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Corporate finance

By Robert Olsen

Mining: a regular money magnet

In a lot of sectors these days, financing isn't so easy to come by. But not mining. There, thanks to strategic investors and bullish pricing forecasts, the deals continue to flow

What could be worse for a cyclical sector such as mining than the headlines of the past few months? Sovereign debt crisis spreading to the U.S., negative earnings reports, continued global central bank cuts, depressed consumer confidence, China's slowing demand for imports, recessionary sentiment in North America…and that's just the macroeconomic conditions.

In terms of industry-specific metrics, metal prices are down from their 2010 highs, while the S&P/TSX Precious Metals & Minerals Index and the S&P/TSX Base Metals Index have both taken a pounding, down 16.1% and 26.8% year-to-date (mid-November), respectively.

With these conditions and that kind of performance, one might conclude financings for this sector are near impossible. But if you did, you'd be wrong. Anyone keeping tabs on the deals being done will know there are a lot of moving pieces in the current markets that make the period unique in the continued availability of investment dollars.

Credit two primary factors: forecasts that indicate base metals and precious metals will either hold their current pricing levels or rebound higher in the next one to three years, and the insatiable appetite of strategic investors for resources. Meanwhile, those dynamics play out differently depending largely on whether the capital-seekers are small development companies and juniors, or larger, well-established firms.

Junior companies are traditionally limited to raising equity or quasi-equity on the CDNX and TSX-Venture exchanges. When they reach sufficient size, with sustainable cash flows, they also become candidates for debt financing, such as public convertible debentures. But while those types of deals are out there, other junior mining companies today are starting to take greater advantage of other more innovative financing options—particularly strategic capital investments. In these circumstances, companies can often raise debt or equity capital from domestic or foreign companies that are looking for access to the underlying resource of the mine and may be less motivated by the rate of return of the security being invested in. There are several examples of this, including many Chinese and Korean organizations with insatiable demand for industrial commodities such as, iron, coal, copper or potash, and also Japanese companies that need access to uranium to power their nuclear reactors.

Certain precious metal miners are also taking advantage of alternative sources of capital to fund projects that fall outside the realm of mainstream attention by the North American markets. Canadian-based Majestic Gold Corp. (TSX-V:MJS) recently arranged a $10-million private convertible debenture to advance its Song Jiagou project in China. The loan will bear interest at 7.5% per annum and has a one-year term and is convertible at the option of the lender into shares of the company at market price.

Illustration Francesco Galle

Another innovative financing option for junior companies is exemplified by Fortune Minerals' (TSX:FT) recent capital raise that closed in August. Under the terms of a joint-venture agreement, Korea's Posco, the third-largest steel producer in the world, acquired a 20% interest in Fortune's Mount Klappan coal project. Based on current cost estimates, Posco anticipates making total payments and cash contributions of $181 million to help develop the Mount Klappan project.

What is most interesting about this and other recent JV deals is that the implied value gap between "project level" JV-style investments versus equity corporate share issuances. In the Fortune/Posco deal, the up-front payment of $30 million for a 20% stake implies a project value of $150 million. At the time of writing, Fortune's market cap is well below this figure, making the market value of the joint venture greater than the market value of the company. And that's excluding consideration that Fortune also holds a second project—a cobalt, gold, bismuth asset—that is at a further stage of development in comparison to the coal asset and therefore likely to be perceived by the market as having a higher value. In short, project-level deals are attracting higher valuations than what the market is reflecting in many junior mining companies' share prices.

Larger mining companies always have significantly more options and that's no different today—all forms of equity as well as corporate or project finance debt are available. Even high-yield debt has become an option for mining companies. Consider the recent bond debt raise by Quadra FNX Mining (TSX:QUX), a company engaged in the development and exploration for copper and other base and precious metals. Quadra raised $500-million worth of senior notes bearing interest at a rate of 7.75% to fund its Sierra Gorda project in Chile.

Project financing, in particular, warrants a closer look. The term refers to debt financing that is non-recourse (rare) or limited recourse to sponsors where lenders extend the loan on the basis of the projected revenues from the operation of a project and rely on the assets of the project as collateral for the financing. (Most common are limited recourse financings where there is recourse to the sponsors until at least completion of the project.) Because of the capital intensive and risky nature of the mining industry, project finance is widely used; it permits mining companies to carry out projects in which the corporate risk is either limited or defined in advance.

The leverage of project finance also serves to greatly enhance project economics for equity holders, assuming that the debt is serviceable in the early stages of production. Common forms of available project-level debt include senior debt, secured or unsecured subordinated debt and convertible debt. More innovative debt options include commodity loans, where the issuer can raise capital and pay it back by way of the underlying commodity being mined. There are several hybrids to this option and they usually include a requirement for a certain amount of hedging so the lender can be sure that the company has the ability to repay the loan regardless of where spot prices have moved on the commodity.

Given the foregoing, it would seem that although the mining industry has traditionally experienced wild swings in the availability of capital, the insatiable appetite from strategic investors together with broadening market interest in mining companies should ensure that the current unsettled macro environment won't have the same impact.

This article was co-written by Graeme Falkowsky of Deloitte's Corporate Finance practice in Vancouver.

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A market that won't quit

Strong metal prices and motivated financiers are keeping the money and the mining deals flowing

Deals happen when demand is high and when buyers think prices are going higher. Both conditions dominate the world of precious and base metals and the deal activity is following in kind. The tables below track annual average metals prices from 2007 and show where they're forecast to be through 2014. When it comes to Canadian M&A transactions, meanwhile, the influence of strategic buying is clearly shown in the fact that, in the first three quarters of 2011, the energy, mining and utilities sector accounted for more than three-quarters of the value of all foreign-buyer transactions (bottom).

Base Metals Prices, 2007-2014

	2007	2008	2009	2010	Current*	2012F	2013F	2014F
Copper	3.03	1.39	3.35	4.35	3.31	3.98	3.60	3.25
Lead	1.16	0.45	1.10	1.16	0.90	1.00	1.17	1.04
Nickel	11.93	5.31	8.40	11.23	8.56	9.46	10.03	9.70
Zinc	1.08	0.55	1.16	1.11	0.87	0.96	1.05	1.00

Figures are in US$ *Q3/2011

Source: Bloomberg

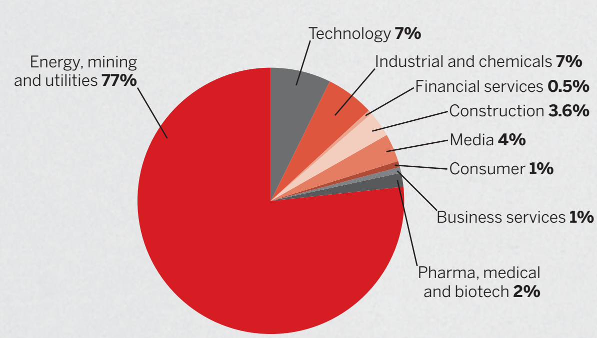
Precious Metals Prices, 2007-2014

	2007	2008	2009	2010	Current*	2012F	2013F	2014F
Gold	834	882	1,096	1,420	1,688	1,836	1,750	1,500
Platinum	1,526	935	1,465	1,770	1,548	1,800	2,000	1,850
Silver	14.80	11.39	16.88	30.92	32.85	39.00	32.00	25.00
Uranium	90.00	54.00	44.50	61.50	52.00	65.00	70.00	75.00

Figures are in US$ *Q3/2011

Source: Bloomberg

Canadian Inbound Deals by Industry Sector, 2011*



*through Q3

Source: mergermarket