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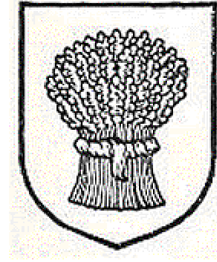

# HALLGARTEN & COMPANY

**Think Piece**

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# Death Spiral Financing

## A Word to the Unwary

# Death Spiral Financings

## A Word to the Unwary

- \+ You have been warned!
- \+ The improved financing environment means the companies do not have to resort to this type of funding. Good management, IR and results can go a long way to avoiding the need to countenance such deals. That could not have been said in early 2009.
- ✘ No-one is talking about this so the more unplugged and unearthly executives in the junior mining space are ripe for the plucking
- ✘ What looks like a steady drip-feed of financing is actually Chinese water-torture for the stock price and shareholders
- ✘ The agreements are couched in terms (example supplied) that almost look like the financiers are "Saints-in-training" but the munificence turns out to be a perpetual motion shorting machine to drag hapless managements to their doom

**First Find your Rube**

We have long contended that one should be wary of managements at Canadian juniors that are financially clueless. This is not a criticism of the people *per se* but if one made a career decision that favoured roaming around cacti in sweltering temperatures or hiking over the rocky outcrops on the tundra then there is probably no correlation with an assumption that one would also be enormously financially savvy. This is particularly the case when it comes to some of the more exotic instruments that abound in financial markets these days. We suspect that even legitimate convertibles don't appear much in the mining space because managements don't understand them, even though the institutional shareholders/bondholders would. Thus it is no surprise that eventually some of the more dubious characters of the financial world should have alighted upon the fact that many Canadian juniors are run by individuals who might be good victims for a scam.

**Death Spirals – knowing the signs**

Traditionally death spiral financing has been a process where convertible financing of primarily small cap companies can be used against it in the marketplace to cause the company's stock to fall dramatically and can lead to the company's ultimate downfall.

Many small companies (though not in mining) rely on selling convertible debt to large private investors to fund their operations and growth. This convertible debt, often convertible preferred stock or convertible debentures, can be converted to the common stock of the issuing company often at steep discounts to the market value of the common stock. Under the typical "death spiral" scenario the holder of the convertible debt initially shorts the issuer's common stock which often causes the stock price to decline at which time the debt holder converts some of the convertible debt to common shares with which he then covers his short position. The debt holder continues to sell short and cover with converted stock which along with selling by other shareholders alarmed by the falling price continually

weakens the share price making the shares unattractive to new investors and can severely limit the company's ability to obtain new financing if the need arises.

An important characteristic of this kind of convertible debt is that it often carries conditions like a quarterly or semi-annual reset of the conversion price to keep the conversion price more or less close to the actual stock price. But a lower conversion price also increases the number of shares that a bond holder gets in exchange for one bond, increasing the dilution of existing shareholders. A lower price reset can also force investors that have set up a long CB/short stock position to sell more stock ("adjust the delta"), creating a vicious circle, hence the nickname *death spiral*.

**… meets the mining community**

The current moment in mining seems like one in which money virtually gushes on all sides.. Or so it appears.. As always there are haves and have-nots.. For some junior miners times are still tough and getting more than the most minimal drip-feed of money is a constant obsession. Just as the starving can only obsess about food, some junior miners spend the bulk of their time stressing about the next financing. They also know that investors do not like a constant stream of bitty financings from which the share price can never rise from the floor before being knocked down again. Thus there is a great temptation for a $10mn market cap stock to leave all its miseries behind when the possibility of a decent chunk of cash is waved in front of them.

In recent times two merchants of financing terms, which look to us like a variation on a theme of death spiral financings, have been brought to our attention by managements who asked our opinion. We didn't even have to get through much of the verbiage to realize that something here was too good to be true.. the more we read the more it became clear that a scam was in the air. Rather bizarrely after being told that it was a scam the CEO of one mining company persisted in his enthusiasm and wanted us to write some pertinent questions back to the "financier" so they would have a chance to "defend their proposal". Ahhh.. hope springs eternal. We declined as it seemed an exercise in futility, as the intent of the documentation was very clear.

Then a few weeks later, another one of these offers was brought to our attention. Now we knew the telltale signs without even getting the paperwork to read. Sure enough, further enquiries by the company justified our skepticism.

Even more recently a major shareholder in a lame-dog gold wannabe came and asked our opinion of how the $20mn market capitalisation stinker could suddenly be so sure of a $10mn financing. Our answer was "*cherchez le death spiral*"! Alas the investor was so in awe of the management's new discovery of alchemy that he seemed afraid to go back to them and raise the issue of whether this might be a death spiral deal or whether they even knew what that might be.

