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Mining in Mexico

All eyes are on newly elected President Enrique Peña Nieto, eagerly and anxiously awaiting his stance on mining the sector.

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Cover photo: Endeavour Silver's El Cubo mine, Mexico, courtesy of Endeavour Silver.

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Mexico: an Overview

A new chapter in a long story

Santa Elena overview with original heap leach pad in the background, new heap leach pad, conveyer system and the new mill construction in the foreground. Photo courtesy of SilverCrest Mines.

In many ways, the story of Mexico is a story of mining. 1492 may have seen Spanish conquistadors arrive in Mexico in search of precious ores, but the history of mining in Mexico and its Latin American neighbors dates back well before the arrival of Europeans to the New World. "We have been exploring for thousands of years, but the real mining boom only started 10 to 12 years ago," said Arturo Perea Saenz, president of the Mining Association of Chihuahua (AMC).

Currently the fourth most popular destination in the world for mining investment after Canada, Australia and the US, Mexico in 2013 is on course to match and possibly surpass 2012's $17 billion investment into its mining industry.

During the 300 years of Spanish rule, not only gold and silver but copper, coal, lead and iron also joined the flow of mineral resources back to imperial Spain. However, Napoleon's conquest of Spain in 1808 resulted in a successful struggle for independence in many of Spain's Latin American colonies. While the relatively stable transition to independent government in countries like Chile brought about a natural evolution of the mining industry, the older mining regions (Mexico, Peru, and Bolivia) had more difficulty adapting to independence, in part because they remained too tied to their colonial mining laws and policies, but they also lacked the resources to subsidize the industry.

The seeds of economic modernization began to be laid under the restored republic in the second half of the 1800s. President Benito Juárez sought to attract foreign capital to finance Mexico's economic modernization. His government integrated more liberal policies, which changed the old Spanish mining code (Ordenanzas de Minería) resulting in the granting of subsoil ownership (mineral rights) to landowners. The consequences of these changes broke the old dominance of Spanish and European mine owners, allowing for new mining companies to begin forming in Mexico. Compañía Minera de Peñoles was founded in 1887 with their activities located within the Sierra de Peñoles in the state of Durango. Foreign investment also rushed in to take advantage of the new political and economic climate.

However, the subsequent years saw widespread nationalization of industries in Mexico; after multiple amendments mining was essentially nationalized in 1961 with mining firms legally required to be 51% Mexican owned. This lead to the mass exodus of foreign companies from Mexico's mining sector right through to the late 1990s. In a repeat of President Benito Juárez vision of the 1860s, modern day Mexico has sought foreign investment to revive and advance the industry once again. The new chapter in Mexico's story has brought about a new mining boom, this time dominated by Canada's prominent resource sector.

Arturo Perea Saenz, president of the Mining Association of Chihuahua (AMC).

Despite the sector's significant history, this kind of interest signals the height of Mexico's first real mining boom. "There was a big deficit in exploration for some time, but the laws governing the industry have changed significantly over the last few decades," said Mesabi distributor L&M's managing director Saturino Ramos.

Under newly elected President Enrique Peña Nieto's administration, all eyes are on Mexico DF, eagerly and anxiously awaiting his stance on governing the sector. One of the more controversial revisions to be made to the mining law in Mexico is the expected introduction of a royalty, which until now, has been non-existent. The introduction of a new financial burden for mining firms at a time of global economic uncertainty, and more pertinently a time of severe downturn in mining's financial markets, has certainly caused some debate. Most agree a moderate royalty is unlikely to cause a mass exodus of mining firms from Mexico. However with issues of drug cartel related crime and violence still looming large in Mexico's north, it may be another point against the nation when being judged against other jurisdictions.

The poor equity markets of late are not bad news for everyone in the industry. Despite some volatility, the relatively strong commodity prices in recent years have meant decent cash flows for producing companies, in stark contrast to their struggling pure exploration counterparts. Seniors and ambitious mid-tier firms are scanning the market for top quality properties at low prices from juniors running out of options and running out of money. In an age of global economic uncertainty and widespread risk adversity, Mexico represents a jurisdiction with the cost advantages of a developing nation and at least some of the risk advantages of a much more developed nation. If Nieto's administration is to make the most of the nation's geology, it will need to find the balance between benefiting the mining industry and benefiting from the mining industry.

Nieto's government and Mexico's first mining royalty

On April 25, 2013, Mexico's congress voted in favor of a proposed 5% mining royalty scheme, paving the way for a full vote in the Senate in the fourth quarter of this year. The royalty scheme is part of a larger initiative to improve Mexico's poor tax take, the lowest in the 34-nation Organization for Economic Co-operation and Development (OECD). The mining royalty is just one part of a much broader set of reforms, which includes proposed overhauls of the energy and finance sectors, that Nieto's administration hope will encourage growth in Latin America's second-largest economy.

In looking at Mexico's history, Hermosillo-based lawyer Francisco Javier Lopez Olivas, director general of local techno-legal firm Lopez Olivas & Associates, recalls a silver 'bonanza' in the 1980s, which pushed the price up significantly; when the government imposed a similar fee on silver at the time, it pushed the price back down. "Most countries have a 3% to 4% royalty scheme, and 5% will affect Mexico's relative competitiveness. We must learn from our history that the industry and its investors will look for other countries that offer better conditions to miners when things change," said Olivas.

AMC's Perea worries that more than affecting Mexico's competitiveness on a global scale—which he argues it may not—the introduction of a royalty will harm Mexico's small-scale miners who play an important role in the sector's development. "This fee may not be a lot for the bigger mining companies, but in trying to revive smaller-scale mining, it could make the difference between breaking even and earning a profit. All of the major mines that are currently operating in Mexico were originally smaller mines that grew through foreign investment," said Perea.

One of those growing junior producers Perea refers to is Scorpio Mining, who maintain one producing mine in Sinaloa state, for which the impact of royalties will be significant. "It is not so much a question of whether royalties will come to be or not, nor is there much purpose in trying to fight them, considering that the politicians can lose face at this stage of the process by just abandoning the idea. It is more a question of seeing at what level they may be imposed and under which type of arrangement can their extent be mitigated by companies. There are talks, for instance, that companies would be able to deduct what they are currently investing in social programs, from the actual royalty owed," said Pierre Lacombe, CEO of Scorpio Mining.


