Interview with David Harquail, CEO of Franco-Nevada Corp.

The Business Secrets of the World's Most Successful Gold Company

David Harquail joined well-known investors 'Lucky' Pierre Lassonde and Seymour Schulich in 1987, when Franco-Nevada was just getting its legs. He's been with the company ever since, currently serving as CEO. The company is now one of the largest companies in the mining sector, with a market cap of around $8 billion.

Franco-Nevada Corp. is the largest holding of the Sprott Gold Miners ETF (NYSE: SGDM). As of November 24, 2014, the ETF had a 16.88% weighting in Franco-Nevada Corp., which is subject to change. For more information and disclosures, please visit www.SprottETFs.com.

What led you to be interested in the royalty and streaming business model, and how did you first get involved with Pierre Lassonde?

I joined Pierre Lassonde and Seymour Schulich back in 1987, a few years after they founded Franco. It was just two years after their first royalty investment at Goldstrike. I've been associated with them ever since. It's been a long history and a great ride.

At the start, Pierre was running mining investments at a firm called Beutel, Goodman and Co. Seymour Schulich was the main oil and gas investor at our firm. My background was in geological engineering and I was hired to help with due diligence on the mining investments. We were successful and had a great reputation in the resource sector and great performance, but I also learned a number of things from looking at these investments.

One of the important lessons was to understand what it meant to invest, or rather speculate, in exploration. Exploration prospects have 1 in a 1000 odds of becoming a mine development project. But even development projects, those 1 in 1000, had challenges. We found that the market really underpriced the risk associated with mine developments. When the capital to finance mine projects was coming in too cheaply, it wasn't really the greatest place to invest to generate a return.

What always attracted us about the mining business was that every once in a while you would have one of these spectacular discoveries – a Hemlo, a Yanacocha, or a Goldstrike – where only a few holes could create billions in market value overnight. So, the question was 'how do you expose yourself to these great value accretion events without taking on all the risks of speculating in exploration or mine development?'

The idea came from the oil and gas side of our investment business – Seymour was already active doing royalty oil and gas trusts. Why was no one collecting royalties on the mining side of the business? So he proposed the idea to Pierre. It was one of the strokes of tremendous luck – and it's why we call him 'Lucky Pierre' – the very first royalty investment he did with this new concept was in 1985 on a property called Goldstrike in Nevada, run by Pancana and Western States Mining. It was a very small mining operation but the formula was quite simple. We could get our money back from the royalty investment, with a small return, from just the existing mine. But there was excellent exploration potential, because some holes drilled at depth showed that there could be something bigger.

We said 'let's see if we can get exposure to that exploration potential for free, and in the worst case scenario we will get our money back.' And that's been our formula ever since. Goldstrike was a company-builder for Franco-Nevada. A $2 million investment will generate over $1 billion. It was a clear example that exposing ourselves to geologically prospective properties and letting other people do the exploration and development could be a real winning formula.

I have been doing this with Pierre now since 1987 and we have expanded the portfolio to over 380 royalties and streaming interests both in mining and oil and gas. We have 47 producing mines in our portfolio that are generating returns today. There are another 35 projects that could be producing mines within the next 5 years – although not all will make it in that time. Our philosophy is to just keep adding wherever we see geologically prospective land where we can have a long-term option on that exploration.

Today, our land exposure is approaching 12 million acres, which is bigger than the size of Switzerland.

We then wait for the equity market cycles to fund the exploration and development on our properties; after 30 years we have proven this can be done successfully both in bull and bear markets.

You mentioned that the odds were 1 in 1000 in exploration, but you've said in prior interviews that your rate of new discoveries is around 1 in 20. How do you get to those superior numbers?

We're not buying upside to raw exploration properties, but to resource projects where we can estimate that we will get our money back in a given time period. We're not worried about the greater return that we might get on them, just on whether we are going to get our money back. What we want is the upside for free.

When you look at mine developments, you find that half of them never recover their capital. Less than 1 in 10 and closer to 1 in 20 are successful great mines, and they tend to be the world-class projects that have a larger number of ounces than forecast. If not everything works as planned in the feasibility study, there are more than enough resources and ounces to compensate.

This situation hasn't changed much from when we started in the 80's. It is exactly what's panned out in our exploration portfolio.

When there is at least a resource known on a property, you know that there will be an incentive for the owner to maintain the property and invest further risk capital to advance it.

For earlier-stage properties, we look for geologically prospective trends. We are always keen on land in the Carlin or Getchell trends of Nevada, the Destor and Kirkland Lake or Detour belts of Ontario. When there is cash from investors available for exploration, these tend to be the properties that get explored first.

Just these simple steps improve our odds a lot. Our experience is that 1 in 20 of these types of assets can become a great performer, like Goldstrike, Detour, Duketon, Tasiast, or Stillwater, which have turned out to be significant major finds beyond what we initially invested in and paid for. We got all that upside for free. That's where the 1 in 20 comes from.

So you're looking at small discoveries that could surprise and turn out to be big or massive discoveries?

