

FLOW THROUGH SHARES TO STIMULATE MINING EXPLORATION IN SOUTH AFRICA

Fact sheet

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MINERALS COUNCIL
SOUTH AFRICA



Orion Minerals – Prieska

“When a discovery is made which leads to the development of a mining project, this will have a positive impact across the fiscus as well as on job creation.”

INVESTMENT IN MINING EXPLORATION IS CRUCIAL

THE STATUS OF EXPLORATION IN SOUTH AFRICA

South Africa’s mining exploration budget has decreased from US\$404 million in 2007 to considerably less than US\$100m in 2018 and South Africa’s share of global exploration budgets has decreased to approximately 1% in 2018. A country that does not explore for new minerals runs the risk of being marginalised as a mining jurisdiction.

Exploration is a high-risk activity. Large mining houses largely engage in brown fields exploration, however most greenfields exploration is conducted by Junior mining companies who rely on venture capital raised in capital markets. Tax incentives are necessary to attract investors into exploration ventures. The Canadians have been highly successful in developing these specialist Junior exploration companies largely by using the **Flow Through Share** tax incentive model to attract equity investors into the sector.

	Scenario 1 (1%)	Scenario 2 (5%)
Exploration budget	R1.8bn	R8.8bn
Total potential impact on GDP	R2bn	R10.2bn
Total potential impact on jobs	5,500	27,700
Total potential impact on tax revenue	R532m	R2.7bn



S&P Global estimates that exploration spend grew beyond US\$10.5 billion in 2019.



South Africa’s exploration budget decreased from US\$404 million in 2007 to under US\$100 million in 2018. In addition, South Africa’s share of global exploration budgets has decreased to approximately 1% in 2018.

SAM

An Economic Impact Assessment (EIA) was conducted, using the Social Accounting Matrix (SAM) methodology to estimate how activities associated with mining exploration could affect other sectors of the economy, and how the revenue generated is distributed in the economy.

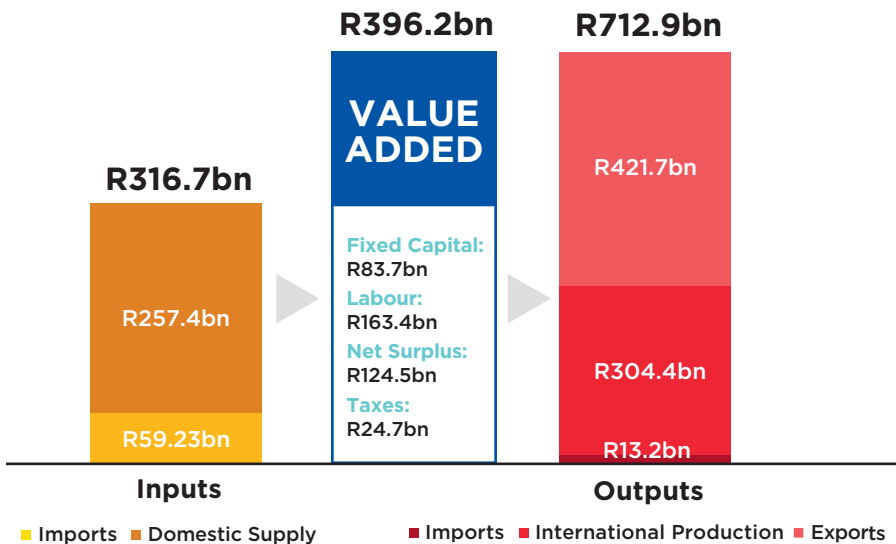
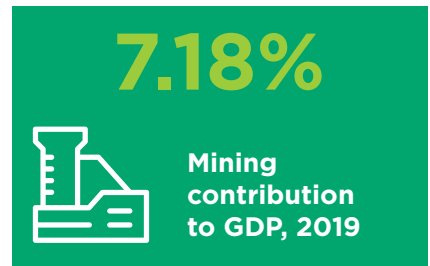


Using data from a typical junior mining company, we calculated the economic contribution of the exploration stage.

We modelled 2 scenarios, taking the assumption that South Africa’s exploration budget increases from 1% to 5%.

Mining is a significant driver of the South African economy. For example, in 2019 mining contributed 7,8% to GDP, was the largest earner of foreign revenue bringing in R421.7 billion in export earnings, and directly employed 454,921 people. In addition, the knock-on effect of mining into the broader South African economy is substantial, once service providers and suppliers to the industry are taken into account. Anecdotal evidence suggests that for each mine worker employed, ten people are directly depended on mining activity.

Without a vibrant exploration sector, the life of the South African mining industry will be finite.

