GLOBAL MINING: THE CREDIT CRUNCH AND BEYOND

Ample evidence suggests that commodity prices will continue to hover around historic highs — significantly above the troughs encountered recently

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An Overview of the Mining Sector

Despite the turmoil in financial markets, the six-year-old commodities boom looks set to continue. However, it is likely to proceed at a tempered pace compared to the frothy heights achieved in 2007 at the peak of the cheap credit-fuelled economic run. US economic malaise, mining project cost inflation and weakened investor appetite for financial instruments (including commodities) are some of the factors that may cause some commodity prices to retreat in the near to medium term. However, there is ample evidence they will continue to tread near historic highs, far above the troughs encountered in the previous decade.

Mineral supply is short as a result of a lack of investment in mining projects during the last mineral bear market (1996-2001). The short and medium term will bring new challenges – and opportunities – to mining companies. Large cash flow-rich companies may benefit in the new environment of lower valuations which will enable acquisition opportunities to replenish depleted commodity reserve bases. Juniors – primarily explorers – will face greater difficulty accessing financing and, in the short term, will have to consider joint venturing or issuing more equity (and face greater dilution) to finance projects as a result of the dry up of the high-yield debt market and weak equity markets.

The turmoil roiling financial markets has also emphasised a step change that has crystallized during the last five years: the emergence of the so-called BRIC nations. Brazil, Russia, India and China (especially the latter) now account for a significant component of global commodity demand growth and consumption. China now consumes more metal than the US and makes up between 75 percent and 100 percent of demand growth for many commodities.[1] Perhaps as seismic a change is the new global corporate and financial landscape. Chinese banks are now among the largest (and best capitalized) banks in the world (the top five banks in the world by capitalization include three Chinese, one British and one US bank).[2]

Among mining companies, Aluminum Corp of China (Chinalco), Vale (formerly Companhia Vale do Rio Doce), United Company RUSAL (RUSAL) and Xstrata now challenge traditional global leaders in the mining sector such as Rio Tinto, BHP Billiton and Anglo American for global domination. These are positive factors as the market for corporate control is strengthened (valuations enhanced) and new financing options are available for juniors to make up for the dearth of debt financing resulting from traditional banks grappling with subprime-related bad debt and ravaged capital adequacy ratios.

Mergers & Acquisitions: Activity and Outlook

Throughout 2007, mergers and acquisitions continued at the torrid 2006 pace. Deals included Uranium One's friendly $3.1 billion acquisition of UrAsia

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Energy, MMC Norilsk Nickel's $6.8 billion cash offer for LionOre Mining International, Yamana Gold's $4.6 billion stock and cash offer for Meridian Gold and Rio Tinto's friendly take-over of Alcan in an all cash $42.9 billion dollar deal.

It is unlikely the credit crunch will significantly slow down mergers and acquisitions in the mining industry, as evidenced by BHP Billiton's $147 billion all share offer for Rio Tinto. Citigroup has suggested that a potential cash pool of more than C$300 billion is available for M&As this year. The BHP take-over offer has likely triggered a further round of consolidation at the top end of the mining sector, with newly-emboldened entrants from China and Brazil involved. Chinalco stunned financial markets with a surprise "dawn raid" on the BHP-Rio Tinto take-over effort by purchasing, along with Alcoa, via an acquisition vehicle, a 12 percent Rio stake for $14 billion (at a significant premium) thereby justifying Rio Tinto's argument that BHP had undervalued its shares in its take-over offer.

Industrial logic and the search for synergies may shape part of the rationale behind these deals. It is estimated that BHP could achieve $1 billion worth of cost savings from a Rio Tinto merger. Other factors include the need to replenish reserves and the need to utilize the huge cash piles which many of the larger mining companies have on their balance sheets. Any producing company, especially those with multiple commodities in production, are able to leverage strong cash flows for debt (if required) or apply shares that have held value in spite of weak market conditions in share exchanges. Finally, many deals are occurring for the simple reason that if a deal is not initiated, the company not initiating may find itself a target.

Financing Sources: The Choice is Canada or London

Equity Financing

During the recent commodities boom, Canada and London have been the source of the vast majority of the equity financing that has fuelled the mining industry. The Toronto Stock Exchange (the "TSX") and its junior market, the TSX Venture Exchange ("TSX-V") along with the London Stock Exchange ("LSE") and its alternative investment market ("AIM" or collectively "LSE-AIM"), were responsible for 2,401 financings as of the first 11 months of 2007 out of a global total of 2,614. Both jurisdictions offer deep, stable and liquid capital pools, the extensive professional resources required to bring a financing off the ground and analyst understanding and coverage of the unique conditions facing the mining industry.

