Mining for alternative forms of financing

As the old adage goes, sometimes you have to go through it to get to it. With the onslaught of economic crises – including the American fiscal cliff, European debt woes and speculation surrounding the Asian market – traditional investors have grown increasingly risk adverse, with reduced appetite for the volatility associated with resource companies.

Despite its potential for high rewards upside, the resource industry has been met with lower trading volumes. On the TSX and the Venture Exchange, resource companies saw 85 billion shares traded in 2012 versus 117 billion in 2011, representing a 27% decline in volume. 2012 trades totalled $534B, compared to $769B the year prior, amounting to a 31% drop in trade value.

Even companies with discovery successes saw limited gains on the market. Their current investors, eager to cash in on any upswing, unloaded their stocks to realize returns; while most new investors continued to wait out more advanced development with view to production.

Slowly but surely, public funding became scarce, leaving the sector strapped for capital.

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Meanwhile, with strong commodity pricing, particularly for gold and oil, it was tempting for resource companies to stay in the game. Demand for production showed no signs of letting up, furthering the need to find and develop new properties. With exploration typically in the hands of juniors – relatively small operations that in the past relied on risk capital for operational funding – a chasm ripped through the sector.

A study undertaken by Collins Barrow Toronto, a leading accounting and advisory firm specializing in the mid-market, showed that between 2011 and 2012, companies in exploration and development stages saw a 24% decline in transaction volumes for disclosed deal values in the range of $5M to $300M. Of private placements, those placed to public investors decreased by a staggering 42%.

"Investors became cautious due to public market volatility and this had a major impact on the resource industry," says Octavio Cabral, Partner at Collins Barrow Toronto. "Last year, we saw IPOs as well as secondary offerings on the decline. Between the TSX and the Venture Exchange, $19B in equity capital was raised by the resource sector, compared to nearly $23B in 2011. With equity as an expensive and highly dilutive option, resource companies (particularly the juniors) had to get creative."

Facing decreases in debt and equity financing, resource companies were under mounting pressure to either preserve capital by scaling back operations or seek new sources of funds. Many indeed found themselves between a rock and a hard place.

Beyond the issues of control and dilution, it is crucial to understand the real cost of capital.

With the retail base stripped of confidence, resource companies were forced to come up with new survival strategies. They looked outside of traditional public markets, securing alternative sources of financing, such as royalty or streaming deals, strategic partnerships, joint ventures and asset sales.

But resource companies need to weigh their options and consider the implications of these deals prior to digging into this new frontier.

Take royalty and streaming deals, for instance. Primarily for near-production projects, but with increasing relevance for exploration companies, these arrangements arise when a resource company receives up-front consideration in exchange for a portion of future cash flows or the right to purchase a percentage of resource production at an agreed-upon price, typically for the life of the mine.

Though royalty and streaming can limit a resource company's ability to realize potential gains should commodity pricing increase, these deals can be implemented much faster than project debt. They also allow retained control.

While resource companies themselves are being shunned by the market, royalty companies are being treated more favorably as a result of realized yields. In turn, companies like Gold Royalties Corp. are passing on this advantage through reduced capital costs. Since March 2011, Gold Royalties acquired 10 mining royalties. Today the corporation is poised for further growth.

"The royalties model shares risks and limits dilution for mining companies. What's more, we can generally strike more favorable terms compared to the equity market," says Stephen King, Board member at Gold Royalties Corporation., and President and CEO of Alaris Royalty Corp. "Because of the size of our company, Gold Royalties is uniquely positioned to partner effectively with smaller companies."

Rather than connecting with royalty or streaming companies, some resource companies are taking a more targeted approach and chiseling agreements with downstream users. While this group has historically avoided direct investment in the resource sector, a growing number of end users are forecasting shortages and looking upstream to secure resource supply.

As a long-term strategy to finance development of its flagship property, Eco Ridge Mine Rare Earths & Uranium Project, Pele Mountain Resources is cultivating relationships with end users of rare earth elements and pursuing uranium off-take agreements with nuclear utilities.

"We believe we are seeing a demand-driven rebound in commodities," says Pele President Al Shefsky. "Japan is expected to resume operation of its nuclear plants, while dozens of new reactors are under construction worldwide. We also expect to see supply tighten with the termination of the Russian 'Megatons to Megawatts' agreement."

"Meanwhile, the five rare earths identified as critical by the U.S. Department of Energy are likely to rise in price as they are forecast to remain in chronic shortage outside of China," he adds. "I am optimistic that these developments will generate opportunities in the public markets."

Wary from a difficult year, the rest of the junior mining sector might not be as confident. More and more, mines that can demonstrate upside potential are teaming with well-funded senior resource companies to form joint ventures in preliminary stages, much earlier than in the past. The decision to enter such an agreement represents a strategic move by management to speed development and preserve value for shareholders, diluting property interest rather than company ownership.

