

# Mining

in 32 jurisdictions worldwide

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# Overview

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The old Chinese warning of ‘be careful what you wish for’ had an element of irony for many long-established Western mining companies over the past year.

The strong commodities market continued unabated throughout 2006 and into 2007, propelled primarily by the insatiable appetites of the Chinese and Indian economies. The resulting impact on demand for most metals kept prices at record levels.

Just when the industry collectively thought that prices could go no higher, a new wave of increases occurred and price points – previously thought unattainable – were quickly surpassed.

To many long-time participants in the industry, it is not only the absolute level of the prices which are hard to believe, but also the duration of the current high price cycle.

Observers are split into two camps. Some believe that the current market conditions are the new norm and that, after some minor retrenchment, metal prices will fluctuate up and down from these levels; others look back to the previous downturns – and from their perspective, it is not a question of whether prices will return to their historic levels, but rather when.

The first group are young enthusiastic fund managers and commodity traders whose world has been defined by ever increasing demand, limited new supply sources and rapidly increasing prices. The latter group are largely industry veterans proudly displaying their scars from the price downturns of the early 80s and mid-90s.

In the face of this strong market for metals, Canadian mining companies, having endured decades of weak demand and over-supply, quickly went from celebrating their healthy balance sheets, to making acquisition and growth plans to deploy their newly bulging war chests.

Unfortunately (or fortunately if you were a long-suffering shareholder), many senior management teams discovered that once in the merger and acquisition arena, predator can become prey. As a result, 2006 witnessed a number of acquisition battles which, once the dust cleared, left far fewer blue-chip mining companies with a head office in Canada.

Much has been made in the Canadian media about the root cause of why so many Canadian resource companies became the prize rather than the predator. To shareholders, however, the outcome of a takeover contest is less important than whether their investment produced a spectacular or mediocre return after the contest concluded.

The consolidation in the Canadian mining industry was, to many observers, long overdue. It is still continuing and will likely carry on as long as current prices are maintained. A number of interesting trends are emerging from the consolidation process and some warrant watching, as they may serve as crude leading indicators pointing to the longevity of the current M&A frenzy in the industry.

## Emergence of private equity firms

Much has already been written about the rising market clout wielded by private equity firms. The hot metals market has certainly been a major attraction to many of them, and a number of firms are taking substantial ownership positions in small, medium and large metals companies.

The change in shareholder demographics has forced the management of many companies to reassess what their shareholder base is looking for from the company.

As an illustrative example, in the takeover battle for Falconbridge between Xstrata and Inco, the auction process yielded a victory to Xstrata even though Xstrata’s all-cash final bid was lower than Inco’s part-cash, part-equity bid.

The clear lesson to CEOs of companies involved in takeover battles (and their financial and legal advisers) is that, very soon after a company is put in play, the shareholder base is likely to shift from a large number of small shareholders who are long-term believers in the fundamentals of the industry to a few large blocks of short-term arbitrageurs who will gladly accept a few extra pennies per share over the promise of continued participation in the industry.

## Regulators’ issues with private equity investors

Some Regulators are clearly not yet comfortable with the entry of private equity firms into the metals industry.

The EU competition authorities overseeing the approval process in the *Inco/Falconbridge* merger insisted, as a condition to their approval, that the Falconbridge Nikelverk refinery in Norway would have to be sold off by the newly merged Inco/Falconbridge immediately following the merger. While many private equity firms expressed a strong interest in acquiring the world-class facility, and very attractive bids were submitted by a number of them, the EU regulators insisted that Nikelverk be sold to a strategic buyer already participating in the industry. The concern expressed by the regulators was that a private equity buyer would not be as vigorous a competitor against Inco/Falconbridge in the market and would be much more likely to exit the market at the first sign of a downturn.

Had the deal gone through, Inco/Falconbridge would have been required to turn down significantly higher offers from private equity firms in favour of less generous offers from other mining companies.

