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GLOBAL BUSINESS REPORTS

# Mexico Mining 2016



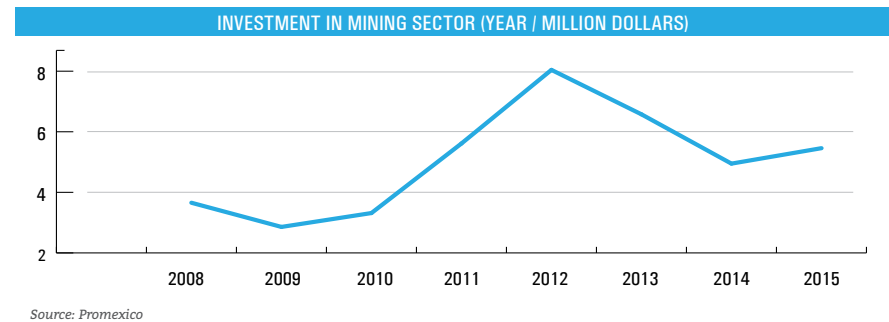
PRE-RELEASE  
EDITION

# Introduction

In Mexico, mining runs deep. First practiced millennia ago by the Maya, Aztec, Mixteco and Zapoteco peoples, mining has continued to play an integral role on this land. Mexico is the largest producer of silver in the world, the second largest producer of bismuth and fluorite, the third largest producer of celestite and wollastonite, and a top-10 producer of cadmium, lead, zinc, salt, gold, and copper. Evidently, Mexico is recognized as a key player in the global mining industry in terms of revenue, production and reserves, which is an extraordinary and promising fact when considering that over 70% of the country possesses mining geological features, but only 27% of the national territory has been explored. As such, it is no surprise that Mexico is a hotbed for mining investment, ranking only behind the US, Canada and Australia as the fourth largest mining investment destination and attracting some of the country's largest foreign and domestic investments.

For nearly 10 years, mining in Mexico enjoyed high and sustained growth: in 2011, investment in the sector jumped 69% to reach USD \$5.6 billion, and hit an all-time high in 2012 of USD \$8 billion. But after a prosperous decade of growth, the brakes have been hit. According to Camimex, the Mexican Chamber of Mines, Mexico's mining sector took a significant hit as the value of the mining-metallurgical production decreased 5% from 2013 to 2014. The value of Mexico's top mining products was reduced significantly when in 2015, the price of gold decreased 8% in just 10 months, while silver fell 18% and copper 20% in the same period. For years this has been the new global reality, and mining companies in Mexico have

not been exempt from needing to adapt to it while also swallowing the introduction of a new fiscal regime that imposes a 7.5% tax on mining activity that increases to 8% for precious metals. While producers remain afloat thanks to prudent operational efficiency measures, exploration has abated. Yet none of this has stopped investment from pouring into the country. It is still estimated that the total value of Mexico's mineral production in 2015 was \$13.5 billion, while investment estimates exceeded \$5.46 billion. The total amount invested is indeed lower than in previous years, but mining investment is down the world over. What is clear is that there are key opportunities in Mexico for those investors who are creative, visionary and, most importantly, patient. •



# The Fiscal Reform and the Introduction of the Special Mining Tax

2014 was a critically important year for the Mexican government as President Enrique Peña Nieto passed historic reforms intended to transform the country's economy. One of these, the fiscal reform, however, has brought changes to the Mexican taxation system impacting several industrial sectors, including mining. Given that the majority of mining companies in Mexico are of foreign capital, experts deeply question the government's recent and inopportune stance and policies which impacted Mexico's attractiveness.

