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The Global Corporate Advisor

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Welcome to the Mining Industries edition of the Global Corporate Advisor (GCA) newsletter

The global economy's appetite for commodities continues to grow and the tight supply is a key concern for major industry players. This increasing demand has resulted in new exploration and production in emerging countries in regions such as Africa, South America and the former Soviet Union.

In this month's issue, Stephen Bullock from Crowe Horwath in the UK discusses corporate M&A activities and capital raisings in these emerging markets, and examines the outlook for M&As in the mining sector this year.

One of the countries set to benefit from the mining boom is Argentina. With major global companies looking to tap its mineral resources, investment has poured into South America's second-largest economy in recent years. Norberto Rosemberg from Crowe Horwath in Argentina provides us with commentary on how to value a mineral property, and keeps us up to date on the latest mining-related developments in the country.

Our members are busy advising clients on transactions in all corners of the world. Joseph Calvanico from Crowe Horwath in Chicago provides advice on how to conduct tax assessment on mining properties in the US, while Darryl Norville from Crowe Horwath in Australia shares his knowledge on how to prepare for the due diligence process when acquiring a mining asset.

Last but not least, Paul Blythe from Crowe Horwath in the UK provides insights into appraising an exploration business plan, giving pointers on the many factors to consider during this process.

Please don't hesitate to contact me or the team to discuss any of the ideas in this issue, or for any needs relating to M&A transaction support, valuations, M&A advisory and related services.

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Inside This Issue:

Mining M&As and Capital Raising – Reflections on the Current Landscape

By Stephen Bullock, Head of Natural Resources, United Kingdom

A shift in global demand for commodities has led to rising prices and new exploration and production in emerging countries in regions such as Africa, South America and the former Soviet Union.

As a result of this trend, corporate merger and acquisition (M&A) activities and capital raisings are no longer the preserve of the traditional resource economies of Australia, Canada, South Africa and the US.

The extreme market turbulence and volatility experienced around the globe in 2011 was especially evident in the eurozone, where fears of another financial crisis were compounded by economic worries in the US and concerns over slowing growth in China.

Mining companies with strong cash generation and low gearing have an opportunity to acquire quality assets in this uncertain environment. By investing in growth in a market with depressed asset prices, rather than by returning cash to investors, companies can help generate healthy M&A activity.

Although caution remains in the M&A market, there is a positive outlook for emerging and established resource economies in the years ahead.

M&A environment

M&As play an important role in the mining industry because larger producers are increasingly outsourcing exploration. A low cost base and high degree of flexibility ideally equips a junior explorer to minimize the equity risk of the exploration and evaluation process.

Many junior explorers have no intention of developing their assets beyond the resource or reserve stages due to the high costs involved in reaching production. Mid-tier and junior producers, on the other hand, need to acquire projects and assets to feed their pipelines.

As part of their natural cycle, smaller producers will periodically divest projects that are no longer a priority or that they cannot raise the capital to develop. Similarly, majors are prepared to divest mature, uneconomic assets to smaller and lower cost producers, who may be able to exploit them profitably.

These industry dynamics create a continuing need for non-organic growth through M&As. As assets move up the value chain from geological targets to producing mines, there is a perpetual requirement for capital raising.

M&A activity in 2011

Mining and metals companies demonstrated continued confidence in 2011 despite the jittery general market and tough conditions for executing M&As. Industry analysts have identified 1,008 global mining and metals transactions in 2011.* This represents a 10% reduction in deal numbers compared to 2010. However, the aggregate value of those deals amounted to a 43% year on year increase and a 63% jump in average deal size.

The driver in 2011 was the 28 ‘megadeals’ of over US$1 billion, a level not seen since the peak years of 2006 and 2007. However, not all is quite as it seems. These mining statistics are influenced by energy-related megadeals – where a ‘mining’ deal involves a mining group diversifying by acquiring an energy asset (oil and gas) and/or straightforward domestic consolidation.