That's right, and we don't know where the great discoveries are going to be. Part of it is a game of numbers, getting as much exposure to good land and geological trends as possible. That's why we're willing to do very small deals. We'll do property deals for as little as $125,000 dollars, which we did a couple years ago at Eastmain in Quebec, to up to a billion dollars, like our Cobre Panama investment. We can do the small deals because we put them into our inventory and there's not a lot of maintenance after that. We just track them to see if there is any discovery or development plan going forward. At some point we may need an auditor to make sure we get paid the right amount, but it's a very scalable business.

We have to be very patient. For example, we did the Detour deal back in 1997 with a 2 million-dollar advance. We just started getting our royalty checks about a year and a half ago. Detour has the potential to generate between 20 million dollars a year for the next 20 to 30 years, but we had to wait 15 years for it come into production. But for these types of wins we can afford to be patient!

We've got the structure in place where we can ultimately take our portfolio from 380 to 1,000 royalties. If you have a really long-term perspective in this industry you can do very well, and especially if you're buying when assets are being sold in a downturn. That's why I think we can be more successful than the rest of the industry.

You mention that you don't have the same operation risks with projects as a big miner would. Did you experience these risks firsthand while you were with Newmont Mining? What was your role there?

I was the head of the Newmont Capital division with responsibility for business development. It was very challenging being in a big operating company.

There are so many management issues around the world. In the early days of our merger with Newmont we had 23 different operations globally. That meant that, on average, there was a crisis every week at the head office. Executives in jail in Indonesia… Electricity getting cut off in Ghana… The Uzbekistan government trying to nationalize our assets… Riots in Peru. There were challenges all the time. Both the board and management get distracted by these crises and there is no time to think about how you're going to invest for the future.

As a royalty company, we have none of those challenges. If there's a problem at one of our royalty assets, we're the last people that get called. We don't run the yellow trucks. It's the operator that handles those issues. We spend our time thinking where next to invest. That is a huge advantage. Even though I have a smaller team reporting to me at Franco-Nevada than I did at Newmont, I've got the biggest business development team in the world because we're not operating anything. The management focus is very little on the day-to-day results, but on where we are going to invest our free cash flow going forward. That, to me, is a hugely strategic advantage that we have as a business. We can afford to look forward as opposed to managing what we have now. I feel very comfortable to continue to add hundreds of royalties without changing that much about our business.

A lot of mines being brought online over the last 5 to 10 years have come in over-budget and under-performed. Is that typical of the mining industry? Do you always have to expect these types of miscalculations to occur?

The fundamentals of the mine development side of the business have not changed over the last 40 years. A majority of the projects still disappoint. Why does this happen? Partly it's just the nature of how the industry evaluates ore bodies. For a typical open-pit ore body, having 25-meter centers to each drill hole is considered to be extremely dense drilling. It is expensive to drill an ore body to this density. But even then, you're only sampling about 1 part per 345,000 of the ore body. From that you are extrapolating continuity, grade, metallurgy, and hardness. A block that large is never going to be uniform all the way through. That leads to generally unpleasant surprises.

Many investors thought that the introduction of the 43-101 studies meant that there was a higher standard. There was in terms of reducing the numbers of frauds and false promotions. But for majority of projects, from a technical standpoint, we're doing things the same way we did in the 1970's – with 25-meter centers. A lot of projects aren't even drilled to that density. In the primary way that we assess the resources of the ore body, there's a wide range of error. That's why I continue to expect that, until technology changes and we can better assess reserves, we're likely to continue to have a wide range of outcomes for mining development projects.

Today's generation of investors have forgotten many of 'rules of thumb' that used to work for this industry. Right now, the financial markets are financing mines generally at the tops of the commodity price cycles. In the 1970's, there seemed to be a good acceptance that any new project was going to have its challenges and that you were never going to get the price cycle right. To compensate, the rule of thumb was to make sure that your reserves were a multiple of what was needed to cover payback. And you wanted to have a long life operation rather than maximize Net Present Value (NPV), simply to give more time for eventually catching a good price cycle. Those rules of thumb had a lot of wisdom. Investors have gotten too focused on NPV, Internal Rate of Return (IRR), leverage and other measures that don't reflect the uncertainty of these projects.

Juniors and miners have a variety of ways to raise capital, the most frequent being to simply issue new shares. What do you think makes Franco-Nevada's capital an attractive alternative from the point of view of shareholders in those companies?

Franco-Nevada is simply another source of capital. Each company and their shareholders have to make a choice about what is the right way to raise capital and it varies with the overall market. Right now, royalty and stream financing is getting much more attention because equity financing is more difficult and potentially much more dilutive.

The best way to think of royalty or stream financing is as something between debt and equity. For a company to take on debt there is solvency risk if the project doesn't go well and they can't make interest payments. There is also a stringent covenant package and many fees. Royalty and stream financing tends to be one-stop, much simpler, and the royalty company shares the downside risk of commodity pricing or delays in production. For a company to issue new shares, there tend to be commissions, discounts to the share price, warrants and other costs. With a royalty or stream, the dilution is limited to a single project, and that can be adjusted downward over time.

When we buy into a project, it is because we have done enough work to believe not only that the project will work but that there is upside potential beyond that. A lot of our investors recognize that. Often when we announce a transaction, our client companies then find it easier to raise further equity and debt capital.

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