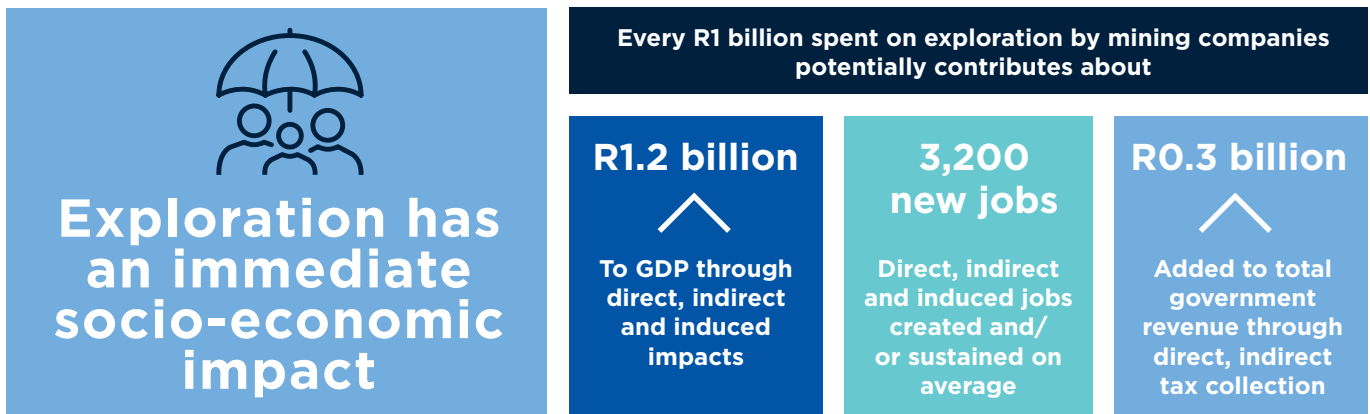


THE ECONOMIC IMPACTS OF EXPLORATION ON THE SOUTH AFRICAN ECONOMY

Research conducted by the Minerals Council South Africa assessed the direct impact that exploration would have on the South African economy, in terms of contribution to GDP, revenue for the state and jobs created. When a discovery is made which leads to the development of a mining project, this will have a positive impact across the fiscus as well as on job creation.

Exploration and mining activity occur largely in rural areas which are some of the most impoverished regions in the country. A case study of a typical Junior exploration company in South Africa estimated the direct economic benefits that the project brings to suppliers, service providers and the wider the local community.

Exploration is important for socio-economic development in South Africa



Exploration ensures the sustainability of the mining industry and is essential to discovering future growth projects

Case study

Using data from a typical junior mining company, we calculated the economic contribution – over a 20-year period – of the various stages of the mining process

* Only local capital expenditure was taken into account

** Includes royalties, income tax and withholding tax of R9.6 billion and induced taxes of R6.2 billion

Source: Orion Minerals and PwC analysis using Social Accounting Matrix for South Africa



	Exploration	Construction	Mining activities
Total cost	R442mn	R3.2bn*	R20.1bn
Total potential impact on GDP	R515mn	R4.7bn	R25.5bn
Average annual potential impact on jobs	1,400	16,500	57,000
Total potential impact on tax revenue	R134mn	R857mn	R15.8bn**



Wesizwe – Bakubung Platinum Mine

THE FLOW THROUGH SHARE MODEL EXPLAINED

The basic idea of the Flow Through Share Model is that the exploration expenditure of the operating company is foregone in favour of the investor. This model can be explained as follows.