These transactions had a significant impact in 2011:

- consolidation in coal assets accounted for 28% of deals by value
- acquisitions of oil and gas assets (principally US oil/shale gas) by diversified mining companies accounted for a further 18% by value (15% by two major deals by BHP Billiton alone)
- domestic consolidation in the Commonwealth of Independent States (the Silvinit–Uralkali potash merger and the Polyus–Kazakhgold gold merger) accounted for a further 19% of deals by value.

Who is buying where?

The following underlying trends can be identified if the distorting factors referred to above are stripped out.

- Buyers in the Asia-Pacific region (39%) and North America (32%) dominate by value.
- Companies are buying assets in the Asia-Pacific region (27%), North America (27%), Latin America (22%) and Africa (18%).
- Asset acquisitions in Africa held upin 2011 following a 400% increase in 2010.
- Asset acquisitions in the BRIC countries (Brazil, Russia, India and China) and developed economies are predominantly (about two thirds by value) domestic transactions.
- Asset acquisitions in emerging and frontier economies are overwhelmingly (80% or more by value) cross border transactions.

Mergers, acquisitions and capital raising in mining and metals – 2011 trends, 2012 outlook, Ernst & Young (2012)

Frontier assets

Three major transactions in 2011 accounted for three quarters of asset acquisitions in frontier nations: Barrick Gold's acquisition of Equinox in Zambia (copper), Rio Tinto's acquisition of Riversdale in Mozambique (coal) and further investment by Rio Tinto in the Oyu Tolgoi copper assets in Mongolia.

Outside these deals, a number of African countries – Kenya, Mozambique, Madagascar, Tanzania and Zambia in East Africa and Guinea, Liberia and Mauritania in West Africa – are emerging as highly attractive to cross-border investors.

This aligns with Crowe Horwath's experiences in 2011 acting on capital raising transactions for junior explorers in Guinea and Madagascar.

There seems little doubt now that Africa is well established to lead the next generation of large-scale mineral development projects. Despite its abundant resources the continent remains one of the least explored regions of the world. Asset prices, particularly in sub-Saharan Africa, remain low in comparison to North America or Australia.

This was confirmed at the Investing in African Mining Indaba in Cape Town in February 2012 this year, which saw record attendance of over 7,000 delegates.

Capital raising environment

Two main types of mining companies were looking to access capital in 2011, with very different results.

Major producers had little difficulty sourcing equity and asset finance, reflected in record levels of bond issues and loan finance at continuing low rates of interest.

Juniors, in particular pre-production juniors, found capital markets increasingly difficult, if not closed completely as 2011 progressed. Small companies now find it difficult to access equity and debt from traditional sources.

Aggregate proceeds of initial public offerings (IPOs) and secondary fund raisings were at similar levels to 2010, but the US$10 billion Glencore IPO represents a significant distorting factor in the analysis.

Stripping out Glencore, global mining IPO proceeds were down 60% on 2010. In terms of numbers of transactions, the 145 global mining IPOs and 2,464 secondary fundraisings represented a reduction of around 20%. Junior IPOs in the second half of the year slowed significantly, with average proceeds falling to just US$7 million.

Mining stock exchanges

The Australian Securities Exchange (ASX), TMX Group's (TMX) Toronto Stock Exchange and Toronto Venture Exchange (TSX and TSX-V) and the AIM market in London took the lion's share of mining IPOs in 2011.

The first half of 2011 saw a year-on-year increase in volume, but deteriorating markets in the second half reversed the promising start to the year. The full year out-turn saw a year-on-year reduction of 18%. Average mining IPO proceeds on these three exchanges in the full year were US$8 million compared to US$21 million in 2010.

So, which exchange is best for a mining junior looking to raise capital and make its mark?

