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The Dos and Don'ts in Raising Equity Finance for Exploration and Mining Companies

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Abstract

Raising equity funding for exploration and mining companies is a condition precedent to a company starting business, and it is equally essential in keeping these companies alive. Nothing happens without funding. Given probably 95% of all companies on the mining bourse never make it to production and positive cash flow from operations on a sustainable basis, it could be said that the skill in raising high risk equity funding is the most important talent for the modern CEO. Yet, very few CEOs excel at this task. Why is that, and what can be done about it? What are the ten commandments in raising equity that CEOs and CFOs need to know?

Engineers, and less so geologists, are used to working in environments of science and certainty, in which the rules are known and understood. Dealing with equity capital market is the complete opposite. You need to master the chaos of markets driven by the psychology of fear, greed and incompetence all rolled into one. You need to consider constantly changing regulations from ASIC and the ASX rules. You need to deal with market participants and seasonal factors. You need to consider not just what your company is doing but you have to place its actions and appetite for capital in the perspective of broader markets and raise money when the funds are available, even if your budget or your representations to shareholders suggest otherwise.

In this paper you will be presented with guidelines of what to consider and how to act. You will be advised as to who can best help you raise capital if you seek external help. Different capital raising methods will be assessed. General principles and their exceptions will be listed. Examples will be offered for your observation. By following the guidelines you should then be better equipped to handle the challenges in the battlefield we call equity markets.

A. When Should You Raise Money?

1) The Overriding Rule is "*When you can get it*"

- Pragmatism is the key here. If the money is on offer, you should take it.
- No time is a bad time if it is on offer.
- A "bought deal" makes it easy, but you still have to commit. Don't get too cute.
- Don't make the mistake of planning out the next two years, anticipating that you will raise it when you need it. Don't assume the money will there to suit your work program 12 months out, because that is when you intend to deploy funds.
- Raise the money you can and don't waste it. Save it until you need it.
- Don't issue options and budget for them to be exercised.
- Markets go up and down, as do shares prices, more on changes in sentiment than pure fundamentals.
- Don't bother over-analysing where markets and your share price is going because it is not an exact science
- Remember the expression "feed the ducks when they are quacking"
- The more you need the money, the more difficult it will be to raise it, particularly if it is to keep the company solvent.

2) Seasonal Factors

- There are good times of the year in which to raise money, and there are times when you shouldn't.
- The best windows of time are usually February and March, and September through to November.
- The worst times are in the weeks leading up to Christmas and the first half of January, and May and June, as we approach the end of the financial year.
- There is a long list of considerations that you need to keep in mind as you try and prise money out of the wallets. These include, but are not limited to;
  - Holiday periods, be they religious, school or other
  - Northern hemisphere holidays – July and August
  - End of quarters when portfolios are being tidied up prior to review
  - Beginning of quarters when revised investment objects have been set and it is time to do some shopping
  - Reporting season for companies
  - When conferences are being held around the world such as INDABA, PDAC, Diggers & Dealers, Beaver Creek and a great long list of other conferences that can take people off-line.

3) Do people even want to invest?

- Sometimes there is a "capital market strike", when doors are closed to capital raisings by companies, in addition to the seasonal factors that affect enthusiasm.
- The good thing about a "capital market strike" is that it won't last forever. If money isn't turning over so that brokers can't make fees, they will eventually get desperate and open the doors again. It is a matter of "when, not if".
- When the market is soft and portfolios are losing money, you can find that the doors are shut. It's nothing personal. It may be that confidence has been rocked by scandals, or the market might just be suffering from fatigue.
- It may be because there have already been a number of raisings before you that have flooded the market, or ones that have not performed, so enthusiasm is down.
- Sometimes people just don't want to invest any more money, regardless of how well you present yourself.

4) Timing is Everything

- You should understand now that timing is everything, for many reasons.
- There is great of intuition involved in getting it right and there are strategies that will give you a better chance of success, even in an unfavourable market.
- Often it comes down to pricing – you will get a lesser price in a poor market. It is a matter of how low you are prepared to come down.
- It is also a matter of preparation and setting of expectations of the market.

