

Thursday, June 25, 2009



Hallgarten & Company

Portfolio Strategy

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Going Ballistic Prospects for Hostile Bids in the Mining Space

Going Ballistic

Making those on the edge.. edgier

- + The markets are firming up. Prices for many metals are well off their floors. Investor interest is reactivating. Worthy companies now have decent valuations again.
- ✘ The mining M&A scene has shown some signs of life but really transformative deals have been few and far between. Everything has to be “agreed” in the time-honoured pusillanimous fashion of the Toronto establishment
- ✘ Hostile bids are the “last refuge of the scoundrel” at least in the popular image of the Canadian marketplace
- ✘ Shareholders both large and small are being short-changed by managements subscribing to this feeble and out of date philosophy. Companies with a strong position are being thwarted in their growth plans by “failed” enterprises that shelter behind the unwritten rule against forceful prosecution of corporate expansion by the “winners”
- ✘ Is it any wonder that Canada has lost its layer of mid-sized diversified mining groups (with the exception of Teck)? Organic growth is stymied by having to pay top dollar to sitting managements at companies holding assets that would be better managed in more competent hands
- ✘ Companies that do not choose the path of cheapest and best in pursuing merger/takeover transactions are delinquent in their responsibility to their shareholders
- ✘ The brokerage community in Toronto has a vested interest in maintaining the status quo as being “friends with everyone” means that the constant drip feed of private placings with 6% fees is far more lucrative than actually do some M&A work
- ✘ The movers and shakers in the Canadian mining community have shrunk to a collection of toothless old men sitting in the village square. If the only deals done are artless “agreed bids” then anyone with any gumption gravitates towards the business of launching endless new issues rather than creating groups out of what is already available. The world’s great miners have not been created out of such gormless behaviour

No more Mister Nice Guy?

We wondered out loud at a meeting recently with a Canadian investment banker as to why there are so few hostile bids in the mining space and his response was “because Canadians are so nice”. Usually Canadians don’t like the “n” word being used to describe them but in this case the banker had no other viable excuse for the outmoded “ban” on aggressive behaviour in the Canadian corner of the international mining patch.

We have all traveled through an extended bull market in which valuations rose to fair levels in many cases and insane levels in some specific cases. Then the collapse took virtually every stock to derisory levels in the general liquidity meltdown. Now the tide has turned and not all boats have been lifted with the same enthusiasm as before. Those who remain “unlifted” can easily regale you with their all-time high price because they are using this as a reference point with any stalkers that may cast their beady eye upon them as an acquisition target. Little do they know that their high was an aberration and they should count themselves lucky to have any suitors at all? The fact that so many companies with reasonable assets should be allowed to dwell forever as moneyless zombies is because they have the force field of the unwritten “no hostile bid” ban to protect them. This situation is not healthy for the market, for corporate Darwinism or for investors. It seems perfectly splendid though for those who dwell behind the bullet-proof glass of “niceness”.

A flood of deals have gone through in the mining space starting from last November when the very worst of the fall in gold had past. A few have made eminent sense. A few have boggled us by their banality. Many mergers of equals so that (almost) everyone can hang onto their positions (a stable of agreed deals). Some tidying up of corporate groups with previously spun off vehicles being brought back on board to save costs. Very few synergistic deals. Very few marriages of money with prospects (i.e. companies with poor projects and lots of cash with good projects with little cash). The latter are a natural for “mergers of (relative) equals” but have not been happening.

We have nothing to fear, except fear itself (or delisting)

Why are “sensible” deals not happening (we shall exclude the Capstone/Sherwood merger which we thought was very smart)? Well, in the land where cash is king those who only have projects do not like the new reality. The rebound in the gold price has been fast enough for them to recall that they had outrageous valuations for projects that were years from production and they imagine that they should be back at the market caps that they saw when gold was at \$930 in early 2008. meanwhile around at the cash rich companies one dollar is still one dollar, and \$20mn in the bank is like being as rich as Croesus.