Ivan Bebek, president, CEO and director of Cayden Resources.

In relation to Scorpio's operations, Lacombe clarifies the impact of royalties in addition to suggestions of a revision of the labor law. "Certainly increases in Mexican royalties will affect us, and there are changes in the labour law that I believe are coming in place with regard to profit sharing that could also impact us significantly. We are monitoring the situation closely and such potential levies become other items to be considered when running sensitivity analysis before taking a decision to go ahead with specific projects."

Although the royalty is not what any miner is likely to want, many accept that mining royalties are a normal imposition around the world and governments should be judged on the level of such taxes and the business environment in general. "We believe that the Mexican government is very reasonable with the tax increase; although at the exploration stage we still have to consider what implications a mine we might find would be under in terms of taxes and profitability down the road. We enjoy working in Mexico; I think the stabilizing influence could arguably be the historic presence of significant foreign investment, i.e. large Canadian mining companies which are operating successfully. My experience of the Mexican government has been positive, the government respects foreign investment and will discuss any significant proposed change to the mining code or law with the mining industry," said Ivan Bebek, president, CEO and director of Cayden Resources, who hold two properties attracting the interest of the major producers in Mexico: El Barqueño and Morelos Sur.

In addition to Mexico's currently operating mines, there are hundreds of smaller ones that have been closed for decades as other areas of the country's economy took precedence over mining. These mines lie along the same belts as those belonging to Grupo México, Fresnillo, and Carlos Slim's Minera Frisco. Under the ownership of older mining families or single concession holders, many of them lack the funding to resume operations. Though the possible introduction of the royalty has the industry on edge, a positive sign for small-scale miners hoping to develop their concessions is President Peña Nieto's pledge to help restart small businesses across the country. Citing easier access to credit as 'a motor' for job creation and the economy, Peña Nieto has industry veterans hopeful that mining can continue with its true reawakening as old mines are reopened.

While royalties and small business support are at the forefront of the current conversations on the mining law, the issue of ensuring a balance between community rights and investor friendliness cannot be ignored. Enrique del Bosque, partner at DF-based law firm RB Abogados, said: "The greatest challenge any foreign company investing in Mexico faces is dealing with communities; these can be a company's biggest help or biggest hindrance."

A satisfied community, del Bosque notes, can be a miner's best security.

These are not necessarily separate issues according to many on the mining side of this debate; those communities who have to live with mining activity on their doorstep should surely have the most to gain from taxes imposed on miners. "We are optimistic the government does not go overboard in implementing too high a royalty, but we do understand the government needs to account for declining oil revenues. My view is the government needs to look at attracting investment in the oil sector versus trying to collect additional taxes from mining. But unfortunately, governments tend to attack mining because of the incorrect view that mining is a dirty business. They forget or overlook the importance of mining in regions of the country that would otherwise have no opportunities for work. We think it makes sense to keep the money in the local community, so if the royalty does get put into place, any investment made in the local community should be deducted against that royalty. That will force companies who are not investing in the local communities to invest in them and any excess amount will then go to the federal government," said Keith Neumeyer, president and CEO of First Majestic Silver, which maintains five mines, producing 11 million oz of silver, in addition to six exploration projects in Mexico.


Keith Neumeyer, president and CEO of First Majestic Silver.

As it stands, socially responsible mining companies invest a great deal of money and time into assisting communities around their properties, be it through medical care, education, infrastructure or general economic development. However, this is not purely altruistic on behalf of the miners; community relations can make or break a mine in this part of the world. "The new government has introduced for discussion a bill including a new royalty. We will have to wait and see how the discussion evolves. While this would be an additional cost to the operation, it is encouraging that 80% of the proceeds would be returned to the community. New Gold spends between $750,000 and $1 million on sustainable development projects for underfunded communities each year; we see this as our corporate responsibility and want to leave behind a positive legacy. Our aim is not to help municipalities pay their salaries, but to support road building, electrification, hospitals and education. I have worked in developing countries around the world and seen that mines run into trouble where all the taxes they pay go to the capital city and not the villages," said Robert Gallagher, president and CEO of New Gold.

The destination of funds gained from the mining royalty is not the only question mark hanging over the new policy. Many believe the details and percentages suggested are

A safe way to acquire Mexican mining properties


Enrique del Bosque, partner at RB Abogados.

In accordance with Mexican Constitution and Mining Law, only Mexican individuals and companies are able to acquire mining concessions in order to explore and exploit minerals subject to a concession.

Mexican foreign investment law allows foreign investment in Mexican mining companies with no limit whatsoever. Mexican companies may exist with two or more shareholders, individuals or entities. No Mexican is needed to hold shares, nor to be part of the board of directors or to represent the Mexican company.

When the mining property is identified by a foreign entity, what we recommend is to conduct a due diligence to determine who owns the mining concessions; if the concession holder is an entity and verify its representative faculties to sell assets on its behalf, if it is an individual verify his marital status to determine if his wife/husband must give his consent for the sale; compliance with payment of government fees and if the mining concession is greater than 1,000 hectares, verify if work assessment reports (minimum investments) have been filed before the Mines Bureau; compliance with any environmental regulations; existence or non existence of liens and encumbrances; if the mining concessions are located in a "natural protected area". Additionally to: identify if there are social conflicts for mining activities in the area where the mining concessions are located; if the land over the mining concession is owned by private entities/individuals or if they belong to social entities such as communities/ejidos (first nation holders) or by a municipality. If all the foregoing results are favorable then the next step is to incorporate the Mexican company that will eventually purchase the mining concessions.

The above is the typical way we conduct mining concessions acquisitions on behalf of our foreign clients for their first acquisition in Mexico and is the typical way to do a reverse takeover of a mining property in Mexico to raise money at the stock exchanges by listed companies.

Robert Gallagher, president and CEO, New Gold.

also set to be revised before the final decision in Q4 this year. It is thought that the government is using a 'two steps forward, one step backwards' approach after its initial proposal was put forward at 5% in April. "The proposed royalty program is based on gross earning and it is believed that the initial proposal will be watered down" said David Hottman, chairman, president and CEO, Galileo Minerals.

