

Mining For an Ideal: Bilateral Financing Structures In a North- South American Context — Paradigms and Practice¹

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The roots of mining experience in the international context has much to contribute to the dialogue on ideal structures to promote efficient cooperation for the development of assets on an international basis. Currently, there are systemic shortcomings and obstacles to project evolution in the public market systems of North and South America, respectively. There is a need in both markets for an integrated approach, incorporating elements from the two hemispheres on all levels. In this regard, the Canadian mining tradition both with its long-standing history of risk capital markets and mining abroad is uniquely situated to inform such a new paradigm. We will, accordingly, examine the characteristics of the current project development archetype and utilize its historical strengths and weaknesses from both the Canadian and South American perspectives to modify its architecture to one more suited to a functioning bilateral context. We will also examine the recent experience in Chile and Peru with their experiments in the risk capital area with a view to beginning to evaluate the effectiveness of the new bilateral paradigm.

A Brief Outline of the Current Project Development Archetype

The trend, certainly over this mining cycle and the last one, has been for many of the desirable assets to be located in South America. 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 dilutes the local owner of the mining interest to a minority position long before the project financing stage and generally results in a passive local participation throughout the project. The usual consequence from the exploration stage, then is little or no local retained interest in the project, save for taxes, royalties and the like. I have identified this set of relationships as the “*current project development archetype*”.

The separation of ownership of the local asset and access to financing is the most salient feature of the current project development archetype. It is most often, the traditional lack of access to local risk capital that pre-determines the eventual dilution of the local ownership interest. It is acknowledged that alternatives such as the development of mining assets by local conglomerates or governmental entities does occur, but it is the absence of local risk capital that principally stalls the course of development of resource assets in South America.

As stated above, another usual feature is the relatively passive role taken by the local owner of the asset in the development process as funding is generally largely provided by the foreign partner. Consequently, the asset not only loses any significant local ownership position, but also 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

Certain South American markets are beginning to move towards more standard requirements for technical review and disclosure in respect of mining projects. Certain jurisdictions in South America have led the charge by using relatively innovative strategies to begin the development of local risk capital markets. It is therefore timely to consider how the current project development archetype can be altered to generate greater efficiencies through (i) increased access to capital, (ii) greater ongoing active local involvement in asset development and (iii) more integrated local and foreign asset management.

Any change must consider the systemic pressures from North America on junior mining companies: (i) the North American regulatory legacy contributed by Bre-X and Enron has resulted in heavy additional burdens on the management, administration, and financial resources of public companies; (ii) there has been a trend away from individual retail investors making their own separate decisions about their investments in favor of the automatic diversification afforded by mutual and index funds, which has had liquidity and volatility implications especially for small cap risk capital stocks, and (iii) 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.

South American-based junior mining companies, by comparison, face quite different challenges. In particular, there has been a 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 where an acquired mining interest is typically funded through the "currency" of public company shares, used to raise money from individuals and institutions who offset the risk of investment by the liquidity in the company's shares.

The availability of capital market financing in Canada is further enhanced by government incentive programs, such as the "flow-through" share structure, which creates a tax advantage for investment in Canadian exploration assets. Mineral exploration funds raised by flow-through shares in Canada increased by 15% from 2005 to 2006 to a total of approximately \$600 million, and this trend has remained through 2007.² 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.

Both sides contributing to the current project development archetype need to identify and pursue new and creative ways to

sustain themselves financially in order to improve the efficiency with which they can develop local projects. A bilateral approach which integrates both North and South American junior actors is needed to finance and manage junior mining companies. While a number of variations are possible, the key ideas are: (i) participation by both sides in a single corporate entity to which the local owner contributes the mining interest, and the junior company contributes initial funding; (ii) both sides should contribute to the management, exploration, development and administration of the entity and (iii) the junior company should be dual listed 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
- Utilizing the local owner's knowledge and connections in the local community to navigate through local regulations and become known in the local financial community
- 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
- Increasing education, dialogue and evolution of the capital market systems in both North and South America
- Increasing networks to attract non-traditional sources of financing
- Helping to promote and develop a more homogenous regulatory system in South America.

Elements of the Bilateral Approach Analyzed

Any proposed archetype should not focus on how to raise more capital for mining, but on how to raise capital for mining in the countries where mining projects are developed. For the reasons outlined in the previous section, elements of investment, financing and development of capital markets must be integrated across both hemispheres.

In order to evolve from the current project development archetype, 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.
- 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.
- 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.
- The benefits of including alternative investments and higher risk profile investments in the name of portfolio diversification needs to be emphasized to South American “big cap” actors.
- The benefits and implementation of a tax expenditure program to promote the development of local mining interests should be considered.

It is important to question whether South America is prepared to accept this approach. Does there exist the real likelihood that mining companies could *invest meaningfully* in the local stock exchanges? Is there the possibility of *functional* dual listings? What are the necessary conditions required for adequate education regarding capital markets, the mining investment process required to advance exploration projects and bring development projects on line, and to actively involve local participants in project management?

