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The Prospect Generator Model: A Primer for the Lay Investor

A Monday Morning Musing from Mickey the Mercenary Geologist

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Analysts, newsletter writers, brokers, fund managers, and savvy investors big and small all seem to love the prospect generator business model for junior exploration companies. I am no exception but my love is conditional and I don't spread it around too much.

A prospect generator / joint venture company shares its risk by partnering with other companies that invest their capital and move exploration projects toward development and production.

Prospect generators are not a rare or endangered species. There are many listed on the Toronto and Venture Stock Exchanges. However, I follow only a few of these companies. The reasons are always the same: They fail at least one of the Mercenary Geologist litmus tests: Share structure, people, and projects.

Let's examine what a prospect generator does, how the model works, and set it within the context of industry practices, standards, and terms.

A prospect generator generates new projects with reconnaissance (also called grass roots, generative, or greenfields) exploration programs. Costs are low for these companies because the work involves basic geological research and compilation followed by field geology consisting of sampling, prospecting, and mapping of targets. Successful prospect generators rely heavily on talented and tough field geologists, geotechnical crews, and support staffs.

To enhance the odds of success, exploration programs are conducted in frontier geological terranes. A frontier terrane is defined as one where geologists have not explored extensively in the past or have developed a new exploration concept.

In the current boom a frontier terrane often is located in an "emerging market country" ([Mercenary Musing, May 18, 2009](#)); that's a politically correct way to say Third World. Because these locales can be remote and inaccessible with little infrastructure, difficult terrain, and challenging climates, the cost of logistics, mobilization, and field support can be the largest budget expense for a prospect generator.

Once a significant prospect is found and land acquired, the prospect generator seeks another company to buy a portion of its prospect for a negotiated price thru a joint venture agreement. To earn its joint venture

interest, the purchaser will pay cash, stock, or a combination of both in staged payments and commit to spend a substantial sum to explore the prospect over a period of time.

Although terms vary widely, the prospect generator usually relinquishes ownership majority, ranging from 51% to 70%. Since it has the requisite geological staff with expertise in the area of interest, the prospect generator often is designated the “operator” during the time that the purchaser is earning its interest. It is paid a management fee of 10% of the exploration budget for providing these services.

Once the purchaser earns its initial interest, it may have the option to earn another incremental interest by spending more on exploration, feasibility, and/or development. At some point, perhaps at 70 or 80% earn-in, the prospect generator must fund its share of exploration and development or be diluted to a royalty. The standard metal industry royalty is termed a Net Smelter Return or “NSR”, which is the gross proceeds from sale of the mineral product less transportation charges to the refinery or point of sale. NSRs vary but 2% is a common industry standard. There may be a set price buyout clause for the NSR or a portion thereof.

Good prospect generators have a stable of prospects in joint ventures and others in various stages of prospecting, exploration, and development. For the companies, it is not only necessary to develop quality early stage prospects but also generate a quantity of prospects.

This is because the chances of targeting and finding a prospect, exploring a project, developing a deposit, and operating a profitable mine are very low. It is best to have a cadre of prospects and spread risk over many projects to ensure eventual success.

When applied correctly, the business model is successful because it allows a junior resource company to continually generate a number of prospects, entice other companies to spend money exploring and developing on its behalf, maintain low administrative expense and burn rate (i.e., no expensive drill programs), hoard equity capital, and preserve a well-managed, tight share structure with a low number of shares outstanding.

There are many variations to the simple generator-joint venture model presented above.

Some companies function as *project* generators. In this model the company acquires raw prospects, drill-ready projects, and/or advance exploration projects and upgrades them by a round of drilling before seeking a partner. Some project generators own drills and employ or contract drillers and support staff.

The upside is the joint venture sale price is higher for an advanced project and the generator can attract top tier juniors and mining companies; the downside is that some projects will not be upgraded and working capital is burned much faster with drilling. Since more equity raises are required, it is more difficult to maintain a low number of tightly held shares over a long period of time.

Others choose to develop *strategic alliances* with mid-tier or major mining companies. In this model, the prospect generator has previous experience and/or a reconnaissance database in a particular country, region, district, or deposit type with strong exploration potential. It sells an interest in the reconnaissance project for a private placement investment by the mining company and a substantial commitment of dollars for exploration over a period of time.

The mining company becomes an exploration partner and holds a significant number of shares of the junior company. The junior uses the miner’s money to fund its share of the exploration program. In developing countries, world banking organizations (e.g., International Finance Corporation) and/or

sovereign wealth funds may take an equity stake as a means of investing in the economy and business development of the host country.