Imposing the royalty on gross earnings rather than profits is crucial to the smaller mining operations. John Brownlie, CEO of newly producing Marlin Gold Mining said: "As it stands, we are expecting 5% of EBITDA, which would not represent the full 5% for start up producers. For Marlin Gold this would represent approximately 3.5%."

Overall the vast majority would agree that the Mexican government is very unlikely to take a decision that will push the mining industry to the point of leaving, especially considering the strength of Mexican mining firms active in the market. The proposal put forward in April was perhaps to gauge the reaction of the industry and most will be expecting a more modest figure, "Santacruz definitely expects fiscal changes and has factored them into its models. However, I do not foresee anything above a 4% tax on revenues. Moreover, the government intends to reinvest these earnings in communities, which may offset some of our own spending. As the tax will also vary with commodity prices, I do not envisage it being a problem for the industry – and, in a country like Mexico, it is our responsibility to support social development," said Arturo Préstamo Elizondo, president and CEO, Santacruz Silver Mining.

Indeed few would begrudge the Mexican government for applying a royalty regime like those we see in many jurisdictions around the world, however the timing could be better. Still in the midst of the global economic downturn, any type of tax is sure to be met with a certain amount of trepidation, and with over 70% of exploration dollars coming from the ailing Canadian mining exchange we can expect a few extra moans and groans. "The timing of the introduction of the mining tax is not ideal due to the uncertainty in the global mining sector. However the introduction of mining taxes is becoming common around the world; governments are seeking to increase funds and the resource sector is an easy target," said Ian J. Stewart, vice president mining division for EBA, a Tetra Tech company.

Finance: The bear essentials

In tandem with the development of Mexico's mining boom, the global economy has been in the throes of a major financial crisis. While Mexican mining houses continue to invest and expand, the Canadian juniors that make up the majority of foreign presence in the country are more bearish than their local counterparts. With silver, gold and copper prices marginally down from recent peaks, investors are understandably hesitant to put more money into the ground, a sentiment that can be seen in the high number of drilling rigs currently sitting idle around the country.

Despite the recent volatility, the long-term outlook for commodity prices looks bright. Chinese growth rates may be easing under the more risk adverse strategies of a once in a decade leadership change, but this is still relative to a considerable base of expectation. Furthermore, the impact of China's slowdown on commodity prices should be mitigated by the continued emergence of large developing economies such as Brazil, India and Indonesia.

Cycles in the financial world of mining may be commonplace but the fundamentals of this downturn are perhaps a little less traditional. "There are many variables on the reasons for the downturn. The correction in 2008 and 2009 saw the leading stock exchanges at their lowest points, since then we have seen the Dow, for example, slowly and progressively grow to recent all time highs. Whereas the venture market in Toronto which also experienced a difficult period in 2009, recovered within a year. The Vancouver market was living in a bubble for 2010 and 2011, when seemingly unlimited amounts of money were being raised; it was one of the few cities in the world where you did not feel the recession," said Grant Block, managing partner of Davidson & Company, a Vancouver based firm that provides more auditing of junior mining companies than any other accounting firm in Canada.

Experienced junior miners can take a more pragmatic approach to the downturn, calling on the long history of cycles to find the dim light at the end of the tunnel. "We have been around long enough to see a few cycles and this one is bound to turn around. The big markets are setting all-time highs, which usually mean they look for weak sectors like ours to invest in. At some point people will look at mining and exploration and conclude they are undervalued," predicts Gary Cope, president and CEO of exploration firm Orex Minerals, who in 2013 sold off sister company Orko Silver and its outstanding La Preciosa property.

The mining industry has become accustomed to outperforming the wider equity markets over the last decade, but that had to change eventually. Although, if you would describe the steady slide in mining stocks during 2012 as causing some concern, then the 20% plunge mining stocks took in the first quarter of 2013 caused widespread panic. "Significant value has been destroyed by companies in this industry over the past 20 years. This chronic underperformance has resulted in capital markets turning their back on our sector and opting for different exposure to precious metals, such as exchange traded funds (ETFs). It is our mission at Coeur Mining to mitigate risks and maximize returns so stockholders can once again feel comfortable owning our stock," said Mitchell Krebs, president and CEO of US based, NYSE and TSX listed, Coeur Mining.

Regaining investor confidence is vital and will depend not only on macroeconomic circumstances, but also on how the industry responds to rising costs, increasingly volatile commodity prices, and other challenges such as community relations and resource nationalism. All of these elements will factor into investor assessment of potential returns, which is of course the bottom line. "The appetite for financing of exploration is a function of returns. In the last year or two we have seen a long drifting down of the Vancouver market, but I think we have reached the bottom. I believe the US and Asian economies will recover quicker than anticipated which will help to spur the junior

La Encantada underground drill. Photo courtesy of First Majestic Silver.

Grant Block, managing partner of Davidson & Company.

market, however the European economies are likely to take longer. At this point I do not see much downside risk and I anticipate more consolidation. Also, the prices of many properties have not yet been adjusted from their high values in 2010 and 2011; we will likely see many more properties being acquired soon" adds Block.

Predictions are rife on the timescale of the anticipated upturn in the junior market. The questions circulating among Canada's business centers are, how many exploration firms will survive? What is the future for Vancouver in the global mining industry? And increasingly, what can the TSX group do to help smaller companies through these difficult times? "I would say that the rules, regulations and the fees placed upon this industry need to be revised. Mining is very heavily regulated and perhaps a system should be put into place which takes into account different tiers, where lower-tier companies have a set of regulations that are not so costly. There is a fear that Vancouver could lose its status as the number one junior exchange in the world to Australia or elsewhere," said David Wolfin, who previously worked on the floor at the Vancouver stock exchange, and is now president, CEO and director of Avino Silver and Gold Mines, one of the first Canadian mining firms to enter the Mexican market with a 49% stake in 1968.