On top of the 30% corporate income tax, the most salient changes in the Mexican tax regulations include tax deductions on pre-operative expenses, such as exploration, will be made in a ten-year period straight-line basis instead of an immediate 100% tax deduction. A new 10% withholding tax on dividends paid to individuals and foreign shareholders will also be instituted. In addition, two new mining taxes were introduced, which have received the heaviest criticism from the mining community. The Special Mining Tax applies a 7.5% royalty or tax rate to the profit generated by the sales of extracting activities, while the Extraordinary Mining Tax tacks on an additional 0.5% on gross earnings obtained from the sale of gold, silver, and platinum. In any country, when a government begins discussing new taxes, investors begin to worry, as taxes can distort the sectors in an important way. Yet the Special Mining Tax hit harder due to the regrettable timing of its implementation during the first half of 2014. Armando Ortega, vice president of New Gold Latin America and director general of the San Xavier mine, stated: "Taxes never come at opportune times; this one in particular, however, came at a very bad time because it coincided with the clear negative inflection in the price levels of precious and non-precious metals. In other words, there was a very unfortunate alignment of a fragile moment in the commodities market and the time the tax was introduced... Unfortunately, the impact of the fiscal reform has made Mexico a less competitive mining jurisdiction during a very

negative economic environment." A separate, unintended effect of the Special Mining Tax was the creation of a point of contention between mining companies and the Mexican government regarding the fiscal reform's failure to recognize the historical and significant amount of time and resources that mining companies dedicate to the well-being of the communities in which they operate.

From this new tax, a certain amount will be allocated for reinvestment back into the community, in which 40% goes to the mining municipality, which varies in size and amount of mining projects in it; 40% goes to the state government; and 20% goes to the federal government. Reinvesting in the community is not what mining companies contest, but rather the implementation.

"The industry is aware and accepting of the federal government needing to become more efficient in collecting revenue for the nation," J. Antonio Berlanga, CEO, Reyna Mining, chairman of the board of Altiplano Goldsilver and CEO of Telson Resources stated, "[however] some of the industry leaders disagree with how the tax revenue would be redistributed, with no clear way to assess the impact on the local mining communities... We, the mining companies, stress heavily our desire for the local mining community to feel the direct impact of our activity, and this is why we directly contributed to the benefit of where the mining took place."

Enrique Rodriguez del Bosque, partner at RB Abogados expanded: "The real issue is not the royalty payment. The issue is that mining companies have long contributed a specific percentage of their operations directly back to the community. Now, a tax is paid to the government, which will, in turn, reinvest part of the tax back into the mining community; however, we have yet to see these funds reach the community, and the industry is unsure as to when and how it will be reverted—but the tax payment implementation has already gone into effect... This causes a new dilemma for companies. Mining companies no longer want to contribute directly to the

*"Taxes never come at opportune times; this one in particular, however, came at a very bad time because it coincided with the clear negative inflection in the price levels of precious and non-precious metals."*

**- Armando Ortega, President, New Gold Latin America**



communities, as it would be considered a double-expense. The government, however, has not provided retributions, and, in some cases, this is souring company-community relations."

Further explaining the impact on the communities, Gabino Fraga Peña, director general of Grupo GAP, a firm that specializes in social impact, indigenous consultation, surface rights, and land occupation, said: "There has been a reduction of the mining companies' programs with the communities—in many cases programs are reduced, but the companies cannot abandon the communities because environmental remediation programs are required, which mandate the mining companies to comply with the regulations to return the lands as the Environmental Authority decrees, which becomes an important issue when mines have had to close operations due to being a marginal operation affected by the lowered metal prices and the additional tax burden." •

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# Mexico: Attractive Nonetheless

Investing in Mexico is certainly not all doom and gloom; quite the contrary, as Rodrigo Sánchez, partner at Sánchez-Mejorada, Velasco y Ribé, pointed out: “Mexico is seeing many juniors packing up and going home, but most companies operating in Mexico are actually in fairly good shape and continue to invest in order to continue their operations.”

Despite recent changes in the tax scheme of the mining sector, the mining industry and its players strongly believe that Mexico is still a country with significant opportunities both in the short and long term. The country is open to foreign investment, enjoys stable economic policies and government, and has institutional strength and transparent regulations and procedures that provide legal certainty for investment in the sector. The challenge is that to survive a downturn in the mining cycle, innovation and creativity can no longer be luxuries. They are in fact critical to the survival and sustainability of the mining industry, integral to value creation and adequate returns on investment, and essential to sustaining mining’s contributions to the Mexican economy.

This point has not been lost on the likes of Reyna Mining and Minera Cima.

