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Addressing Market Volatility By Using Production as a Financing Tool

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Metal prices and equity markets are currently extremely volatile. This has sometimes made it difficult for commodities companies to raise equity financing. So what should a company do if they are struggling to raise equity but need or want to fund mine development and production? One possible solution involves using production as a financing tool. This discussion seeks to provide an overview of commodity forward purchase products and how they benefit the different parties involved, an outline of the legal framework applicable to such agreements, and a description of common commercial considerations.

Product Features

Commodity forward purchase agreements are essentially sales contracts where a buyer agrees to purchase a set quality and quantity of a commodity from a producer in exchange for an up-front payment. Each contract is bespoke to the results of the investor's due diligence of the underlying assets, the profile and nature of the borrower's business, the relevant jurisdiction for purposes of the perfection of the security package, and the nature of the relevant commodity. For example, under a customary gold forward purchase agreement, a gold miner is required to deliver a specified quantity of gold or related proceeds at monthly intervals over a specified term and the transaction will normally be structured to gradually increase to reflect greater production of gold at a developing mine.

Normally, the buyer bears the price risk of the commodity while the seller bears the costs and expenses associated with the production, transport, refining and delivery of the commodity to the buyer. While the agreement is often governed by New York or English law through a choice of law provision, the security package resulting from the agreement is often tied to the jurisdiction of the mining assets and related operating companies. As a result, security packages are generally structured based on input from relevant local counsel.

Potential Benefits for Both Parties

Junior mining companies that are developing projects from the ground up (including those that have not yet completed feasibility studies for such

projects) often face unique challenges securing financing. In the absence of access to traditional financing or equity investments, production-linked alternatives such as prepaid commodity forward agreements fill a void in the market. As a result, these junior mining companies are often able to benefit from the access to capital that production-linked agreements provide.

From a seller's perspective, this financing vehicle may prove advantageous because it may avoid or minimize share dilution and outside input into the day-to-day management of operations unlike a joint venture or equity financing. Also, commodity forward purchase agreements are typically associated with advantageous accounting treatment if structured properly (the contract will not be accounted for as debt). They also often do not contain the full suite of financial covenants included in traditional financings. Further, these agreements often lack traditional interest payment concepts and accrual, and it is common to have a grace period on repayment tied to production.

For buyers, these are often shorter term credits that present a significant financial opportunity for the buyer. They offer attractive margins, robust security packages and negotiated sweeteners. Often, these agreements are originated by commodity trade houses and specialty hedge funds with expertise that enables them to assess project feasibility.

Specifically, the buyer will assume a senior, secured position and typically expects to receive a comprehensive security package as well as robust representations and warranties surrounding freedom of collateral from liens, effectiveness of concessions, and licenses, as well as other assurances surrounding due diligence issues that will affect the development of the mining asset. If there is a creditworthy parent company, it is not uncommon to see guarantees issued by this entity in favor of the buyer. Additional credit support in the form of these guarantees or promissory notes may enjoy an expedited enforcement proceeding in some jurisdictions and these issues would typically be considered in conjunction with local counsel.

Legal Considerations

As discussed above, commodity forward purchase agreements are generally structured as a sale. Depending on the commodity at issue, many agreements require that the seller enter into and maintain contracts for refining and selling the commodity being produced as a condition to closing or subsequent disbursements through an offtake agreement. The buyer may exercise significant oversight in the commercial terms related to these refining and offtake arrangements by providing eligibility criteria, and any breach of these criteria would constitute a breach of the agreement.

As the mining assets are located in different countries, jurisdictional risk and issues involving documentation and enforcement of liens are significant legal considerations. For example, many civil law jurisdictions in Central and South America have intricate requirements to document and perfect security interests that must be followed precisely in order to have an enforceable security interest. Additionally, there are often legal issues involving consideration or corporate benefit that, if not adequately addressed with the expertise of local counsel, may render security packages unenforceable or void or limit recovery under credit support instruments such as guarantees.

Commercial Considerations

Commercial negotiations of commodity forward purchase context often involve the setting of minimum and maximum prices of the commodity. These set points may be documented in the agreement or in an ISDA Master Agreement. The buyer assumes the risk that the commodity price may fall below the minimum price, while the seller largely assumes the risk that the price may exceed the maximum set price.

Additionally, technical analysis is given significant weight, including any conclusions relating to necessary permits and licenses for operation of a project. There are often commercial discussions surrounding what permits or licenses will be

required prior to the buyer making partial or full payments under commodity forward purchase agreements.

Finally, maximizing the benefits of commodity forward purchase arrangements often involves a negotiated agreement on the part of the seller to sell the commodity to the buyer at a discount.

Conclusion

While prepaid forward agreements run the gamut from smaller transactions that fly under the radar to larger transactions that make the headlines, their strategic value in the commodity space is clearly evident in the case of those producers that are over-levered or lack access to traditional debt and equity markets.

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