The main mining exchanges – ASX, TMX, LSE – and, increasingly, the Hong Kong Exchange (HKEX) were all represented at the recent Mining Indaba in Cape Town. All pressed the case for their own exchange. Each was careful to stress the complementary relationship between the different platforms, at least in public.

The TSX and TSX-V host the largest number of mining companies by a considerable margin, followed by the ASX and then the London Stock Exchange (LSE). Using a broad rule of thumb, there are about three times more mining companies listed on the ASX than there are on the LSE (including AIM), and about three times more again on the TSX/TSX-V than on the ASX.

However, the aggregate value of equity financings for mining companies over the five-year period 2006 to 2010 on all significant exchanges shows an inverse correlation between funds raised and number of companies listed.

While the TSX/TSX-V leads the list in terms of aggregate funds raised, the LSE emerges as clear leader in a ranking of funds raised per company listed on the exchange:

Exchange	US$m equity raised 2006-10 per mining company listed
LSE	258.91
TSX/TSX-V	48.19
ASX	40.96
Average	**63.08**

Source: TMX presentation

In summary, and with apologies for some over-simplification, when looking at the different exchanges mining companies should bear in mind that:

- Australia and Canada have the largest number of listed mining companies but many of these have small market capitalization and/or speculative mining assets

- Australia and Canada have active retail investor bases and a strong focus on earlier stage exploration
- Australia and Canada have had the most mining IPOs but those in London and Hong Kong have tended to raise considerably more equity
- Canada has the most secondary raises and raises the most cash in aggregate
- Canada has the strongest supporting infrastructure for mining companies, followed by the LSE and Australia
- The LSE has the most diverse spread of listed assets within the mining sector
- Larger companies have demonstrated a preference for the LSE and HKEX
- The LSE and HKEX have larger average deal sizes due to the focus on issuers with assets further along the value chain.

Outlook for mining

So where does all of this leave the outlook for mining M&A and capital markets activity?

By far the most significant driver of corporate activity in mining activity is economic growth in key economies. This establishes global demand for key resources and, in turn, drives commodity prices.

Over 80% of world commodity volumes are accounted for by iron ore, copper, coal and gold. Even if the economies of China and India only grow at 4% per year, the medium-to-long-term demand trends in those commodities are unlikely to fall significantly. Similarly, the emerging Indian middle class is unlikely to stop buying uncut diamonds.

Despite a disappointing second half of 2011, most observers expect continuing strength in the mining sector in 2012.

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Uncovering Argentina's Mining Potential

By Norberto Rosemberg, Manager, Argentina

The immense mining potential of Argentina is only just beginning to be uncovered. The introduction of a new pro-mining law in 1993, aimed at promoting international investment in the mining industry, has resulted in the development of significant mining operations over the last two decades.

In 1995 mining exports surged 33%, and by 2006, mining investment had reached US$1.27 billion. In 2010, Argentina produced 20.6 million ounces of silver. Among the many to turn their attentions, and funds, towards Argentina, are mining giants such as Xstrata (LSE, SIX: XTAN), Barrick Gold (NYSE: ABX, TSX: ABX), AngloGold Ashanti (NYSE: AU), and GoldCorp (TSX: G, NYSE: GG).

The measures introduced by the pro-mining law included fiscal stability for 30 years, accelerated amortization of capital goods, import tax-free capital goods and tax-free inputs. Similarly, a mining royalties agreement was established in the provinces which could not exceed 3% of mine value minus production costs.

In the 1990s, Crowe Horwath participated in two projects: SINATEM (National Mining Technology System) – based on a survey of all mining companies in Argentina – and the PFM (Mining Reinforcement Institutional Program), which proposed reform to the Ministries and mines' provincial authorities.

Project valuation

There are three main classifications of mineral property. The first category comprises properties in operation which have a production history, substantial reserves, and an operating cost structure in place.

Properties in the second classification have been well explored, reserves have been measured, and construction has commenced in an effort to bring the project into production.

The third category consists of deposits that are considered not economically viable at the present time due to market conditions.