While TMX Group is endeavouring to help support juniors through the listing process, the depression currently afflicting mining markets is a cause for concern for many small-cap juniors, no matter which jurisdiction their projects are in. Many analysts at Toronto's Prospectors and Developers Association of Canada (PDAC) in March were pessimistic about the prospects for junior players. "This is an extremely grim time," Don Coxe, a BMO investment strategist, financial historian and a 40-year industry veteran told Canada's *Globe and Mail*. "As a matter of fact, it is the grimmest I can ever remember."

Junior explorers

The have nots

Diamond drill rig at the Coneto silver-gold project, Coneto de Comonfort, Durango State, Mexico. Photo courtesy of Orex Minerals.

"The worst it has ever been" is a term you hear often from mining executives in their offices in Vancouver and Toronto. Making up more than 70% of Mexico's mining exploration dollars, Canada's pessimism is echoed in the board rooms of Hermosillo, Chihuahua and Mexico City. A function of this gloom is unrealistic share valuations, according to Tammy Thompson, partner at BDO Canada in Toronto. "Even as auditors, we cannot understand why some of these companies' market capitalization is so low: they have only had good news and every press release is positive yet their market cap is going down and down," said Thompson.

When the financing situation will ultimately take a turn for the better, many are predicting it will swing up with vigor. Currently, however, the key strategy for a depressingly large number of juniors is simply survival. When running a company on a shoestring budget and waiting for traditional financing to turn around, it is only a matter of time before you trip up. The more proactive junior miners have long been seeking alternative sources of financing. The debt market offered mining companies extremely attractive terms in 2012, and they responded by issuing a staggering amount of it. Canadian miners sold $15.6 billion of debt in 2012 (including convertible debt). That compares with $9.4 billion in 2011, and just $5.5 billion in 2010.

Another alternative to the brokerage community is through private investment. Those with good assets and social skills have been campaigning full-time in order to maintain their status or, in some cases, actually progress their projects. "The actions we are taking with the project mirror our expectations in the market; for example, raising our capital through private investment rather than the brokerage community. I believe the market will continue its path towards recovery for the next year or two, in which time I would expect continued consolidation in the industry," said Stuart R. Ross, president and CEO, El Tigre Silver, who is looking to bring a tailings stockpile into production in order to fund mine construction.

Consolidation is a word heard often in and around the offices of junior exploration companies. There are currently over 1,600 mining firms listed on the TSX and TSX-V, and that is far too many in the eyes of many across the industry. As part of the necessary and natural cycle in the mining markets, many companies will not survive and many will consolidate in one way or another. Through this process, the market will experience a cleansing and we will be left with a strong and more attractive group of companies, ready to woo investment back to the sector. A spring clean in the market may not be a bad thing – the gross quantity of qualified people who should be involved in the industry is insignificant to the amount of people who have been attracted to the industry by the boom. Perhaps there should only be 500 companies on the Venture Exchange," said Marc G. Blythe, president and CEO of prospect generator exploration firm Tarsis Resources.

Drilling. Photo courtesy of Cayden Resources.

The options are few for those without cash flow, while for those companies producing, with what have until recently been very healthy commodity prices, the conditions in the junior market open up a world of opportunities. Struggling juniors with promising assets have become a target for ambitious producers looking to widen their portfolio of projects at knock down prices. "The junior exploration market is in a tough spot; commodities remain at good levels however junior companies are not able to find the financing they need. I would agree with many experts that consolidation is needed and that many firms will have to go under in order to leave a stronger core of exploration companies and therefore a stronger market as a whole. There are too many single asset companies which represent too much of a risk for investors. It is a natural cycle in this industry. At Capstone we see the current junior market as an opportunity. Where previously exploration companies would be able to approach brokerage firms to finance and take their projects into production, the current market allows us to acquire promising properties at relatively low cost," said Darren M. Pylot, president and CEO of ambitious copper producer, Capstone Mining.

Producers

The haves

Rosario mine in Mexico. Photo courtesy of Santacruz Silver Mining.

Producers are discovering many opportunities brought about by an environment of relatively healthy commodity prices and unhealthy exploration financing. When the dust settles, the success stories of this era will be those mid-tier producers who have used the opportunity to pick up promising near-production assets at bargain prices. The trouble, it seems, is filtering through the masses of properties on offer.

Vancouver-based First Majestic is one of the biggest Mexican success stories; celebrating their 10th birthday this year, the firm has experienced a 35% compound annual growth rate over the past nine years. With their focus on silver, First Majestic has amassed five producing mines and six exploration assets in Mexico raising total expected production to 11 million oz for 2013. Despite the strong pipeline of projects, Keith Neumeyer, First Majestic's president and CEO, is not done expanding yet. "I am unsure if consolidation has anything to do with recovery. We have just experienced a 10-year bull market and many of the properties we see in the current market are recirculated properties. We have experienced extended bull markets before and it creates somewhat of a 'used car salesman phenomenon.' It is similar to the high-tech boom in the 1990s, which attracted vast numbers of people to build bogus businesses that were often unable to raise money. The mining industry has a lot of public companies that should not be listed and many properties that should not be in public companies. The market is simply going through a natural process of cleansing, which should of course result in a cleaner group of companies. First Majestic is also taking the opportunity to look at assets in companies that cannot be financed in this environment. Treating it like a 'shopping list,' we study approximately four properties a month and we are finding out how bad many of them are."

In the treasure hunt for top assets, ambitious producers are often being caught up in bidding wars over the most exciting properties. First Majestic was outbid by Coeur Mining for the acquisition of Orko Silver, finalized on April 16, 2013, for the promising La Preciosa property. "With the addition of La Preciosa, we can assume an additional estimated 7 to 10 million oz of production per year, which would bring us up to around the 30 million oz/y producer mark. It would also increase the overall amount of production and cash flow from Mexico, which would dilute the amount of cash flow and production coming out of other higher risk political jurisdictions. From a stock holder's perspective, therefore, increasing Mexican exposure in our portfolio is an attractive step for us to be taking," said Mitchell Krebs, president and CEO, Coeur Mining.

Mitchell Krebs, president and CEO, Coeur Mining.

