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Mining industry trends – Strategic investment transactions

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The combination of macroeconomic uncertainty and speculation over trade wars has not been kind to commodity prices or the mining industry lately. The impact has been especially felt among junior companies without producing assets, as financiers and the public capital markets are reluctant to take on exploration or development risk with their investments in the face of broader uncertainty. Fortunately, for companies with compelling exploration projects there is a silver lining, as major mining companies are reviewing their mineral reserve/resource portfolios and project pipelines and starting to reinvest after almost a decade of fiscal restraint. While there is continued reluctance to be overly aggressive with acquisitions (financial discipline is still top of mind for the majors), there have been a number of strategic investment transactions involving major companies acquiring significant minority equity stakes (5% to 19.9%) in junior exploration companies. These transactions represent a win-win outcome for both parties as junior companies receive much-needed financing and major companies are positioned for future opportunities on potentially accretive projects. As a result, we anticipate seeing more of them, especially in the current market environment where other financing opportunities are limited.

Recent examples of strategic investment transactions include Hochschild's acquisition of an 8.3% interest in Skeena Resources, Newmont's acquisition of a 5% interest in Evrim Resources, CITIC Metal Co., Ltd.'s acquisition of a 19.9% interest in Ivanhoe Mines, Barrick's acquisition of a 19.9% interest in Midas Gold, Goldcorp's acquisition of a 12.7% interest (with additional warrants) in Mawson Resources and Zhaojin International Mining Co., Ltd.'s acquisition of a 9.9% interest in Sabina Gold & Silver. The market has also seen examples of follow-on transactions, such as South32's acquisition of Arizona Mining following on from its original 17% investment a year earlier.

Background factors for successful strategic investments

There are some common elements to a number of the recent strategic investment transactions in the junior mining space. Perhaps the most important criteria (for both sides) is the makeup of the junior company, especially its asset base and management team. Generally, junior companies able to source strategic investments have had a proven management team and one or more projects that have the potential to appeal to majors: district-size scale, potentially economic grades and a compelling geological model. Interestingly, while the project's stage of development does not seem to be an impediment to strategic investments, it can have an impact on the size of the investment.

Major companies' primary motivation to pursue strategic investments is to gain exposure to a compelling project in a lower-risk transaction rather than an outright purchase. Essentially the major gets a front-row seat on additional exploration and development work with an opportunity to influence programs through technical co-operation. The toehold investment position can be advantageous for a follow-on acquisition transaction.

From the junior company's perspective, the benefit of a strategic investment is that it is able to raise additional capital, almost always at a premium to market, in a way that often helps its share price and adds credibility to the project and the management team by virtue of its ability to attract the support of a major company. Strategic investment transactions also provide technical and other resources to the junior company, which may not otherwise have been available to it.

Strategic investment transactions tend to work best in market environments where there are limited financing alternatives and an unwillingness to complete a more permanent transaction like a sale or joint venture.

Principal terms of strategic investments

The principal terms of strategic investment transactions are becoming more established and more uniform and in many ways mirror elements of strategic investments in other sectors. Certain key attributes of these transactions and the perspectives of both the investor and the investee company are summarized below.

Board representation

While sometimes investors eschew board representation to avoid conflicts for subsequent transactions, it is more typical that an investor acquiring a significant equity position will receive a right to nominate one or more directors to the board of the company. For more significant investments, agreements can specify multiple director nomination rights or express the nomination right as a percentage of the number of directors based on pro forma ownership. It is also common for investors to prescribe limits on the size of the board to maintain the agreed upon proportional representation on the board.

The practice is mixed as between the nomination of a direct representative of the investor versus an unrelated nominee who has a skillset that the investor believes is valuable on the company board. This can also mitigate against conflicts of interest that may arise at the board, but not always if there are differences as to the parties' views as to the independence of a particular nominee.

Technical committee

Since greater exposure to a particular project or projects is usually the principal driver of a strategic investment for the investor, it is no surprise that the concept of a technical committee for the exploration and development of the project is one of the most common terms for strategic investments. Technical committees are usually advisory in nature, meaning that the company has ultimate decision-making authority on programs. The investor receives regular updates on planned programs and results, and may provide specialized expertise or proprietary exploration techniques.

Through the technical committee, the investor can receive rights to project data that can enhance its understanding of the project beyond what is in the public disclosure record of the company.

Anti-dilution protection

Anti-dilution protection for the investor is virtually universal in strategic investments. The terms of pre-emptive rights are typically very thorough, covering a number of different

financing structures by which the investor will have a right to maintain its percentage shareholding in the company by electing to participate within a prescribed number of days. Adherence to market precedent in recent transactions has made these terms rather balanced as between the company and the investor.

