

## **MANAGEMENT'S DISCUSSION AND ANALYSIS**

(All amounts are expressed in United States dollars, unless otherwise stated)

This management's discussion and analysis ("MD&A") of the operating results and financial position of Alamos Gold Inc. and its subsidiaries ("the Company") is for the year ended December 31, 2008 compared with the year ended December 31, 2007. Together with the consolidated financial statements and related notes, the MD&A provides a detailed account and analysis of the Company's financial and operating performance for the year. The Company's functional and reporting currency is the United States dollar. This MD&A is current to March 6, 2009 and should be read in conjunction with the Company's Annual Information Form and other corporate filings available at [www.sedar.com](http://www.sedar.com) ("SEDAR"). Management is responsible for the interim consolidated financial statements referred to in this MD&A, and provides officers disclosure certifications filed with securities commissions on SEDAR. The audit committee reviews the interim consolidated financial statements and MD&A, and recommends approval to the Company's Board of Directors.

The MD&A should be read in conjunction with the consolidated financial statements of the Company and related notes, which have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP"). Refer to Note 2 of the December 31, 2008 and 2007 audited consolidated financial statements for disclosure of the Company's significant accounting policies. Refer to Note 3 of the December 31, 2008 and 2007 audited consolidated financial statements for a discussion of changes in accounting policies and presentation.

### **Note to U.S. Investors**

All references to mineral reserves and resources contained in this MD&A are determined in accordance with National Instrument 43-101, Standards of Disclosure for Mineral Projects ("NI 43-101") of the Canadian Securities Administrators ("CSA") and Canadian Institute of Mining, Metallurgy and Petroleum ("CIM") standards. While the terms "mineral resource," "measured mineral resource," "indicated mineral resource," and "inferred mineral resource" are recognized and required by Canadian regulations, they are not defined terms under the Securities and Exchange Commission ("SEC") standards in the United States ("U.S."). As such, information contained in this MD&A concerning descriptions of mineralization and resources under Canadian standards may not be comparable to similar information made public by U.S. companies subject to the reporting and disclosure requirements of the SEC. "Indicated mineral resource" and "inferred mineral resource" have a great amount of uncertainty as to their existence and economic and legal feasibility. It cannot be assumed that all or any part of an "indicated mineral resource" or "inferred mineral resource" will ever be upgraded to a higher category of resource. Investors are cautioned not to assume that all or any part of the mineral deposits in these categories will ever be converted into proven and probable reserves.

## Overview

Alamos Gold Inc. is a publicly-traded company on the Toronto Stock Exchange (TSX: AGI). The Company owns 100% of the 28,500-hectare Salamandra group of concessions located in the state of Sonora in northwestern Mexico. The Salamandra group of concessions includes the Mulatos mine (the “Mine”) and numerous other prospective exploration targets throughout the district. The Mine currently produces gold in dore bars from the Estrella Pit for shipment to a refinery. Gold may be sold in refined form or as dore. The Company achieved commercial production at the Mine on April 1, 2006.

The Salamandra group of concessions contains both advanced and grassroots exploration prospects. There are several advanced exploration projects near the Estrella Pit that have the potential to continue to add resources and reserve ounces to the global Mulatos deposit, including both mineralization extensions and satellite deposits.

## 2008 Highlights

In the year ended December 31, 2008, the Company:

- Produced 151,000 ounces of gold, an increase of 42% over the 106,200 ounces produced in 2007.
- Reported strong revenue growth, increasing revenues 80% to \$133.0 million.
- Recognized earnings of \$29.4 million (\$0.31 per share (basic)) compared to \$2.9 million or \$0.03 per share in 2007.
- Generated cash from operations of \$65.3 million (\$0.68 per share (basic)) compared to \$20.9 million (\$0.22 per share) in 2007.
- Significantly strengthened its balance sheet by increasing cash balances by \$36.0 million to \$43.8 million at December 31, 2008, retiring its convertible debenture liability and repaying all outstanding debt obligations.
- Announced new gold discoveries at the La Yaqui and Cerro Pelon regional exploration targets, and reported new resources at Puerto del Aire.

Subsequent to year-end, the Company:

- Completed a bought-deal financing for net proceeds of \$62.5 million, increasing the Company’s cash balances to \$110 million.

## Results of Operations

Throughout 2008, the Company completed a number of operational initiatives that have resulted in significant improvements to gold production. Specifically, in the first half of 2008 the Company converted from truck-loading to conveying and stacking crushed ore on the leach pad, initiated a new lime-application process and implemented the first phase of the Company’s plans to apply inter-lift liners to the leach pad. In the fourth quarter of 2008, the Company began drum agglomeration. The key result of these operational advances has been improved leach pad dynamics and significantly higher gold recoveries. Higher gold recoveries have resulted in continually increasing gold production throughout the year, which combined with appreciably higher gold prices, resulted in the Company’s record financial performance in 2008.

<b>Production summary</b>	<b>Q1</b>	<b>Q2</b>	<b>Q3</b>	<b>Q4</b>	<b>2008</b>	<b>2007</b>
Ounces produced <sup>(1)</sup>	33,253	38,500	39,900	39,347	<b>151,000</b>	<b>106,200</b>
Ore mined (tonnes)	1,230,000	1,201,000	1,168,000	1,181,000	<b>4,780,000</b>	<b>3,941,000</b>
Waste mined (tonnes)	1,653,000	1,602,000	1,399,000	1,905,000	<b>6,559,000</b>	<b>9,859,000</b>
Total mined (tonnes)	2,883,000	2,803,000	2,567,000	3,086,000	<b>11,339,000</b>	<b>13,800,000</b>
Ore crushed (tonnes)	1,244,000	1,173,000	1,133,000	1,191,000	<b>4,741,000</b>	<b>4,015,000</b>
Ore mined per day (tonnes)	13,500	13,100	12,700	12,800	<b>13,100</b>	<b>10,800</b>
Ore crushed per day (tonnes)	13,670	12,800	12,300	13,000	<b>13,000</b>	<b>11,000</b>
Waste-to-ore ratio	1.34	1.33	1.20	1.61	<b>1.37</b>	<b>2.50</b>
Grade (g/t Au)	2.33	1.85	1.98	1.86	<b>2.01</b>	<b>1.96</b>

<sup>(1)</sup> Reported gold production for Q1 – Q3 2008 has been adjusted to reflect final refinery settlement. Reported gold production for Q4 and YTD 2008 is subject to final refinery settlement and may be adjusted.

The Company has achieved significant increases in ore mined and crushed in 2008 compared to 2007. In 2007, the Company reorganized the open pit and mined additional waste. As a result, mining operations were more efficient in 2008, contributing to a 21% increase in ore mined and a 33% decrease in waste mined. Also in 2007, the Company commissioned a new crusher which has improved the Company's ability to meet its targeted crusher throughput rates. Average daily crusher throughput of 13,000 in 2008 represents an 18% improvement over the comparable period of 2007.

The grade of ore crushed and stacked on the leach pad in 2008 of 2.01 grams of gold per tonne of ore ("g/t Au") was consistent with the prior year period. The life of mine average reserve grade is 1.68 g/t Au. Recent block model reconciliations have indicated a positive ounce variation, however, there is no indication that the positive variance in the past will continue in future periods. Since the start of mining operations at the Mulatos mine in 2005, the reconciliation of mined blocks to the block model has reflected a positive ounce variance of 2.7%.