Such deals can enable junior exploration companies to enter the market themselves, as might be the case for Orex Minerals, Orko's sister company, according to Gary Cope the firm's president and CEO: "Further joint venture activity in the coming years is a possibility. The market is certainly set up for strong juniors with treasuries or stock prices they can use for acquisitions. I would be lying if I said there were not opportunities right now for companies like Orex Minerals to pick off attractive properties which others are unable to refinance. We have identified some projects we may pursue in future, but there is nothing imminent."

Continued heavy spending even on the most interesting properties is not always in the interests of shareholders. Endeavour Silver's chairman and CEO, Bradford Cooke, explained the firm's caution after the additions of the El Cubo mine and San Fernando property in 2012: "Since the acquisition of El Cubo, the precious metal and stock prices have fallen precipitously so no company currently has a strong stock price to

Gary Cope, president and CEO, Orex Minerals.

Geoff A. Burns, president and CEO, Pan American Silver.

use as a currency for a big deal. We plan to finish our turnaround of El Cubo in order to translate that success into a stronger stock. In this weak market, however, the one sector beaten up more than the producers is the explorers and developers, so we actually do have a stronger stock vis-a-vis the juniors. Therefore, we are interested in smaller acquisitions if they are accretive to our net asset valuation. On a broader scale, there was a nice round of consolidation in the market last year with a number of successful acquisitions and we expect this to continue this year."

Despite this wise level of caution, Endeavour Silver is still marching through the ranks of mid-tiers and on to a bright future as a senior silver producer in the coming years: "In three years, I think Endeavour Silver will be a premier senior silver producer, with more than 10 million oz of silver production per year. The path forward involves completing the turnaround and anticipated expansion at El Cubo, capturing more growth opportunities at Guanaceví and Bolañitos, turning San Sebastián into our fourth mine and capturing at least one new discovery, or acquisition that can be put into the growth pipeline for 2015 and beyond," said Cooke.

Growth is not just for growth's sake; mining companies in this economic climate need to work hard to keep shareholders happy and that means returns, be it short or long term. "Pan American is the absolute leader in our sector for returning value to shareholders: our initial dividend was 5 cents a share per annum in 2009, now we are paying 50 cents a share annually. There is no other company in the silver sector that is even close to providing that kind of return," said Geoff A. Burns, president and CEO, Pan American Silver.

In 2012, Pan American Silver ranked in first position for the largest public-company profit gains in British Columbia. The TSX listed firm has followed many others in the market in focusing their efforts on stable but also low-cost jurisdictions such as Mexico. "Just over 50% of Pan American's current silver production comes from our three operations in Mexico: Alamo Dorado, La Colorada and the recently acquired Dolores. Almost three quarters of our profitability comes from these three operations, largely because they are also our lower cost mines. The success of Pan American Silver lies in our operations in Mexico," said Burns.

Geoff Burns' belief and commitment in Mexico is echoed by his namesake at major gold producer Goldcorp. Executive vice president and COO at Goldcorp, George R. Burns is beginning the process of closure at the exceptional El Sauzal mine in Chihuahua, but the future still looks Mexican for the Canadian gold giant. "Mexico is a very significant jurisdiction for Goldcorp, a large proportion of our production portfolio is there and an even larger proportion of our cash flow is derived from it. Mexico has been a stable mining jurisdiction for a long time and we believe it will be well into the future; as a result it will remain one of our primary focuses."

Another firm making big waves in Mexico due to their surge into the ranks of mid-tiers in recent years is Santacruz Silver Mining. Not even two years since listing on the TSX-V, Santacruz is building a reputation for developing projects ahead of time and under budget after their success with the Rosario property. "The management was firmly Mexican and highly experienced; our COO, Francisco Ramos, knows the local industry very well. This helped our supply chains and community relations to run smoothly. Santacruz has a very good relationship with the local communities; they have a very mining-orientated economy, with labor on-hand and knowledge of the industry. The local municipality has a history of mining, dating back to around 450 years ago," explained Arturo Préstamo Elizondo the firm's president and CEO.

This mine building ability is the delight of Santacruz' investors and the market in general. "The investor reaction to Santacruz' development has been excellent. When we went public in April 2012, we were not a run-of-the-mill TSX-V company with only exploration assets as we had one asset fully funded to production and two other mineable assets capable of eventually taking us to 8 million to 9 million ounces of silver equivalent per year with relatively little dilution. Stories like ours do not come along very often," said Neil MacRae, Santacruz' director of investor relations.

Arturo Préstamo Elizondo, president and CEO, Santacruz Silver Mining.

Aside from shopping for and developing new properties, producers are seeking to optimize production and reduce operating costs in an era of rising salaries, fuel costs and diminishing grades. As the fourth most popular mining district in the world behind Canada, Australia and the US, Mexico can consider itself relatively low-cost in comparison, but strong management and local knowledge is essential to control operational expenditure. An example to be followed is the continued success of SilverCrest Mines' Santa Elena mine in Sonora. J. Scott Drever, SilverCrest's president and director said: "Our current cash operating costs are just under $8 per oz

J. Scott Drever, president and director, SilverCrest Mines.

silver equivalent with a projection for 2013 of $8.50 per oz. The main demands on costs are cyanide, diesel, and labor. Market pressures govern cyanide and diesel costs, albeit we do receive some benefits due to our volume uptake. With labor costs we aim to be fair to our employees while also trying to remain competitive. The rising costs are somewhat offset by our declining strip ratio and the rising grades as we get deeper into the pit. We are coming towards the bottom of the open pit and the strip ratio is reducing; in 2012 we were 4.25:1, in 2013 will be closer to 3:1, and in the final year of open-pit production will be 1:1 or less."

As the Santa Elena mine looks to the end of its successful open-pit years, results from Q2 2013 show a long life still to come underground as Drever explained: "When we begin underground mining at Santa Elena, we will be fortunate that the mine is not the typical 1.5- to 2-m underground vein scenario found in Mexico. The ore deposit is running between 10 m to 20 m of minable widths underground, accommodating large equipment for development and production. Costs can be kept lower than a normal underground operation, albeit not as low as open-pit mining."