There has been no shortage of such deals in Australia. Canada though seems in a stasis due to the “no hostile bid” ban. This means that the serially deluded amongst the explorer fraternity are impervious to overtures that make sense. We recently had a \$300mn mkt capitalization company complain to us that none of the targets they had approached could be cajoled into further discussions because they had seriously overblown estimations of what they were worth. Clearly these ideas are solely in the heads of their executives because the market is not indicating as much by the value put upon their shares. If one thinks about it the absence of a hostile bid culture means that companies in fact have nothing to fear. The Canadian-listed mining company lives in a jungle with no predators. Even the smallest creatures have no one to prey upon them. There is no food chain. In their eyes the corporate denizens of this world have created the perfect environment for low stress evolution. If real life was like this the planet would still be ruled by amoebas!

The Dawn Raid – a good starting point

One can't get much more hostile than launching a dawn raid. Canadians probably think this is getting up early to go goose hunting but in the UK and Australia it consists of brokerage firms hitting the phones after the market has closed to get as many institutions to sell up stock in the target as they can. Not being able to reveal the purpose or the aggressor the brokers have to go out and feel out the market. Institutions theoretically would not want to sell into this onslaught as the price could (and most likely will) go higher in the coming days and weeks. Then again it may not be a takeover raid but just a serious accumulator in the market. Thus the raid can sometimes have the startling effect of taking the aggressor up to the takeover threshold or beyond. The aggressor had better have the paperwork in order for a full bid if they bust through the threshold because the next morning an announcement of the bid will have to be made and the helmets go on and the bullets start flying. The battle has gone ballistic. However, if the raid stays under the threshold merely a holding announcement will be required and the target can dangle in the wind wondering what comes next.

The dawn raid, we might also note, is a cash expenditure by the target, though the ultimate deal may be a stock swap or a cash/stock mix.

The beauty in the mining space of such a tactic is that if one can take out a series of the biggest institutions (and if the management has a fairly minuscule position itself) then all the incumbents have to build their defensive wall with is a coalition of private shareholders, which can be like herding sheep. In the Canadian context where many of the companies do not have a strong institutional base (many with less than 30% in total), then the battle for hearts and minds with the retail holders is crucial. However very few companies have managements with a following. The number of mining “figures” that can make the

retail crowd swoon with admiration (e.g. McEwen in his glory days) can be numbered upon one hand these days. It is a reflection of the distance between retail investors and the managements in recent times that these “fan bases” have become so feeble.

Thus, if the nature of the relationship between investors and the managements have changed, maybe it is time to reconsider the means by which deals are arranged in the mining space. Managements do not represent the shareholders in these transactions, they are representing themselves. This is made more poignant when managements hold so few shares in the companies they themselves run.

Lowballing

The goal of the dawn raid is to gain position in the target, and fast. Sometimes the bidding may even involve escalation offers to the institutions or other holders selling out. This may largely negate the potential for getting stock on the cheap to lower the full transaction price.

The cheaper method of accumulating stock in the market always appealed more to us. Maybe that is just because we are stingy (and patient). Accumulation though is a strategy with two risky elements. Firstly it can take time to get up to the first announcement of a declarable stake and anything can happen in that time. Secondly the mere fact that there is a consistent buyer in the market place could excite the stock to levels that take it above where one ultimately wants to bid. In Australia bidders are not allowed to offer a lower price in the formal bid (once the takeover threshold is breached) than that at which they have done any on- or off-market purchases in the previous six months. That creates a ceiling. If one ultimately intends to bid \$1.50 in a formal offer then one can't have paid \$1.60 for any one share in the qualifying period or the bid would need to be moved up to the level of that solitary example.

We can think of an example of a copper/cobalt company we like at the moment. Its stock is trading at 1 ct, which is derisory, but a reflection of the deep disinterest in this story (and its lack of viability as a long term independent entity). However it is eminently suitable for a trade buyer but alas won't talk with anyone except on its “own terms”. It would rather expire than do a deal. An aggressor could ponder making a bid at 20 cts but such is the volume of stock available at lower levels that an aggressor would be foolish to not “take candy from babies” before making a 5% announcement. Moreover it could probably make an announcement and still be able to plough on buying more stock to the takeover threshold at much lower levels than where it might ultimately bid. Just on our own observation, we suspect the predator could get most of the first 5% at 1 or 2 cents and could get to 15%-20% without exciting the stock above 10 cents. Such is the level of distrust and dissatisfaction amongst holders of this stock that they are scarcely going to hold onto stock they bought at 4 cts when they can sell out at 10 cts. Companies that have not developed a loyal base due to using and abusing shareholders over time cannot expect them to hang around when a profit is there for the taking after a long and gruesome holding period for the investor.

