

**BILATERAL FINANCING STRUCTURES FOR MINING
COMPANIES ACROSS THE NORTH-SOUTH
AMERICAN AXIS: A CONCEPT PAPER**

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Abstract

This paper will analyze the issues and challenges facing junior mining companies both those originating in North America with assets in South America and those originating in South America seeking to gain access to the North American financial markets. Regulatory obstacles and capital structure considerations will be identified and strategies for bilateral establishment and growth of such junior companies will be outlined. In addition, corporate governance considerations, management structures that are necessary or desirable for companies wishing to gain access to the North American financial markets will be discussed.

Mining exploration and exploitation has a long-standing tradition of international cooperation among various players from property holders, to financiers, technical personnel, co-venturers and the like. It is, therefore, appropriate for the sector to form the cornerstone of a new paradigm for the development of assets on an international basis. This paper examines some of the systemic shortcomings of and obstacles to project evolution presented by the public market systems in North and South America respectively and concludes with the need for an integrated approach to project development that incorporates elements from the two hemispheres on all levels. As stated in the title, it is meant to be a concept paper, a theoretical analysis of the current and potential dynamics of mining asset development involving both North and South American actors. It is far from a definitive thesis on the subject, rather a blue print for further thought, dialogue and debate.

I. The Current Project Development Archetype

First let us understand the dynamics of the current situation: the trend, certainly over this mining cycle and the last one, has been for many of the desirable or prospective assets to be located in South America, and the usual pattern for their development from a grass roots level onward has been one of collaboration, generally on a joint venture or earn in basis, between a foreign junior company and one or more local owners of the mining interest. Typically, the funding required to develop the exploration potential of the asset over time, dilutes the local

owner of the mining interest to a minority position, long before the project financing stage. Indeed, frequently the foreign junior company is also eliminated (bought out, joint ventures with a major company, etc.) prior to the project financing stage as well, resulting in little or no local retained interest in the project, save for taxes, royalties and the like. This set of relationships will be referred to as the “*current project development archetype*” in this paper. Of course, there are a number of variations and exceptions to this scenario, the intent is not to canvas them all, but to describe a familiar pattern of mining exploration and development structures involving South American assets.

The key signature in the current project development archetype is the initial separation of ownership of the local asset and access to financing and it is the traditional lack of access to local risk capital that pre-determines the eventual dilution of the local ownership interest. This is not to suggest that alternatives such as the development of mining assets by local conglomerates or governmental entities do not occur as well, but these exceptions do not disprove the fundamental point that it is the absence of local risk capital that drives the course of development of resource assets in South America – the conglomerate/governmental approach works, because the primary actor has access to financial capital from *other* activities or endeavours that can be applied to develop the local mining project.

Another customary feature of this pattern is that the local owner typically takes a relatively passive role in the development process, in particular, as funding is provided more consistently by the foreign partner. The consequences of this more passive role are that the asset does not benefit from the efficiencies that arise from local knowledge of regulatory, social, political and other infrastructures that would be applied in the case of a motivated local partner and ultimately, the asset loses any significant local ownership it once had.

Reflection upon the desirability of perpetuating the current project development archetype is timely, as several South American markets begin to move towards more standard requirements for technical review and disclosure in respect of mining projects and trend towards amending their public market regimes to encourage greater risk capital sectors within them. In my view, in light of this era of greater tolerance for risk capital in South American markets, now

is the time to critically analyze the current project development archetype to determine whether it can be improved to promote greater development efficiencies through (i) increased access to capital, (ii) greater and more ongoing active local involvement in asset development and (iii) more integrated local and foreign asset management.

II. Principal Issues and Challenges Facing Junior Mining Companies Arising from Shortcomings Endemic to the Current Project Development Archetype

This section identifies the impediments to the development of mining projects both from the perspective of North American-based junior mining companies with South American mining assets, and that of South American-based junior mining companies who wish to gain access to equity markets in North America. (Note that many of the considerations will be the same in the latter case for European equity markets such as the AIM market as well as the Australian exchanges, however, this paper is confined to a discussion of North American, specifically Canadian markets).