Operational changes made in 2007 and 2008 have demonstrated improvements in both operating and production statistics, which in turn have contributed to cost efficiencies and lower costs per tonne. The following table compares costs per tonne by quarter, and compares year-to-date in 2008 to 2007:

<b>Costs per tonne summary</b>	<b>Q1</b>	<b>Q2</b>	<b>Q3</b>	<b>Q4</b>	<b>2008</b>	<b>2007</b>
Mining cost per tonne of material (ore and waste)	\$1.50	\$1.67	\$1.88	\$1.03	<b>\$1.50</b>	<b>\$1.34</b>
Waste-to-ore ratio	1.34	1.33	1.20	1.61	<b>1.37</b>	<b>2.50</b>
Mining cost per tonne of ore	\$3.51	\$3.90	\$4.13	\$2.70	<b>\$3.56</b>	<b>\$4.67</b>
Crushing/conveying cost per	\$2.24	\$2.11	\$1.95	\$1.66	<b>\$2.00</b>	<b>\$2.51</b>

tonne of ore						
Processing cost per tonne of ore	\$2.22	\$2.39	\$2.24	\$2.24	<b>\$2.28</b>	<b>\$2.39</b>
Mine administration cost per tonne of ore	\$1.47	\$1.71	\$1.84	\$1.73	<b>\$1.67</b>	<b>\$1.70</b>
Total cost per tonne of ore	\$9.44	\$10.11	\$10.16	\$8.33	<b>\$9.51</b>	<b>\$11.27</b>

Total cost per tonne of ore in 2008 was \$9.51 or 16% lower than the \$11.27 incurred in 2007. The lower total cost per tonne of ore in 2008 is primarily attributable to a 45% decrease in the waste-to-ore ratio from 2.5:1 in 2007 to 1.37:1 in 2008. Total cost per tonne of ore in the fourth quarter of 2008 of \$8.33 benefited from an accounting change in 2008 whereby costs incurred for component changes that benefit the related mining equipment for a period greater than one year are capitalized to mineral property, plant and equipment, rather than capitalized to inventory and charged to mining and processing costs. Lower costs in the fourth quarter of 2008 also resulted from the Mexican peso weakness against the United States dollar.

Mining cost per tonne of material was \$1.50 in 2008, 12% higher than \$1.34 in 2007, due in part to an 18% decrease in the total number of tonnes mined. Mining cost per tonne of ore decreased as a result of a 21% increase in tonnes of ore mined, and due to reclassification of component changes from operating expense to capital, as discussed previously.

Crushing and conveying cost per tonne of ore in 2008 was \$2.00. This represents a 20% decrease compared to the prior year period and is primarily attributable to a 18% increase in the number of crushed tonnes and cost savings realized from the new conveying and stacking system. Additional costs associated with the new stage of crushing and an enhanced preventative maintenance schedule have been more than offset on a per tonne basis by operational efficiencies resulting in higher crusher throughput. Crusher throughput averaged 13,000 tonnes per day in 2008 compared to 11,000 in the same period of 2007. The new conveying and stacking system has also contributed to lower crushing and conveying cost per tonne of ore as costs associated with truck-hauling and loading ore on the leach pad have been eliminated.

Processing cost per tonne of ore in 2008 was \$2.28 compared to \$2.39 in the comparable period of 2007. Processing costs include expenditures incurred with respect to the leach pad, gold recovery plant and refining activities. The conveying and stacking system commissioned in the second quarter of 2008 has resulted in lower lime consumption and corresponding lower costs as a result of the more efficient mechanized lime application. Cost savings related to lower lime consumption have been offset by the addition of cement costs to the Company's processing cost structure. The Company began belt agglomeration with cement in July 2008. In December 2008, the Company ceased belt agglomeration as the drum agglomeration circuit was commissioned and operational. Drum agglomeration is expected to contribute to higher gold recoveries, which should more than offset additional costs incurred in the process.

Mine administration cost per tonne of ore in the year ended December 31, 2008 was \$1.67 compared with \$1.70 in the same period of 2007.

Cash operating costs of \$345 per ounce of gold sold in 2008 was 12% lower than the \$390 reported in 2007. The Company's cash operating costs have been steadily decreasing since the fourth quarter of 2007, from \$469 in that period to the range of between \$295 and \$365 reported throughout 2008. Cash operating costs per ounce have declined as a result of lower costs per tonne of ore and a higher estimated recovery factor.

Initiatives taken in the past few quarters will continue to benefit future operations at the Mine. The Company commissioned the conveying and stacking system in the second quarter of 2008. The conveying and stacking system together with the automated lime application process and inter-lift liners, have resulted in improved pH control and reduced processing costs. In addition, the drum agglomeration circuit that was commissioned in December 2008 is expected to further improve leach pad percolation and corresponding gold recoveries. The Company also expects to close the crushing circuit in 2009, resulting in an optimum product stacked on the leach pad. As a result of these improvements, recoveries are expected to be approximately 60% in 2009, increasing to the 65% range in 2010 when the full benefits of closing the crushing circuit are realized. These expectations are based on projected recoveries from independent testing of composite columns of ore at various crush sizes.

### Cautionary Non-GAAP Statements

The Company believes that investors use certain indicators to assess gold mining companies. They are intended to provide additional information and should not be considered in isolation or as a substitute for measures of performance prepared with GAAP. "Cash flow from operating activities before changes in non-cash working capital" is a non-GAAP performance measure which could provide an indication of the Company's ability to generate cash flows from operations, and is calculated by adding back the change in non-cash working capital to "Cash provided by (used for) operating activities" as presented on the Company's consolidated statements of cash flows. "Mining cost per tonne of ore" is a non-GAAP performance measure which could provide an indication of the mining and processing efficiency and effectiveness at the Mine. It is determined by dividing the relevant mining and processing costs by the tonnes of ore processed in the period. "Cost per tonne of ore" is usually affected by operating efficiencies and waste-to-ore ratios in the period. "Cash operating costs per ounce" and "total cash costs per ounce" as used in this analysis are non-GAAP terms typically used by gold mining companies to assess the level of gross margin available to the Company by subtracting these costs from the unit price realized during the period. These non-GAAP terms are also used to assess the ability of a mining company to generate cash flow from operations. There may be some variation in the method of computation of "cash operating costs per ounce" as determined by the Company compared with other mining companies. In this context, "cash operating costs per ounce" reflects the cash operating costs allocated from in-process and dore inventory associated with ounces of gold sold in the period. "Cash operating costs per ounce" may vary from one period to another due to operating efficiencies, waste-to-ore ratios, grade of ore processed and gold recovery rates in the period. "Total cash costs per ounce" includes "cash operating costs per ounce" plus applicable royalties.

### Financial Highlights

A summary of the Company's financial results for the three-month periods and years ended December 31, 2008 and 2007 is presented below:

	Q4 2008	Q4 2007	2008	2007
Cash provided by operating activities before changes in non-cash working capital (000) <sup>(1)</sup>	\$16,623	\$5,011	\$54,505	\$20,666

Changes in non-cash working capital (000)	(\$590)	\$4,204	\$10,834	\$193
Cash provided by operating activities (000)	\$16,033	\$9,215	\$65,339	\$20,859
Earnings before income taxes (000)	\$8,679	\$917	\$39,021	\$6,374
Earnings (000)	\$9,140	(\$260)	\$29,380	\$2,934
Earnings per share				
- basic	\$0.10	\$0.00	\$0.31	\$0.03
- diluted	\$0.09	\$0.00	\$0.30	\$0.03
Weighted average number of common shares outstanding				
- basic	96,028,000	94,429,000	95,428,000	94,065,000
- diluted	97,300,000	94,429,000	97,111,000	96,427,000

<sup>(1)</sup> A non-GAAP measure calculated as cash provided by operating activities as presented on the consolidated statements of cash flows and adding back changes in non-cash working capital.

The Company reported strong financial results in the fourth quarter of 2008, as a result of near-record quarterly gold production and gold sales. In the fourth quarter of 2008, the Company generated \$16.6 million in cash from operating activities before changes in non-cash working capital, and \$16.0 million (\$0.17 per basic share) after changes in non-cash working capital. The \$16.0 million cash provided by operating activities in the fourth quarter of 2008 represents a 74% increase over the \$9.2 million (\$0.10 per share) generated in the fourth quarter of 2007. The change in non-cash working capital in the fourth quarter of 2008 of \$0.6 million is the result of a reduction in the Company's gold in-process inventory, offset by increasing value-added tax receivable balances. Decreases in gold in-process inventory since the start of the year reflect both lower unit operating costs and improved recoveries resulting from the conveying and stacking system and agglomeration processes. The Company recognized earnings before income taxes of \$8.7 million in the fourth quarter of 2008 compared to \$0.9 million in the same period of 2007. The Company recorded earnings of \$9.1 million or \$0.10 per share in the fourth quarter of 2008 compared to \$0.00 per share in the corresponding period of 2007.