Canada has maintained its place as the jurisdiction of choice for the financing of mining companies, followed by AIM. The TSX and the TSX-V had 1,373 mining issuers listed in the first 11 months of 2007, while LSE-AIM had 229. Out of the $44.7 billion in equity capital raised globally during the same period, $15.3 billion was raised on the TSX/TSX-V. An additional $6.7 billion was raised through LSE/AIM financings. By contrast, the New York Stock Exchange (the "NYSE") raised $2.6 billion during the same period and the Hong Kong Stock Exchange raised $909 million.

What makes Canada so attractive as a financing center to mining companies? Canada has developed a unique world-leading cluster of service and finance competencies peripheral to the mining industry that has nurtured the domestic mining industry and made Canada a domicile of choice for many international miners. The TSX/TSX-V is home to a large peer group of mining companies. Fifty seven percent of the world's public mining companies list on the TSX, though LSE/AIM can boast of a greater market capitalization (C$529 billion against C$372 billion).[3] Other factors include: a significant domestic pool of capital resulting from an equity-friendly population (49 percent of Canadians own shares); a large analyst community that covers juniors and seniors guaranteeing greater press coverage than in other markets; ease of raising capital for non-North American projects and a large pool of non-Canadians with TSX directorship experience.

The LSE/AIM provides an excellent complementary (or alternative) avenue for mining companies to raise equity finance. AIM relies more on self-regulatory requirements than the TSX (which requires compliance with a technical reporting standard governed by National Instrument 43-101) and offers access to the extensive capital pool available in London. Additionally, mining companies from some regions, such as South Africa, have found certain advantages in dealing with AIM over the TSX/TSX-V (such as a greater investor interest in financing projects in these regions).

Debt Financing

Financial institutions in London and Toronto are heavily involved in providing debt financing to the mining industry. As a general rule, junior companies have difficulty raising debt financing and accessing capital via the equity markets, while companies with cash flow and advanced stage projects are more likely to have the option of debt financing. There are also other financing vehicles such as project finance and commercial banking debt. The use of debt financing can greatly enhance the equity return, as funding exclusively from equity can be dilutive. However, putting in place the debt financing can be time consuming and complex. It is critical that mining clients understand the costs and benefits of each option.

Financing in the Credit Crunch Era

The credit crunch has changed the dynamics of financings by putting a premium on producing companies while discounting the value of exploration companies. Financial market sentiment has gradually deteriorated since the nadir and collapse of the credit-fuelled bubble in the summer of 2007. This has resulted in lower share prices broadly and has affected junior mining companies to a greater extent than producing companies. With risk aversion in the ascendance in the credit crunch era, investors are less willing to take on speculative stocks.

While environmental concerns and permitting difficulties have soured the hopes of many junior companies, even well advanced projects (such as with Galore Creek[4]) have stalled due to unprecedented project inflation costs — and have all but dried up equity financings for juniors for the moment. Fortunately, other options exist for financing (either accepting greater dilution through equity financings or through the more traditional path of joint venturing with a large mining corporation). The current dearth of interest in financings for junior explorers is more dependent upon general financial market conditions and investor appetite as well as bank weakness than upon fundamentals in the mining industry. Indeed, it is only a matter of time before producing properties are no longer available for acquisition by larger mining companies, at which point valuations of juniors with properties and completed feasibility studies in place will once again find more favourable valuations, thus better debt and equity financing options.

Compliance: Canada Foreign Investment Review and Use of Proceeds

Foreign Investments in Canada

Foreign investment in Canada by foreign state-owned enterprises ("SOEs") has resulted in the take-over of some of Canada's most venerated and well-established companies. For example, Inco, a Canadian mining icon, was taken over by Vale in a C$19 billion cash deal in 2006. The government of Brazil owns a golden share of Vale and the question was raised as to why Vale could enter the Canadian market and take over Inco, while Inco could be blocked by the government of Brazil if it tried to do the same to Vale. The public was aroused by the Inco deal and considerable political debate occurred on what policy approach Canada should take in response.