It may seem a tedious process to accumulate stock rather than launch an outright bid but the more stock the aggressor has on board, the less stock the management has to appeal to in its defense strategy. And if one can accumulate a decent position at a low price and then one is either overbid by another aggressor or thwarted in some way (a white knight counter-offer of an agreed merger not being unthinkable) at least the aggressor can walk away with a profit from the battlefield. Heads we win, tails you lose.

Breaking up is costly to do

The Rosemary's Baby of the agreed merger game is the break-up fee. This insidious beast is the weapon that management's use against shareholders to ensure that the best deal is obtained for management. Frankly, regulators should come out against these fees, which have spread like a weed through capital markets transactions over the last ten years. Basically, when boiled down, they are a means by which

management scares off any higher competing bids that would almost certainly benefit shareholders. Why shouldn't shareholders be open to receive a competing offer?

There is a legitimate reason to have break-up fees which compensate for the out of pocket transaction expenses that the spurned party may have spent when the "runaway bride" dashes from the church. But nowadays the breakup fees are being concocted at punitive levels to be killers for competing bids. Why should the break-up fee on the Rio-Chinalco deal be \$160mn? Neither of the parties spent anything vaguely like that on the transaction. The breakup fee in the Gammon/Capital Gold deal was \$4mn, which was equal to around half a year's earnings for the target.

Regulators though should move in on the whole practice and enforce breakup fees that are related to the transactional costs of termination and nothing more. We could also argue that getting overbid is in the very nature of commercial life and thus no compensation should be available for a failed lowball bid if:

- a higher offer appears (rationale being why should shareholders undersell their holding just because management wants to?)
- shareholders reject the offer (after all why should they have to swallow a deal they don't like and then pay to retain their freedom!)

A little parable

Once upon a time there was a precious metals company that arranged a merger with another company six times its size. We thought the deal stank and so did the bulk of the shareholders (except for two institutions that had well positioned themselves and, frankly, seem to have been sounded out, if not tipped off, in advance). We were boggled because the deal seemed not even to be in management's favour as only one of the existing board/executives was parachuting into the next scenario while the rest would be jobless.

Lo and behold, the deal was called off on the last day of the due diligence period. No official reason was given, but curiously the breakup fee was not brought into operation with both parties walking. It was let be known by one party that they didn't like what they had found and that the other party didn't want this revealed so the breakup was pacific and no fee was invoked against the "walker".

Subsequent chatter would seem to indicate that there might be other reasons why the spurned party did not claim their pound of flesh. This version says that the acquirer could not work out a way to pay off the various pigs in the trough at the target company with their lucrative multi-year contracts for doing little more than being Cigar-store Indians at the company's HQ. This then helps to explain why more of them hadn't tried to move over to the takeover vehicle. They wanted golden parachutes and how!. And this ultimately was not acceptable to the acquirer despite the bargain basement price the acquirer was paying for the asset.

This raises a few questions (as any parable does). It makes us wonder whether, in their haste to do their own personal deals, the question of price for the shareholders was merely a secondary issue...It also raises bigger issues though because we are aware that the company received many overtures over the preceding months, and years, and some seemingly made a lot of sense and brought synergies and yet nothing was done. Was it that suitors were turned away (even ones with good offers) because they balked at the part of the iceberg below the waterline (i.e. management demands for their own satisfaction)? Lots of companies have run their slide rules over this asset and yet nothing ever happens (except this abortive "friendly" deal). If ever a case could be made for an aggressor moving in on a Canadian listed stock it is this one. The management want to be bought, but on their terms. They never sell out because the terms for themselves (which the shareholders are blithely unaware of) are the sticking point in the pre-offer jockeying. Time for an aggressor to go for this one.

Used and abused

This parable serves another purpose. There is an assumption out there that shareholders are resistant to the concept of hostile bids. We do not know whom these queasy shareholders might be but they should definitely get out of the mining space if they have such weak stomachs. Nothing gets our blood churning like opening up the newspaper and seeing a bid for one of the companies we cover. Even more exciting is a counter-bid. Where does the myth that investors don't like a bidding war for their holdings come from? Is this the Big Lie in the mining space? Sounds like a self-serving fabrication of the managements.