For the year ended December 31, 2008, the Company generated cash flows from operations of \$65.3 million, a 213% increase from the prior year period. Increased cash flows from operations were the result of higher production and sales, a higher realized gold price and lower costs. Earnings for 2008 of \$29.4 million (\$0.31 per basic share) represented a ten-fold increase over 2007 earnings of \$2.9 million.

## Gold Sales

Details of gold sales are presented below:

	Q4 2008	Q4 2007	2008	2007
Gold sales (ounces)	40,176	27,029	151,560	108,281
Gold sales revenues (000)	\$32,400	\$20,683	\$132,974	\$74,028
Realized gold price per ounce	\$806	\$765	\$877	\$684
Average gold price for period (London PM Fix)	\$795	\$786	\$872	\$695

Gold sales revenues of over \$32.4 million in the fourth quarter of 2008 represented a 57% increase over the same period of 2007 as a result of a 5% increase in the realized gold price per ounce and a 49% increase in the number of ounces sold.

Gold sales revenues were \$133.0 million in 2008, 80% higher than gold sales revenues of \$74.0 million in 2007. The increase in gold sales revenues is the result of a combination of a 40% increase in the number of ounces sold and a 28% increase in the Company's realized gold price. The number of ounces sold increased in 2008 as a result of higher gold production resulting from improved tonnage, grade and gold recoveries.

The Company realized an average gold price of \$877 per ounce in 2008, compared to an average London PM Fix spot gold price of \$872 for the year. The Company enters into forward gold sales contracts periodically in order to match sales contracts with the next expected delivery. The Company's objective is to realize a gold sales price consistent with the average London PM Fix spot gold price. However, the Company may enter into forward gold sales contracts for future deliveries within a six-month future period in order to fix a gold price that management believes is attractive. At the current time, apart from short-term forward gold sales noted, the Company is fully leveraged to changes in the price of gold.

### Assessment of Gold Market

The Company's realized gold price in 2008 was \$877 per ounce. At these levels, the Company realizes an operating cash margin (before taxes and corporate and administrative costs) in excess of \$500 per ounce. The gold price has been extremely volatile in recent periods, and the Company expects that this volatility will continue so long as global credit markets remain uncertain. The gold price increased briefly to above \$1,000 per ounce in February 2009, before retracing to its current level of approximately \$900 per ounce.

### Operating Expenses and Operating Margins

Mine operating costs allocated to ounces sold are summarized in the following table for the periods indicated:

	2008	2007	Change %
Gold production (ounces) <sup>(1)</sup>	151,000	106,200	42%
Gold sales (ounces)	151,560	108,281	40%
<b>Cash operating costs (000) <sup>(2)</sup></b>	<b>\$52,357</b>	<b>\$42,195</b>	<b>24%</b>
- Per ounce sold	<b>\$345</b>	<b>\$390</b>	<b>(12%)</b>
Royalties (000) <sup>(3)</sup>	\$6,600	\$3,776	75%
<b>Total cash costs (000) <sup>(4)</sup></b>	<b>\$58,957</b>	<b>\$45,971</b>	<b>28%</b>
- Per ounce sold	<b>\$389</b>	<b>\$425</b>	<b>(8%)</b>
Amortization (000)	\$20,723	\$11,000	88%
Accretion expense (000)	\$324	\$200	62%
<b>Total production costs (000) <sup>(5)</sup></b>	<b>\$80,004</b>	<b>\$57,171</b>	<b>40%</b>
- Per ounce sold	<b>\$528</b>	<b>\$528</b>	<b>0%</b>

- Realized gold price per ounce	\$877	\$684	32%
- Operating cash margin per ounce <sup>(6)</sup>	\$488	\$259	88%

- (1) Reported gold production is subject to final refinery settlement.
- (2) "Cash operating costs" is a non-GAAP measure which includes all direct mining costs, refining and transportation costs and by-product credits. "Cash operating costs" is equivalent to mining and processing costs as reported in the Company's financial statements.
- (3) Production royalties are included as of April 1, 2006 at 5% of net precious metals revenues (as determined in accordance with the royalty agreement).
- (4) "Total cash costs" is a non-GAAP measure which includes all "cash operating costs" and royalties and production taxes. "Total cash costs" is equivalent to mining and processing costs and royalties as reported in the Company's financial statements.
- (5) "Total production costs" is a non-GAAP measure which includes all "total cash costs", amortization, and accretion of asset retirement obligations. "Total production costs" is equivalent to mining and processing costs, royalties, amortization and accretion of asset retirement obligations as reported in the Company's financial statements.
- (6) "Operating cash margin per ounce" is a non-GAAP measure which is calculated as the difference between the Company's gold sales and mining and processing and royalty expenses as reported in the Company's financial statements.

Unit amortization and accretion expense increased from \$103 per ounce in 2007 to \$139 per ounce in 2008. This increase reflects higher capital expenditures in 2008 which are expected to improve operations. The Company expects to report an increase in reserves as at December 31, 2008, which should lower the per unit amortization cost for 2009.

Production from the Mine is subject to a sliding scale production royalty. At current gold prices above \$400, the royalty is set at a rate of 5% of the value of gold and silver, less certain allowed refining and transportation costs. The royalty is calculated based on the daily average London PM Fix gold market prices, not actual prices realized by the Company. With the achievement of commercial production on April 1, 2006, the Mine's production to a maximum of two million ounces of gold is subject to royalty. As at December 31, 2008, the royalty was paid or accrued on approximately 330,000 ounces of applicable gold production. Royalty expense for 2008 was \$6.6 million compared to \$3.8 million in 2007 due to higher production applicable to royalty and a 25% increase in the average market price of gold.

## Exploration

The Company's accounting policy for exploration costs requires that exploration spending that does not meet the criteria for mine development is expensed as incurred. Exploration costs charged to operations during 2008 were \$4.2 million or 81% higher than the \$2.3 million incurred in 2007. Exploration costs in 2008 were focused on drilling at Cerro Pelon (\$1.5 million), La Yaqui (\$0.7 million), and at El Halcon (\$0.4 million), concession payments (\$0.3 million) and costs related to other projects (\$1.3 million).

On a year-to-date basis in 2008, an additional \$1.6 million of costs related to drilling the Puerto del Aire zone immediately adjacent to the existing Estrella Pit were capitalized to mine development.

## Corporate and Administrative

Corporate and administrative expenses of \$4.6 million in 2008 compared to \$3.5 million incurred in 2007. Higher corporate and administrative expenses in 2008 compared to 2007 are the result of higher travel costs, increased costs associated with the Company's administration office in Hermosillo, increased audit and internal control compliance costs and higher corporate development expenditures.

Corporate and administrative costs in 2009 are expected to be approximately \$5.0 million, exclusive of unusual items.

## Stock-based Compensation

Stock-based compensation expense in 2008 was \$4,363,000 compared to \$3,425,000 in 2007. The value of stock-based compensation expense is added to the contributed surplus account within shareholders' equity, resulting in no net effect on total shareholders' equity.

	2008	2007
Number of stock options granted	1,545,000	2,472,000
Average exercise price of options granted (CDN\$)	\$6.12	\$7.22
Value of stock based compensation (as determined by Black Scholes option pricing model)	\$3,485,000	\$6,060,000

In order to promote employee retention, the Company implemented vesting provisions for all stock option grants effective December 2005. Under the vesting provisions, 20% of all stock options granted vest on the date of grant and 20% at each subsequent six-month period. The vesting provisions result in the market value of stock option grants being charged to expense in accordance with the vesting terms of the option.

The higher stock-based compensation expense in 2008 is the result of the higher amortization of the fair value of prior period option grants. Based on existing stock option grants only, stock-based compensation expense for 2009 is expected to be approximately \$2.9 million. Any additional grants in 2009 will increase this expense.

## Accretion Expense

Accretion expense includes accretion of the Company's asset retirement and property acquisition obligation liabilities.