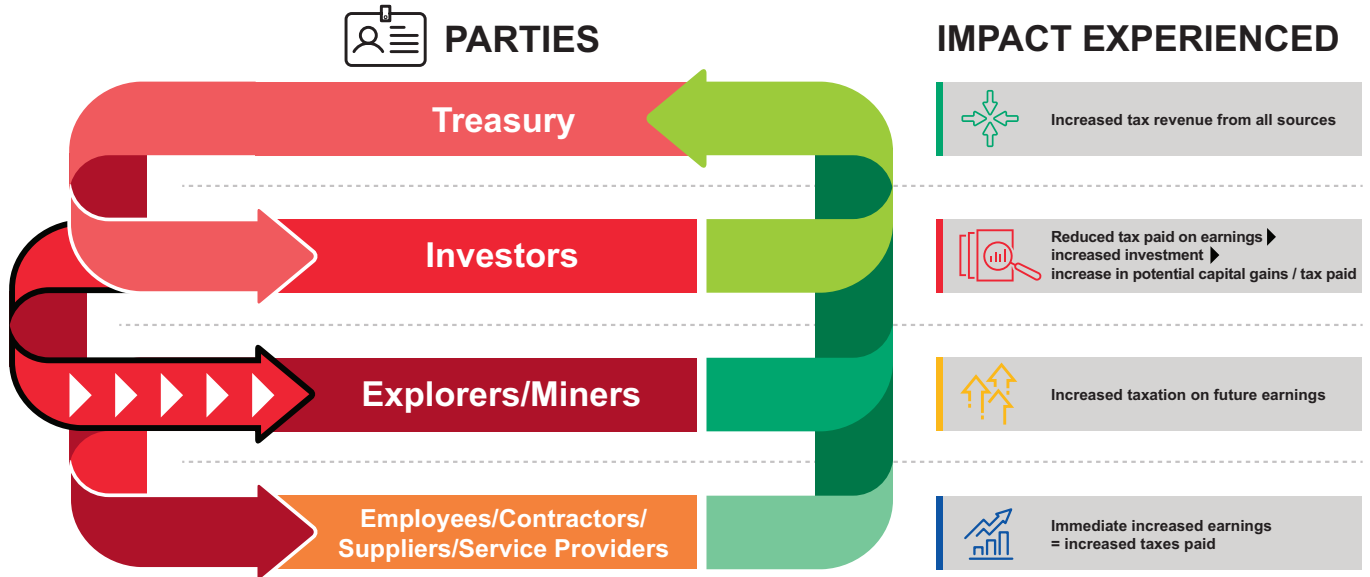
The investor concludes a subscription agreement with an operating company for the issue of and the subscription for a share called a flow-through share. This share provides the investor with all the rights of an ordinary shareholder but also a right to deduct exploration expenditure incurred by the operating company which will reduce its normal tax liability.

The operating company incurs exploration expenditure which qualifies for a deduction from its taxable income and chooses to renounce a portion or the full amount of such expenditure to the holders of the flow-through shares in the year in which such expenditure has been incurred. The operating company loses its right to deduct such expenditure to the extent that the expenditure has been renounced.

The holders of the flow-through shares then become entitled to deduct their portion of the expenditure renounced by the operating company from their taxable income. This deduction is in aggregate limited to the expenditure incurred by the investor in acquiring the flow-through shares.

Value Cycle

Benefits to all players in the process, including the fiscus, of the proposed tax incentive

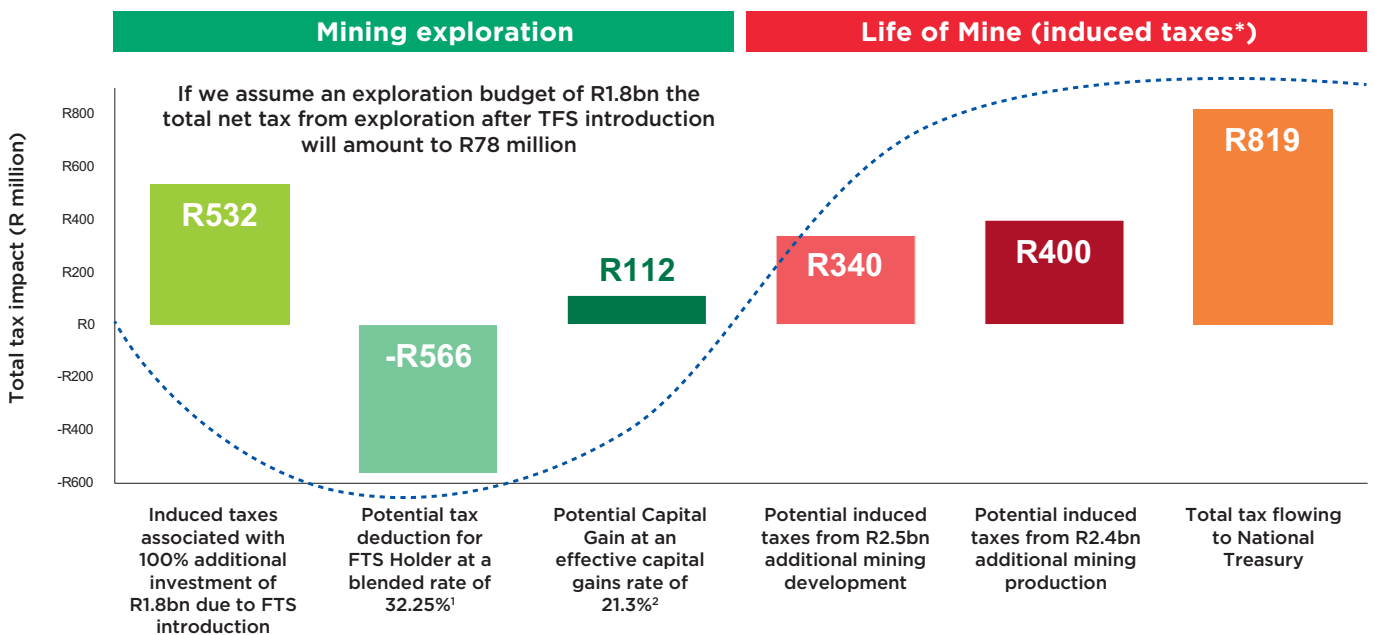


Direct taxes refer to taxes based on income generation that the entity is entirely responsible for and cannot pass on to another entity. SARS defines these as “taxes charged on taxable income or capital of individuals and legal entities”.