A. North American- based Junior Mining Companies with South American Assets

The principal systemic trends and obstacles affecting North American-based junior mining companies that are developing South American mining assets include:

- Increased costs of regulatory compliance as a result of the influence of the Sarbanes-Oxley regime, including audit, technical and continuous disclosure requirements
- Institutionalization of the historic retail risk capital investor base due to the advent of mutual funds

- Increased competition in the public markets arena from new products e.g. hedge funds, income trusts and emerging “resource” sectors such as alternative fuels, wind farming etc.

Increased Costs of Regulatory Compliance

The combined post-Bre-X, post-Enron regulatory environment in North America is marked by heavy additional burdens on the management, administration, and financial resources of public companies as a result of the increase in compliance in a wide variety of areas, notably continuous disclosure, scientific and technical disclosure for mining companies and the imposition of financial and auditing controls.

Without making any judgments about whether the additional requirements are justified or effective, it is clear that the weight of the additional compliance procedures is felt more keenly on the backs of junior companies than their senior counterparts. This is due to the limited financial and administrative resources, which constrain most junior companies in any event. In my experience, the greater demand upon management and financial resources which is required in order to be compliant necessitates that fewer resources, including management focus, are spent in more direct furtherance of the mining project.

A more esoteric, but nonetheless noteworthy consequence of this factor is the introversion that occurs on a corporate level as management focuses on developing and ensuring that appropriate corporate governance, audit, technical and general compliance procedures are being followed. Particularly in the case of junior companies, this shifts emphasis towards process and away from the essential core of the business, namely project development. It is essential that management recognize this shift and counter for it appropriately. This statement will be fleshed out subsequently in this paper.

Institutionalization of the Historic Retail Investor

With the rise of the mutual fund industry and modern portfolio theory, there has been a trend away from individual retail investors making their own separate decisions about their investments in favour of the automatic diversification afforded by mutual and index funds. This has removed the traditional heart and soul of the North American risk capital markets and has several consequences for junior mining companies listed or financing through the North American public market system.

First, with fewer individual investors making decisions independently, prices, in particular of junior mining stocks are less liquid and more volatile. This has negative implications for financing and can lead to sluggish financings or financings at lower values as investors seek to be compensated for the additional liquidity and volatility risks.

Second, with greater institutional holdings, volatility is compounded due to portfolio limitations and parameters that can trigger a chain of selling into the market. This further discourages individual investors from participating in a “David vs. Goliath” market and can wreak havoc with a company’s stock price and financing goals. In turn, capitalization is affected as companies are forced to incur additional dilution in the event that financing and market timing do not coincide.

Third, historically success stories fuelled the market for an individual stock and boiled over into general enthusiasm for the sector more widely. This translated into investor confidence and levels of investment that were fuelled from the retail component of the market. With a greatly diminished retail component, I wonder whether there is the momentum in retail to meaningfully make and impact on stock price.

All of the foregoing consequences of the decline in the retail segment of the investment market result in more volatile, less liquid junior markets, and less certain financing scenarios as well as less planned capital structures for junior companies.

Increased Competition from Other Products

Together with the decline in junior market participation from the retail sector, junior mining stocks now have to compete with a wider variety of investment products chasing investors' money. As new products find fashion and favour with the investing public, mining stocks are tarnished with the "old school", traditional reputation and must compete with new products for financing. Once again, this supports the view that at a minimum, a change in the project development paradigm is warranted in order to re-inject some freshness into the sector.