Essential to all of the above questions and to the success of the proposed bilateral approach is the ability to create and develop a successful capital market framework in South American countries which can nurture a local junior mining sector. Recent attempts by Peru and Chile to develop their own capital markets show promise. Until a short time ago South American stock exchanges had been virtually absent from mining financing activities.³ However, recent trends indicate a substantial shift in the market capitalization of the mining sector. For example, from 2001 to 2006, market capitalization of the mining sector on the Lima Stock Exchange increased by 112% to nearly US\$15.8 billion.⁴

The first signs of this change were the creation of a risk capital segment of the Lima Stock Exchange and discussions in the Chilean Congress of a Bill to regulate competent persons for mining projects and create a qualifying committee for competence in mining resources and reserves.

Both Peru and Chile have sought to develop certain preconditions that are necessary to sustain an effective local capital market for the mining industry in South America. First, there must be political will and support for such development. In Peru, the Risk Capital Segment of the Lima Stock Exchange was created at the end of 2003. The project was spearheaded by a private group connected to mining exploration with experience in foreign risk stock exchanges, particularly that of Toronto. Though this process was initiated by private parties working with the Lima Stock Exchange, it resulted in a regulation for the new Junior Stock Exchange⁵ being approved by resolution of the governmental entity CONASEV (National Supervisory Committee of Enterprises and Values).

There are four junior mining companies that are listed in that stock exchange, all of which have a dual quotation in other stock exchanges and other listings are expected in due course.⁶

Chile’s risk capital markets were christened through a Congressional bill in December, 2005. The fulcrum of the bill regulates the qualification and competence of technical persons, much like the Canadian equivalent of “qualified persons”. The Chilean law makes the competent person responsible for his or her technical reports as compared with the professional organizations themselves, which perform this function in Peru.

The extension of the bill in Chile is the creation of the Foreign Securities Market of the Santiago Stock Exchange, also called “Bolsa Offshore”. Through the Bolsa Offshore, foreign companies can have their shares quoted on the Santiago Stock Exchange provided that local investors have access to all of the publicly available information concerning the company in Spanish.⁷

The second requirement to establish the necessary preconditions to sustain an effective local capital market for the mining industry in South America is the need for clear rules and legislation that not only support the international structure, but also mesh well with already developed rules and legislation in North American markets.

In the case of Peru, companies participating in the Bolsa Junior are subject to a series of regulations. These include a regulation of the Risk Capital Segment⁸ and a Regulation for public offers of common shares that have been approved by CONASEV. These later regulations provide that initial public offerings cannot offer shares at less than US\$0.10. Furthermore, the offering must result in at least 500,000 free trading shares with a total value of at least US\$300,000 and a minimum of 20% of shares issued to public hands. Also, the pro group cannot have more than 20% of the total listed shares directly or indirectly.⁹

In addition, there is a Code of Reporting Standards to Report on Mineral Resources and Reserves. The Code’s objective is to

evaluate a candidate's capacity to meet the requirements the Registry of Qualified Persons of the Stock Exchange of Lima.

Both the Chilean and Peruvian early-stage experiments in risk capital markets have sought to create a structure that encourages foreign participation and both have sought to assure the technical integrity of projects listing on their exchanges through the creation of a technical accreditation and oversight process based, in large part, on Western experience.

The third precondition for sustaining an effective local capital market for the mining industry in South America is the existence of a market. The lack of representation of the mining sector in Chile's stock market is not due to a lack of confidence in the institutional and financial system of Chile. Rather, the weak mining component stems from a disconnect between the Chilean financial sector and the mining activity developed in the country. The financial sector does not properly understand the mining business and its risks. It will be interesting to see if the increased political focus on capital markets as illustrated by the creation of the Bolsa Offshore and the added integrity afforded by the implementation of the competent person approach will help to bring the financial markets and the mining sector together in Chile.

Finally, it goes without saying that the stability of a country, especially as regards foreign investment, is fundamental for the development of stock exchanges that attract and finance junior companies. For example, the Metals Economic Group in its 2007 report, listed a drop of 40% in exploration investments in Venezuela, likely not coincidentally concurrent with the ongoing

nationalistic trend in that country. It is unquestionable that political stability is one of the great attractions of Chile and to a lesser extent of Peru.

Conclusion

An alternative to the current project development archetype which aims to address the obstacles facing junior mining companies, and encourage the more efficient development of mining assets in South America is necessary. 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, which has been tentatively outlined in this article. To further the objective, all interested parties should: (i) integrate their long-term objectives and complementary skills as well as assist in the evolution of local risk capital markets, and (ii) adopt a bilateral approach to structuring project development, in particular, during the exploration stage.

The question remains whether most countries in Latin America are ready to embrace this new archetype and approach to capital markets in their country. Although in general terms the preconditions to establishing local capital markets have been satisfied in both Peru and Chile, Chile has some problems in relation to the mining exploration market. Both Chile and Peru can be regarded as front-runners in the bilateral capital markets experiment in conjunction with predominantly Canadian cooperation. ⁿ

1. The assistance of Ricardo Irrazabal of Philippi, Yrarrazaval & Brunner in Santiago, Chile and Jeff Levine of McMillan Binch Mendelsohn, Toronto, Canada is gratefully acknowledged.
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