An interesting feature of anti-dilution rights are top-up rights, pursuant to which the investor has the right to maintain its percentage shareholding after the company completes dilutive share issuances that are often carved out of pre-emptive rights, such as share-based compensation awards or where shares are used by the company as currency to make acquisitions. In that situation, the investor would have the right to top up its shareholding to the percentage it held prior to the dilutive event at the prevailing market price. This provision avoids friction between the parties on negotiating exclusions from pre-emptive rights that can diminish their utility. Top-up rights, if included, are generally structured on a quarterly basis (or other infrequent basis) to avoid the administrative burden of multiple share issuances.

Standstill restrictions

Standstill provisions, which limit the ability of the investor to acquire additional shares of the company in the open market or carry out a hostile takeover bid, are an integral protection for the company in strategic investment transactions. Since the investor's motivation is often to use the strategic investment as a potential stepping stone towards a full acquisition, it is important for the company to maintain as much control over a potential sale process as it can, thereby assuring its shareholders of a fair price in a subsequent acquisition transaction. It is also important to flag to other potential acquirers that the toehold investment will not preclude or disadvantage other interested parties. Standstill restrictions in strategic investments are often more onerous than those included in early stage confidentiality agreements.

The form of standstill restrictions and the carveouts from such provisions are generally customary market terms. However, the duration of the standstill provision can vary from deal to deal. To work optimally for both parties, the standstill provision should be in effect long enough for the company to expend the proceeds of the strategic investment and/or for the project to reach the next development milestone. The attainment of such milestones typically results in full public disclosure of all material facts relating to the project (often by triggering the requirement for a new technical report), which addresses any concerns about the investor having undisclosed material information on which to launch a take-over bid and the company's ability to level the playing field by ensuring all material information is in the public domain to properly market the project.

Restrictions on disposition

For all the credibility that a strategic investment by a major company adds to a junior company, an unanticipated disposition by a key investor can have the opposite effect. As a result, strategic investments can involve restrictions on disposition on the part of the investor. A number of different concepts may be used depending on the size of the investment and bargaining position of the company, such as (i) an advance notice requirement, (ii) a restriction from selling more than a prescribed portion of the investment in a prescribed period or (iii) a right on the part of the company to place the shares to be sold with a friendly buyer to avoid having a block of shares hit the market price or land in the hands of an unwanted suitor.

From the investor's perspective, registration rights can be included to provide the investor with the right to participate as a selling shareholder in a prospectus offering or a registration

of securities to facilitate a resale. These rights are seldom exercised but provide for optionality for the investor, which can justify accepting restrictions on disposition in the investment agreement.

Shareholder voting support

The degree to which the investor agrees to support management at shareholder meetings should be approached with caution. Junior companies often push for these terms as a take-over defence mechanism and to ensure that a significant shareholder will not use its voting power to thwart management or be used by other dissident shareholders to mount a campaign to thwart management. Generally speaking, major companies are reluctant to be activist shareholders for reputational concerns, but parties should ensure that any shareholder support terms are reasonable and do not result in an effective controlling block that would adversely effect corporate governance practices and entrench the existing board and management. This is also something that can attract additional regulatory scrutiny to ensure that the interests of minority shareholders are not adversely affected without a shareholder vote to approve the transaction.

Future-oriented project rights

Perhaps one of the most customized aspects of strategic investments are the provisions (if any) around future rights relating to project development. Where included, these provisions can be anywhere from broad statements of intention (which can create issues around enforceability for both parties) to specific rights. Examples include the right to procure or provide project debt financing, the right to offtake from the project or rights to pursue a specific interest, such as a right of first offer or right of first refusal over the project. The key is to ensure that the rights are equally understood by both parties and that they have considered the long-term ramifications of these terms. These rights may be coupled with area of interest provisions to protect the company from having the investor acquire a land position in close proximity to the company's project.

Conclusion

In the near term, we expect to see more strategic investments in the mining industry, especially with private equity funds also seeking late-stage development projects alongside major companies. With access to capital continuing to be fairly restricted in the current market, this should be a positive development. After all, junior companies require access to capital to advance discoveries, and the easiest way for major companies to increase their resource base and project pipeline is through acquisitions of juniors. Strategic investments may stimulate both aspects of the mining industry which in turn can invigorate overall mining markets.

In the interim, parties considering a strategic investment transaction should familiarize themselves with the current terms to best position themselves for a successful outcome.