One of the most important phases of property valuation revolves around the procedure for determining a market rate of capitalization. This rate enables projected future net operating income to be converted into an estimate of present value.

The selection of an appropriate discount rate is critical to discounted cash flow (DCF) analysis. The appraiser must verify and interpret the attitudes and expectations of market participants during this process.

Product prices are also an important consideration in developing discounted cash flows for a particular project. Generally these can be either current prices, an average of the past several years, or forecast prices predicated on a perception of future markets.

The valuation method used for valuing a mineral property can be controversial. There are three recognized ways: DCF, capital asset pricing model (CAPM), and Monte-Carlo simulation.

DCF analysis can be extended to properties characterized by data; however, mining analysis must use probabilities. CAPM is relevant to mineral property valuation and can satisfy assumptions if the model is properly applied. Using the Monte-Carlo simulation project can predict specific risks.

Based on a Bernoulli's utility function, net present value (NPV) could be used to value a mining target:

$$E\,[U\,(x_1..x_k)] = \bullet_{\,j=1..k}\, d^{\,-(j-1)} \bullet\; U_1(x_j)\,P_j(x_j)\,dx_j$$

$$NPV = \bullet_{\,j=1..k}\, E(x_j)\,d^{\,-(j-1)}$$

- U is the scalar utility value
- E is the expectation operator
- $X_1 \ldots X_k$ denotes cash flow random variables for time 1 to k
- $U(X_1 \ldots X_k)$ is the multidimensional utility function
- $P(X_1 \ldots X_k)$ is the joint probability density of the cash flow variables representing the belief of the investor.

Traditional DCF methods of investment valuation implicitly assume inflexible management, which may systematically undervalue actively managed investment projects. A negative NPV implicitly assumes that management will maintain a poor operating program without exercising change management. Simulation analysis is well suited to the evaluation of complicated operating environments. The valuation of managerial flexibility can be accommodated as an extension to typical discounted cash flow analysis.

Regional news

In the Argentinean province of Mendoza, the local government authorized Brazilian company Vale to reopen a potassium mining project that was suspended. The suspension was lifted after the company submitted an investment plan of more than US$2 billion.

Extorre Gold Mines Ltd. – a Canadian gold–silver company with advanced-stage properties in Argentina – released an updated NI-43-101-compliant mineral resource for Cerro Moro on November 3, 2011. The discovery of a vein at Cerro Moro Zoe caused the company's share price to move from US$5.09 per share to US$14 per share from March to April 2011. Currently, it trades around US$7.50 per share.

In its recent newsletter, explorer and producer Barrick Gold Corp. has rejected an Argentine government decree to repatriate sales from mining operations to pesos before being distributed. It reflected a 2.1% increase of costs based on revenues.

Eldorado Gold Corp. (TSX: ELD, NYSE: EGO) who has shown an interest in Argentina after making an offer for Andes Ltd. Yamana Gold Inc. (TSX: YRI, NYSE: AUY; LSE: YAU) and Goldcorp, have both established operations in Argentina, and may be interested in a high-quality production of a certain size.

Early this year, residents of Famatina and Chilecito in the northern province of La Rioja, blocked access to Canadian miner Osisko´s (TSX: OSK) gold deposit in protest against the company's plans to explore. People suspect that Osisko's operations may contaminate their source of water.

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US Tax Assessment for Mining Properties

By Joseph Calvanico, National Property Tax and Real Estate Valuation Services Leader, United States

Across the vast and varied landscapes of the US a total of fifty states impose tax on real property and approximately forty states tax business personal property. No matter where they are based in the country, most taxpayers are valued and then taxed by their local jurisdiction – most often a town, city, or county.

However, mining properties are 'centrally assessed' and belong to a certain class of taxpayer that is valued by state authorities and then taxed in the jurisdiction(s) in which they are located. As the name implies, one governmental entity is charged with placing a value on the property. Taxation of mining companies frequently falls into this category.