The asset retirement obligation liability on the Company's balance sheet of \$3.8 million at December 31, 2008 reflects the discounted value of the amount the Company expects to incur on closure of the Mine for closure, reclamation and reforestation activities. The Company's estimate of the expected future costs associated with mine closure and reclamation is based on a mine closure plan presented in a report prepared by an independent third-party consultant and reviewed by management. Accretion expense represents the increase in the liability due to the passage of time. Accretion of asset retirement obligation expense in 2008 was \$234,000 compared to \$183,000 in 2007.

## **Employee Future Benefits**

The Company is required to recognize employee future benefit liabilities associated with its Mexican work force. On an annual basis, the Company hires an independent consultant to review and calculate the liability for seniority premiums and termination benefits in accordance with Mexican Labor Law. As at December 31, 2008, the Company had accrued an employee future benefit liability of \$479,000. Employee future benefits expense of \$166,000 in 2008 is a non-cash charge reflecting the increase in the present value of the employee future benefit liability.

## **Interest Income**

Interest income in 2008 was \$395,000 compared to \$202,000 in 2007 due to higher average cash balances in 2008 compared to 2007. The Company expects interest income to continue to increase on a quarterly basis, as strong cash flows from operations combined with the net proceeds of the financing the Company completed in February 2009 have resulted in significantly higher cash balances.

## **Interest Expense**

Interest expense in 2008 of \$275,000 compared to \$1,326,000 in the same period of 2007. In the second quarter of 2008, the Company induced redemption of all outstanding convertible debentures and repaid its capital lease obligation liability. Accordingly, the Company no longer has any outstanding interest-bearing debt.

## **Foreign Exchange Loss**

The Company recognized a foreign exchange loss of \$99,000 in 2008 compared to \$48,000 in 2007. The foreign exchange loss in 2008 resulted primarily from the effect of the weakening of the value of the Canadian dollar against the United States dollar on the Company's Canadian dollar cash holdings and Canadian dollar denominated available for sale securities. Volatility in the Canadian to United States dollar foreign exchange rate could continue to result in foreign exchange gains or losses as the Company does not actively offset its exposure to changes in the value of the Canadian dollar.

The Company's objective is to effectively manage its balance sheet exposure to volatility in the Mexican Peso/United States dollar foreign exchange rate by maintaining a balance between its Mexican peso-denominated monetary assets and liabilities. During 2008, although the value of the Mexican peso weakened significantly against the United States dollar, the net impact on the Company's financial results was not material.

## **Income Taxes**

Current tax expense in 2008 was \$7.5 million compared to \$0.5 million in 2007. In 2008, the new Single Rate Tax Law (minimum tax) came into effect in Mexico. The application of the new law did not impact the Company's tax expense in 2008, but may in future periods. The Company is now cash taxable in Mexico and must calculate and provide for tax installments on a monthly basis. The Company recorded a future income tax expense of \$2.2 million in 2008, mainly as a result of accelerating certain tax deductions relating to mineral property, plant and equipment acquisitions, compared to \$2.9 million in 2007.

The general statutory income tax rate in Mexico is 28%. In Canada, the combined federal and provincial statutory income tax rate is approximately 33.5%. The effective tax rate in 2008 (calculated as a percentage of earnings before income tax) was 25% compared to 54% in 2007. Factors that tend to increase the effective tax rate include: stock-based compensation, inflation gains in Mexico, withholding taxes and the inability of the Company to offset losses in Canada against income in Mexico. Factors that tend to decrease the effective tax rate are: a lower statutory tax rate in Mexico where most of our earnings occur, decrease in the value of the Mexican peso which will currently result in a tax deductible foreign exchange loss on the Company's United States dollar denominated liabilities. If these adjustments are significant in the aggregate in the year, the resulting effective tax rate may be materially different from the statutory rate.

### Summary of Quarterly Results

The following table summarizes quarterly results for the past eight quarters. Quarterly gold production has been adjusted to reflect final settlements, where applicable.

	Q1 2007	Q2 2007	Q3 2007	Q4 2007	Q1 2008	Q2 2008	Q3 2008	Q4 2008
Gold production (ounces)	24,940	28,200	21,670	31,390	33,253	38,500	39,900	39,347
Gold sales (ounces)	27,200	30,880	23,170	27,029	34,609	35,482	41,293	40,176
Gold sales (\$000)	16,958	20,797	15,590	20,683	31,030	32,337	37,207	32,400
Earnings from operations (\$000)	2,558	2,941	1,062	830	9,423	10,175	11,387	8,708
Earnings (loss) (\$000)	1,189	1,888	117	(260)	5,703	6,191	8,346	9,140
Earnings (loss) (\$ per share) – basic/diluted	0.01	0.02	0.00	(0.00)	0.06	0.07/ 0.06	0.09	0.10

The Company began commercial production at the Mulatos mine in the second quarter of 2006. Gold production, gold sales and earnings have generally trended higher over the past eight quarters as the Company has resolved start-up issues, optimized mining operations and benefited from rising gold prices. Higher realized gold prices and gold sales have resulted in improved financial results in each consecutive quarter of 2008. Generally, third quarter operating and financial results could represent seasonal lows if the anticipated rainy season in northern Mexico is significantly worse than average, as was the case in the third quarter of 2007.

### Financial and Other Instruments

The Company's financial assets and liabilities consist of cash and cash equivalents, amounts receivable, accounts payable and accrued liabilities and current and future income tax liabilities, some of which are denominated in Canadian dollars or Mexican pesos. The Company is exposed to financial gains or losses as a result of foreign exchange movements against the United States dollar.

The Company's cash and cash equivalents may be invested in short-term liquid deposits or investments which provide a revised rate of interest upon maturity. At December 31, 2008, the majority of the Company's reported cash and cash equivalents were held in bank deposit accounts or 30-day term deposits.

In addition to United States dollar costs, the Company also incurs operating costs denominated in both the Canadian dollar and the Mexican peso. Accordingly, the Company's operating costs are affected by changes in foreign exchange rates in those currencies.

The Company has elected not to hedge its exposure to fluctuations in the Canadian dollar by buying fixed rate forward contracts in Canadian dollars. Corporate and administrative costs associated with the Company's head office in Toronto are denominated in Canadian dollars. A 10% increase in the value of the Canadian dollar against the United States dollar could increase the Company's reported corporate and administrative costs by approximately \$0.5 million annually.

The Company has exposure to monetary assets and liabilities denominated in Mexican pesos. Significant cash balances, outstanding amounts receivable, accounts payable or tax liabilities denominated in Mexican pesos could expose the Company to a foreign exchange gain or loss. Recently, the value of the Mexican peso compared to the United States dollar has weakened significantly. The Company has reduced the majority of its balance sheet exposure to changes in the Mexican peso/United States dollar exchange rate by maintaining additional cash balances in Mexican pesos to offset its future tax liabilities and taxes payable balances denominated in pesos. As the Mexican peso weakens against the United States dollar, the Company's operating costs (as reported in equivalent United States dollars) decrease. A 10% decline in the value of the Mexican peso compared to the United States dollar could reduce the Company's reported mining and processing costs and increase reported earnings before income taxes by approximately \$2.5 million annually.

### Investment in Mineral Property, Plant and Equipment

A breakdown of the cash invested in mineral property, plant and equipment for the year ended December 31, 2008 is presented below:

	<b>2008</b> (\$000)
<b>Construction projects</b>	
Conveying and stacking system	1,863
Agglomeration	2,653
Leach pad expansion and inter-lift liners	1,512
Warehouse	923
Truck shop	971
Camp improvements	683
Laboratory and ADR plant	1,069
	<b>9,674</b>
<b>Mineral property and mine development</b>	
Acquisitions and Mulatos relocation	2,571
Puerto del Aire capitalized exploration	1,612
	<b>4,183</b>

Other mine infrastructure	4,019
High-grade mill development	2,131
Mining equipment	4,947
Office and computer equipment	85
<b>Cash invested in mineral property, plant and equipment</b>	<b>25,039</b>

Capital spending in 2008 was focused on successful completion of a number of key construction projects intended to improve recoveries and the efficiency of mining operations as described below. In the first half of 2008, the Company invested approximately \$1.9 million to construct the conveying and stacking system and lime application silos. The conveying and stacking system was successfully commissioned in April 2008 and has contributed to improved levels of gold recovery, reduced lime consumption and generally higher gold production.