Other companies are *development* generators. In this model, the generator acquires advanced exploration and/or development projects, sometimes at contrarian times and low prices in the commodities cycle. When markets improve, it spins them out as flagship development projects to exploration juniors or to mining companies that have operations acumen. The company may retain a small minority interest or a royalty. More working capital is required for initial purchases than the early-stage prospect or exploration project models but the proceeds from joint ventures or sales are significantly higher, often in the tens of millions of dollars.

The prospect generator model will succeed only if there is something to be found by modern exploration techniques within a reasonable time frame and exploration cost. It is critical for the prospect generator to choose a permissive geological terrane and develop compelling prospects.

Examples of failure abound in our business because a company did not choose wisely.

Some prospect generator juniors have the requisite share structure, experienced people with positive track records, and a treasury well-stocked with cash and equities but they picked wildcat prospects in the wrong part of the world of geology.

Reasons for failure include: The selected terrane is mature as an exploration province, it has little potential for ore grade outcrops or shallowly buried deposits, and/or the targets require deep and expensive wildcat drilling (e.g., 600 meters of gravel cover in Nevada).

Another common mistake is picking a country or a region with unacceptable geopolitical risk. Venture capital will flow where risk is perceived as lowest for the highest potential reward.

Choosing a country with a friendly, stable government, honest business culture, rule of law, desire for foreign investment, security of mineral tenure, support of the local people, and acceptable environmental and permitting regulations is not easy but is essential for a prospect generator.

The task is doubly difficult because geopolitical risk is a wild card that cannot be accurately predicted. A good risk/reward scenario today may become a very bad case tomorrow. There are numerous examples of countries coming in and out of favor with venture capital investors during the current commodities boom, now in its seventh year, and undoubtedly that will continue.

As with all companies in our business, many prospect generators fail due to incompetent management. I wrote about geologists and their shortcomings as CEOs last year ([Mercenary Musing, September 21, 2009](#)).

The prospect generator model is flavor of the year, largely because lots of analysts and newsletter writers (including yours truly) have said so within the past year. So as more CEOs listen to the message time and time again, more and more juniors will adopt the model as a corporate philosophy and a greater percentage will fail.

Others go under because they pick the wrong commodity or the wrong timing for that particular commodity. Acquiring millions of hectares of moose pasture and muskeg in geological basins in the far north of Canada for uranium and attempting to joint venture these lands in 2007 was not a viable business plan.

You, the lay investor, know that I love my career, this business, and the educating and mentoring parts of it. However, it's always necessary for me to be candid with you. We must keep in mind that 95% of juniors eventually will fail. My job and yours alike is to pick companies for speculation with the right share structure, people, and projects at a time they are undervalued.

The average life span of a junior resource company is five to eight years before the company dilutes itself beyond viability, drills and kills its projects, changes direction, rolls back, becomes a shell, installs new management, reincarnates as a different entity, gets delisted, and/or goes bankrupt.

The goal of the prospect generator is to preserve capital and avoid share dilution by spending someone else's money to explore and develop its projects. If done effectively, the company increases its life span and generates significant cash flow from its minority working interests, royalties from mining projects, or the outright sale of a project to a developer or miner.

A company successfully implementing this model can grow old without becoming, in the words of Jerry Garcia, "*Old and in the Way*".

The well-run prospect generator resembles the Energizer Bunny: It just keeps going and going and going. By monetizing its projects, a prospect generator can achieve a zero sum balance between incoming cash and tradable securities versus outlays for general, administrative, and exploration expenses.

The prospect generator is built for the long haul. Time is on its side and given time, success likely will come and shareholders will be rewarded.

Folks, now you see why the pros in our microcap junior resource business love prospect generators.

I presently cover a worldwide gold and copper prospect generator and a uranium development generator in the western U.S. Each has monetized significant assets in the past year. In the near future, a venerable North American prospect generator will be added to my list of sponsors.

Please stay tuned.

Perhaps you, the lay investor, will want do your own due diligence and research the merits of prospect generators as speculative investments.

For a list of companies I cover in my newsletter, interviews, and speaking engagements, here's the link: [Mercenary Site Sponsors](#).

Ciao for now,

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Mickey has worked for junior explorers, major mining companies, private companies, and investors as a consulting economic geologist for the past 22 years, specializing in geological mapping, property evaluation, and business development. In addition to Mickey’s professional credentials and experience, he is high-altitude proficient, and is bilingual in English and Spanish. From 2003 to 2006, he made four outcrop ore discoveries in Peru, Nevada, Chile, and British Columbia.

Mickey is well-known throughout the mining and exploration community due to his ongoing work as an analyst, newsletter writer, and speaker.

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