

Alternative Funding Sources For Mining Projects

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There has been recent, cautious suggestion from within the mining project finance sector that sentiment is changing for the better. Certainly not boundless optimism, and not even a belief that the market has seen off the worst of it and is rebounding. But there are some signs that conditions are softening with an indication that the equity and debt markets, effectively shut for so long now to the junior and midcap miners, might just be opening again, albeit slowly and quietly.

When the last great commodity supercycle crashed to a spectacular halt, as dramatically reduced demand for metals, raw materials and other resource consumption meant metal prices fell as quickly as they had risen previously, many mining projects became unviable as investment concerns.

Precious and base metals, bulks and other industrials, strategic and specialty projects all suffered. No one across the mining and minerals sector avoided the downturn and the effect this had on investment so vital for mine development.

Without doubt, mining projects owned by the major mining houses were adversely affected too; however, it was those miners owning single or small assets, often at, or near to, development stages, and with balance sheets really no stronger than their reserves in the ground, who suffered so drastically. The consequential withdrawal, and almost complete disappearance, of the equity and debt markets from the sector as the natural funding source for mine development and capital programs was almost unprecedented.

To compound the misery caused by the stressed commodity markets, the banks and other financial institutions were working through their own internal problems. The lasting effects of the liquidity crisis, followed by a new world of regulation around capital requirements and banking operations, meant lending any new money became more difficult.

This was made even harder in the context of commodity and resource markets where traditionally risk-weighting considerations for project finance loan assets had been an internal challenge for banks. (Arguably, had the mining and metals' sector continued to enjoy the same bull market for the last few years that it did in previous ones, bank debt may not have been available still in the same volumes and on the same terms as it had been prior to the liquidity crisis because of these issues).

The miners, therefore, were presented with a double-pronged onslaught: equity investors of yesterday



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redeploying cash into other asset classes and debt providers locked-up by both the absence of that equity and unsympathetic credit and risk committees. The traditional gearing models for junior mining greenfield projects relied heavily on substantial amounts of equity being committed and spent first, with project finance debt often only accounting for 50-60 percent of the total capital cost (particularly in respect of more exotic mineral production and challenging locations).

As always with commodity-based projects, timing is everything. And those junior miners with assets in most need of capital, to either bring them into production or to expand existing production, were hit hardest.

While the development or expansion of many mining assets was shelved, with capital programs suspended and operations put on care and maintenance, some miners faced down the toughest of conditions and brought their assets into production.

The Junior Miners Response and Alternative Funding Sources for Mining Project Finance

As predicted by many within the industry, private equity funds did not rush in to fill the gap left by equity and conventional project finance debt. While a number of specific resource-focused funds did feature as capital providers, mining and minerals was, and remains, an asset class generally too challenging for PE liquidity and hurdle rate requirements. So how did certain miners secure the necessary capital to finance projects into production when others failed?

There were some who sought more traditional options for funding where the prime equity and debt markets would not oblige — this, of course, not being the first (or, dare we say it, last) time those markets retracted from the sector.

Cash

There were, of course, those who had cash available going into the funding crisis. There were also those few with assets capable of being sold in the market, with the sale proceeds made available for development.

With supportive shareholders content to see cash committed to, and actually spent on, development, those miners came through relatively intact. But they were the few. The funding crisis period did not bear witness to the cash-rich majors taking advantage of the troubled times and acquiring exploration, development or producing assets at a discount; they too were having their own funding issues.

Private Placements

Existing shareholders were tapped for new investment. This was in the form of rights issues, preferential equity, high yield notes, convertible instruments and other structured forms of equity and quasi-equity investment with an overriding requirement to avoid dilution. All of these were documented and issued in very different ways, but with the one common aspect of eye-wateringly high returns or coupons reflecting the troubled times.

Contractors

Miners also looked to their contractors and suppliers. As with any industry in stressed times, the stakeholder community in a development project tends to expand (at the request of management and

insistence of equity) to a larger pool of participants who are expected to "have skin in the game" and to "share the pain." Thus, more traditional forms of contractor finance were deployed.

Contractors and suppliers facing employers with no access to funding and, as result, on the verge of bankruptcy, had no real option but to amend their contracts. Key construction and supply contracts were varied to defer fees, rental payments and staged payments on terms that mitigated employer liquidity problems and provided the contractors with financial upside on a delayed basis (either in the form of interest payments in cash on deferred payments, other bonus structures and, in some cases, equity allotments in the mining operator/employer in lieu of payments due and owing).

Government

There were even mining operators who were able to renegotiate royalty commitments and other fiscal arrangements with host governments. While each of these arrangements were bespoke, the principle underpinning them was that the money saved from royalty payments was being redeployed into capital programs that would enhance the value of the asset and, in the longer term, increase the return to those governments.

Royalties

There were miners who were able to sell royalties on their projects. In return for an initial capital payment, buyers receive a share in the project's future revenues for the mine life. The buyer's entitlement is commonly to a "net smelter return," being a fixed percentage share in the gross revenues of a project less certain, defined costs for transportation and processing. Traditionally, royalty transactions funded relatively small costs for exploration and early stage development projects. But more royalties were sold during this period to bring assets into actual production, and sometimes for greater capital amounts than had been previously seen.

In certain jurisdictions, royalties can attach to the actual mining property title through a legal registration process. This means they are capable of binding any purchaser of those mining properties, and are not limited to just a contractual right to enforce payment against the mining operator who sold the royalty in the first place.