Describing Reyna Mining’s strategy, Berlanga explained: “Cash flows have decreased and thus, one of the first things to be cut down is exploration. Exploration is very high-risk, which is why companies like Reyna Mining like to partner with foreign companies, as well as look into projects that have already started their exploration phases. On the other hand, these times of crisis are also times of opportunities, so our focus is looking for companies that may be lacking financial

resources, which is where we could come in through our investment team.”

One particularly interesting move by Reyna Mining, whose core business has been buying concentrates and minerals with high yield, is its recent foray into mining operations. In 2015, Reyna Mining bought more than 51% of Telson Resources, a Canadian company that had been exploring its Tahuehueto gold and silver project in Durango for more than fifteen years and had certified 1.8 million ounces of gold reserves, but had not taken it to production. Together, Reyna Mining and Telson Resources intend to invest \$30 million to begin production by May 2017. “We are currently working on extracting 500 metric tons per day (mt/d), which is considered a small operation. It is a very selective mining project, however, with an average of 10 grams of equivalent gold/mt. An additional, yet significant advantage is that since we are extracting only 500 mt/d, the investment needed for capital expenditure could be minimized. This will allow us to generate an important level of cash flow and demonstrate, once again, that we can revive a project in a remote zone. The idea behind this is to have

a reliable source of valuable mineral activity and subsequent revenues that will allow us to withstand any type of crisis. We will start out small, with an expansion plan of multiplying the efforts and production.”

Minera Cima, a Mexico-based firm that specializes in finding and exploring mineral and ore deposits for larger companies to then evaluate, develop, and mine, continues to seek opportunities in the exploration stage. As finder and originator of at least ten mineral projects in Mexico that are either in or near production, Minera Cima has enjoyed a fair share of success, but Jorge Ordoñez, director general of Minera Cima, understands that his company’s success is dependent on adaptability: “Our business model worked extremely well when metal prices were high, but with the low prices, interest in advanced exploration properties has waned. Currently, most mining companies are focusing on either optimizing their operations and reducing costs, trying to revive some projects that have their sunk costs written off, or taking advantage of the bottom-fishing opportunities available with some companies in distress... [Minera Cima] is currently consolidating, and re-studying in profound detail and upgrading its properties with drilling, sampling, and geophysical studies in order to bring them to a standard that will be interesting for an operator when the prices come back to reasonable economic levels,” stated Ordoñez. “This work allows Minera Cima to be in a very favorable position today and even better for when companies search once again specifically for projects that are ready for development and production.”

“Minera Cima has not stopped,” Ordoñez concluded, “we see these harsh economic times as a superb moment of opportunity to get ahead and prepare for when the good times return. We are very optimistic that the mining sector will come out even better than it was before. In the end, seven plus billion people in the world need minerals.”

*“[Minera Cima] is currently consolidating, and re-studying in profound detail and upgrading its properties with drilling, sampling, and geophysical studies in order to bring them to a standard that will be interesting for an operator when the prices come back to reasonable economic levels.”*



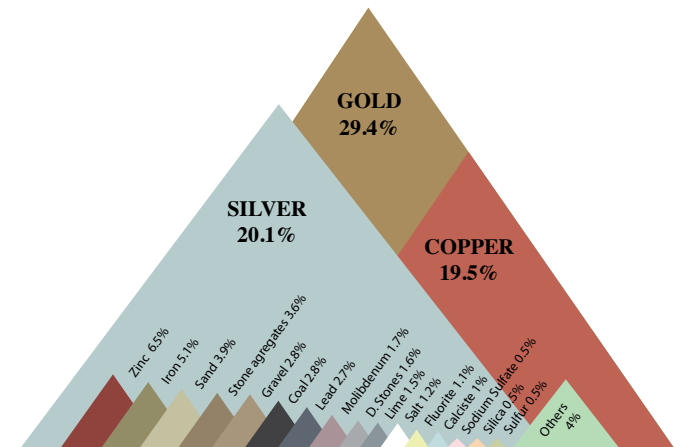
- Jorge E. Ordoñez,  
General Director,  
Minera Cima

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## MEXICAN MINE PRODUCTION BY MINERAL