Likewise, the Chancery Court in Delaware, arguably the most influential commercial court in North America, recently handed down a ruling in which it expressed concern and caution with respect to a friendly takeover of a medical supply company by a private equity firm. In essence, the court held that the interests of management and the new owner were too closely

aligned, given the intention of the buyer to give a portion of the ownership of the company to management and keep them on to run the company. The court concluded that, in the interests of good governance, the board of the company should be more directly involved in the sale process of the company to ensure that the interests of the shareholders were properly considered when seeking potential buyers and negotiating the actual sale of the company.

In its ruling, the court observed that, in the face of an offer from a private equity firm, the board must take over the sale process from management and actively solicit additional offers from industry participants. The conclusion of the court was essentially that the very nature of an offer from a private equity firm (providing for continued employment of top management and a share in the ownership of the enterprise) creates a conflict of interest for management which can only be addressed by the board soliciting alternative offers from industry participants.

Whether the inherent drawbacks seen by regulators in the participation of private equity firms in the marketplace will result in any significant limitations on their emergence on the M&A stage, remains to be seen. Based on these two cases, however, the prize may not always go to the highest bidder.

### Emergence of the small caps

An interesting result of the disappearance of many of the old blue-chip mining companies is the emergence of small- and medium-sized companies to fill the newly created vacuum.

This trend is a result of a number of factors. Often mining properties or metallurgical facilities are freed up or put on the auction block after two large companies are combined. This often occurs involuntarily as a result of regulators insisting on strategic divestitures as a condition to their granting competition clearance to business combinations occurring in the same industry.

In other cases, the divestitures are prompted by the acquirer's need to help finance the acquisition of a competitor, or because of its desire to streamline operations or deal with a duplication of assets arising from the combination.

The natural buyers for these surplus assets are smaller companies looking to grow bigger or become more vertically integrated. In situations where the divestiture is mandated by a regulator, there is often a perception that the asset can be acquired at a 'fire sale' price since the sale arises in something of a distress situation usually involving very tight timelines.

In addition to processing facilities and ore bodies, key operating and technical people also suddenly become available to join these smaller companies after the workforce reductions are completed at the newly merged entities. In addition to the involuntary separations arising from business combinations, the clash of cultures which often arises after the merger, prompts a second wave of good people to leave the organisation and seek alternative employment in the industry.

These people often have very detailed knowledge about the assets and properties being offered up for sale by their former employers. In some cases, these former insiders spearhead efforts on behalf of the mid-range companies to purchase properties or assets which are not being actively marketed by their former employers, because the insiders are aware of their potential value to a smaller company.

The entire support infrastructure of consultants, bankers, lawyers, financiers and accountants which were previously focused on the large cap companies find that they must secure new clients to replace the ones lost to consolidation. The business development activities of these service providers often act as cata-

lysts for growth for the mid-range companies, as new opportunities are brought forward and aggressively marketed.

And finally, there is the 'bull market' itself: the rising tide that lifts all boats. Vastly improved share prices, stronger revenues and mining properties containing mineral inventories which were previously sub-economic but are now highly prospective ore bodies, all contribute to the transition of many former junior companies or mid-range companies into the next level.

This movement is facilitated by happy investors who cashed in their holdings in the recently combined major companies and are now looking for new investment vehicles to repeat the process.

### Corporate Darwinism

Many companies filling the space previously held by the older, more established Canadian mining giants have tremendous advantages over their predecessors.

