Michael S. (Mickey) Fulp
M.Sc., C.P.G.

MercenaryGeologist.com
contact@mercenarygeologist.com

Takeover or Takeunder? That is the Question.

A Monday Morning Musing from Mickey the Mercenary Geologist

Contact@MercenaryGeologist.com

December 26, 2008

Happy Boxing Day, Canuck fans. Speaking for my fellow Americans, we will never cease to be amazed at your quaint colonial traditions. Since we rebelled against all that stiff upper lip British monarchist crap and feudal lord of the manor with a servant for every task who knows his place in life biz (well except for Alexander Hamilton whose banking principles are to blame for the current depression), there is not much understanding below the 49^{th} about Boxing Day and that it is actually about *boxes*, eh?

Most Americans think it must be some sort of pugilistic fest, perhaps something on the order of Frank Castanza's airing of grievances and his subsequent scrap with George during their celebration of *Festivus*, a holiday for the rest of us.

But it does not make a lot of sense to halfway work the day after Christmas or bother to open the banks, stock, and commodity markets. I commend you, fellow hockey fans, for taking the day off.

Props to cold weather Habs and down a Spicy Caesar for me.

With that intro, let's get down to skin and bones.

In my opinion, the stocks that will perform well in 2009 will be gold producers with positive cash flow and low debt, those juniors nearing gold production with access to project financing, and those with significant gold deposits that are takeout targets by larger companies or merger candidates amongst equals. Gold companies that meet these criteria are badly beaten down with current market valuations and in many instances, are trading at less than their cash in hand.

2009 will be a year of severe demise, failure, and bankruptcy in the junior resource market. Many juniors will not survive to see another. However it will also be one of opportunity for select companies thru mergers, acquisitions, consolidations, and multi-company business combinations.

However, it is a veritable mine field out there for investors, even the most savvy and astute. Careful is our word for the day. Due diligence and thorough evaluation are required to profit from this unitization of precious metals explorers and miners.

Let's consider four recent takeovers in our business as examples:

Kinross (K.T) took out Aurelian Resources (ARU.T) in late July with a friendly $1.2 billion all share and warrant deal. Based on an *inferred only* resource of about 14.0 mm oz gold-equivalent at Fruta del Norte, that equated to nearly $86 per ounce of gold in-the-ground.

Risk factors are enormous in this project including: The geopolitics of socialist Ecuador, a continuing moratorium on exploration and development pending passage of a new mining law (now imminent), no measured or indicated resources, another large drill program required to delineate the deposit and move it into the indicated resource category, a prefeasibility study, high capital expenditures to develop the mine and infrastructure as a greenfields project, socioeconomic conditions and requirements of local *Indios,* a tropical cloud forest environment in difficult terrain bordered by a national forest preserve, and of course, well-organized NGO opposition in that part of the world.

In my opinion, Aurelian shareholders made out handsomely on this deal, at a premium of 63% over the ARU.T share price on the day of announcement.

Yet there was vehement though minor shareholder opposition to the buy-out. Some continue to trash ex-Aurelian management for making the deal without a fight.

But I wonder what price could have been commanded if takeover had occurred five months later in the current "no bid" capitulating market.

Be thankful for your early Xmas gift, new Kinross shareholders!

Another shareholder success story was the concurrent acquisition of Gold Eagle Mines Ltd.'s (GEA.V) Bruce Channel discovery at Red Lake by Goldcorp (G.T) a week later. This friendly deal was valued at $1.5 billion or a 36% premium over the Gold Eagle price.

In this instance, it can legitimately be argued that the acquirer paid way too much for deposit potential with no qualified resource, albeit an excellent target and likely a mine in the making. Various analysts have speculated on a 7.5 million oz gold deposit in sight, giving a buy-out valuation of $200 per ounce. Goldcorp estimated the all-in costs of Bruce Channel, including acquisition and development, at $650 per ounce. That's not exactly in the lowest quartile although it is a brownfields project with low risk.

Goldcorp's trigger finger likely got real itchy a month before when Agnico-Eagle (AEM.T) took down a $50 million bought-deal private placement making it a 5% shareholder in Gold Eagle. They obviously did and do not want competitors in their wholly owned Red Lake camp.

A possible pitfall to playing the takeover stock game came to light recently with London-listed Fresnillo PLC's bid for MAG Silver (MAG.T).

Various analysts have been touting MAG Silver as a takeover candidate for a couple of years with its robust silver-lead-zinc deposit in Zacatecas, Central Mexico and rightly so. But analysts' valuations of MAG.T as a $15 per share takeout with silver at $10 per ounce were unrealistic in the currently depressed market environment. Pundits did not take into account that there was only one buyer out there for MAG Silver *then and now*—Fresnillo. Less than four weeks ago, they made a hostile takeover bid for MAG.T at US$4.54 per share, a 12% premium to the 20 day moving average.

MAG Silver called “foul” and deemed it the *takeunder* bid. A Vancouver analyst called it a “stink bid”.

What will management and shareholders do? And how, you may ask, can such a thing happen?

It happened because there is not and may never be competition from another company in this part of Mexico. The project is in the Fresnillo district; Fresnillo PLC owns the big concentrator and will build another; it’s parent company, mining giant Penoles, operates the smelter in Torreon; it has a 56% majority interest in the project; and it presently owns almost 20% of MAG Silver stock.

Who else is going to bid on it? Would someone out there like to be a proverbial fly in the ointment? Because that’s all you could possibly be. Development of this deposit will proceed if and when Fresnillo sees fit.

The takeunder bid is not surprising to me. I’m just lucky I never took the time to evaluate the company and get on the MAG Silver bandwagon.