These factors have led to the decision to construct a 3,000 mt/d processing facility at the mine, set for completion in Q1 2014. 2014 is set to be a banner year for SilverCrest and the remarkable Santa Elena mine. "From the start up of the mill in 2014, the Santa Elena mine will have an eight year minelife; with further exploratory drilling it could extend to 12 years to 15 years. The grade of the resource is far better than was originally attributed. This project has proven to be extraordinarily profitable; last year's cash flow was more than the total capital invested since the project's inception, providing an excellent rate of return on shareholder equity," said Drever.

Productivity and efficiency of operations are set to become even more critical in the coming years considering this summer's unexpected dip in commodity prices and the introduction of a royalty in Mexico. Operators will be searching for new ways to reduce their all important cost per gram, ounce or ton statistics, and this is where the innovators of the service sector come to the fore. "CAE Mining has a view that the next three years will be heavily focussed on productivity and efficiency in mining. We have been developing and investing in solutions that target productivity improvement in order to meet our customer's needs in these areas. Three years from now we expect to see a number of clients benefitting from our integrated solutions that span the entire mining value chain and cover technical planning, operations management and training. Integrating data sources, management processes and implementing best practices in operator training can deliver productivity improvements of up to 25%. Achieving this will be critical for mines looking to maintain profit margins in a period of lower commodity prices," said Damian McKay, president, CAE Mining.

Global engineering firm Martin Engineering is also focusing on efficiency through innovation despite the reduced pressure

Javier Schmal, managing director for Latin America of Martin Engineering.

offered by traditionally low operating costs in markets such as Mexico. "Mexico's lower operating costs constitute a great advantage for Martin Engineering. However, this aspect is not the only focus that we should have, as we need to continue developing new technologies to improve efficiency. Martin Engineering is a well-known industry innovator, developing best quality, performance, wear life and easiest maintenance technologies in the market, factors which lead to a lower total cost of ownership than low-cost providers," said Javier Schmal, managing director for Latin America of Martin Engineering, which is building a reputation for such engineering innovation across Latin America.

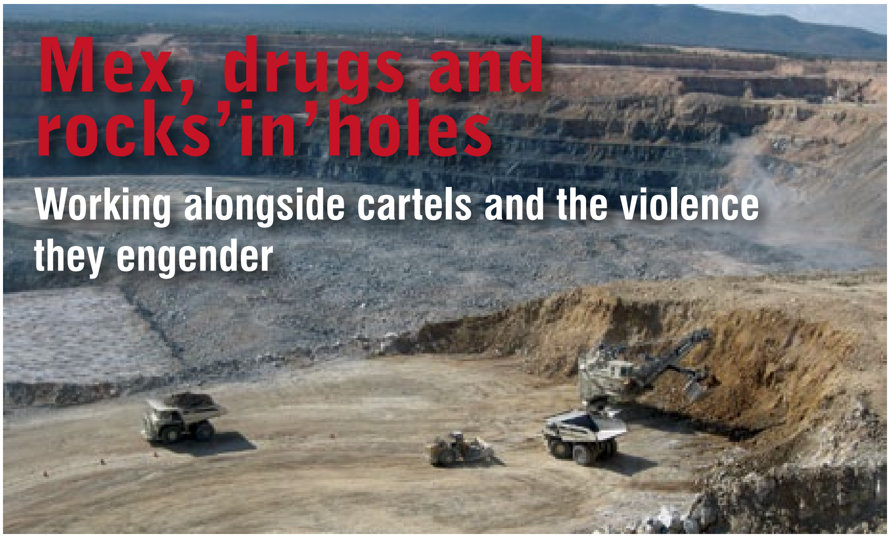
Equally, global mining equipment suppliers have found cost savings by choosing to establish their manufacturing base in Mexico. Ingetrol, a manufacturer of drill rigs and a contract drilling company with a presence in over 44 countries, chose to establish their manufacturing base in Torreón, in the state of Coahuila, for the availability of skilled labor in the region and its history as a manufacturing center for many of the world's largest METS companies.

Luis Silva, president and CEO of Ingetrol, said: "Torreón has become the mining services capital of northern Mexico. There are 23 technical universities within the area; those educated in the region are excellent and in abundant supply – unlike technically skilled labor in many other regions. Many of the world's largest METS providers – John Deere, Caterpillar – have established themselves there for this reason. This lends itself well to large-scale metal-mechanic works, something that Ingetrol would like to do. While Mexico may be too large and diverse a market to handle alone [without a distributor], we believe that by having our facilities in Torreón we can better cater to the needs of our clients. This influenced our decision to establish there."

The relatively healthy growth of metal prices in recent years has given producers the capacity to significantly offset rising costs with secondary production. Mexico ranks first, 11th and 12th for global exports of silver, gold and copper respectively. For international gold producer New Gold who operate the Cerro San Pedro mine 20 km northeast of San Luis Potosí, these secondary metals are playing an increasingly important role. "Although metal prices have increased significantly in the last five or six years, so have mining costs. Fortunately New Gold produces copper and silver as byproducts; where input, labor and currency costs have increased at our operations, the value of these metals has risen alongside them, providing a natural hedge. As our production of these byproducts has increased, we have become one of the few gold companies to reduce costs. We are also one of the few to consistently meet annual production targets. Our operations also continue to be effectively optimized through incremental improvements. For example, at Cerro San Pedro production has risen from 100,000 oz/y to 140,000 oz/y of gold. New Gold prides itself on its ability to adjust to the surprises that mining can throw up," said Robert Gallagher, president and CEO of New Gold.

Mex, drugs and rocks'in'holes

Working alongside cartels and the violence they engender



Peñasquito mine, Mexico. Photo courtesy of Goldcorp.

Mexico's most geologically promising regions in the country are the northern states of Zacatecas, Sonora, Chihuahua and Durango. Also prevalent in Mexico's north are a multitude of drug cartels who, over three decades, have waged brutal wars against each other and the state to stake their share of the $25 billion per annum illicit drug trade to the US.

