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Mining Year in Review – Progress amid volatility

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Although 2017 saw increased activity and optimism in the mining sector compared to the previous three years, significant challenges remain. Especially among mid-tier and junior mining companies, which represent the largest segment of the Canadian mining sector, this past year could be effectively summed up as ‘two steps forward, one step back’ in terms of overall market conditions and outlook. In such an uncertain market environment there is often no single dominant theme or issue that defines the year, especially from a legal perspective. However, there were a number of developments that significantly impacted the mining industry and merit close attention as we head into 2018.

Exploration activity

Capital flowed back into mineral exploration in 2017, as financings of junior exploration and development companies (particularly follow-on bought deal and marketed offerings) increased and major companies allocated more money to exploration budgets. This increased activity bodes well for the market as a whole, as mineral exploration tends to fuel the Canadian mining capital markets.

This also led to a greater number of property transactions as mining companies optioned, joint ventured or sold exploration projects in an effort to optimize their property portfolios. While this should result in more exploration projects being advanced (which is a good thing in a market hungry for a new high-profile discovery), many of the projects for which financing is being sought among junior companies are ones that have been assessed (or reassessed) over the years.

However, while more deals were completed, and on the whole vendors enjoyed more favourable terms than they have in the previous few years, many property transactions utilized an option or earn-in structure with relatively small committed investment amounts. Of course, options tend to start with smaller commitments that increase based on exploration success, so this is partly a return to normalcy after seeing year-over-year decreases in mineral exploration in Canada from 2012 to 2016. It will be interesting to track whether exploration programs on recent earn-in transactions increase into 2018.

Private equity

There has always been some skepticism as to whether private equity is a good fit for the mining sector due to commodity price volatility, long timelines from discovery to production (and cash flow), and the significant capital required to develop mines. These factors are at odds with a private equity fund’s finite lifespan and mandate to deliver cash flow positive investments within that timeline. In the recent downturn, private equity funds have been quite active in various non-core asset disposition initiatives undertaken by the majors, which resulted in those projects not seeing the market devaluation that earlier stage projects experienced. However, amid market rumours of funds being wound down and seeking to exit underperforming assets, private equity funds are likely to continue to focus on lower-risk, late-stage assets.

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Private equity funds have established a track record of success in niche metals that do not have as much of a market following. In particular, the acquisition of Dominion Diamonds Corp. by The Washington Companies is a rare example of a successful leveraged buyout by private equity in the mining space.

Consolidation

There was moderate M&A activity in 2017, with a number of mid-tier consolidation plays, particularly in gold. The number of deals has increased slightly in 2017 over 2016, but aggregate deal values remain relatively constant. This suggests that more junior companies with earlier stage projects are being acquired by larger companies or combining with other juniors, often with smaller change of control premiums. This reflects the continuation of the consolidation of the mining sector that has been called for by analysts and financiers in the mining sector since 2013.

Alternative finance – Streams and royalties

In 2017, there was also continued attention on alternative finance structures like metal streams (where a mining company receives an upfront pre-payment against a commitment to sell a portion of production of a specific metal at a price below the prevailing market price) and royalties (where the royalty holder acquires an interest in a mineral project which entitles them to a portion of production (or revenues) after deducting certain costs). The streaming space is becoming more crowded with a larger number of financing sources, while at the same time the impact of streams on mining companies is increasingly being scrutinized. While streams of non-core metals are more accepted by the market, streams involving the primary metal of a mineral project attract greater scrutiny over the effects of the stream on project economics. Securities regulatory authorities are also starting to weigh the impact of streams on continuous disclosure obligations.

The market for royalties is also evolving. The basic terms for royalties have not changed. However, royalty agreements are becoming more comprehensive and arguably more onerous for the property owner with respect to issues such as reporting and access to data, property maintenance and reversionary interests in favour of the royalty holders. Many option or earn-in transactions are being structured in a way that the optionor's (vendor) interest in the property is immediately diluted to a royalty interest rather than a minority ownership interest in a joint venture following the exercise of the option. Current market sentiment appears to value royalty interests more than a minority ownership interest. A good illustration is the recent acquisition by Osisko Gold Royalties of the royalty portfolio of Orion Mine Finance in July 2017 for a purchase price of $1.1 billion.

A key risk for royalties is the question of whether they are more properly considered interests in land or contractual obligations. This goes to the question of whether a royalty can be bankrupt-proof. The recent downturn resulted in a number of instances where companies going through restructurings have made proposals that are dependent on striking existing royalty interests. Courts have considered a number of factors to determine whether the parties intended the royalty to run with the property as a property interest, or whether the royalty is purely a contractual obligation.

One recent example involved the Walter Energy restructuring proceedings in British Columbia where a royalty interest was disclaimed by the debtor company upon the sale to a third party of the royalty-generating mining property. In early 2018 the Court will hear a claim from the former royalty holder for damages arising from the loss of revenue stream from the disclaimed royalty. If successful, this claim would be a significant change in the rights of royalty holders and a significant additional avenue for royalty holders in bankruptcy situations.

Market volatility and the next big thing

Overall, while 2017 has been a much improved year in the mining sector, headwinds still remain. In the face of global political and economic uncertainty, perhaps that is no surprise. However, typically periods of economic uncertainty have seen market conditions improve for precious metal commodities like gold, and many market watchers expected the gold price to increase as the central banks de-levered.

There has also been a great deal of market interest in metals used in batteries, such as lithium, cobalt or graphite. The changing global landscape for these metals, and potential value increases arising from the evolution of new technologies also pose challenges for regulators.

Postscript

We are pleased to announce that Osler’s Mining Group Co-Chair James Brown has been appointed to the Canadian Securities Administrators’ Mining Technical Advisory and Monitoring Committee. The MTAMC provides guidance to the provincial securities commissions on technical mining matters.