Central versus non-central valuation

State authorities often centrally assess taxpayers using the 'business enterprise value' approach. This involves placing a value on the entire operation and then allocating the overall value to the elements of the total business enterprise.This includes real estate, tangible personal property, and intangible personal property.

In contrast, a non-centrally assessed taxpayer will have both its real estate and business personal property valued separately. More importantly, it will not contain the value of intangible personal property, which is not taxable for property taxes in most jurisdictions.

State assessors claim they are able to carve intangible personal property from the overall business enterprise value so that these taxpayers are not unfairly assessed. However, upon closer examination of common law, this claim falls flat. The most famous of these cases was the landmark Burlington Northern versus Iowa decision in 1993, which recognized there was inequality in the system as far as treating taxpayers equally across all classes of taxpayers.

Factors affecting value

Whether you are a centrally or locally assessed taxpayer in the US, a mining company assessor should be aware of all the factors that affect value. For instance, a coal mining company may have many mines that contain high-sulfur coal. These mines often have much lower, if any, production compared to a low-sulfur mine.

Similarly, if a lead miner has decreased smelting capacity and the assessor is not aware of this fact, over-valuation can occur. Lastly, as salt mining is a corrosive process, the machinery, equipment, and buildings have a much shorter useful life because of accelerated depreciation.

Another issue important to the assessment of a mining property is the use of a capitalization rate. This rate should be considered when using a discounted cash flow valuation model in the income approach to value. The capitalization rate must reflect the risk associated with the location, industry, and track record of the properties.

Often assessors apply one cap rate unilaterally for the mining industry that does not take into account all of the appropriate factors. All of the above considerations must be part of a dialogue with an assessor.

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Appraising an Exploration Business Plan

By Paul Blythe, Director, Natural Resources team, United Kingdom

The Natural Resources team at Crowe Horwath in the UK has written working capital reports on many mining exploration business plans and reviewed numerous other plans made by explorers seeking finance. The following are the many factors to consider when appraising a business plan.

The business appraiser should first take a close look at the structure of the investment chain, from the offshore investment vehicle through to funding arrangements into the local entity holding the assets. Are the arrangements optimal in terms of capital flows, repatriation of profits and tax efficiency and are they properly reflected in the business plan?

By reviewing the licenses, an appraiser should understand the minimum expenditure commitments to keep the licenses in good standing and to meet the extension and renewal criteria. Are the financial requirements properly reflected in the business plan?

Foreign exchange

The next question the appraiser needs to ask is: do foreign exchange controls or restrictions apply in the asset jurisdiction? These may take the form of prohibitions or the requirement for pre-approval of certain financing arrangements from the local financing ministry. For example, in certain jurisdictions, prior approval is required from the local Ministry of Finance for the terms and documentation in relation to loan finance provided from abroad.

Also, whilst the operation of foreign currency bank accounts is usually not restricted, there may be a local pre-approval requirement for the opening of a foreign bank account by a local entity. Penalties for breach can be draconian, the rectification process fraught with difficulty and local advice opaque or contradictory.

Taxation

The appraiser shouldn't only focus on corporate tax rates, tax breaks for mining companies and the availability of double tax treaties. Local transaction taxes such as withholding tax, value added tax and customs duties can present major compliance risks and add significantly to the projected cost of exploration.

Withholding tax can be applied to a range of transactions including royalties, interest, dividends and management fees. Don't forget that, particularly in African jurisdictions, it is often applicable as a final tax on the gross value of the transaction levied on the recipient of services provided in country. This is often the case regardless of the source of the service provision, the jurisdiction of the service provider and the absence of profits.

Contracts

Carefully consider significant contracts such as those with drilling companies. Key expatriate staff are likely to be employed on a consultancy basis on site (for example, country managers and geologists) and at assay laboratories. Appraisers should understand how these contracts are structured and what the company's obligations are in relation to local taxes.