The shareholders in the Canadian mining space have only one alternative if they do not like the management of a company or its strategy. They must sell out. In other jurisdictions a company as blatantly incompetent or self-serving as we sometimes stumble across in the mining space would be on guard constantly against a bidder moving in to take advantage of a low price caused by disgruntled investors fleeing for the door. Such management would also be accumulating stock to create a blocking holding at the management's discretion.

We see companies with imperious (and impervious) managements in the Canadian mining space where the whole executive group own a mere 10%, at best, of the stock outstanding. That is not a defensive position by anyone's definition. That sounds like as good a reason as any to propagate the myth of "agreed bids only". Any switch to aggressive bids would take the whip hand away from the managements and shake them out of their lethargy or send them into long overdue retirement.

Institutions

Investors will recall our *magnum opus* of early last year where we pondered the differences between Australian and Canadian miners and the investors in both countries markets. We discussed the difference in the institutional base. It has long been kosher for the most "conservative" asset managers in Australia (the life insurance companies like AMP and NatMut) to be players in all levels of the mining food chain. In Canada, we can only muse on the reasons why mainstream institutions do not seem to figure in anything but the biggest names. This seems to have created an extra cozy relationship between a handful of resources-oriented investment entities (you know their names) in Canada and the managements and the broking community. No-one in Australian mining regards one mining fund as omnipotent. That is not the case in Canada. Frankly that is an unhealthy situation.

Institutions of the Australian variety have a goal to produce returns on premiums invested and have an actuarially defined output of future payouts that they must satisfy. King-making or a papal role is not in their mandate. Thus nothing thrills an Australian institution more than a bid, with a follow-on of a counterbid.. and then more countering. Frequently none of these offers are acceptable and the institutions vote it down.

We have been intrigued by meeting Canadian miners who crave retail shareholder bases and then regard institutions as something they will add on later. This is almost the opposite of what a corporate in the US or UK would want. Is it that the retail shareholder base in Canada is easier to control via a "divide and rule" strategy? They have clearly been acquiescent in the "no hostile bids" philosophy promoted by the PTBs in the corporate halls and corridors of the TSX.

Obviously the current lie of the land suits the institutional community in Canada. Keep it small, keep it a closed circle, keep it to ourselves.. From our perspective this sounds like a dereliction of duty to the investors at best and at worst a conspiracy between the institutions and the companies against the majority of shareholders in the listed mining company universe. Is it a coincidence that Canada (unlike Australia or the UK) does not have preferential rights for shareholders in capital raisings? The coziness extends to the placement of stock where issues can be placed at nice discounts into the hands of institutions that have played along with the managements in the past.

And it is not only the institutions who get first bite of the apple. Much as we love IAMGold.... Much as we favour Oromin.... Much as we are on record as saying IAG (or Semafo) should make a move on Oromin... It sticks in the craw that last week IAG got itself into the box seat at Oromin (OLE.to), when it acquired 17% (16.1 million shares) of Oromin through a private placement. IAG bought the shares for about CAD 70 cts each (CAD\$11.3 million). At the time OLE was trading in the mid to high 80 cent range. IAG stated it "has no plans to acquire ownership or control additional securities of Oromin, but will continue to evaluate its investment on an ongoing basis" Oh yeah.... Who needs to stage a dawn raid or accumulate on the cheap when some companies are prepared to offer strategic (almost) blocking stakes at a discount?

Meanwhile the Great Unwashed amongst the public shareholders must pay full price for whatever stock they wish to accumulate. Then if one considers the nature of not underwritten rights issues in the UK and Australia (and even Argentina) we note that brokers do not make money from these if the existing base takes up the issue.

Thus the brokerage community in Canada has a vested interest in 6% fees for placing stock with the institutions that are in the pocket of the corporates (or vice versa). No wonder there is no desire to rock the boat by launching hostile actions.

The Worm Turns?

Not all institutional holders are prepared to be the frog in the boiling water of management's indulgences. Then again is a hedge fund an "institution"? The ill-starred and ill-conceived HudBay/Lundin merger was one where the backlash was fatal for the management that tried to ride roughshod over shareholders. The original deal was announced in the darkest hours of late 2008 with HudBay supposedly ending up on top (though the Lundin family have a history of winning in the long run). Prominent shareholders argued that the deal would result in a change of control of the firm and that HudBay was misusing its strong balance sheet to bail out cash-strapped Lundin. Prominent amongst the resisters was the merchant bank Jaguar Financial and the hedge fund, SRM Global Master Fund. The opponents pushed for a proxy battle to have the firm's board replaced, and asked the Ontario Securities Commission to overturn TSX approval for the deal.

