

THE INTERNATIONAL

RESOURCE JOURNAL

NOVEMBER 2012

Volume 4

Issue 11

www.irjonline.com

IN THIS ISSUE ►

IRJ INTERVIEWS
ENDEAVOUR'S WOODYER

COMMODITIES STREAMING:
A SURE THING

LABOUR STRIFE IN
SOUTH AFRICA WRAP-UP

STREAMING SUCCESS

Ag Ag
Ag

Ag

Ag

Ag

Ag

Cu

Zn

Ag

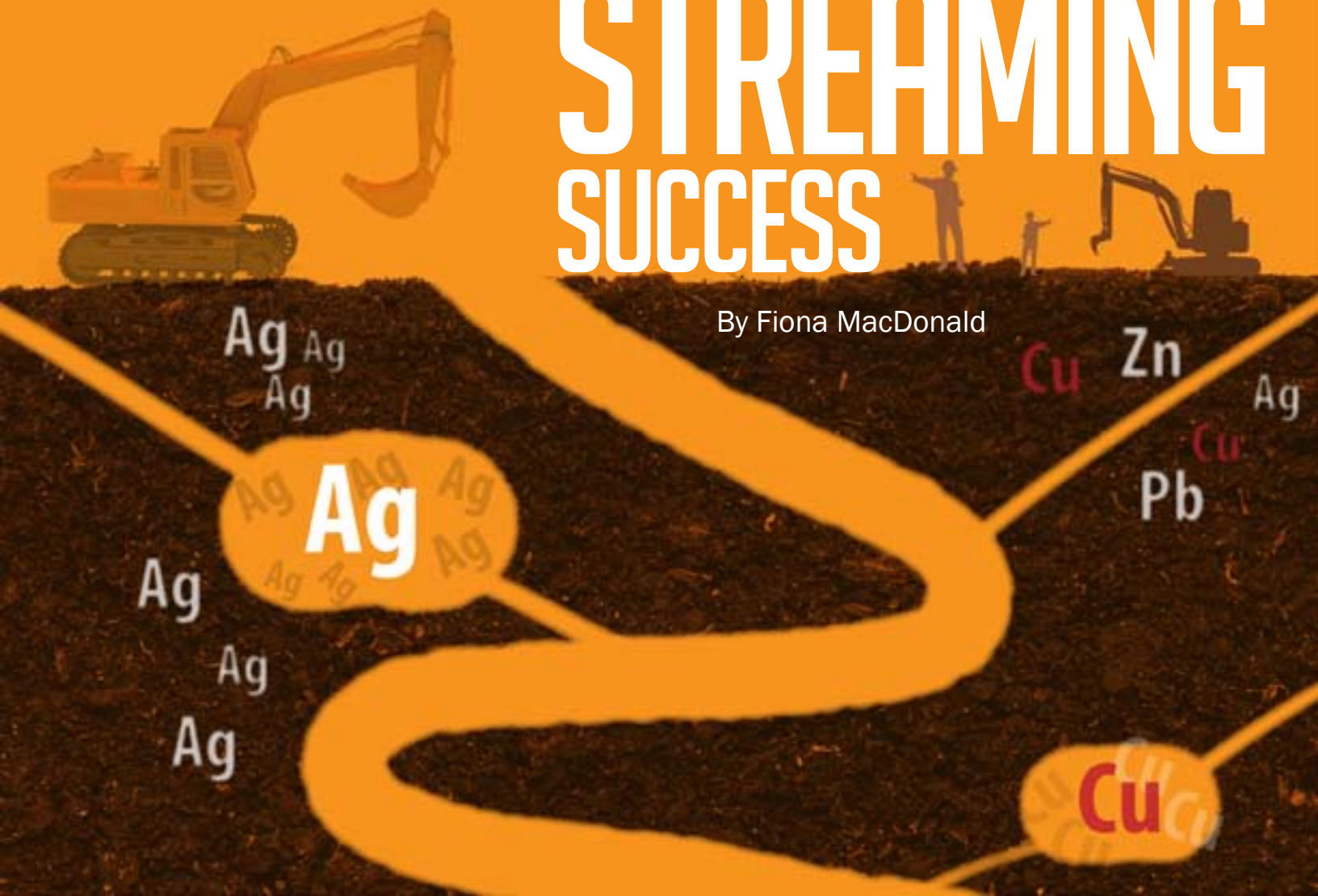
Cu

Pb

Cu

STREAMING SUCCESS

By Fiona MacDonald



For miners looking to raise funding, and for investors looking for a sure thing in an all-too-often unpredictable field, streaming might just be the answer.



RANDY SMALLWOOD, CO-FOUNDER AND PRESIDENT
OF SILVER WHEATON

RANDY SMALLWOOD, CO-FOUNDER and President of Silver Wheaton, encapsulates the benefits of silver streaming for investors thus:

“It takes all the cost risk out for traditional mining investors; they still get all the exposure to the exploration success, the expansion potential, the commodity price growth, but they don’t have cost risks and there’s no operating cost surprises because they’re all fixed by contract.”