- 1<sup>ST</sup> Silver
  - 2<sup>ND</sup> Bismuth, Fluorite
  - 3<sup>RD</sup> Celestite, Wollastonite
  - 4<sup>TH</sup> Cadmium
  - 5<sup>TH</sup> Molybdenum, Lead
  - 6<sup>TH</sup> Zinc
  - 7<sup>TH</sup> Salt, Diatomite
  - 8<sup>TH</sup> Barite, Graphite, Gold, Gypsum
  - 10<sup>TH</sup> Copper
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## Daniel Chávez

President, Camimex



*"Mexico is a country where 25 out of 32 states have significant mining activity, making mining a key economic driver for the country. The last two years were particularly rough, not only for Mexico, but for the rest of the world. The high mineral prices which the world enjoyed are now history."*

### Given the issues previously discussed, how can Mexico maintain its status as one of the top mining jurisdictions?

As previously mentioned, Mexico is and will continue to be a mining country. Close to 70% of the land has the potential for mining and geological development, as its territory is, without a doubt, rich in minerals.

The mining sector in Mexico has several areas of opportunity that must be seized, such as its strategic geographical location, skilled workforce, world-class mineral deposits, sound community relations, security, institutional strength and transparent regulations and procedures that provide legal certainty for investment in the sector.

We trust that the prices of the main minerals will show a recovery by the second half of 2016 and therefore the expectations of employment, investment and production value should increase accordingly.

Even before that point, we still see investment entering the country. In 2015, major mining projects started operations, including El Boleo in Baja California Sur; Límon-Guajes in Guerrero and San Sebastián in Durango; while, at the same time, major mergers took place whose value would exceed \$2 billion.

### What are Camimex's goals for the medium-to-long term?

As an association, Camimex will promote a nationwide broadcast campaign in 2016 called 'everything has a beginning, and it begins with mining.' The aim of this campaign will be to raise awareness of the importance of mining in Mexico and encourage Mexicans to be proud of our land and the care and respect that goes into the process of converting our mineral resources into the well-being of the nation.

To achieve this, the campaign will raise awareness of mining activity and how it adds value to everyday life, the national economy and employment. Everything around us comes from mining: computers, washing machines, TVs, stethoscopes, desks, phones and tools, equipment and utensils that are of everyday use at home or in the office or in hospitals. Not all Mexicans are aware to what extent mining impacts their lives and so the campaign aims to raise public awareness about the relevance of mining to us all.

Ultimately, the mining sector is one of México's main economic engines, as it provides 352,000 direct jobs and more than 1.75 million indirect jobs, while being an important economic activity generating dividends. Camimex will continue working responsibly and is committed to promoting this strategic activity for the development of the country and its people. •

### How has the mining sector evolved since GBR last met with Camimex in 2013?

México is a country where 25 out of 32 states have significant mining activity, making mining a key economic driver for the country. The last two years were particularly rough, not only for Mexico, but for the rest of the world. The high mineral prices which the world enjoyed are now history.

Mining companies understand that these are cyclical trends and that they must be patient, while at the same time focusing on increasing operational efficiency to enhance their competitiveness. Additionally, the mining industry must redouble its efforts to launch cost-control measures, disinvest assets, reduce project sizes and execute them in phases, as well as prioritizing the development of projects in zones already in operation.

### Mexico's 2014 fiscal reform affected numerous industries. What has been the impact of the fiscal reform on mining?

With the fiscal reform's stipulation of an additional tax on the mining sector coming online in January 2014, México has become less attractive in comparison to other mining jurisdictions.

Not only did the new tax come into effect at a time of low international mineral prices, but it was coupled with the elimination of the immediate deductibility of exploration investments. This has accentuated the contraction of the principal mining indicators in México.

On the other hand, Camimex does consider the energy reform and its secondary laws to be quite positive, as mining is the fifth largest sectorial consumer of energy. The industry will benefit from the reform opening up the electricity sector as mining companies will be able to increase their self-reliance capabilities, look for better prices, or be able to sell off the excess energy to third parties. In addition, article 27 of the energy reform allows carbon-producing companies to explore and exploit natural gas.

However, mining companies are still cautious of the Energy Transition Law, which establishes that the industry must reduce its carbon emissions through the use of renewable energy within a very short period of time. Failure to do so will mean that companies must pay fines; this is positive for clean and green energy, but could once again hamper mining's competitiveness.