B. Who Should Raise you the Money?

- The most logical agent to use is a stockbroker. They have all the experience that you, as a company, will never have.
- However, not all brokers are equal. Not all of them are good at their jobs. In fact, very few brokers acquit themselves satisfactorily. Yet, you still have to deal with them.

1) Brokers - The Good, the Bad and the Ugly

- The most important motivator for a broker is the fee. They want to write a ticket. They can't survive on secondary market commissions so they need corporate fees.

- You get a whole range of brokers with differing capabilities and different levels of professionalism, but at the end of the day they want the fee and they want a business model that will enable them to keep earning fees.
- Some will provide good after-market support. Some will provide research coverage. Some will actively engage with the company post raising and others will just pump out stock and move onto the next deal. You need to know who you are dealing with and set your expectations accordingly.
- Every deal needs a champion. You might be dealing with a broker with a reputation for being able to close deals, but are you dealing with the right person. Will he successfully champion your deal? Is he on the A Team or the C Team? Is he in a team at all? What other deals is he working with that may distract him? Remember, brokers will gravitate to the deal that offers least resistance for the largest reward.
- Every capital raising involves risk. Every day is a new day in the market with sentiment depending upon what is happening in the rest of the world.
- When a broker launches a capital raising it is like going out on the football field for another match. There will always be butterflies in the stomach. They may be in a great team with expectations of winning, but we all know what happens when you get too cocky.
- Don't ever expect that a raising will be underwritten. These types of deals don't exist anymore. It will invariable be at "best endeavours".
- Don't expect to get anything for the 5-6% commission that you will have to pay, other than the money, and maybe you will be charged options on top of this.
- Be wary of meeting with brokers that are full of love and enthusiasm. Don't leave their board rooms feeling they are great guys who will deliver your capital licketty split. They are salesmen who usually give you the good news first in order to keep you on the hook. Reality bites somewhat later.
- The more realistic the brokers are, the more measured will be their responses. With the benefit of experience they will tell you the pros and cons of what you are planning and the difficulties on the way.
- Don't expect to be able to hand over the capital raising exercise to brokers and assume it will happen. You need to be involved intimately and stay on top of the procedure to ensure there is no slippage.
- Don't be surprised if they prefer you to come up with a meaningful level of funding from you own endeavours as a lead-in to their commitment.
- The whole exercise is about caution and building confidence, and conveying that confidence when they go out to sell the story to their clients.

2) Other Agents

- Occasionally there will be other groups that provide an alternative to brokers. These might be licenced specialists who have a particular focus and expertise. They might collaborate with brokers, with some success.
- You might use these agents because you have a relationship already, or because they give you a good sales pitch.
- They might do as good a job as brokers, but there is one thing that they are unlikely to be able to offer – a sales desk for secondary trading (not that brokers guarantee this anyway).
- There is a risk of alienating brokers by giving fees to other agents, thereby taking the cream that brokers want. Remember that the animal instincts of jealousy and rivalry are alive and well.

3) The Company Directly

- It is rare for companies to undertake placements on their own. Very few directors have the reach into the financial markets, though it can happen. Even if there is a good level of competence in this area, it is more likely that a broker or agent will be used as part of a team effort, with the company offering strong back up that adds to overall confidence.

C. Methods of Raising Money

1) Placements

- Most of what we have mentioned to date relates to placements. They should be the least onerous in term of paperwork, and they can happen quickly – depending upon the size and the amount of red tape that your broker likes to impose upon you.
- These have a restriction on them though, and that is the need to be dealing with sophisticated investors who fit the s.708 definition.
- You also need to be in contact with the placees. There is an intense 24-48 hour period when all hands need to be on deck, usually in a trading halt.
- You need to have all document prepared in advanced and you will probably need to have "wall-crossed" some key players, though this always means a risk of someone breaching confidentiality.