**Watching for signs**

A picture tells a thousand words so we thought it would be useful to reproduce (on the following pages) what we were first sent to see if investors can spot the signs before we reveal what we think are the clues. We took the details verbatim and changed the name and stock price to protect the innocent (and the guilty). Bizarrely the law firm (here restyled as Tooth & Nail) is about as *white-shoe* as one can get….

**SharkBite Funds**

## Stock Purchase Guarantee

*This document does not constitute an offer to sell or a solicitation of an offer to buy any securities, in any jurisdiction and may not be relied upon in connection with any offer or sale of securities. Any obligation on behalf of Investor shall only arise upon the execution of definitive documentation related to the proposed transaction.*

Issuer: Hapless Mines Ltd.

Investor: SharkBite Funds

Agent: None

Securities: Listed Ordinary Shares

Amount: Up to CAD 10 million

Term: Company may exercise the Guarantee at any time within 24 months of the execution of definitive documentation

Minimum Sales Price: Set by the Company at the time of each Sale Notice

Sale Notice: Company may at any time during the Term deliver a Sale Notice to Investor. The Sale Notice shall state the number of Securities to be sold, the Minimum Price per share that the Company shall receive, and shall be subject to the Conditions. Investor shall purchase the Securities tendered pursuant to the Sale Notice.

Conditions: A Sale Notice is subject to:
a) The amount of Securities in the Sale Notice not exceeding 500% of the average daily trading volume for the 30 days preceding the Sale Notice date.
b) There is no outstanding prior Sale Notice.
c) No Material Event has occurred.
d) Company has caused the delivery of the Securities to the Holding Account.
e) Company is not in breach of the definitive documentation

**SharkBite Funds**

Closing: Investor shall deliver a Closing Notice to Company at its option, but not later than 30 trading days following the Sale Notice.
a) The Purchase Price of the Securities shall be 90% of the average closing price of the Securities for the non-excluded trading days between the Sale Notice and the Closing Notice (Due Diligence Period).
b) Any trading day during the Due Diligence Period for which 90% of the closing price is less than the Minimum Price shall be an excluded trading day. Investor's obligation to purchase securities pursuant to a Sale Notice shall be reduced by 7% for any excluded trading day.
c) For any trading day during the Due Diligence Period, the closing bid price shall apply for that day if it is more than 0.5% different than the closing trade price.

Investor shall deliver the aggregate purchase price to the Company within 2 business days of the Closing Notice and the Securities in the Holding Account shall be released to Investor.

Warrants: 10 million warrants, CAD 0.23 exercise price, 3 year term

Fees: Company shall pay Investor a commitment fee of 1% of the Stock Purchase Guarantee amount upon the sooner of the first Closing Notice or 12 months from the execution of definitive documentation. In no event shall the payment of the commitment fee exceed 35% of Closing Notice amount during the first 12 months of the Term. In the event Company has not utilized at least 35% of the Stock Purchase Guarantee amount within 12 months of the execution of definitive documentation, Company shall additionally pay to Investor a usage fee of 1% of the unused balance of the Stock Purchase Guarantee.

## Documentation

Tooth & Nail shall draft definitive documentation and represent Investor. Company shall deposit USD 15,000 with Tooth & Nail and shall pay Investor's legal expenses up to USD 20,000 in total.

The documentation shall contain customary anti-shorting provisions that prohibit investor from directly or indirectly selling stock it does not own or have the right to purchase. Material Event shall mean any stop in trading of the Securities for more than 20 days or any change of control of the issuer.

**Telltale…**

First Clue - Company A that brought us this deal had a $10mn market cap and had done for ages. Thus an offer of $10mn in easy financing was pretty generous even by the standards of these flush times. Clearly a red flag.

Lots of the talk is of various triggers being "at the company's discretion" but when examined closely the triggers that matter were at the financier's discretion. (We do not use their word" investor" as this might imply the party would be long the stock. The "investor" would largely be long the right to buy stock, and probably short the paper most of the time).

The financier gets a fee of 1% of the value of the Stock Purchase Guarantee so if the company eventually wises up and desists it is still on the hook to pay $100,000 for the pleasure of having entertained this deal in the first place.

Then the financier gets 10mn warrants so he appears to have "skin in the game".. when it comes down to it though he is going to be making way more money in other parts of the deal that this only serves as insurance should the company manage to escape the death spiral, through wits or luck.