The parties to the deal had hoped to close the takeover by January 28th 2009, but the Ontario Securities Commission stuck a stick in the spokes when it ruled earlier that month that HudBay must allow its shareholders to vote on the plan. Once again we see management fighting tooth and nail to keep shareholders from having a say in the transactional process. Mother knows best!

After being right royally trounced, Allen Palmiere, the CEO of HudBay, admitted that it had received very strong feedback indicating that shareholders would not approve the merger. In early March, Palmiere threw himself under the wheels as the pressure for his ouster grew. That was good for a near 4% pop in HudBay's share price.

In late May HudBay eventually sold off its 16.7% stake in Lundin to GMP Securities for cash proceeds of approximately CAD\$236 million, representing a before tax gain of approximately CAD\$100 million. Not a bad return for a failed deal. We like both Lundin and Hudbay now and have them both in our model portfolio.

Mercifully the break up fee was a "mere" USD 2.5 million, but it was eventually waived.

Swashbucklers in Short Supply

Call us nostalgic but one does pine for the days when people like Robert Holmes A'Court roamed the global markets spreading terror like Godzilla. As we already noted the "names" in the Canadian mining

space are a very small group and even some of them are spent firerockets (he of the large-print raves to hedge funds about why they should buy gold comes to mind).

Once again we come back to the fallout from Bre-X, which is like Chernobyl in that it continues to poison all those in its proximity. The Canadian mining space has fallen to the soporific management style of geologists and mine managers because financial movers and shakers were declared beyond the pale after Bre-X blew up in the faces of people who should have known better. The fallout curiously didn't travel any further than Canadian borders so in the rest of the world mining companies of consequence (and most that are not also) are run by people with financial savvy who could be running Starbucks or Heidelberg Cement. In what other industry would a geologist, with no previous management experience, be put in charge of a major industrial enterprise?

If it comes to a mud-wrestling match between a skilled financial operator building a major mining group or a geologist who can go into a trancelike state over a porphyry outcropping we would not be putting our money on the geo. Nevertheless the hothouse environment of the Toronto (and Vancouver) mining scene (and we refer to their protection from cold blasts of reality rather than to superheated transaction frenzy) has become the happy (non-) hunting ground of the geologists who want to be friends with everyone. Anyone who is not of this cheery disposition must play by the rules which signal "no hostile bids" no matter how intransigent, incompetent or disliked the management of the target company might be.

Will the eventual passage of time turn Bre-X and its malefactors into distant memories? Will the arrival of companies with managements from farther afield cast aside the prohibition against unilateral action? Will someone break the ice around this shibboleth (let's mix metaphors while we are at it) and turn what has been a dance with everyone playing the wallflower into the mining equivalent of Stravinsky's Rite of Spring?

Reasons to not go hostile

Ummmm... someone (or everyone) in Toronto may not like you anymore. Can't think of any others.. Sorry..

Conclusion

Mergers and takeovers go on in Toronto despite the lack of "hostile" activity, but in whose interest is the lovey-dovey arrangement of the current times? Clearly not shareholders, either big or small. Clearly not predators for they frequently find the best deals not doable because of managements that can remain in the splendid isolation of their intransigence of their isolation with only the share price reflecting the concomitant frustration of investors with this stalemate. This is no skin off management's nose as it provides more opportunities to issue more cheap executive options and await the day until Mr Right comes along.

The TSX likes to trumpet how many listed miners it has, but we wonder if the lifestyle was more Darwinian on Bay Street, whether so many would survive 2009. In the shark pool of the Australian market, much of the Canadian contingent would be seen as mere whitebait. Wouldn't it be amusing to merge the two markets? It would be like feeding time at the Aquarium... Most of the geologists ensconced in management positions wouldn't know what had hit them until they were in the digestive tract of some top-level predator.

Graveyard humour aside, many of the more passive audience at the mining games in Toronto are doing themselves a disservice by allowing the current regime to go on. Moreover, managements in companies with ambitions to grow, and the wherewithal to do so, are shortchanging themselves and their investors by allowing the pygmies of the marketplace to rebuff their overtures with impunity. Speak softly and carry a big stick...

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