As a result, on December 7, 2007, the Industry Minister announced the issuance of new guidelines under the *Investment Canada Act* (the "Act"), directed at clarifying how the Act will be applied to SOEs. Under the new guidelines, in reviewing an SOE investment, the Minster will continue to use the traditional benefit factors enumerated in Section 20 of the Act but will, in undertaking that review, have particular regard to the corporate governance and reporting structure of the non-Canadian SOE investor. The Minister will examine, among other things, whether the SOE adheres to Canadian standards of "corporate governance and to what extent the non-Canadian is owned or controlled by the foreign state." Before approving the investment, the Minister may require specific formal undertakings to Canada that address some or all of the foregoing factors. In addition to these guidelines, legislation will be introduced later in 2008 which will be aimed at protecting Canada's national security in the context of foreign investment.[5]

Use of Proceeds

Recently, Canadian securities regulators have begun to focus on the question of disclosure in prospectus documents relating to use of proceeds.[6] Commission staff are thoroughly examining the extent to which proposed expenditures have been approved by third party technical reports. The Securities Regulators have noted that, in some offerings, the principal purpose of the offering is simply described as for "general corporate purposes," for "potential acquisitions" or for "working capital." Also, it has been noted that once a purpose is identified, a significant portion of the remaining proceeds is not allocated to any purpose.

The Securities Regulators point out that these practices are not compliant with the securities regulations. Item 7 of Form 41-501F1 and item 4 of Form 44-101F1, for example, require issuers to describe in reasonable detail each of the principal purposes, with approximate amounts, for which the issuer will use the net proceeds. Mining issuer prospectus disclosure must support the disclosure in their NI

43-101 technical reports, and issuers are asked to disclose when there are inconsistencies between the disclosure in the prospectus and the recommended work plan in the technical report, or when there is insufficient disclosure in the prospectus to support the disclosure in the technical report. The Securities Regulators require that issuers describe in the prospectus the principal purposes for which they are intending to use the net proceeds from the offering and the approximate amount they intend to use for each purpose in order to support the disclosure in the technical report.[7]

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Exploration

With metal demand outstripping supply, a key question is: When will a supply balance be restored to the markets? The mining industry typically cycles between investment and production phases, the last major investment cycle ending in 1997. During the bear market, investment in exploration virtually stopped. Now with mineral commodities prices up, a new investment cycle has begun. Mineral companies are scrambling to either make new finds, rehabilitate old projects that were uneconomic during the bear market, or make corporate transactions for junior exploration companies with mineral assets.

Unlike the last investment cycle (late 1980s to 1997), the completion of projects during the present investment cycle is proving more costly and lengthy, not only with regard to projects in developed nations. As mentioned above, the example of Galore Creek has shown the scale of project cost inflation, even in a stable economic environment such as British Columbia. In addition to cost inflation, obstacles are challenging project completion that may not have been as significant a factor 20 years ago and include increased environmental compliance costs, less favorable taxation, most demanding royalty regimes and equipment and skilled labor shortages.

The drafting of new royalty regimes in certain South American countries, for example, has dissuaded some larger mining corporations from continuing with development projects. The recent example of the Democratic Republic of the Congo (DRC) and the introduction of the License Review Commission, which is empowered to review over 60 of the most significant mining concessions agreements involving foreign investors in the DRC, is a reminder of the risk associated with investing in politically unstable – but commodity rich – countries.

Canada: A Favoured Destination for Exploration Budgets

Besides capital raising, Canada is a favored destination for exploration expenditure, too. In 2007 an estimated $10.5 billion was spent on non-ferrous mineral exploration, a 40 percent increase on 2006 figures. Canada was the favoured destination, receiving 19 percent (South America as a whole received 24 percent while Africa received 16 percent).[8] Canada received the highest share of exploration spending because of its rich endowment of mineral commodities and because of the favorable business climate for mining companies that it has fostered.

In addition to possessing a highly developed infrastructure of professional support services, financing opportunities and investors, Canada has created favorable tax incentives for companies to invest in exploration. The Investment Tax Credit for Exploration (ITCE) and the flow-through share mechanism ("super flow-through shares") have led to more than C$1.4 billion of exploration funds being raised between October 2000 and September 2005. This number represents 60 percent of the total exploration spending by juniors. Whether these numbers can be maintained in light of the difficulties juniors are experiencing raising financing in the current credit crunch remains to be seen. What is certain is that once appetite resumes, Canada will remain a favored destination.

Will the Commodities Boom Continue?

The rally that started with gold in 2002 spread

— from copper to uranium to molybdenum, metals prices have rocketed. Gold has hit $923/oz, up from lows of $265/oz in July 2001. Copper has risen from $0.75/lb in 2003 to over $3.48/lb. Molybdenum sits at $33.25/lb from lows of $2/lb. Uranium has gyrated, but is currently posed high above historical prices, rocketing upwards from $6/lb in 2000 to $136/lb in June 2007 now at $80/lb.