During this period, and particularly in jurisdictions where royalties could not attach to the title, royalty documentation, in some instances, allowed a purchaser to demand repayment of its capital payment in certain default scenarios, and to have that repayment obligation secured on the assets of the mining operator. Traditionally, upfront payments were generally not capable of being repaid early, or indeed secured. Further, the economics of a royalty transaction tended to provide that the buyer received a return on its capital spread proportionately over the entire life of mine. In recent times, there has been suggestion that some of the royalty structures put in place gave buyers the same downside protections as a secured lender would traditionally insist on, but, at the same time, the financial terms of the royalty were such that the buyer received full value and more for its capital investment at a much earlier stage in the mine life.

Offtakers

Perhaps the most notable funding source during this period, and the one most distinct to the mining and metals sector, came from the actual buyers of the mine production.

In the first instance, it was industrial consumers of metals who sought to secure supply direct from the mines. They had the balance sheets to provide upfront, advance payments. They did not require financial hedging instruments to support these payments. These payments could be used for capital programs, mine development and even working capital. In return, the buyers received fixed-term discounted metal delivery commitments in volumes sufficient to both “repay” the advance payments and to supply their industrial and manufacturing divisions.

Traditionally, metal traders have played roles in providing forms of offtaker finance at the mine site level. However, a trader’s interest in the metal being committed under an offtake contract is very different to that of an industrial buyer. The former being solely financial, the latter being solely about supply security. Without a market into which the trader could sell the necessary volumes committed under its mine offtake contract, there was little incentive for that trader to put any of its capital at risk.

So enter the metal streaming companies.

These were large, highly specialized buyers of precious metal mine production. They had big balance sheets and a risk appetite to match. Streaming contracts combine elements of industrial offtaker transactions and royalty structures; like industrial offtake agreements, the metal streamer makes an upfront capital payment in return for a priority allocation of metal at a discounted price; and, like royalty transactions, the metal streamer enjoys preferential benefits in the mine operations for the life of the asset (in the form of discounted production, rather than the net revenues available to the royalty purchaser).

Advance payments under streaming contracts could be considerable capital investments. As such, the contracts provided for similar default and repayment protections for the buyers and a condition that the mine assets were secured in favor of the buyers. Like the secured royalties, streaming exposures, up to the point sufficient metal had been delivered to the buyer to “repay” the advance capital payment, gave the buyers the same protection as project finance lenders in the mining sector would commonly enjoy. After that point, the buyers secured life of mine priority to a percentage of production at an agreed discount. And if the contract was terminated early due to seller/operator default, a payment became due to the buyer. This payment would be based on a net present value calculation of the return the buyer should have obtained from receiving discounted metal had the contract survived for the mine life.

The Future — Some Questions and Considerations

Returning to our opening statement, that there are signs that traditional equity and debt markets might be opening again, what does the future hold for junior miners with development assets in search of capital investments?

Given the range of alternative funding sources discussed above, there are a number of miners with complicated capital structures. Capital structures that have been put in place during highly stressed times in order to get to production levels required to support returns to shareholders.

There can be no doubt that the alternative funding sources have allowed production to come on stream with a view to maximizing shareholder value as best as possible during the period. As such, mining companies and mining projects have survived the toughest of times. In doing so, investment and continued production has been secured, and with it, jobs and livelihoods of those closest to, and dependent upon, mining operations. In a sector defined by resourcefulness and resilience, this cannot but be applauded.

But the question has been: at what cost in the long run? Can miners raise new equity quickly when existing shareholders have been afforded preferential rights in return for their rescue financing? With the life of mine deals structured as royalties and metal streams, will new equity come into a project if it is perceived that value could be diverted from shareholder returns for the mine life to the buyers' in the form of priority allocation of net revenues (in the case of royalties) and discounted metal (in the case of the streamers)?

Important questions arise as to whether streaming and other offtake structures can coexist with traditional project finance lending. There have been examples of this, and indeed streaming contracts generally provide for a set of intercreditor principles that would support a debt financing of the same asset at a later date.

The considerations in such capital structures include the ability to share security over mine assets, and whether all assets are shared equally or are distinct and ring-fenced in respect of specific exposures: for example, the stream having priority security interest over production and the debt having priority over all other mine assets. Other considerations revolve around enforcement of security: how and when can security be enforced, and by whom? Traditionally, voting constructs in intercreditor agreements are based around the size of the respective exposures and the expected returns to each of the creditors (reflecting their position in any capital structure and their risk placing and giving them priority over other creditors). These are made difficult when the returns on a loan investment and a return on a prepaid stream investment are so different.

Fundamentally, a stream sees its full value returned over the life of the mine, whereas, the return profile on a project finance loan will never extend so far, and rarely extends beyond a sensible 30 percent reserve tail. In an enforcement scenario, a lender may be able to obtain sufficient value through either a court or bank/receiver-led asset sale where, for example, the trucks, equipment and other capital assets are sold separately and relatively quickly. This may well be at odds with a stream provider who, based on the above, would have a preference for the project to be sold as a going concern with any buyer assuming all of the obligations under the streaming agreement. The enforcement scenarios are very different and are unlikely to realize value for both sets of creditors.

Further questions arise as to the extent to which commodity hedging (nearly always a condition to project finance lending and providing for downside price protection to the producer and upside value to the commodity provider) can ever coexist with a life of mine stream. There have been suggestions that the two are, in fact, mutually exclusive.

The above is not intended to be an assessment of the merits of the alternative sources of funding; rather, it is a consolidation of some of the questions and considerations currently surrounding the sector. In previous times of financial stress, miners have been able to access the equity capital and debt markets, albeit on a limited basis and at a price. They have taken the pain of high coupons and margins and restrictive terms and covenants. But as the markets have turned in their favor they have been able to refinance and unwind some of these positions with cheaper debt and less restrictive covenant packages. If the equity and debt markets are indeed showing signs of improvement, the considerations above will be some of the central issues in determining how certain junior miners can access these markets, and at what price given existing capital structures based on alternative sources of finance.

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