In the latter half of 2008, the Company invested in the construction and infrastructure of the drum agglomeration system, which was commissioned ahead of schedule in December 2008. Drum agglomeration is expected to contribute to improved leach pad percolation and corresponding increased gold recoveries.

Other significant construction spending in 2008 included spending related to the leach pad inter-lift liners, completion of the warehouse and truck shop and capital improvements to the camp, laboratory and ADR plant.

The relocation of the town of Mulatos commenced in the third quarter of 2007. Relocation contracts have been signed with more than half of the families resident in Mulatos at the start of the relocation program. Property owners and possessors are being offered a comprehensive package of benefits including compensation for their property and/or relocation benefits. In certain cases, relocation benefits include deferred monthly payments. In 2008, the Company capitalized home purchase and relocation payments totaling approximately \$1.3 million. The Company paid an additional \$1.25 million as part of a temporary occupation and land purchase agreement, whereby a second payment of approximately \$1.0 million (based on current foreign exchange rates) becomes due if and when the land is vacated and transferred to the Company. The Company has also recognized a liability of \$0.9 million representing the discounted value of expected future payments for relocation benefits to property owners and possessors that had signed contracts with the Company as at December 31, 2008. The discounted value of the liability was capitalized to mineral property, plant and equipment.

During 2008, the Company invested \$4.0 million in mine site infrastructure, focused primarily on the construction of a water treatment pond, an intermediate pond to optimize solution control during the rainy season, and a powerhouse expansion. Investments in mine equipment in 2008 of \$4.9 million include in excess of \$2.0 million in costs related to rebuilding the Company's mobile equipment fleet.

A total of \$2.1 million was invested in the Escondida high-grade mill development project in 2008. The Company expects to release the final technical report related to mill construction, as well as a positive production decision in the first quarter of 2009. Capital costs associated with mill construction are expected to be approximately \$20.0 million for the gravity plant and \$25.0 million in waste removal development costs, expected to be incurred throughout 2009 and 2010.

## Exploration and Mine Development Activities

Exploration expenditures in 2008 were \$5.8 million, of which \$4.2 million was expensed and \$1.6 million of spending at Puerto del Aire was capitalized as mine development. Exploration activities throughout 2008 have been focused on near-mine reserve expansion and regional exploration targets. Exploration activities have been successful in adding resource ounces at Puerto del Aire and delineating new gold zones at both the Cerro Pelon and La Yaqui regional targets.

### *Puerto del Aire*

Drilling at Puerto del Aire, located immediately adjacent to the Estrella Pit has been ongoing throughout 2008. The Company has been conducting exploration drilling at Puerto del Aire since early 2007. In the third quarter, the Company announced a resource estimate at Puerto del Aire, as shown in the table below, calculated at a 0.5 g/t Au cut-off:

	<b>Tonnes</b>	<b>Grade (g/t Au)</b>	<b>Contained Ounces</b>
Measured	4,190,000	1.13	152,556
Indicated	4,716,000	1.05	158,831
Total Measured and Indicated	8,906,000	1.09	311,387
Inferred	5,935,000	1.03	197,000

The measured and indicated resource is largely confined to drilling within 260 metres of the existing open pit, whereas the inferred resource is located in the remaining 190 metres of the zone. This resource is in close proximity to the existing mining operations and is expected to result in a pit layback that will significantly extend the life of the existing Mulatos mine. Drilling in the fourth quarter of 2008 and early in 2009 has concentrated on infill and step-out drilling in the inferred portion of the resource. An updated reserve and resource update for Puerto del Aire will be announced in conjunction with the Company's global reserve and resource update expected in March 2009. The Company invested and capitalized \$1.6 million in costs associated with Puerto del Aire in 2008.

### *Cerro Pelon*

During the third quarter of 2008, the Company announced the discovery of a new gold zone at Cerro Pelon. Cerro Pelon is located approximately 2.5 kilometres southwest of the leach pad and is a high-priority regional target for the Company, given both its proximity to existing mining operations and its geologic similarity to the Mulatos deposit. In 2008, target definition started with the completion of a soil geochemical grid combined with road-cut channel sampling. A well-developed gold anomaly (greater than 100 parts per billion) approximately 600 metres long and 200 metres wide was identified. First phase exploration drilling during the third quarter of 2008 resulted in discovery of the Cerro Pelon zone. Phase II exploration drilling is ongoing with two core rigs and one reverse circulation drill rig. A total of 113 drill holes representing 15,484 metres of drilling has been completed to date. The upper 70 metres of the gold zone is fully oxidized. The Company expects to report resources at Cerro Pelon in the latter half of 2009.

### *Resource and Reserve Update*

The Company expects to release its global resource and reserve update in the first quarter of 2009. The reserve update is expected to include Estrella, Escondida, El Salto and Mina Vieja. In addition, reserves at Puerto del Aire and El Victor are expected to be reported for the first time.

The global resource update is also expected to include a number of new resource areas. Initial resource estimates are expected to be presented for the Gap, La Yaqui and San Carlos targets.

### **Liquidity and Capital Resources**

At December 31, 2008, the Company had \$43.8 million in cash and cash equivalents compared to \$7.8 million at December 31, 2007. The Company's working capital position increased from a working capital surplus of \$39.2 million at December 31, 2007 to \$63.0 million at December 31, 2008.

Subsequent to year-end, on February 17, 2009, the Company completed a bought-deal financing, issuing 10,410,000 common shares of the Company for net proceeds of \$62.5 million. As a result, the Company's cash holdings post-financing are \$110 million.

Cash flows from operating activities in 2008 were \$65.3 million or \$0.68 per basic share. The Company reinvested \$25.0 million in capital and exploration in 2008, primarily focused on mine development and infrastructure improvements. Proceeds from the exercise of stock options added \$4.3 million to the Company's cash flows from financing activities.

Strong cash flows from operations throughout 2008 have enabled the Company to eliminate all interest-bearing debt obligations. In the second quarter of 2008, the Company induced conversion of its outstanding convertible debenture liability and repaid approximately \$8.6 million to retire its capital lease obligations. The Company generated record cash flows from operations and free cash flows in 2008, resulting in a \$36.0 million increase in its cash holdings in the 2008 year.

The Company expects to release a technical report for the Escondida high grade mill project in the first quarter of 2009. The Company expects that it will proceed to construct a 500 tonne-per-day gravity plant to process high grade ores. Expected capital costs associated with pre-stripping Escondida and constructing the mill are estimated to be approximately \$45 million. The Company expects that it will be able to finance the construction of a mill with a combination of current cash balances and cash flows from operations.

To date, the Company has not been adversely affected by the recent volatility in global credit and foreign exchange markets. The Company is benefiting from the devaluation of the Mexican peso compared to the United States dollar, as its net financial liabilities denominated in Mexican pesos are revalued at a lower United States dollar amount. In addition, should the current weakness in the value of the Mexican peso persist, the Company's future mine operating costs will decrease as approximately 45% of the Company's mine operating costs are denominated in Mexican pesos.

## Changes in Accounting Policy and Presentation

Effective January 1, 2008, the Company has adopted the following new Canadian Institute of Chartered Accountants (“CICA”) Handbook Sections:

- Section 1535: Capital Disclosures
- Section 3862: Financial Instruments – Disclosure
- Section 3863: Financial Instruments – Presentation
- Section 3031: Inventories

The impact of these standards on the Company’s financial statements was primarily to increase the disclosures surrounding the Company’s capital management program, financial instruments and inventories.

## Recent Accounting Pronouncements

The CICA has issued a new standard that has the potential to affect the Company’s financial disclosures and results of operations for interim and annual periods beginning January 1, 2009.

In February 2008, the CICA issued Handbook Section 3064, “Goodwill and Intangible Assets”, which replaces Section 3062, “Goodwill and Other Intangible Assets”. This new standard provides guidance on the recognition, measurement, presentation and disclosure of goodwill and intangible assets and is effective beginning January 1, 2009. Concurrent with the adoption of this standard, EIC-27, “Revenues and expenditures in the Pre-operating period”, will be withdrawn. The Company will assess the impact of these changes on our consolidated financial statements.