B. South American-based Junior Mining Companies Developing Local Assets

By comparison, the principal trends and obstacles affecting South American-based junior mining companies developing local assets include:

- Ongoing lack of risk capital market confidence and experience among investors despite recent endeavours to develop same
- Domination of equity markets by a relatively small number of "big cap" investors
- Lack of homogenous standards for public market regulation and technical compliance among South American state actors

Lack of Experience and Investor Confidence in Risk Capital Markets

Perhaps the single most significant obstacle for the local development of mining projects has been the historic lack of risk capital markets in the majority of South American countries. This factor has resulted in the widespread dependence upon foreign equity markets, particularly at the exploration stage, in order to develop local mining assets. Contrast this approach with the North American experience: an individual or company acquires a mining interest, financing it through the exploration stage initially, perhaps as a private company. Generally, the company's shares are listed in due course on a stock exchange or over-the-counter

market, and thereafter the shares in the company are used as “currency” to raise money from individuals and institutions who offset the risk of investment in an early-stage play by the liquidity in the company’s shares. In this way, an illiquid asset, which has no immediate ROI potential, can be rendered liquid and can attract a much wider range of potential investors through equity.

The availability of capital market financing in Canada was further enhanced by government incentive programs, such as the “flow-through” share structure, which created a tax advantage for investment in Canadian exploration assets by high net worth individuals. Such a program would greatly assist the capital market system in South America and should be considered as a key element in future attempts to develop local capital markets.

Predominance of “Big Cap” Market Participants

Another component mitigating against the development of capital markets that can actively support a “small capitalization” company base is the preponderance for South American markets to be dominated by institutional and other “large capitalization” investors, such as pension funds, multinationals, conglomerates and the like. The investment parameters for such entities generally preclude risky “small cap” investments, in no small part due to the minimum preferred size of investments for such actors, which would often swallow significant equity positions in junior companies if not the entire junior company. This factor becomes a self-fulfilling prophecy: if junior companies are not fostered, little ability for them to grow to a “mid-cap” market arises, and the investment landscape remains dominated by large players.

Lack of Homogenous Securities, Technical and Financial Compliance Structures

Compared with the more established capital markets in the United States, Canada and the United Kingdom, the capital markets in most South American countries are very thin in terms of capitalization, number of listed companies and aggregate market value. In addition, the regulatory regimes are different in each country. One way to stimulate the growth of risk

markets would be to combine several South American stock markets and develop a uniform regulatory framework to support them, in particular as regards securities, scientific, technical and financial compliance. In this way, there could be more broad access to investors, and a critical mass of solid listed companies could more quickly and effectively be attained to serve as the foundation for the risk capital market structures in these countries.

III. Bilateral Approach to Financing and Managing Junior Mining Companies Across the North-South American Axis

Even the cursory analysis of the key obstacles facing North and South American actors in the junior mining industry highlights some of the shortcomings of the current project development archetype: North American junior mining companies are burdened by the sharp increase in regulatory compliance obligations placed on them, which, when coupled with the changing public markets landscape featuring a vastly expanded offering of competing products and the absence of the staunch market participation and support in the junior sector historically performed by a robust retail investment segment, implies a need for them to become more creative in sourcing their financing at the pre-feasibility stage. Likewise, owners of local mining assets in South America continue to suffer from an absence of developed risk capital markets with an active “small cap” sector and lack the ability to access North American sources of financing directly due to their relative lack of knowledge of the “ins and outs” of the North American regulatory system, and their lack of profile in and familiarity to the North American investment community.

Both sides contributing to the current project development archetype need to identify and pursue new and creative ways to sustain themselves financial in order to maintain or improve the efficiency with which they can develop local projects. In my view, it is necessary for junior mining companies in North America to embrace an enlightened archetype due to the greater variability in securing financing on a predictable basis and the fact that there has never been greater open dialogue in favour of promoting South American risk capital markets, indicating that there is a will to attempt to develop these, present a powerful argument for an

integrated approach to project development. Similarly, if local owners of South American mining assets want to increase the likelihood of their ongoing interest in the asset in quantum and over time, they cannot rely on the nascent risk capital markets being developed in their countries.