“We look for ‘management-proof’ assets: because these are life of mine agreements we have no control over who will be operating the mines, so they better be good mines.”

– Randy Smallwood, co-founder and
President of Silver Wheaton

His investors would have to agree: Silver Wheaton Corporation, the world’s largest silver streaming company, has some major success stories to its credit.

While the commodities streaming model may have come from the world of oil and gas, Silver Wheaton pioneered it in connection to silver, a commodity to which it is ideally suited.

Silver streaming – a method of financing that involves a large upfront payment to the miner that does not have to be repaid, which buys the right to a per centage of the silver subsequently produced at a competitive rate – comes with considerable margins in a bull market. “We turn around and sell that silver at the spot price,” says Smallwood.

“The production payment is fixed by contract. Our capital cost is the acquisition in the first

place. We make a large upfront payment and then as silver gets delivered to us we make a production payment on a per ounce basis and it's fixed."

Pascua-Lama (a Barrick Gold mine located at the border of Chile and Argentina) and Penasquito (a Goldcorp mine located in Mexico) are two standout examples; while the mines are the work of two of the largest gold producers in the world, they made use of silver streaming as a method of financing.

"At Penasquito we supplied about 40 per cent of the capital for about six per cent of the revenue stream," says Smallwood. "Gold Corp shareholders gained substantially — if they had to go out to market to finance that they would have been diluted that much further."

While these two large projects have marquee value, the ventures that stick with Smallwood are the smaller projects where the financing may even exceed the company's capex. A prime example is the Keno Hill Project (owned and operated by Alexco Resources Corp.) in Canada's Yukon territory.

"This is an asset that is very high grade, with very high operating margins," says Smallwood. Their market cap is about C\$30 million and we gave them \$50 million to build their mine. That



NOLAN WATSON, PRESIDENT AND CEO OF SANDSTORM GOLD

mine is up and running, it's doing well, and we get 25 per cent of the silver. We're much more flexible than traditional sources of financing."

'Hands Off' financing

More important even than that is the attractively 'hands-off' nature of the funding from the miner's side.

"In my mind it kinda replaces a jv," says

Streaming replicates the funding component of a JV, but does so in a way that is bound by contract “and does not provide us with any ability to tell you how to run your life.”

– Nolan Watson, President and CEO of Sandstorm Gold

Nolan Watson, President and CEO of Sandstorm Gold, a firm that specializes in similar streaming financing, albeit not confined to silver.

All too often, he says, joint ventures give rise not only to additional funds, but to “a lot of monkeying around and meddling from the parties who now believe that they are an owner of the project and should have the rights of an owner. The bad thing about joint ventures is you get a co-manager you might not want.”

Streaming replicates the funding component of a JV, but does so in a way that is bound by contract “and does not provide us with any ability to tell you how to run your life,” says Watson.

If raising funds via JV tends to come with a noisy meddling partner, other methods of



fundraising come with what sounds a lot like a controlling, miserly, worrywart maiden aunt.

“If you think what a bank fundamentally is,” says Watson, “a bank is financed itself with over 80 per cent debt – it takes money from its depositors and lends it out; it is an entity that cannot afford to lose any money because it’s not their money – it’s depositors money – and depositors want that money when they ask for it. So banks behave like entities that can’t



afford to lose money, they're the first ones who will call you into default right away and they get super hostile and force you to raise equity at the worst possible time."

Other options for raising funds — debt raising and dilution — can be equally unappetizing.

The advantage to miners able to raise capital in a challenging environment by selling off a non-core asset and thus reinvest back into their core focus area is clear.

The typical stage at which these deals are made — the moment the miner is in greatest need of additional liquidity — is unsurprisingly, often at the construction phase, when looking to expand operations or when on the verge of making an acquisition.

About half of Silver Wheaton's projects were operating mines looking for capital to reinvest in their core focus when they did the streaming deal.

The recent transaction with Hudbay Minerals is a perfect example. The company, looking to raise capital for their copper Constancia mine in Peru, were paid US\$750 million by Silver Wheaton for the right to 100 per cent of the life-of-mine silver production from the already-operating 777 Flin Flon mine, and 100 per cent of the life of mine silver production from the Peruvian Constancia mine.

Silver

Silver as a commodity is uniquely well-suited to this model of capital raising. As Smallwood points out most silver is produced as a byproduct of other types of mining — the lion's share of the silver that accrues to Silver Wheaton as a result of silver streaming deals originates from copper mines, lead/zinc mines and gold mines, meaning that the producer is not facing



the prospect of losing some or all of their main commodity.

“We go to those copper miners, those lead/zinc miners and those gold miners and we buy their non-core silver production.,” says Smallwood. “Its not what they’re there for; they’re there for the other assets.”