2) SPPs

- A Share Purchase Plan (SPP) can be used to get around the restrictions of s.708 requirements. You have to make the offer to all shareholders through a published offer document. This takes a few weeks and markets can move adversely in that time. Shareholders can take up to $30,000 each at a designated price, up to a maximum total amount that the company has announced.
- An SPP is not always popular amongst professionals, especially when it follows hard on the heels of a placement. It tends to suck the demand out of the market for the duration of the SPP, which can range from 2 to 4 weeks.
- Companies will do an SPP to keep the little guys happy – the guys that complain about not being offered a placement. But will they take up an SPP? It is anyone's guess.
- Sometimes companies will do an SPP when there is no broker or agent willing to do the heavy lifting. In cases like this it is almost an appeal to the general, loyal shareholder base to stump up with money to keep the wheels turning. It is most unlikely to create any FOMO in the market place.

3) Entitlement Issues

- Entitlement issues are generally the most egalitarian type of issue where everyone gets a bite at the raising, proportional to their holdings. They get a set ratio such as 1 new share for every 4 shares already held, at a set price.
- Often there is no broker involved, though there may be deals where brokers agree to partially underwrite or "best endeavour" to place out shortfalls.
- Like with SPPs, it helps to understand your share register when setting terms of an issue.
- There is more room to offer larger discounts to shareholders with an entitlement issue, thereby enticing shareholders to put up money at cheap prices.
- There is no concern with dilution of existing shareholders, a cause of concern when a placement is undertaken, as everyone get the chance to participate and maintain their level of ownership. Of course, if you can't or won't take up your entitlement, you will suffer dilution.

4) IPOs

- IPOs are the hardest issues to get away. You might have to work for 6-9 months to prepare a prospectus and negotiate with lawyers and the ASX, even before you ask for any money. This exercise can easily cost you hundreds of thousands of dollars, with no guarantee of success.
- There is also a higher level of risk for investors as well. The first problem is the lack of a secondary market that would enable price discovery. Has it been priced correctly?

- Is this an exercise to get on the boarse or is it the real deal with worthwhile assets that will take the shares higher? Is enough money being raised?
- Is the capital structure burdened by too many promoter or vendor securities?
- Perhaps the most important questions that promoters forget to ask themselves are,
  - "Is there already one or more companies on the ASX that have similar projects at a lower market valuation? i.e.
  - What new opportunities do we get with the IPO that aren't already available.
- There are plenty of examples of companies that have IPOd, and never sold above their issue price. You want to avoid these sort of situations like the plague because they get only one rating – a fail. It is hard to go back for more money at lower prices.

D. How important is Due Diligence?

- The level of DD undertaken by a broker will vary considerably according to:
  - How big the broker is – the bigger the broker the more mouths to feed and the greater the involvement of committees that are more concerned with processes than execution
  - How seriously the brokers take themselves – this ties in with the previous point, with bigger brokers taking themselves more seriously and it brings into play the ever increasing list of compliance conditions and involvement with lawyers.
    - Take the directors DD questionnaire, that can run into 30 pages. You do it because brokers say you have to, but once you have done it, who looks at it anyway? What is it used for? How many companies complete it with great care, and even answer the questions truthfully? Who checks the accuracy of the answers.
    - The reality is that it is an arse covering exercise that ticks boxes, and maybe, just maybe it will be referred to in the event that investors lose money and are looking for someone to sue. It doesn't seem very relevant for junior companies that carry high speculative risk, though there is more merit where it is a serious producing company and much larger sums of money are involved.
    - If truth be told, the real DD from brokers starts and ends with the question "*Can we get this placement away to our clients?"* and pricing is a bigger motivator than perfect accuracy of information and representations. The decisions to act often involves a statement like "*Let's just make sure this doesn't turn around to bite us*".
    - DD takes time and it costs money. It increases the risks involved in negotiating and undertaking a capital raising initiative as it is very difficult to keep discussions confidential. Any leaking of news of an impending

raising will at the very least scare buyers away from the market, which always lead to a softer share price.

- Unfortunately DD is now a necessary evil, especially if there is not a relationship of knowledge and trust already existing between the broker and the company. Keep relationships strong at all times, not just when raising capital.