- *Lean management teams with less bureaucracy.* With relatively rapid growth there has been little opportunity for these newly emerging companies to become weighed down with cumbersome systems, management processes and institutional bureaucracy. Their top management teams are generally lean and, by necessity, entrepreneurial.
- *Low overhead costs.* For most of the older mining giants, a major operating cost was the ever-increasing burden resulting from pension and other benefits costs built up over decades of operations. For these companies, the ongoing costs of paying pensions and benefits to generations of workers who had long since ceased to be active employees meant that a base level of operating costs continued to be incurred regardless of actual operating levels or productivity improvement programmes. The newly emerged mid-tier companies do not have this legacy to contend with. They have also learned from history, and are providing much leaner benefit plans to the current employees. Many have moved away from the defined benefit pension plans to less costly and more predictable defined contribution pension plans.
- *Workplace flexibility.* For the big blue-chip companies, years of unionised operations resulted in workplace rules, which often inhibited productivity. Historical management/labour animosities resulted in productivity improvement initiatives being blocked by unions. Efforts to modernise plants were often frustrated or rendered ineffective by job security provisions and, when successful, came with a huge price tag in the form of expensive severance packages provided for in labour agreements.

- *Absence of legacy costs.* During their long lives, many of the blue-chip companies acquired a large stable of closed down mines, abandoned project sites, contaminated town-sites, rail lines, superfund sites, and various other property interests which require ongoing remediation or rehabilitation.

Prior to the onset of stringent environmental regulations, many of these companies went on a buying spree for old abandoned mine workings which had interesting exploration potential. While the exploration potential was rarely realised, the environmental liabilities invariably crystallised with the application of more stringent environmental regulations.

In other cases, these companies operated their own sites according to the operating norms and regulations of the day,

only to find, decades later, that new rules and regulations meant that they would have to go back to these sites and spend millions of dollars to bring them into compliance and keep them there.

By their very nature, these obligations involved perpetual care and maintenance. This not only requires a constant level of funding in the millions of dollars, but also large and permanent reclamation departments. Perhaps even more significantly, the maintenance of these sites also occupies a significant amount of board and senior management attention, as a misstep in this area has immediate and serious personal consequences to senior officers and directors.

Management of the newly emerged companies have in general avoided these 'tar pits' largely because the previously missing warning signs relating to the purchase of closed down sites are now well known and recognised.

- *Operating at the top of the cycle.* Finally, if there is no institutional memory of the dark days at the bottom of the market cycle, then acquisition, growth and expansion plans tend to be more optimistic and aggressive. Long-term prices used in NPV calculations trend up, political risk assessments tend to ignore previous nationalisation programmes and technical reviews don't take into account past spectacular technical failures. This approach tends to favour the smaller, younger companies as long as the market keeps its upward trajectory. The opposite is true for the older, more conservative companies who delay expansion plans, pass on acquisition opportunities, or decline to bet on new innovative technological processes.

#### Equity market's pull on the mining sector

The economic maxim that, if there is a demand for a product, the market will rush in to fill it, is amply illustrated in the Canadian mining sector.

The disappearance of the large blue-chips, and more recently a number of mid-sized nickel companies, has resulted in two complimentary forces:

- those shareholders lucky enough to have had investments in these companies are now sitting on substantial piles of cash; and
- these very same shareholders, as well as other investors who looked on enviously as large amounts of money were made, are now eagerly seeking investments in new publicly traded mining companies, to repeat the process.

The Canadian stock market is the ideal environment for this phenomenon, given its history in this sector and the large number of supporting players (investment dealers, lawyers, accountants, consulting engineers and geologists, etc) whose continued livelihood depends on its continued success.

The end result is that in addition to the natural 'push' forces created by the continued worldwide demand for metals, there is also a very strong 'pull' force exerted by investors which, when combined, have promoted the growth of smaller mining companies and the emergence of new mining companies on the Canadian public markets.