Indirect taxes refer to taxes relating to consumption activities. SARS defines these as “taxes imposed on goods and services rather than on individuals or companies”.

Induced taxes refer to the different rounds of the multiplier effect, from the taxes associated with initial spending in the sector, through to employees spending their salaries on goods and services (and its resultant effects).

If the FTS is introduced it will leave National Treasury in a net positive position in terms of tax revenue received



¹ Deduction based on a blended tax of 32.25% (based on the investors ratio) [(0.75 x 28%)+(0.25 x 45%)]

² All disposals of shares are on capital account (conservative view); assumed value in share amounts to 30% of original value (conservative view); and subject to a blended effective capital gains tax rate of 21.3% (based on the investors ratio) [(0.75 x 22.4%) + (0.25 x 18%)]

* Induced taxes exclude royalties, income tax and withholding tax

Source: PwC analysis using Social Accounting Matrix for South Africa

Simplified Illustration of FTS Scheme workings

CORPORATE TAXPAYER
R1 million taxable profits

OPTION 1

R280,000 paid to SARS



With remaining R720,000 corporate treasury buys low-risk, liquid, “blue chip” shares on JSE

- Little/no stimulus for economic growth
- Little/no induced taxation yield
- No jobs created
- No value created

OPTION 2

Incentivised by “tax break” paying no direct tax

Elects to rather invest R1 million in higher risk FTS in Junior Explorer
Exposure to future Capital Gains Tax

FLOW THROUGH

Junior Explorer spends R1 million on Allowable Exploration Expenditure

- SARS yields R300,000 from induced and indirect taxes within one year
- Economic stimulus of R1.2 million in GDP growth
- Three direct jobs created
- Explorer sacrifices R1 million of future tax shield



BENEFITS OF THE FLOW THROUGH SHARE MODEL FOR SOUTH AFRICA

The Minister of Mineral Resources and Energy Gwede Mantashe has set a target for South Africa to attract 3 - 5% of global exploration dollars within the next five years. Without an efficient tax incentive system in place this will not be possible.

Currently the only tax incentive offered is section 12J of the Income Tax Act. The Venture Capital Company (VCC) regime has become increasingly popular in recent years and there are more than 100 registered section 12J companies in South Africa. It is estimated that the market has raised more than R3.6 billion in investments at the end of 2018.

Though section 12J was intended to encourage exploration funding, it is unfortunate that from a mining perspective it has rarely been utilised, with only one VCC operating in the mining space. Reasons for this may include the inability to trade the shares which makes it an illiquid investment (investors are required to hold the shares for a period of 5 years, failing which the tax benefit is lost) and restrictions on the amount of shareholding that any individual shareholder may have. In any event, the VCC regime is a temporary measure ending in June 2021, unless extended.

It is therefore clear that for South Africa to reach the target of attracting 3 - 5% of global exploration dollars it needs to revise its tax incentive system with respect to exploration, as well as modernise its licencing system to ensure further investment into the mining sector.

THE SUCCESS OF THE FLOW THROUGH SHARE MODEL IN CANADA

After the Second World War, the Canadian government realised that although it was well resourced in minerals, the sector was not growing as it should, being consistently below its potential. As a result, in 1958 the federal government introduced flow through shares to encourage investment into the mining sector. As more countries became attractive destinations for mining FDI and the competition for capital intensified, Canada scaled up its financial innovation by introducing super flow through shares. The difference between regular and super flow through shares is that the former attracts a 100% deduction write-off for exploration while super flow through shares have an additional 15% federal tax credits for grassroots exploration.

In Canada regular and super flow through shares have had three major effects. They have:

- stimulated and financed exploration and development,
- positioned Canada as a global leader in mining finance and exploration expertise by developing strong capital markets and exploration management expertise unique to Canada, and
- created new job opportunities.

As a result, from 2000 to 2018, Canada attracted on average US\$2 billion a year in exploration expenditure. South Africa in contrast, only attracted US\$194 million annually.