E. Tactics in the Negotiation of a Raising

1) Timing of a Road Show

- One of the worst mistakes companies make is to suddenly realise that cash balances are getting a bit low, so they resolve to go on a road show to raise money. Investors can see them coming a mile away and the game of cat and mouse starts as soon as the plane lands.
- Is it a deal-based road show or non-deal based? It takes 30 seconds to look at what a company's cash balance is, and what the expected expenditure is for the next quarter. Is it confidential that a company is looking to raise money? Only to a blind man. Yet, companies often foolishly deny that they are raising money and guess what, they go into a trading halt within a few days and bang out a placement.
- As far as investors are concerned, hosting a presentation from a company on a road show is almost guaranteed to cause the investors to back off from going on-market to purchase, even if they like the story. It can actually hurt the share price until there is greater clarity about what the true intentions of the company are. Why pay market price when you can hang out for a 10-20% discount in a placement.

2) The Negotiation – Keep it Short

- Extended negotiations with brokers are not a good idea. The longer it takes the more likely the price will drift lower and a company will end up suffering as a result.
- A classic scenario from times gone by, as quoted by clients companies of a London broker, goes something like this;

  - The Company: We want to raise $5m at 25¢
  - The Broker: But the share price is 27¢. It is too tight.
  - The Company It's been trading at 27-30¢ this week.
  - The Broker Maybe, but it's still too tight.
    I'll tell you what, we will do it at 22¢
  - The Company That is way too cheap.
  - The Broker Why don't you think about it over night.
  - The Company Ok, but I will still think that 22¢ is still too cheap.

The next day the shares are trading at 23¢.

- The Company: Alright, we will do it a 22¢.
- The Broker Hang on, the market has moved. We can do 20¢

And so the negotiations continue.

Now, the rules are supposed to stop this happening now, but the message is still the same. A quick deal is a good deal.

- **3) Funding for a Specific Purpose**

  - The Samantha/Samson Example

  For one of the most successful exploration teams I have seen, go back to the 1980s when the Peter Allchurch and David Mueller team was working for Samantha Exploration and Samson Exploration. Peter was the deep thinking, hard-nosed geologist, while David, also a geologist, more adept at promotion.

  The guys would generate or option a prospect that often needed a round of drilling to take it to the next level. They would take it on a road show to the east to generate some interest with a well-articulated story. The brokers would get excited about the possibilities but they needed to get set. They needed to have some skin in the game. While it was possible to go into the secondary market to buy stock you would usually find that buying pressure would make the share price rise before anyone got set properly. That increased the risk for the punters.

  So, there was a smarter solution. The company would do a small placement to cover the cost of the drilling program, and then some. It was a win-win for the company, the brokers and his clients;

  - The broker managed to write a 5% commission on funds raised
  - The clients managed to get set in the stock without driving the share price up, and
  - The Company was able to fund the work program without running down its cash balances.

  Further,

  - There was heightened speculation running into the commencement of drilling such that turnover would increase in the market, giving better liquidity for the people who took the placement to trade out according to their level of risk appetite.
  - The increased volatility that coincided with these events is one of the essential ingredients to encourage punters to come in to the market
  - The availability of funding with this strategy enabled the companies to efficiently explore and turnover prospects on a regular basis. If they made a discovery, then everyone was happy. If they were unsuccessful, then they moved on to the next idea.

- Shareholder knew that the directors weren’t going to be flogging a dead horse. If they couldn’t show quick value from the drilling they would drop the project and move on. It was all about having a go.

F. Smart use of Options

1) Why use Options?

- To assist in raising money, as a sweetener
  - Encourages traders/punters
  - Holds back head share price
- For loyalty reasons
- To avoid discounting head share price

2) Tactics with Options

- Never give them away for free
- But maybe different with an IPO
- Stager the exercise price
- Capture time premium for the company
- Keep ratios of options shares low e.g <1:8 (except for IPOs)
- Consider pressure at exercise dates

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There is much more than can be said on how to handle capital raisings, but time is short.

Just remember, if a Company’s CEO isn’t on top of this task, he might not be in the job very long.