In a joint venture with ITOCHU Corporation; Pure Nickel Inc., a North American mineral exploration and development company, negotiated a $40-million option to earn in to fund exploration at its MAN property in Alaska. Importantly, Pure Nickel acts as operator of the venture, clearing a 10% management fee. The agreement was signed in November 2008 and, on last report, ITOCHU had invested $21M and conferred a 30% stake in the property.

"At times like these, survival depends on taking a pragmatic approach to ensure solvency for shareholders. With our deal, we knew we had to go big or go home," says David McPherson, President and CEO of Pure Nickel. "Capital is out there, the key is to negotiate on a scale that is meaningful to larger companies by

demonstrating potential to make a significant economic impact. By developing a vision and evaluating needs for the long term, juniors can find the right partner to help get the job done, but they need to think strategically."

Other resource companies are taking stock of current holdings and opting to liquidate non-core assets. While many initially subscribe to buy-and-build plans to bolster or diversify their asset portfolios, efforts eventually become concentrated on key project sites where early stage exploration has proven positive, leaving non-core assets undeveloped.

Given that the market has favored management teams with a strong core strategy, resource companies stand to improve their positioning by paring down and bringing in non-dilutive capital to put towards projects in advanced development and production.

McPherson encourages firms considering the sale of non-core assets to review core assets as well.

"The reality is that costs are increasing across the board, we literally need to dig deeper and further from key access routes," he says. "My advice is to think long and hard about what it costs to explore, develop and operate a given interest. Sink ties to sweat equity or emotional attachments and convert unfeasible assets, be they core or non-core, to cash."

Experts are divided on whether the market turbulence seen over the past year has led to a complete paradigm shift for investors in the public market. One thing is for certain; the sector is not wasting any time in reacting to its current plight.

"Transactions we are seeing in the resource sector are chiefly comprised of royalty, streaming, private placements and M&A deals. In 2012, over 75% of mid-market transactions occurred in this space," says Tracey Strauss, Partner, Corporate Finance, Collins Barrow Toronto. "Increasingly, we are advising resource companies on M&A prospects, joint venture transactions and alternative capital options. I view this as a positive trend as smaller interests amalgamate to increase their relevance to investors, both public and private."

Her thoughts were echoed at the recent Vancouver Resource Investment Conference, where experts predicted waning share prices for the next year or two, leading to more M&A activity as majors observing growing demand and higher commodity pricing swoop in to either assist with, or conduct, exploration to ensure future production.

Also, experts have long anticipated an increase in the number of strategic consolidations undertaken by juniors to assemble focused property portfolios and shed costs through economies of scale, given the importance of infrastructure in moving resources to domestic and international markets.

These transactions will serve to sweeten the pot for investors, eventually.

But for now resource companies will have to see past the end of the drill bit, keeping their options open while recognizing that every opportunity comes with risk. In service to shareholders, resource companies will need to focus on preserving the intrinsic value of equity and plan for the long term by bringing greater clarity to their vision and outlook.

Beyond the issues of control and dilution, it is crucial to understand the real cost of capital. Regardless of the deal on the table, terms and implications should always be scrutinized with a trusted advisor. ■

The experts weigh in

Tracey Strauss, Partner, Collins Barrow Toronto

Tracey Strauss leads Collins Barrow Toronto's corporate finance business. For over 18 years, she has worked with professional service firms to initiate mergers and acquisitions, private placement of equity securities and strategic advisory assignments. Tracey has advised founders, CEOs and boards in a wide range of industries.

Octavio Cabral, Partner, Collins Barrow Toronto

Octavio Cabral has extensive expertise with domestic and international mining sector companies. At Collins Barrow Toronto, he is a partner in the Public Companies group, leading assurance engagements for publicly listed companies and those planning to pursue public listings in the future.

Alan Shefsky, President and Director, Pele Mountain Resources

Al Shefsky has been President, CEO and a director of Pele Mountain Resources since founding the company in 1996. He has provided leadership in the acquisition of the Eco Ridge Mine Rare Earths & Uranium project, recruitment of a world class technical team, and advancement of the project to its current pre-development stage.

David McPherson, President and CEO, Pure Nickel Inc.

David McPherson has over 25 years of financial institution experience with a major chartered bank, a number of those years being at the executive level. He joined the board of Pure Nickel when it went public in March 2007, assuming the role of President and Chief Executive Officer in December of that year.

Stephen King, President and CEO, Alaris Royalty Corp.; Board member, Gold Royalties Corporation

Stephen King cofounded Alaris Royalty Corp., a Calgary-based business royalty company, in April 2004. Committed to structuring deals that benefit all involved parties, he actively manages every aspect of the investment process.

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