In January 2009, the AcSB issued the following new Handbook sections: 1582 – Business Combinations, 1601 – Consolidations, and 1602 – Non-Controlling Interests. These standards are effective January 1, 2011. The Company has not yet determined the impact of the adoption of these standards on its consolidated financial statements.

In January 2009 the Emerging Issues Committee (“EIC”) issued EIC-173. In this EIC the Committee reached a consensus that in determining the fair value of financial assets and financial liabilities an entity should take into account the credit risk of the entity and the counterparty. While the EIC is effective for periods ending after the issuance date, the Company has adopted the EIC for its results ending as of December 31, 2008. Adoption had no impact on the classification or valuation of the Company’s consolidated financial statements.

## Conversion to International Financial Reporting Standards

Effective February 13, 2008, the Accounting Standards Board announced that publicly accountable entities will be required to prepare financial statements in accordance with International Financial Reporting Standards (“IFRS”) for interim and annual financial statements for fiscal years beginning on or after January 1, 2011.

The Company is currently completing a preliminary diagnostic and will develop an IFRS conversion implementation plan, which will include a detailed assessment of the impact of the conversion on the consolidated financial statements and related disclosures. The plan will also

consider the impact of the conversion of the Company's information technology systems, internal controls over financial reporting, performance measurement systems, disclosure controls and procedures and other business activities that may be influenced by GAAP measurements.

The Company is currently performing an analysis of the significant IFRS-GAAP differences with respect to the Company's financial statements and disclosures. The Company will quantify the potential effect of these differences as part of the conversion implementation plan. Certain key members of the finance department of the Company have or will be attending in-depth training sessions regarding significant IFRS-GAAP differences with a particular focus on how they apply to entities in the mining industry.

### **Internal Control over Financial Reporting**

Management is responsible for the design of internal controls over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the financial statements in accordance with accounting principles generally accepted in Canada. Based on a review of its internal control procedures at the end of the period covered by this MD&A, management believes its internal controls and procedures are appropriately designed and operate effectively in providing reasonable assurance that financial information is recorded, processed, summarized and reported in a timely manner.

### **Changes to Internal Control over Financial Reporting**

The Company has made a number of significant changes to its internal control over financial reporting in the year ended December 31, 2008. These changes have resulted from a formal comprehensive review of the Company's internal control structure and have been implemented in order to improve existing internal controls, policies and procedures. While changes have been made, the Company has not detected any material weaknesses in the design or operating effectiveness of its internal controls over financial reporting since October 1, 2008 and as at December 31, 2008. The majority of the changes that have been made have resulted in formalizing pre-existing controls.

### **Disclosure Controls**

Management is also responsible for the design and effectiveness of disclosure controls and procedures to provide reasonable assurance that material information related to the Company, including its consolidated subsidiaries, is made known to the Company's certifying officers. The Company's Chief Executive Officer and Chief Financial Officer have each evaluated the effectiveness of the Company's disclosure controls and procedures as of December 31, 2008 and have concluded that these controls and procedures are effective in providing reasonable assurance that material information relating to the Company is made known to them by others within the Company.

### **Off-Balance Sheet Arrangements**

The Company may enter into gold contracts which could, in certain circumstances, be classified as off-balance sheet arrangements. Due to the nature of the contracts entered into and in accordance with the Company's accounting policy, the mark-to-market value of these contracts is recorded on the balance sheet. At December 31, 2008, the Company had contracts to deliver up to 6,911 ounces of gold in the first quarter of 2009 at prices below the

December 31, 2008 closing market price. Accordingly, a mark-to-market loss of \$406,000 was recognized in other expense and classified within accounts payable and accrued liabilities on the Company's balance sheet.

### Commitments Table

The following table summarizes the Company's contractual obligations at December 31, 2008:

#### Payments due by period (\$000)

		Less than 1 year	2 – 3 years	4 – 5 years	More than 5 years
<b>Contractual Obligations</b>	<b>Total</b>				
Operating lease	40	40	-	-	-
Employee future benefits <sup>(1)</sup>	720	-	-	-	720
Asset retirement obligations	5,681	-	-	-	5,681
Property acquisition obligations	1,055	323	468	264	-
	<b>7,496</b>	<b>363</b>	<b>468</b>	<b>264</b>	<b>6,401</b>

<sup>(1)</sup> Certain termination benefits are provided to Mexican employees on involuntary termination at the end of the life of the mine, as mandated by Mexican Labor Law. In certain circumstances, the Company must also pay other contractual termination or severance benefits, the timing and amount of which are contingent on factors outside of the Company's control.

Contractual obligations also exist with respect to royalties; however gold production subject to royalty cannot be ascertained with certainty and the royalty rate varies with the gold price. Based on the current gold price and rates of production, quarterly royalty expense is expected to continue to be in the range of \$1.6 to \$2.0 million per quarter.

The Company has signed relocation contracts with certain property owners and possessors in the town of Mulatos. The amount and timing of expected future relocation benefit and property acquisition payments to the residents of Mulatos who had signed contracts with the Company as at December 31, 2008 are presented in the table above. Although future relocation, property acquisition and legal costs may be material, the Company cannot currently determine the expected timing, outcome of negotiations or costs associated with the relocation of the remaining property owners and possessors and potential land acquisitions.

To-date, the Company has not made any material purchase commitments with respect to the proposed construction of a high-grade mill or the development of the Escondida high-grade zone. Such commitments may be material should such plans be approved.

### Outstanding Share Data

The table below describes the terms associated with the Company's outstanding and diluted share capital:

	March 6, 2009
Common shares	
- Common shares outstanding	107,011,406
Stock options	

- Average exercise price CDN\$6.50; Approximately 70% vested	6,382,500
<b>Total</b>	<b>113,393,906</b>

## Outlook

Throughout 2008, the Company has continually improved its operating and financial performance. The fourth quarter of 2008 represents the fourth consecutive quarter in which the Company has reported record quarterly earnings. The Company has positioned itself to expand in the future by reducing debt levels, strengthening its balance sheet, and investing in capital projects to improve recoveries and reduce operating costs.

In 2009, the Company's existing mining operations at Mulatos are expected to produce between 145,000 to 160,000 ounces of gold at a total cash cost of \$350 per ounce (including the 5% royalty). At current gold prices, cash flows from operations in 2009 are expected to be more than sufficient to fund the Company's planned mill construction, invest in operational projects to further improve recoveries and to fund exploration spending. Significant capital spending in 2009 will focus on closing the existing crushing circuit to ensure that the crusher discharge product size is 100% passing 3/8<sup>th</sup> of an inch. Independent metallurgical testing shows that closing the crushing circuit could improve recoveries by between 4–7%.

A technical study supporting the construction of a mill to process high grade ores including the Escondida deposit is expected to be released in the first quarter of 2009. The estimated cost of pre-stripping Escondida and constructing the high-grade mill is \$45 million, and is expected to be incurred over a two-year period, with production from the mill expected to start in late 2010.

The Company plans to provide a resource and reserve update in the first quarter of 2009, and expects significant increases to both reserve mine life and to the global resource at Mulatos. Exploration activities in 2009 will be focused on resource delineation at Cerro Pelon, and Phase I drilling at the prospective El Carricito regional target.

The Company has a solid current financial position, debt-free with \$110 million in cash on hand and strong cash flows from operations. This will allow it to finance its existing capital and exploration plans, as well as provide significant funding for development of additional projects through potential acquisitions.

## Critical Accounting Estimates

The preparation of financial statements in conformity with Canadian GAAP requires the Company to select from possible alternative accounting principles, and to make estimates and assumptions that determine the reported amounts of assets and liabilities at the balance sheet date, and reported costs and expenditures during the reporting period. Estimates and assumptions may be revised as new information is obtained, and are subject to change. The Company's accounting policies and estimates used in the preparation of the consolidated financial statements are considered appropriate in the circumstances, but are subject to judgments and uncertainties inherent in the financial reporting process.