“Silver in a copper mine or lead/zinc mine is attached at the mineral level so when a mining company wants to maximize its copper production, its copper recovery, its copper processing,

silver will always come along for the ride. The only place that silver gets separated [from the copper] is at the smelter and the only place silver gets separated from lead is at the lead smelter; with gold, silver dissolves into the same cyanide solution that gold dissolves into, so silver truly comes along for the ride.”

Silver Wheaton does do a small amount of streaming trade using gold as the commodity, but as Smallwood points out, gold is much less likely to be a byproduct.

“Only about 10 per cent of gold is produced as a byproduct. It’s tougher to buy an asset from a company if it’s a core asset, a core focus, that’s why we like silver so much; it’s generally copper miners and lead/zinc miners and gold miners that we deal with.”

Other commodities?

Applying the principals of streaming to commodities other than precious metals is something Sandstorm have taken on in the vehicle of new company Sandstorm Metals and Energy (of which Nolan Watson is President and CEO) which has already done deals in oil, gas, copper, palladium and coal and has plans for deals involving copper, zinc, lead, and oil and gas, in the next 24 months.

“While the underlying fundamental principles are the same,” says Watson, “which is try to find assets that have a low cost of production so that if that commodity price drops you are not going to have a mine that goes bust; and with an exploration upside and management who know what they’re doing – regardless of what commodity it is, those are the three fundamental underlying principles that we try to follow. Obviously there are nuances because different commodities have different fundamen-

tals, different mechanics. If you do a copper stream, copper is copper is copper is copper, everyone agrees that you’ve got to get your copper to at least a cathode level of purity, and it’s easier to make that contract, whereas we’ve done deals on coal and coal is a whole ‘nother animal because when you load a train full of coal every rail car will get a different price depending on what quality of coal you put in it and we have to make a lot of tweaks to the contract to make sure that everyone gets a fair price.”

Selection

Smallwood says Silver Wheaton selects their partner projects carefully, and it is this pickiness which is at least part of the secret of their success.

Specifically, Silver Wheaton looks for mines in the lower half of their commodity’s respective cost curve – in the case of gold, that would be a mine that produced in the order of \$500 to \$600 oz; for copper mines the target is to find mines that are producing for under \$2 per pound.

“We focus on the low operating cost base. We do a very thorough technical analysis of these mines, we look at the drill holes, we look at the mining plans, we review the whole process and



make sure that they're strong enough quality. We joke about the fact that we looking for 'management-proof' assets: because these are life of mine agreements we have no control over who will be operating the mines, so they better be good mines."

Risk

This touches on a pitfall that comes with any life of mine agreement — what of the day when the asset changes hands and the connection with the team that made the initial deal is severed?

"So far we've had three assets that we own silver streams on change hands and we've had

no problems at all with that," says Smallwood. "People recognize that's where the capital came from that built the mine; our contracts are structured such that they move through a merger or an acquisition with no problems at all."

But what of the case of a mine that performs poorly? Smallwood cites the Silver Wheaton track record, indicating that this is not a case that the company has had to face.

Nonetheless a risk inherent in the model is the cyclical nature of commodities: selling at spot only works if spot is higher than the production payment.

"We know that commodities are always

cyclical,” says Smallwood. “That’s part of the reason that prior to the HudBay transaction this year we hadn’t done any transactions for two and a half years — its mainly because silver prices were so high.”

Watson concurs: “We’re buying at that fixed price and we’re selling at spot, so in a downturn we make a lot less money than we thought we were going to, but we bear that downside risk as the cost of being able to get that upside potential. It’s not like debt where companies take on debt and then gold goes from \$1700 to \$1000 and they haven’t hedged and they go bankrupt.”

Nonetheless, with Silver Wheaton imposing neither minimum deliveries nor performance targets “we share the risk,” in the case of an under-performing mine, says Smallwood. “The fact that we do share that risk is something that provides comfort to our partners.”

Smallwood stresses the need to choose the right project, the right partner and the right moment in which to act.

“It’s definitely the key ingredient in terms of success -- having the capacity to be able to afford to be patient and wait for the right opportunities. We’ve already got so many good strong assets in our company going forward that we don’t need to grow, so we can be patient and

wait and make sure the acquisition is something that is accretive on all metrics. It definitely gives us an advantage.”

This year Silver Wheaton will do about 28 Moz of silver production, and current assets alone will account for 40 Moz by 2016. “so we don’t need to grow,” says Smallwood. “That’s why we’ve been very patient and waited ‘til silver prices have pulled back a bit. We completed the HudBay transaction this spring when silver was trading at about \$26-27 an ounce, and now it’s up to close to \$35 an ounce. We try to focus on the bottoms of the low part of the commodities price cycles. If I had bought silver assets last year when silver was trading at over \$40 an ounce I would have had some explaining to do, so we’re quite patient, we wait for what we see as bottoms or plateaus in terms of silver prices.” **IRJ**