Return to mineral exploration – a legal perspective

MARCH 1, 2017 6 MIN READ

Related Expertise

- Mining and Natural Resources

Author: Alan Hutchison

The past few years have not been kind to mineral exploration companies. In the face of uncertain commodity prices — and a difficult financing environment that focused on production or development stage assets — exploration budgets were slashed by both major and junior companies alike. But, as 2017 begins, there appears to be a newfound sense of optimism in the mining industry. For example, capital is starting to return to exploration stage projects and there has been increased activity with asset transactions using earn-ins, joint ventures and strategic alliances. However, memories of the recent downturn are still fresh, and a number of considerations are influencing deal terms and positions on property-level transactions in the current market environment.

Changing view of royalties

Not that long ago, a royalty was considered to be a residual interest that was seen as consolation for being diluted on a project, but today royalties are market darlings. Royalty companies have positioned themselves along with stream financiers as credible alternative financing sources, and they represent a type of investment in the mining sector that carries no material operation or cost overrun risks. Exploration companies following the project generator business model are also looking at royalties as a way to fund other exploration projects and minimize equity dilution. Instead of taking minority positions in joint ventures, it is now more common to see project generators granting options to earn a 100% interest in a property with the vendor reserving only a residual royalty interest. This has simplified option to purchase transactions as there is no longer the need for relational legal structures like joint ventures upon the earn-in of a partial interest in a property. However, it has resulted in more complex forms of royalty agreements that reflect an alternative financing mindset (i.e., royalty payments tied to prevailing commodity prices as opposed to revenues from the project) and terms designed to make the royalty more marketable by the royalty holder. This includes more significant rights affecting the property, such as

- restrictions on alienation which require the royalty holder's consent, or at the very least an express acknowledgement and assumption of the royalty interest in any agreement involving the disposition of an interest in the property
- restrictions on allowing tenure to lapse (including requirements to transfer title back to the royalty holder)
- significantly enhanced information rights even prior to the royalty beginning to pay

Changing deal timelines

Even with an uptick in market sentiment, exploration property deals continue to be difficult to do – for a number of reasons. Most notably, exploration budgets remain limited. In addition, companies want to mitigate potential liabilities, including issues like corporate social responsibility. Many larger companies are unwilling to commit to a new exploration project until they have had an opportunity to assess not only the technical merits but also the reputational aspects of developing mining projects. As a result, more and more property deals are being structured with a non-committal interim stage where the acquirer is provided the opportunity to conduct in-depth due diligence in the field and assess the non-technical aspects of the property like community engagement. These are effectively options to enter into an option to purchase or earn-in for a property. From an acquirer's perspective it is easier to go through internal budgeting processes for more significant exploration programs with results of a preliminary program in hand. However, it results in greater uncertainty for vendors in managing their property portfolios.

Focus on value-enhancing milestones

Traditionally, the form of payment used to acquire interests under exploration property agreements are exploration work, cash payments and share payments, with payments escalating over the life of the option. Interests in properties were earned based on the overall investment by the acquirer. However, the market has evolved to impose more milestone-based thresholds such as resource estimates (often specifying a minimum size and grade) or advanced technical studies (preliminary economic assessments, pre-feasibility studies or feasibility studies). Milestone-based terms align the earning of an interest in a property with value creation events and reflect the industry's commitment to cost efficiency. However, acquirers should be careful to ensure that they have cost certainty with respect to milestone-based terms. Future payments based on the size of a mineral resource or linked to the net present value derived from an economic assessment can result in an unanticipated increase in acquisition costs, which can significantly impact the feasibility of vesting interests in a mineral property. Resource estimates and economic analyses can also vary significantly based on the methodologies used, so parties should be careful about generalizing that anything that is CIM or NI 43-101 compliant will suffice as a basis for milestone payments generated from such studies.

Equity interests vs. back-in rights

Back-in rights, where a vendor can re-acquire a controlling interest in a project (usually upon payment of a multiple of exploration expenditures incurred by the original acquirer), have largely fallen out of favour in the current market. Properties subject to back-in rights are difficult to finance due to the uncertainty about ownership that overhangs valuation. Moreover, the multiple paid upon exercise of back-in rights is often less than what the market might reward companies for exploration success, especially with junior companies where investors aspire for returns greater than two or three times their investment. In the place of back-in rights, many vendors, especially major companies, are taking significant equity positions in acquirer companies as a term of option to purchase transactions. These equity interests often guarantee a certain percentage of the acquirer's share capital and are accompanied by significant shareholder rights like board representation and pre-emptive rights for future financings. While equity positions can be important to bridge concerns over a seller's remorse or embarrassment in the event of a significant discovery, it is important to ensure that equity participation rights do not impede companies from pursuing other projects or discourage capital raising. Leaving money on the table can be a bigger problem for exploration companies, especially in volatile capital market environments.

Control and flexibility

Perhaps the most significant deal term in the current market is control of an exploration project. Wary of an uncertain global economy and commodity price volatility, an interesting dynamic in many property deal negotiations is control over the project to position it for maximum flexibility in the future. This typically manifests itself in operatorship. The traditional approach of the party incurring the greatest costs or holding the largest interest in a property serving as operator of the property is no longer automatic. Operatorship provides an opportunity to control the exploration and development of a project beyond what a party's percentage interest may suggest. Importantly, the operator will also control the information flow of exploration results which can enable it to better promote the project to the market. Junior companies in particular can benefit from having a greater role as operator of a project, and greater market recognition of the value of that project as well.

Conclusion

As the early movers complete acquisitions, overall deal activity appears poised to increase in 2017. However, creativity will remain a key feature amid a continuing uncertain global economic environment. This can often lead to different types of transactions than originally envisioned – for example, option to purchase discussions can lead to strategic alliances for full M&A transactions. Accordingly, it will be important to be prepared for multiple transaction scenarios, and to assess corporate objectives to enable companies to select the most advantageous course of action.