I would argue, that what is needed, is a bilateral approach to financing and managing junior mining companies integrating both North and South American junior actors. Instead of pursuing traditional option, purchase or joint venture arrangements, in respect of local mining assets, both sides would participate in a single corporate entity, to which the local owner would contribute the mining interest, and the junior company would contribute initial funding. Technical expertise and infrastructure would be provided by both sides according to their strengths, and both sides would also participate directly on the management team and at the board of directors level, provided that compliance with any applicable exchanges was adhered to.

Going forward, both sides would contribute to the management, exploration, development and administration of the entity and the objective would be to dual list the junior company on relevant stock exchanges in *both* North and South America. This dual listing and integrated management would have the advantages over the current project development archetype of:

- Allowing the junior company to benefit from the local owner's previous knowledge and experience with the asset in an active and motivated way
- Utilizing the local owner's knowledge and connections in the local community to navigate through local regulations, become known in the local financial community with a view to securing local investment either publicly or privately and more efficiently develop the project
- Decreasing reliance for financing on any one market in North or South America
- Sensitizing both sides to their respective local regulatory, legal and political frameworks

- Allowing value to be added to the project holistically and attracting investment on account of the project not retaining earn-in or option risk
- Retaining access to North American capital markets, in effect, on a project basis, not a company basis, emphasizing the asset to a greater degree
- Increasing education, dialogue and evolution of the capital market systems in both North American and South America
- Increasing networks to attract non-traditional sources of financing and would also have the long term benefit of helping to promote and develop a more homogenous regulatory system and more robust risk capital markets in South America.

IV. Key Ingredients for the Success and Promotion of Junior Mining Interests

In order for the above-described evolution from the current project development archetype to occur, and to enhance the likelihood of success of junior mining interests along the North-South axis, the following key ingredients and recommendations must be implemented:

- The separation, at the initial stage, of ownership of the local asset and access to financing must be reduced or eliminated
- Local owners must be given a long-term and motivating stake in the asset by being meaningfully integrated into the capital and management structures of the junior company from the outset, and must take an active and significant role in asset management and development.
- Management of junior companies must seek to develop profile in both hemispheres in order to diversify its network and access to financing

- The advantages of an integrated approach to asset development should be promoted so as to rekindle interest in the sector in North American markets despite a declining retail sector and increased competition from other products
- Local success stories will help to attract additional investment from non-traditional, and especially local South American sources
- Both sides must actively work to support and assist the evolution of local risk capital markets
- South American countries need to coordinate their regulatory and legal frameworks so as to present a homogenous set of requirements and broaden the potential risk capital base across several countries
- The benefits of including alternative investments and higher risk profile investments advocated by modern portfolio theory in the name of portfolio diversification needs to be emphasized to South American “big cap” actors, encouraging them to invest a small portion of their holdings in “small caps” with local interests
- The benefits and implementation of a tax expenditure program to promote the development of local mining interests should be considered

V. Conclusion

This paper has identified the key features and shortcomings of the current project development archetype and reviewed some of the principal obstacles facing junior mining companies in both hemispheres on a structural basis. From this review, an alternative to the current project development archetype has been proposed, which aims to address the obstacles facing junior mining companies, and encourage the more efficient development of mining assets in South America. It is my view, that this objective requires an integrated bilateral approach that utilizes markets in both North and South America and undertakes project development along the

North-South axis. Concurrently with this approach, it is essential that all market participants work to promote the existence and improve the function of risk capital markets in South America.

As a useful step in furtherance of the foregoing recommendations and suggestions, I would encourage all interested parties to: (i) relegate their competing interests in order to participate in the dialogue and influence action to assist in the evolution of local risk capital markets, (ii) adopt the proposed integrated bilateral approach to structuring project development, in particular, during the exploration stage, and (iii) continue to explore new and creative methods to enhancing project development. Accordingly, I would issue the following call to action: that as one step to assist in these objectives, interested parties should form a dialogue group or “think tank” to exchange information, points of view and further these critical objectives.

I would invite anyone interested in being part of such an endeavour to contact me at:

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