at 47p (with new resources delineated pro-rata to existing ones), with the potential to rise to £1.40 (in the event that new resources are delineated pro-rata to the industry average). However, both figures may be increased (or brought forward) in the event

that Arian deploys the excess funds (US\$8.8m) available for its exploration campaign towards either upgrading or fast-tracking its resource, rather than expanding it.

Exhibit 5: Financials

Note: FY10 exceptional item relates to a non-cash impairment of current assets held for sale.

Year end 31 December	US\$'000s	2008	2009	2010e	2011e
		IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS					
Revenue		0	0	2,833	12,750
Cost of Sales		0	0	(1,501)	(6,314)
Gross Profit		0	0	1,333	6,436
EBITDA		(3,665)	(2,027)	253	4,409
Operating Profit (before GW and except.)		(3,720)	(2,068)	212	4,368
Intangible Amortisation		0	0	0	0
Exceptionals		0	0	(5,167)	0
Other		0	0	0	0
Operating Profit		(3,720)	(2,068)	(4,955)	4,368
Net Interest		31	0	(151)	42
Profit Before Tax (norm)		(3,689)	(2,068)	61	4,410
Profit Before Tax (FRS 3)		(3,689)	(2,068)	(5,106)	4,410
Tax		0	(196)	0	0
Profit After Tax (norm)		(3,689)	(2,264)	61	4,410
Profit After Tax (FRS 3)		(3,689)	(2,264)	(5,106)	4,410
Average Number of Shares Outstanding (m)		149.1	258.1	248.9	239.6
EPS - normalised (c)		(2.5)	(0.9)	0.0	1.8
EPS - normalised and fully diluted (c)		(2.2)	(0.8)	0.0	1.5
EPS - FRS 3 (c)		(2.5)	(0.9)	(2.1)	1.8
Dividend per share (c)		0.0	0.0	0.0	0.0
Gross Margin (%)		N/A	N/A	47.0	50.5
EBITDA Margin (%)		N/A	N/A	8.9	34.6
Operating Margin (before GW and except.) (%)		N/A	N/A	7.5	34.3
BALANCE SHEET					
Fixed Assets		6,173	7,789	6,198	8,139
Intangible Assets		6,038	4,803	5,303	9,460
Tangible Assets		135	2,986	895	(1,321)
Investments		0	0	0	0
Current Assets		1,378	6,087	5,306	6,721
Stocks		0	0	236	1,062
Debtors		625	349	233	1,048
Cash		753	101	2,787	3,285
Current Liabilities		(255)	(2,133)	(1,573)	(519)
Creditors		(255)	(521)	(1,573)	(519)
Short term borrowings		0	(1,612)	0	0
Long Term Liabilities		0	0	0	0
Long term borrowings		0	0	0	0
Other long term liabilities		0	0	0	0
Net Assets		7,296	11,743	9,931	14,341
CASH FLOW					
Operating Cash Flow		(3,147)	(1,076)	1,655	4,613
Net Interest		31	0	(151)	42
Tax		0	(196)	0	0
Capex		(2,651)	(1,048)	0	(4,157)
Acquisitions/disposals		(48)	0	(500)	0
Financing		3,451	0	3,294	0
Dividends		0	0	0	0
Net Cash Flow		(2,364)	(2,320)	4,298	498
Opening net debt/(cash)		(3,134)	(753)	1,511	(2,787)
HP finance leases initiated		0	0	0	0
Other		(17)	56	0	0
Closing net debt/(cash)		(753)	1,511	(2,787)	(3,285)

Source: Edison Investment Research, Arian Silver accounts

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