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Mining companies' financial positions have benefited enormously from these positive, near exuberant, market conditions. Since the end of the last minerals bear market in 2001, global market capitalisation of mining companies has risen by 564 percent — from $195 billion in November 2002 to approximately $1.1 trillion as of February 2007.[9] Commodities, while no longer at peak heights (aside from gold which is riding a super bull market), are still priced at historical highs.

The prospects for gold look strong in the near to medium term. While gold rose over the last five years in line with the general commodities boom, its rise has accelerated with the credit crunch. Currency debasement, inflation, derivatives dislocations have increased anxieties amongst financial market actors and have led to further flight toward the supposed safety of gold. Thus gold has entered into an investment driven phase characterized by over 845 tonnes of gold ETF holdings, worth over $25 billion, for example.

Base metals prices, such as copper and zinc, have benefited from global economic GDP growth, booming demand from China and a corresponding lack of inventory levels sufficient to meet demand. China's GDP grew 9.9 percent in 2005 and 10.2 percent in the first quarter of 2006 and industrial production grew an impressive 27.7 percent in 2005.[10] A vast infrastructure building program that includes building dams, power plants, factories, roads and ports continues unabated.

From a negligible market, China has become the world's largest consumer of copper, nickel and zinc. Chinese imports of iron ore increased from 14 million tonnes in 1990 to 148 million in 2003. Meanwhile, refined copper imports rose from 20,000 tonnes in 1990 to 1,272,000 tonnes last year. China's share of global copper demand is 20.6 percent, global aluminum 21 percent, global coal production 35 percent, zinc output 20 percent and magnesium 20 percent.[11] As China consumes two to four times more metal than the US and makes up between 75 percent and 100 percent of demand growth for many commodities, the slowing US economy may have a limited impact on commodity pricing.

For coal miners, the resurgence of coal prices has led to increased profits and growth and the need for capital for project development. Coal prices are being fed by high natural gas prices (which force electricity utilities to switch to coal as a fuel stock). Coal demand has also been fed by US steel maker usage of metallurgical coal and by enormous consumption resulting from Chinese industrialization.

Conclusion

The mining industry faces challenges that are unique to the industry including political risk, cyclical mineral commodities markets and fickle equities and debt markets. The recent coming of the credit crunch and deterioration of financial market sentiment adds to worries held by market participants regarding the longevity of the mineral commodities boom, and questions have amplified as to whether another commodity bear could be around the corner.

Conditions in the mineral commodities markets have, however, changed dramatically since the 1997-2002 bear market. The emergence of China is a step change in the fundamental supply and demand equation creating a much more durable commodities market less at risk of a sudden cyclical downturn. Significant imbalances in the supply and demand equation suggest a global downturn would have to be particularly severe to bring prices to a bear market level.

Mining companies are flush with cash from the record prices of the last several years, and will remain healthy even with the moderate pullbacks recently seen in commodities prices. While undoubtedly there will be turbulence, the prospectivity of the near to medium terms look positive indeed.

Endnotes

1. Elisabeth Behrmann, "China insulates metals from meltdown" *Dow Jones Newswires* (19 January, 2008).
2. Aaron Kirchfeld, "ICBC Deposes Citigroup as Chinese Banks Rule in New World Order" *Bloomberg.com* (4 February, 2008) [The top five banks by market capitalization are (in order descending from largest): Industrial & Commercial Bank of China (ICBC), Bank of America, HSBC Holdings, China Construction, Bank of China].
3. A large portion of the total LSE/AIM market capitalization is the result of several large mining companies such as Rio Tinto, Anglo American and BHP Billiton having listings on LSE/AIM. Source: TSX.
4. Joint venture partners Teck Cominco and NovaGold Resources Inc. were forced to suspend construction on the massive Galore Creek project in British Columbia after it was announced that projected costs had ballooned from $2 billion to over $5 billion, a price at which the mine would no longer be economic.
5. Fasken Martineau, *Antitrust/Competition & Marketing Bulletin* (December, 2007).
6. Unlike the US which has one primary National Regulator, Canada has 13 regulators, one for each province and territory.
7. Corporate Finance Report, November 2, 2007 (2007) 30 OSCB 9069.
8. Press Release, Metals Economics Group (MEG) (13 November, 2007).
9. Source: BMO.
10. CIA World Fact book, online: <http://www.cia.gov/cia/publications/factbook/>.
11. David Hale, "Will China Need a Blue Water Navy to Protect Commodity Imports," online: China Online <www.chinaonline.com/>.

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