Then there is the transaction limit relating to daily volumes. Why should that matter if the financier was really an "investor". Surely he is buying to hold.. or is he? If the company is really a small cap then it is unlikely to be turning over more than a few percentage points of its capital on a busy day. If we imagine it is turning over even 0.5% per day that might be only $250,000 at most that the company can pick up from this accord in any given month. The financier can now start selling or shorting its "starter position".

How does it work? Let presume that the average volume is as we just suggested and that the stock price is 20 cts when the Sale Notice is delivered. The company sends the financier the notice that it wants to take up the $250,000. Thus the purchase price shall be 18cts for the financier if the stock does not move. If the stock declines then the days where it falls below 90% below the minimum price shall be excluded from calculating the average price and the financier gets to reduce the amount of money he hands over by 7%. Thus the lower the stock goes the less money the company gets.

In the model shown at the right the days marked yellow are excluded days. In the first scenario, 14 excluded days occur so the company gets only 2% of the amount of money it wanted to get. In Scenario B without the exclusions the average price is almost the same.

| | Scenarios | |
|---|---|---|
| Day | A | B |
| 1 | 20 | 20 |
| 2 | 22 | 19 |
| 3 | 21.5 | 18.5 |
| 4 | 20 | 18.5 |
| 5 | 20 | 18 |
| 6 | 20.5 | 18 |
| 7 | 20 | 18.5 |
| 8 | 19.5 | 19 |
| 9 | 19 | 20 |
| 10 | 19 | 20 |
| 11 | 19 | 20.5 |
| 12 | 18.5 | 20.5 |
| 13 | 18.5 | 21 |
| 14 | 18 | 22 |
| 15 | 18 | 21.5 |
| 16 | 18 | 21 |
| 17 | 17.5 | 21 |
| 18 | 17.5 | 20.5 |
| 19 | 17.5 | 20 |
| 20 | 17 | 20 |
| 21 | 17 | 19.5 |
| 22 | 17.5 | 19 |
| 23 | 17 | 20 |
| 24 | 17.5 | 19 |
| 25 | 17 | 18.5 |
| 26 | 16.5 | 18.5 |
| 27 | 17 | 18 |
| 28 | 17 | 18 |
| 29 | 17.5 | 18.5 |
| 30 | 17 | 19 |
| Av. | 17.52 | 17.57 |

We had to do a double take because this did not look too bad but then we

wondered what the Minimum Price had to do with it, and the answer is "not much". It only serves to exclude the days that flunk the 90% test. The Purchase Price can actually be lower (substantially so) than the Minimum Price.

Then there is the last gem (the anti-shorting provision) to soothe furrowed brows. We were intrigued by this but then worked it out. This is not the no-shorting rule but rather the no-naked-shorting rule. The "investor" only needs to buy a starter position of a few hundred thousand shares and then start shorting those shares. The operative words here are the it may "not short stock it does not own or have the right to purchase". What is the whole Sale Notice but a "right to purchase" for the financier? It will restock its starter position or cover its shorts with ever-cheaper stock from the corporate ATM.. wash and repeat…

Essentially the financiers can short the corporate with impunity, knowing in advance that they are going to be delivered in 30 trading days some stock at a price level guaranteed to be lower than the market.. The only thing they need to make sure of is that the downward price moves do not exceed 10% below the Minimum Price. Thus the financier can be almost guaranteed a gain of between 10% to 20% (a 10% discount to the average price which is also allowed to be 10% below the Minimum Price) and that gain is booked even before it has handed over the money to the company.. Nice money if you can get it..

**Conclusion**

It is said that there is "nothing new under the sun" but one can put old wine in new bottles. And this financing "technique" is vintage indeed, just not in the minds of ingénue managements at cash-strapped juniors. These believers in Santa Claus are almost destined to be boggled as to why their stock keeps going down despite the "wonderful" new financing source they have found. However they fail to note that the market may not like lumpy and dilutive financings but at least they make news. They depress the stock price beforehand but it moves up after. In this new style of financing the stock price is almost pre-destined to go down in perpetuity until they kick the drug.

Ironically when they finally do move on (hopefully before having used yup their whole guaranteed line) they get to find they are paying fees as if they took the whole lot and its back to the grind of financing *a la* Bay Street. You would never have imagined you would hear us say this, but frankly Bay Street's ways look almost philanthropic in comparison.

What relevance does this have to the common or garden shareholder? Well, if they suddenly find their favorite junior has a mystery source of financing and yet its stock starts to be stubbornly leaden-footed (or maybe even cement-overcoated) they might dare to pose the question of where the money is coming from and whether the company really knows what it has gotten itself into.

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