The Company accounts for its in-process precious metals inventory using a process flow for applicable costs appropriate to the physical transformation of ore through the mining,

crushing, leaching and gold recovery process. The Company is required to estimate the ultimate recovery of payable metals from laboratory tests and from ongoing analysis of leach pad kinetics in order to determine the recoverable metals from the leach pad at the end of each accounting period. If the Company determines at any time that the ultimate recovery should be adjusted downward, then the Company will adjust the average carrying value of a unit of metal content in the in-process inventory and adjust upward on a prospective basis the unit cost of subsequent production. Should an upward adjustment in the average carrying value of a unit of metal result in the carrying value exceeding the realizable value of the metal, the Company would write down the carrying value to the realizable value.

The Company is required to determine the expected value of the estimated costs of asset retirement obligations and to recognize this value as a liability when reasonably determinable. This valuation is added to the cost of the relevant mineral property on the consolidated balance sheets, and amortized as an expense in the consolidated statements of operations when the mineral property is in production. Asset retirement costs include future removal and site restoration. Key assumptions in determining the amount of liability are total undiscounted cash outflows, expected timing of payment of the cash outflows and appropriate discount rates to apply to the timing of cash outflows. Because the liability is recorded on a discounted basis, it is increased due to the passage of time with an offsetting charge to accretion expense in the statement of operations. The Company calculated its estimated mine site closure costs based on a mine closure and reclamation plan prepared during the year by an independent third party. The majority of the expenditures associated with reclamation and mine closure will be incurred at the end of the mine life, expected to be in 6 years based on expected proven and probable reserves and the current rate of production.

The Company estimates an employee future benefits liability associated with expected future payments to its Mexican employees in accordance with the statutory laws and regulations in Mexico that govern severance and termination benefits. Such estimates are necessarily calculated with reference to expected salary increase and minimum wage rates, employee turnover, interest and inflation rates and various other factors, all of which are subject to annual review and change.

The Company follows accounting guidelines in determining the fair value of stock-based compensation, as disclosed in Note 15 to the financial statements. This computed amount is not based on historical cost, but is derived based on subjective assumptions input into an option pricing model. The model requires that management make several assumptions as to future events, including: an estimate of the average future hold period of issued stock options before exercise, expiry or cancellation; future volatility of the Company's share price in the expected hold period (using historical volatility as a reference); and the appropriate risk-free rate of interest. The resulting value calculated is not necessarily the value that the holder of the option could receive in an arm's length transaction, given that there is no market for the options and they are not transferable. It is management's view that the value derived is highly subjective and dependent entirely upon the input assumptions made.

### **Risk Factors and Uncertainties**

The financing, exploration, development and mining of any of the Company's properties is subject to a number of factors including the price of gold, laws and regulations, political conditions, currency fluctuations, environmental regulations, hiring qualified people and obtaining necessary services in jurisdictions where the Company operates. The current

trends relating to these factors are favorable but could change at any time and negatively affect the Company's operations and business.

The following is a brief discussion of those distinctive or special characteristics of the Company's operations and industry which may have a material impact on, or constitute risk factors in respect of the Company's future financial performance.

## **Industry**

The Company is engaged in exploration, mine development and the mining and production of precious metals, primarily gold, and is exposed to a number of risks and uncertainties that are common to other companies in the same business. Unusual or unexpected formations, formation pressures, fires, power outages, labour disruptions, flooding, cave-ins, landslides and the inability to obtain suitable adequate machinery, equipment or labour are risks involved in the operation of mines and the conduct of exploration programs. The Company has relied on and may continue to rely upon consultants and others for mine operating and exploration expertise. Few properties that are explored are ultimately developed into producing mines. Substantial expenditures are required to establish ore reserves through drilling, to develop metallurgical processes to extract the metal from the ore and in the case of new properties, to develop the mining and processing facilities and infrastructure at any site chosen for mining. Although substantial benefits may be derived from the discovery of a major mineral deposit, the Company may not be able to raise sufficient funds for development. The economics of developing mineral properties are affected by many factors including the cost of operations, variations in the grade of ore mined, fluctuations in metal markets, costs of mining and processing equipment and such other factors as government regulations, including regulations relating to royalties, allowable production, importing and exporting of minerals and environmental protection. Where expenditures on a property have not led to the discovery of mineral reserves, spent costs will not usually be recoverable.

## **Commodity Price**

The value of the Company's mineral resources and future operating profit and loss is affected by fluctuations in gold prices, over which the Company has no control. A reduction in the price of gold may prevent the Company's properties from being economically mined or result in the write-off of assets whose value is impaired as a result of low gold prices. The price of gold may also have a significant influence on the market price of the Company's common shares. The price of gold is affected by numerous factors beyond the Company's control, such as the level of inflation, fluctuation of the United States dollar and foreign currencies, global and regional demand, sale of gold by central banks and the political and economic conditions of major gold producing countries throughout the world. The price of gold has increased significantly in the past several years. The current gold price is significantly above impairment levels. The Company has elected not to engage in significant forward selling, as a number of gold mining companies have been adversely affected by maintaining a substantial forward sales book in the face of a rising gold market. At the current rate of production, revenue will change by approximately \$150,000 with each \$1 change in the price of gold.

## **Currency**

The Company is subject to currency risks. The Company's functional currency is the United States dollar, which is subject to recent fluctuations against other currencies. The Company's primary operations are located in Mexico and many of its expenditures and obligations are

denominated in Mexican pesos. The Company maintains its principal office in Canada, maintains cash accounts in United States dollars, Mexican pesos and Canadian dollars and has monetary assets and liabilities in United States and Canadian dollars and Mexican pesos. The Company's results of operations are subject to foreign currency fluctuation risks and such fluctuations may adversely affect the financial position and operating results of the Company. The Company has not undertaken to mitigate transactional volatility in either the Mexican peso or the Canadian dollar at this time. A 1% change in the relative value of the Canadian dollar would impact corporate and administrative costs by approximately \$50,000 annually; a 1% change in the relative value of the Mexican peso would impact operating costs by approximately \$250,000 annually.

## **Business**

The Company has limited financial resources which could affect its ability to carry out its business plan. The Company's ability to secure fixed gold prices or future foreign exchange rates is affected by its creditworthiness. Because of its limited operating record, it may not be able to hedge future risk to the extent it feels is appropriate. The Company's ability to obtain financing to explore for mineral deposits and to continue and complete the development of those properties it has classified as assets is not assured, nor is there assurance that the expenditure of funds will result in the discovery of an economic mineral deposit.

## **Competitive**

The Company's business is intensely competitive, and the Company competes with other mining companies, many of which have greater resources and experience. Competition in the precious metals mining industry is primarily for mineral rich properties which can be developed and produced economically; the technical expertise to find, develop, and produce such properties; the labour to operate the properties; and the capital for the purpose of financing development of such properties. Many competitors not only explore for and mine precious metals, but conduct refining and marketing operations on a world-wide basis and some of these companies have much greater financial and technical resources than the Company. Such competition may result in the Company being unable to acquire desired properties, recruit or retain qualified employees or acquire the capital necessary to fund its operations and develop its properties. The Company's inability to compete with other mining companies for these mineral deposits could have a material adverse effect on the Company's results of operations and business.

## **Country**

The Company conducts exploration, mine development and mining and production activities in Sonora, Mexico. Mexico is a developing country and obtaining financing, finding or hiring qualified people or obtaining all necessary services for the Company's operations in Mexico may be difficult. Mexico's status as a developing country may make it more difficult for the Company to attract investors or obtain any required financing for its mining projects.

The Company strives to maintain good relations with the local community by providing employment opportunities and social services. The Company has entered into a surface agreement with the Mulatos Ejido. In addition, the Company has entered into agreements with individual Ejido members for the surface rights to which they have been assigned. The transfers of title to these surface rights have been registered under Mexican law.

The Company is also in negotiations with Ejido and non-Ejido members, as a group and individually, to relocate the existing community of Mulatos, and to acquire additional surface rights. Negotiations with the Ejido can become time-consuming if demands for compensation become unreasonable. With the assistance of experienced legal advisors and the input from state and local government officials, the Company expects that it will be able to acquire its land-use requirements at a reasonable cost, however, there can be no assurance that this will be the case.