This is not a done deal by any stretch of the imagination and will take at least a two more months to play out. It will be interesting to see how MAG Silver shareholders respond to the low ball offer.

Too bad for them that Fresnillo didn’t offer an all share deal. Mina Fresnillo is the world’s second largest primary silver producer and overall, the company is in the lowest quartile of costs at less than $5/oz. The future looks bright indeed for Fresnillo, PLC.

The final proposed acquisition I review happened just last week. To no one’s surprise, the Venezuela government’s preferred miner, Rusoro Mining (RML.V) launched an all share bid for Gold Reserve Corporation (GRZ.T) at a 209% premium to the 20 average trading price. It would give GRZ shareholders over a 30% stake in RML. But the total bid is worth only $61.5 mm on a fully diluted share basis.

The Brisas project holds reserves of 10.2 million oz of gold plus 1.39 billion lbs of copper. Conversion to a gold equivalent using GRZ’s economic parameters gives in-the-ground reserves of 15.4 mm oz gold equivalent. So the Ruskis are offering a measly $4 per ounce of gold *reserve.* There is another 2.3 million ounces gold equivalent in measured and indicated resources.

But is this really a *takeunder* bid or not?

I have a well-stated policy of never naming names when disparaging a company or person. But I always made a caveat that the rule goes out the window when management totally disregards the best interest of its shareholders. I make that rare exception now.

Consider these facts: Gold Reserve announced in May that its construction permit had been revoked by the Venezuelan environmental ministry. In early October it announced sale of $43 mm in mining and milling equipment slated for the project for cash and settlement of remaining debt on said equipment.

Therefore, I would surmise that Gold Reserve’s management has given up on ever developing the project.

And for good reasons: Capital expenditures to production are estimated at $731 mm. Where in the world of capitalism are they going to find an institution willing to fund a project of this magnitude located in the land of *Chavistas*?

An official from the Venezuelan ministry of mines said last week that the state is taking over gold production in the Km 88 district. He called for the creation of a government joint venture with Rusoro that will be responsible for exploration, mining, marketing of gold, and building of infrastructure.

I expected Gold Reserve to resist the bid, but to this analyst's surprise, Gold Reserve management has chosen to file a *$550 million* lawsuit alleging, among other transgressions, that RML sneaked onto their *walled* compound and stole core samples!

Don't you just love that, GRZ shareholders? Your management, after spending some $230 mm of your money since 1992 on a still undeveloped project, has decided that your working capital is better spent on a protracted proxy battle and paychecks to Bay Street lawyers, bean counters, advisors, consultants, and court costs.

Km 88 has been a veritable Bermuda Triangle for 20 years for all Canadian juniors, most notably Crystallex (KRY.T) and Gold Reserve.

At some point don't you just give up, walk away, and give your long-suffering shareholders a chance of seeing a major mine developed by the previously announced Venezuelan government's preferred strategic joint-venture partner, Rusoro Mining?

As these four examples illustrate, I readily admit that the potential acquisition game is often a tough one to analyze.

Acquiring companies can act for a variety of reasons including cash flow or production growth, securing reserves and resources for the future, lowering costs of production, maintaining or securing control of a district, region or country, buying smaller undervalued companies at opportune times, buying a cash position with stock (e.g., Fronteer Development's share bid for Aurora Energy, a U3O8 takeunder), or securing a strategic mineral commodity (Belgian-controlled George Forest International's private cash acquisition of Forsys Metals, a U3O8 takeover at a 55% premium). I'm sure we could add to this list.

Perusal of the Fronteer-Aurora deal looks like a "more working capital than market capitalization scenario", aka a company trading at a discount to cash. There are many Canadian juniors trading well below their cash breakup value at present.

These companies, especially if liquid, can be subject to "smash and grab" tactics whereby a suitor gradually and systematically acquires shares in the company in the open market at lower and lower prices by driving bids down, becomes an insider at 10%, continues to quietly acquire until just less than 20%, then makes a cash buy-out offer to shareholders for money in the bank. The remaining shareholders then have a choice of taking the depressed price offer or allowing management to fritter away the kitty by fighting off a hostile takeover, continuing to pay themselves salaries and management fees, and/or spending more dollars on marginal exploration prospects.

Result: The company exists no longer, the suitor owns a shell and makes good money on his cheaply acquired open market shares, and the mis-management and bad projects go by the wayside. Many longtime shareholders will simply write it off as a tax loss.

Such is the beauty of Darwinian capitalism: Eat or be eaten.

When choosing *takeover* candidates and avoiding those that may become *takeunder* acquisitions, I think the most important criterion should include those companies with the following characteristics:

- Economically robust flagship project.
- Geopolitically stable jurisdiction.
- Established brownfield camp with more than one operator.
- Good exploration upside to the project.
- Strong experienced management dedicated to the best interest of the shareholders.

The latter might be the most important criterion of all as we retail shareholders are usually at management and directors' mercy.

Finally, choose those companies with many potential suitors and where a bidding war is a possible or even a likely scenario.

I revealed two of my favorite *takeover* targets in recent interviews with AuReport.com and EnergyReport.com. I invite you to read about them and see what you think.

Note that I am a shareholder of both and am therefore unabashedly biased.

Otto sez: DYODD, dude.

Ciao for now,

Mickey Fulp
Mercenary Geologist

The **Mercenary Geologist Michael S. "Mickey" Fulp** is a Certified Professional Geologist with a B.Sc. Earth Sciences with honor from the University of Tulsa, and M.Sc. Geology from the University of New Mexico. Mickey has 30 years experience as an exploration geologist searching for economic deposits of base and precious metals, industrial minerals, uranium, coal, oil and gas, and water in North and South America, Europe, and Asia.

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.

Contact: **Contact@MercenaryGeologist.com**