#### Cautionary notes

While no one likes to rain on a really good parade, there are a number of cautionary notes that should be sounded amid the current celebrations:

- *Hypersensitivity of the market.* There have been a number of recent incidents involving incorrect information being given to news services with respect to takeovers in the industry or production disruptions at key metallurgical facilities. Without proper verification and in their haste to get the story out, news outlets have released the information, which in today's market has meant immediate and sharp run-ups in stock prices for the companies involved. Obviously, the news agencies need to review their verification procedures, but the fact remains that, given the hair trigger that currently exists amongst many investors and the unbridled optimism that many have in the market, the consequences that such incorrect stories have on the market become greatly amplified.
- *Bre-Ex part II.* Notwithstanding the overhaul of regulations which arose post-Bre-Ex and the beneficial effect of National Instrument 43-101, there is a growing sense that the conditions are now ripe for another massive stock scam. With worldwide metal inventories at their lowest levels in decades and precious few new major discoveries in the development pipeline, there is a very great temptation for the reporting of a major new discovery. Investors need to be especially cautious at times like this and maintain a healthy dose of scepticism when assessing where to put their money.
- *Downside of higher prices.* Because the metals market is a cyclical market, it is important to recognise that hidden within the fruits of higher metal prices, company revenues and stock prices, lie the seeds of the next downturn.
  - Operating cost escalation occurs in lock-step with higher prices since wages are directly (commodity price bonus, performance bonus, etc) and indirectly (unions demand more and companies are less willing to take strikes when profits are high) tied to prices. Other consumables such as energy, raw materials and transportation costs also traditionally rise when commodity prices are high.
  - Higher construction and project costs also manifest themselves during the boom times as all the long-dormant projects are dusted off and owners chase after the limited number of contractors, steel suppliers and equipment manufacturers to get their projects completed first. After a prolonged period of inactivity in project development, these suppliers as well as the skilled workforce required to staff the projects have generally shrunk in size and are not capable of expanding quickly enough to meet the new demand. The result is ever-increasing project developments costs.
  - Increased government royalties and taxes are likely in various jurisdictions around the globe. New regimes either don't remember or aren't inclined to honour the tax holidays or other fiscal inducements offered by their predecessors during the lean times when prices were low and investment risks were high. Often under pressure from their constituents, governments argue that the high prices have created an environment of excessively high profits for the mining companies. The increased levies are bad enough to bear during the current high price cycle but, worse still, can be the catalyst for mine clo-

sure once prices start to fall.

- Higher overhead costs are a natural handmaiden to the more prosperous times of high prices. The severe cost reduction programmes and head office downsizing of the early 90s are long forgotten and, with increasing profits, senior executives find it difficult to say no to a variety of costly programmes that do little or nothing towards getting the ore out of the ground.

The cumulative effect of these higher costs is an industry that is a less profitable one dependent on higher commodity prices to keep operations in production. The new higher price floor hastens the day on which less profitable operations will be shut down and remaining ones forced to once again embark on cost-cutting programmes.

- The correction. As long-term price projections continued to creep up, a large inventory of greenfield mining projects, which were uneconomic at \$3 nickel, 80 cents copper, and 45 cents zinc, are now quite attractive. Previously closed down sites are also getting re-evaluated and it would be hard to find any brownfield expansions that would not be economic at the new higher prices.

This will, of course, lead to a gradual build-up in new production facilities that can only be economic at these higher prices and which will have embedded in them the higher costs referred to in the previous section.

Any glitch on the demand side for metals will therefore result in significant economic problems for these operations. The historic reaction of mining companies in this situation is to immediately look for ways to increase production (at both old and the new facilities) in order to lower unit costs of production. The resulting across-the-board increases in supply interacting with slowing demand only worsens the overall situation and the free fall in prices then begins.

#### **Birth of the new cycle**

The silver lining contained within the inevitable sequence of events outlined in the previous section is, of course, that the foundation is thereby laid for the next upturn in the market.

The moth-balling of newly built facilities, the closure of old ones and the abandonment of exploration properties will provide the raw materials out of which new mining companies will emerge.

Also, the aggressive acquirers of the current cycle will no doubt embark on divestiture programs, in effect creating a period of de-consolidation. For the shrewd observers of the price cycles inherent in the metal markets, all these events will signal the opportunity to take advantage of these newly available acquisition opportunities and await the next upswing in the metals market and the consequent reemergence of merger and acquisition activity.