The acquisition of the right to exploit mineral properties is a detailed and time-consuming process. Although the Company is satisfied it has taken reasonable measures to acquire unencumbered rights to explore on and exploit its mineral reserves on the Salamandra group of concessions, no assurance can be given that such claims are not subject to prior unregistered agreements or interests or to undetected or other claims or interests which could be material and adverse to the Company.

Mexico recently enacted new tax laws which provide an additional layer of complexity and uncertainty in evaluating the financial benefit from current and future operations.

## **Environmental**

The operations of the Company are subject to environmental regulations promulgated by government agencies from time to time. Specifically, the Company activities related to its Salamandra Concessions are subject to regulation by SEMARNAP, the environmental protection agency of Mexico. Regulations require that an environmental impact statement, known in Mexico as a *Manifiesto Impacto Ambiental*, be prepared by a third-party contractor for submittal to SEMARNAP. Studies required to support the *Manifiesto Impacto Ambiental* include a detailed analysis of the following areas: soil, water, vegetation, wildlife, cultural resources and socio-economic impacts. The Company must also provide proof of local community support for a project to gain final *Manifiesto Impacto Ambiental* approval. Environmental legislation provides for restrictions and prohibitions on spills, releases or emissions of various substances produced in association with certain mining industry operations, such as seepage from tailings disposal areas, which would result in environmental pollution. A breach of such legislation may result in imposition of fines and penalties. In addition, certain types of operations require the submission and approval of environmental impact assessments. Environmental legislation is evolving in a manner which means stricter standards, and enforcement, fines and penalties for non-compliance are more stringent. Environmental assessments of proposed projects carry a heightened degree of responsibility for companies and directors, officers and employees. The cost of compliance with changes in governmental regulations has the potential to reduce the profitability of operations.

## **Regulatory**

The Company's activities are subject to extensive laws and regulations governing worker health and safety, employment standards, waste disposal, protection of historic and archaeological sites, mine development, protection of endangered and protected species and other matters. Specifically, the Company's activities related to its Mulatos Mine and the Salamandra group of concessions are subject to regulation by SEMARNAP, the environmental protection agency of Mexico, *Comisión Nacional del Agua* ("CAN"), which regulates water rights, and the Mexican Mining Law. Mexican regulators have broad authority to shut down and/or levy fines against facilities that do not comply with regulations or standards. The Company' mineral exploration and mining activities in Mexico may be

adversely affected in varying degrees by changing government regulations relating to the mining industry or shifts in political conditions that increase the costs related to the Company activities or maintaining its properties. Operations may also be affected in varying degrees by government regulations with respect to restrictions on production, price controls, export controls, income taxes, expropriation of property, environmental legislation and mine safety.

A number of other approvals, licenses and permits are required for various aspects of mine development. While the Company has used its best efforts to ensure title to all its properties and secured access to surface rights, these titles or rights may be disputed, which could result in costly litigation or disruption of operations. The Company is uncertain if all necessary permits will be maintained on acceptable terms or in a timely manner. Future changes in applicable laws and regulations or changes in their enforcement or regulatory interpretation could negatively impact current or planned exploration and development activities within the Company's Salamandra group of concessions or any other projects with which the Company becomes involved. Any failure to comply with applicable laws and regulations or failure to obtain or maintain permits, even if inadvertent, could result in the interruption of exploration and development operations or material fines, penalties or other liabilities.

### **Estimates**

The mineral reserves and resource estimates of the Company are estimates only and no assurance can be given that any particular level of recovery of minerals will in fact be realized or that an identified reserve or resource will ever qualify as a commercially mineable (or viable) deposit which can be legally and economically exploited. The Company relies on laboratory-based recovery models to project estimated ultimate recoveries by ore type at optimal crush sizes. Actual gold recoveries in a commercial heap leach operation may exceed or fall short of projected laboratory test results. In addition, the grade of mineralization ultimately mined may differ from that indicated by drilling results and such differences could be material. Production can be affected by such factors as permitting regulations and requirements, weather, environmental factors, unforeseen technical difficulties, unusual or unexpected geological formations, inaccurate or incorrect geologic, metallurgical or engineering work, and work interruptions, among others. Short term factors, such as the need for orderly development of deposits or the processing of new or different grades or ore types, may have an adverse effect on mining operations or the results of operations. There can be no assurance that minerals recovered in small scale laboratory tests will be duplicated in large scale tests under on-site conditions or in production scale operations. Material changes in proven and probable reserves or resources, grades, waste-to-ore ratios or recovery rates may affect the economic viability of projects. The estimated proven and probable reserves and resources described herein should not be interpreted as assurances of mine life or of the profitability of future operations. Based on the expected 2009 rate of production and budgeted cash operating costs, a 1% change in the expected rate of recovery of gold would result in a \$5 per ounce change in cash operating costs, and an approximate \$1,500,000 change in income and cash flow annually, before royalties and income taxes. A 1% change in cash cost per tonne of ore would result in a \$5 per ounce change in cash cost, and approximately \$500,000 change in income and cash flow annually, before royalties and tax charges.

### **Dependence on Management**

The Company is dependent on key personnel and the absence of any of these individuals could result in a significantly negative effect on the Company. The Company strongly depends on the business and technical expertise of its management and key personnel. There is little

possibility that this dependence will decrease in the near term. As the Company's operations expand, additional general management resources will be required, especially since the Company encounters risks that are inherent in doing business in several countries. The Company is dependent, in particular, on its Chief Executive Officer, John McCluskey and its Chief Operating Officer, Manley Guarducci. Key man life insurance is not in place on Messrs. McCluskey or Guarducci. If the services of the Company's management and key personnel were lost, it could have a material adverse effect on future operations.

## Legal

Substantially all of the Company's assets are located outside of Canada, and are held indirectly through foreign affiliates. It may be difficult or impossible to enforce judgments obtained in Canadian courts predicated upon the civil liability provisions of the securities laws of certain provinces against the portion of the Company's assets located outside of Canada.

## Forward-Looking Statements

Except for historical information contained in this management's discussion and analysis, disclosure statements contained herein are forward-looking, as defined in the United States Private Securities Litigation Reform Act of 1995. Forward-looking statements are subject to risks and uncertainties, which could cause actual results to differ materially from those in such forward-looking statements.

This MD&A contains forward-looking statements concerning the Company's plans for its properties and other matters within the meaning of Section 21E of the Securities Exchange Act of the United States. Forward-looking statements include, but are not limited to: statements with respect to anticipated commencement dates of mining expansions; potential expansion costs; operations; projected quantities of future metal production; anticipated production rates and mine life; operating efficiencies; costs and expenditures and conversion of mineral resources to proven and probable reserves; and other information that is based on forecasts of future results, estimates of amounts not yet determinable and assumptions of management.

Statements concerning proven and probable reserves and mineral resource estimates may also be deemed to constitute forward-looking statements to the extent that they involve estimates of the mineralization that will be encountered if the property is developed, and in the case of mineral resources or mineral reserves, such statements reflect the conclusion based on certain assumptions that the mineral deposit can be economically exploited. Exploration results that include geophysics, sampling and drill results on wide spacings may not be indicative of the occurrence of a mineral deposit. Such results do not provide assurance that further work will establish sufficient grade, continuity, metallurgical characteristics and economic potential to be classed as a category of mineral resource. It cannot be assumed that all or any part of an "indicated mineral resource" or "inferred mineral resource" will ever be upgraded to a higher category of resource. Investors are cautioned not to assume that all or any part of the mineral deposits in these categories will ever be converted into proven and probable reserves.

Any statements that express or involve discussions with respect to predictions, expectations, beliefs, plans, projections, objectives, assumptions or future events or performance (often, but not always, using words or phrases such as "expects" or "does not expect", "is expected", "anticipates" or "does not anticipate", "plans", "estimates" or "intends", or stating that certain

actions, events or results "may", "could", "would", "might" or "will" be taken, occur or be achieved) are not statements of historical fact and may be "forward-looking statements." Forward-looking statements are subject to a variety of risks and uncertainties which could cause actual events or results to differ from those reflected in the forward-looking statements.