Drillers and other foreign parties may prefer not to contract directly with a local entity with no income and few assets or may believe that contracting directly with a foreign parent will avoid local withholding taxes. However, contracting directly with the foreign parent is not foolproof and appraisers should take local advice.

In accounting terms, the applicability or otherwise of local withholding taxes may not be significant as exploration costs tend simply to be capitalised in any event. However, transaction taxes and penalties for compliance failures can add significant liabilities which can adversely impact a business plan.

Consider the contract with the drillers and understand what the minimum commitments are and the respective financial obligations of the parties. Who is responsible for the cost of commissioning the rig, paying customs duties and transporting the rig to site?

Other factors need to be considered such as feeding and housing the drillers, moving the rig, fuel, site labor, security, insurance and local taxes. Are these properly costed into the financial projections?

Other considerations

Understand and comply with local employment tax obligations. These are often just as complex as in more developed economies and the penalties for non-compliance can be more aggressive.

If in doubt about local transaction and employment taxes, an appraiser should include a contingency in the financial plan on the basis that all costs will be inflated by irrecoverable transaction taxes at the applicable rates. In some African jurisdictions we have inflated all costs by 20% to 30% for planning purposes to allow for uncertainties.

Don’t underestimate time scales. It takes longer than you expect to get rigs and assay samples through customs and to transport drill rigs on unmade roads.

Finally, assess the entire process. The company will have given a series of expenditure assumptions to the ‘competent person’ compiling a report on the project. To avoid embarrassment, check that the exploration expenditure included in the financial model for the project ties in with the assumptions used in the competent person’s evaluation.

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Sealing a Mining Deal with Robust Financial Diligence

By Darryl Norville, Principal, Corporate Finance, Australia

Financial diligence is typically overlooked when acquiring mining assets, however financial diligence is highly relevant and should be considered for all mining acquisitions, albeit with different focus to that undertaken for assets in other industries.

For example, an understanding of local laws and regulations (including those relating to taxation, environmental obligations, health & safety, labour laws and accounting principles) in conjunction with an objective view of the market, assessment of capital expenditure requirements and quantification of potential synergies will significantly impact a robust financial assessment of any mining asset.

Cash flow is key

Understanding the cash flow profile and its degree of uncertainty is vital for a successful transaction. Although, the value attributable to a mining deal is necessarily reliant on the underlying mineral deposit, the value and risks associated with financial performance and cash flows should not be underestimated, whether the subject be an operational or exploration asset.

No matter how robust the mine model or business case that is being relied upon for an acquisition, performing robust diligence can add value by providing financial and industry expertise to analyse historical and forecast results to determine the 'real' story.

Crucial areas of diligence should include:

- the impact of assumptions concerning reserve and resource volumes modelled
- commodity price assumptions and their impact on earnings and the sensitivity of deal value
- significance of currency and commodity hedging activities
- the level of forecast unit operating costs together with achievability of forecast synergy/restructuring benefits
- the underlying basis of the estimated cost and timing of decommissioning, restoration and rehabilitation obligations
- confirming the nature and exposure to all taxes – corporate as well as resource or jurisdiction specific
- understanding projected capital and maintenance expenditures
- assessment of a normalised level of working capital for the target business and optimising net debt and working capital adjustments in completion documents to minimise the purchase price
- assessment of the consistency of accounting policies between the target and acquirer, including identification of those areas that could result in earnings erosion post completion.

Through providing an independent challenge of the explicit and implicit assumptions of the cash flow model together with a review of the underlying mechanical integrity improves a model's robustness and reliability.

Conclusion

In this challenging and uncertain economic environment, a comprehensive and fully integrated approach to diligence that covers all geological, metallurgical, engineering, financial, commercial, operational, taxation, legal and environmental aspects of a deal, will provide significant assistance to buyers looking to manage risk before engaging in a transaction.

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