For many firms, the region's geology is too compelling to ignore, and companies continue to explore and develop projects in these northern states despite the prevalence of crime in the area. However, it is not only the exploration and production companies who need to accept the risk in order to do business in Mexico, employees of service companies are often under the same dangers. Companies need to adapt to the circumstances in whatever way they can, as Damian McKay, president of CAE Mining, who recently opened an office in Zacatecas, explained: "CAE Mining operates in many countries around the world with varying levels of community crime and standards of living. We take appropriate precautions in each of the regions we operate, including Mexico. Where possible we prefer to establish a local presence with local staffing. This minimises the need to send staff on temporary assignments who may be less familiar with local conditions and more vulnerable, and improves the level of service that we deliver to our customers in the region."

The issue is also having an impact on the recruitment of skilled professionals, not only the foreign workers on which Mexico depends so much, but also in the case of Mexicans being asked to relocate to certain areas of the country.

"Security issues surrounding the drug cartels in Mexico are a serious concern. There are people who flatly refuse to go to Mexico, others have expressed an interest and then backed away. We have encountered local Mexicans who are afraid of certain areas of their country, but we have also encountered people who live and work in these areas who say things are not as bad in their region as some suggest," explained Elizabeth Suttie, principal – executive talent agent, of The Suttie Group,

CAE Mining's blended learning approach incorporates simulation, eLearning and on-the-job training. Photo courtesy of CAE Mining.

George R. Burns, executive vice president and COO of Goldcorp.

a boutique recruitment agency that provides services exclusively for the mining sector.

In 2010, the Mexican mining chamber (CAMIMEX) claimed that threats and security costs resulting from the cartels were on the rise following the theft of gold and silver bars worth $3 million from Pan American Silver's La Colorada mine in Zacatecas. In the same year, Goldcorp built a landing strip at its Los Filos mine in Guerrero as an alternative to transporting gold and employees via road due to heightened security risks as a result of increased cartel activity in the area. "Goldcorp has not had any direct experience of crime and violence from drug cartels; our major concern is the problems our employees have to face in transit. The majority of mines in Mexico are in rural areas; our Peñasquito mine, for example, requires that we bring our employees in from across the region. Travel on rural roads does carry with it a risk. Therefore Goldcorp has invested in a number of aircraft to safely transport employees, avoiding the high-risk rural roads," said George R. Burns, executive vice president and COO of Goldcorp.

Efforts to control this situation have taken several forms. On taking office in 2006 former Mexican President Felipe Calderón declared war on the drug cartels, putting more than 50,000 soldiers on the streets and attempting to reform a police and judicial system rife with corruption. Over the subsequent five years, drug war killings increased from 2,119 in 2006 to 47,000 by the end of 2011, with the cartels ramping up violence and increasingly targeting civilians.

Nieto's government faces a Herculean task of routing out corruption and reforming the justice system, yet there have been signs of success. According to a survey conducted by the American Chamber of Commerce, 42% of foreign and domestic companies in Mexico believe the security situation has improved over the past year. Extortion, however, has been on the increase, with 36% of companies raising the issue this year as compared with 16% in 2011. Companies are now spending between 2% and 4% of their budget on security. Many mining firms protesting against the government's proposed 5% royalty claim they already have to fork out for a "security tax" to protect themselves against the cartels. First Majestic, as an example, is investing 10% of its annual budget on security, employing armed guards to protect its assets and workforce. Last year, the company had silver concentrates worth $4 million hijacked from trucks and now chooses to fly its heavier bars out of the country. Riverside Resources, on the other hand, is simply moving 30% of its business outside of Mexico, claiming that the security costs simply are not worth it.

Mining companies can now insure themselves against the threat of the cartels through newly tailored "narco insurance policies" such as that launched by Marsh Brockman and Schuh this year, which covers up to $25 million for losses sustained as a result of organized crime as well as police actions against organized crime. Many firms also have a risk management plan in place whereby they employ security firms to provide specialized risk management services: they review the location of the project and coordinate a plan of how to transport workers and goods safely to and from the site.

After six years of bloodshed, depressingly little has been accomplished at the cost of so many lives. Nieto's reforms may well reduce violence against civilians, but it seems as though little can or will be done to eradicate the cartels themselves. As long as the insatiable demand for illicit drugs exists in the US, so too will Hispanic cartels. Miners in Mexico should get used to operating alongside the cartels. As many say, "it is simply the cost of doing business."

Del Toro silver mine. Photo courtesy of First Majestic Silver.

Communities

A best friend or a worst enemy

In geologically rich, developing countries such as Mexico, the potential benefits of mining activity to poor rural communities are undeniable. "No industry has a higher level of impact on local communities than mining does; it can turn ghost towns into bustling communities," said Keith Neumeyer, president and CEO of First Majestic. "The local community will define how successful you are; if you have problems, they will be serious; if you can gain their credibility and support, they will be your biggest advocates for what you need to do," said John Smith, president and CEO of Silver Standard Resources that own four promising properties in Mexico within a broader pan-American portfolio.

The nature of this often delicate symbiotic relationship between miners and local communities varies widely within Mexico; state to state, town to town and company to company. A culture for corporate social responsibility (CSR) is well illustrated by Goldcorp. George R. Burns, explained the company's strategy: "We maintain six strategies, the first three represent the people side of our business; grow people, grow safety, grow partnerships. If we get those three strategies right, the following three; grow reserves, grow margins and grow production – will naturally follow. Our partnership strategy is the strongest approach for dealing with activism and similar issues. The communities around Los Filos, for example, whether this is those who work with us or those who do not, all understand the culture of the company and the benefits we bring to the surrounding area. We openly invite the government and media to our mine sites, we connect them to the local community who can explain the pros and cons of having a Goldcorp mine in the area. It is important to keep in mind that Mexico is a mature mining market; activism often comes from regions that are not aware of the benefits mining can bring about and do not understand how seriously we take our commitment to social responsibility and environmental stewardship."

Successful CSR activities begin at the exploration phase and due to the staggering importance of community relations through the life of a mine, positive community engagement at the exploration stage can have a huge bearing on the salability of a property. Junior exploration companies are aware of this and even when finances are tight, efforts are made to foster community relations from the outset. The first stage often begins with overcoming differences with the multitude of landowners across Mexico governed by the somewhat conflicting rights of landowners and miners in Mexican law.