# What's ahead for GBR's Mining Mexico Research

Thank you for reading our pre-release! As we continue our research for the final report that will appear in the September 2016 edition of Engineering & Mining Journal, we will travel to the most important mining states in Mexico and cover the full range of topics relating to the industry. Here is a snapshot of what to expect!

### Geographic Opportunities

The northern Mexican states are more mining friendly and they see mining as a business opportunity, where economic wealth and can be derived as a result of mining creating poles of economic development. The southern states also have great mineral wealth and superb potential, however the indigenous peoples of those states are not as mining friendly, possibly because they are not as well informed on the potential of mining for the development of economic advance. Several states are very focused on tourism, as such, they have yet to rationalize the benefits mining can bring. It is now the responsibility of mining companies to create that awareness of how mining can be a generator of wealth and benefits for the people.

- Jorge Ordoñez, Director General, Minera Cima

### Finance

Mergers and acquisitions have not increased as a result of metals appetite in the market, per se. What has increased is the opportunity for strategic acquisitions at incredibly low prices. An aggressive reduction in metal prices causes those companies that are fighting to control costs in order to maintain the profitability of their operations, and are not receiving any additional value either for their reserves or for the advancement of the exploration projects that they have in their portfolio from the market, to have an immediate incentive to make their portfolios more efficient. This implies making all of their non-strategic assets available to the market, but once that option is exhausted, and they are left with their core assets only, they have to constantly evaluate a merger with someone

with a stronger balance sheet or a sale of a primary asset, starting with a marginal one with higher production costs.

- Mauricio Candiani, President & CEO, Candiani Mining

### Community Relations

There is not only a disagreement between the laws protecting the mines and those protecting the ejidos, there is a contradiction. The constitutional article places in its first term that all the land is the property of the nation, then come the ejidos and communities and lastly private property, in that order. When a mining company has a concession to exploit, the federal government grants the permits so that it can extract the mineral, but the government does not give the superficial use of the land, only underground; the ejidos, on the other hand, have the preferential right over the land and its superficial use, which causes miners to come into conflict with ejidatarios because the miner does not know exactly what part of the land he has the right to. The government granted him the right with the concession, but the ejidatario has that right of the land; thus, the ejidatario is the owner of the land and the miner has to negotiate with the ejidatario, after the miner has gone through all the procedures, to temporarily use the land with a temporary occupation that the mining law granted him in accordance to the agricultural law or, in some other cases, the acquisition of the land and the disincorporation from the social regime and the incorporation to the private regime.

- Gabino Fraga Peña, Director General, Grupo GAP

### Technology Adoption

Mexico's challenge is that it is slow in acquiring technology, given the fact that cash flow is quite a significant factor here, whereas companies should really be focusing on the cost-benefit factor. Systems without the adequate quality, engineering, or norms are used simply because of the cost. There seems to be a change, however, especially through project management companies like 3M, which are

much more demanding and stringent with equipment manufacturers, which in turn favors companies like Doka.

- Jorge Vera, Director General, Doka

### Service Providers

Since most of our equipment is around fifteen-years old, the main priority is the technological upgrade and renovation of our equipment because the market that we are working in and want to keep servicing is demanding us to go deeper. Twenty-five years ago, companies wanted holes that were 300-meters deep, now they are asking for a minimum of 1,200 meters with the larger NQ diameter of 2.9 inches.

- Victor Ruiz, Director General, Investigaciones Geológicas de México (IGAMEX)

### Education and Training

The AIMMGM is currently carrying out a very important project of communicating directly with the universities in order to make them much more competitive and elite to gain acceptance into a mining engineering program at them. This can be achieved through establishing stricter grade and testing requirements, as well as trying to give students vocational orientation tests to help them decide which career to take, while at the same time, increasing awareness about the current situation of the mining sector so they then can better decide. The attractiveness of the mining sector, however, comes from the fact that it offers some of the best salaries, 35% higher than the majority of industries; thus, there is significant interest from students to undertake a career in mining.

- Manuel Reyes, President, Asociación de Ingenieros de Minas, Metalurgistas y Geólogos de México (AIMMGM) •

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