Most industry professionals in Mexico agree that the laws governing land and concession ownerships are perfectly clear. The problem lies in applying the law in cases where the two overlap. Mining concessions give companies the right to extract what lies below the surface, but the superficial terrain still remains in control of the landowner. What remains unclear is what the obligations of the concession and landowners are to each other. The ejidos—the communities that own the land—often believe that they automatically have a right to extract the minerals beneath the surface they own.

It falls upon the mining companies to navigate this uncertainty and construct agreements with ejidos for access to their land. "There is no involvement of the authorities to secure and protect the agreements reached between mining companies and landowners," said Enrique del Bosque, partner at RB Abogados, discussing the grey area of superficial and subterranean ownership.

In order to eliminate the confusion surrounding this relationship, laws need to be developed that outline the various agreements that need to be made between groups. Mining projects often bring much needed infrastructure and economic development to rural areas, but this cannot be realized unless and until communities are re-

Martin engineering facilities, located in Chihuahua. Photo courtesy of Martin Engineering.

assured that they will be able to take part in the development of their lands, and mining companies are similarly at ease with regards to the agreements they have made with communities.

There is an underlying feeling that some companies, while rightly commended for their generosity, often judge the process of community engagement by the number of dollars spent. What may seem, from a foreign company's perspective, to be the "need" of the community, may not be the popular demand of that community. Giving greater involvement to the communities in allocating investment only enhances the process of engagement. "There is a danger that foreign mining companies may enter an area and identify a problem in their local community, such as water shortages for example, and go ahead in solving that issue without consulting the community itself undermining the whole process of community engagement," said Mohammed Bhabha, Tetra Tech's director of Latin America development in mining and minerals.

Community engagement can have a significant influence on the productivity and stability of a mine, aid exploration and can have dramatic consequences for the salability of a project. Mitchell Krebs, president and CEO of top ten silver producer Coeur Mining, whose Palmarejo mine was recognized with the Socially Responsible Business Distinction Award for a fifth consecutive year, said: "Coeur Mining views our health and safety, environmental, community relations and social responsibility programs as critical to the business. At Palmarejo, our community relations program has improved considerably over the last year through direct engagement at the local level and building trust by working with the community and collaborating in ways that are sustainable and leave a positive impact that extends beyond our time there. We view ourselves as guests in the local community."

Leach pad, Dolores mine. Photo courtesy of Pan American Silver.

Tied in with the social aspect of doing business in Mexico is the pressure on mining companies to maintain a responsible attitude towards the environment. It is often the local communities supported by environmentally conscious NGOs who sustain the pressure on government and the mining industry to operate in a responsible manner. This pressure is one of the key drivers in the Mexican authorities developing a thorough environmental regulatory regime for their booming mining industry.

"Mexico has a well-advanced environmental regulatory environment. There exists a highly regulated set of laws and standards, called NOMs (Norma Oficial Mexicana / Official Mexican Standard), which detail a number of environmental standard requirements for the mining industry, including tailings design," said Chris Brodie, manager of environmental services at global environmental and engineering consultancy Knight Piésold. "Mexico is still an evolving area in regards to environmental assessment and, similar to many mining jurisdictions, playing catch up on the social aspect of assessment. Mexican environmental regulators are currently looking to increase their knowledge on certain specific studies in the mineral sector such as geochemistry and the prediction of potential acid mine drainage. These are areas they are particularly concerned about," continued Brodie.

Indeed Mexico's most prominent mining region is in the arid north of the country where the scarcity of water resources multiplies its social and environmental value. Mining processes for the effective extraction of precious metals such as silver and gold bring with them inherent risks for the contamination of local water supplies. Minimizing that risk is at the forefront of policies for most mining firms in the region. "Everywhere that silver exists dominantly, there are issues with water. Making sure that we do not impact the quality and volume of the water supply in the nearby vicinity is absolutely critical," said John Smith, Silver Standard.

Of course growing corporate responsibility for environmental stewardship is not unique to Mexico, this is a growing trend we see all over the world, but with the current stage of economic development we see in Latin America, the environment is taking an increasingly central role. "In Chile, there is a strong demand for services related to the provision and use of water and energy. In Peru mining companies need to pay particular attention to the interaction with their local community, whereas in Brazil companies need to ensure they are showing the appropriate level of environmental stewardship. Tetra Tech has seen growth in each jurisdiction by adapting to the unique circumstances and the demands of our clients, be it power, water, social or environmental," explained Brent Thompson, president of Tetra Tech - Mining and Minerals, a global provider of consulting, engineering, program management, construction management, and technical services.

It must be said that many companies active in Mexico have kept exceptional environmental standards. Of particular note is Pan American Silver whose Alamo Dorado mine recently received the PROFEPA (Procuraduría Federal de Protecciòn al Ambiente) clean industry certification. "All of Pan American's mines in Mexico now have the PROFEPA certification. It is a process whereby the government sends in external auditors to review all aspects of the business, from running mining operations to processing plant operations and administrative operations. They look at how you control and track your effluence, your water usage and your waste products," said Geoff A. Burns. "In order to become certified, you have to meet qualifying guidelines across all these categories. Mining is often perceived in a negative light in regards to environmental standards; this certification demonstrates that Pan American is not only meeting environmental standards, but going beyond that and running a clean business."


Brent Thompson, president of Tetra Tech - Mining and Minerals.

Conclusion: more than just geology

Be it environmental stewardship, added security costs, community investments or rising salaries, the cost of mining in Mexico is going up. The introduction of a mining royalty may not be unexpected but the whole sector will be waiting for the details of the final decision and its potential implication for the industry. If Mexico is to maintain its position as the fourth most popular mining jurisdiction in the world, it will it will take more than geology.

Approximately 70% of Mexico's terrain remains unexplored, countless mines await reopening, and a growing presence of local spending in the sector all help ensure that, as long as the government remains committed to enabling continued investment and maintaining a favorable atmosphere, Mexico is set to weather the current economic storm. José Armando Cordoba, director of the General Directorate of Mines in Sonora, said: "Even in tougher economic times, investors believe in Mexico."


A consulting engineer checks over drawings at the Campo Morado project. Photo courtesy of Knight Piésold.