

## NEW OPTIONS IN FINANCING MINING PROJECTS

AS THE END OF THE RECENT COMMODITY PRICE DOWN CYCLE MOVES FURTHER BEHIND US, ATTENTION IS RETURNING TO THE DEVELOPMENT AND FINANCING OF GREENFIELD MINING PROJECTS. BY **ALEC BORISOFF, PHILLIP FLETCHER** AND **CATHY MARSH, MILBANK TWEED HADLEY & MCCLOY LLP.**

The last few years have seen relatively few large-scale mines come to the financial markets, the long-planned US\$4.2bn financing of the Oyu Tolgoi copper and gold mine in Mongolia being the most prominent exception.

Instead, focus was on the restructuring of a number of copper, titanium and nickel mines in Africa and Latin America that had been financed before the commodity price collapse. However, lenders are now being asked to finance new or expanded mines in, among other jurisdictions, Chile, Ecuador, Panama, Peru, Guinea, Mauritania, South Africa, Canada, Australia and the UK, as well as large-scale mine-related infrastructure projects in Mozambique and Chile.

Commodity cycles turn for a variety of reasons, but in the current circumstances perhaps the most prominent is demand growth as the global economy has improved.

Demand for steel and other commodities has been further driven by the introduction by a variety of governmental incentives for the construction of infrastructure, including notably the Chinese “One Belt, One Road” initiative.

Supply to meet that demand has been constrained in recent years by a lack of investment in the mining sector, and a number of host states, the Democratic Republic of Congo being the most notable example, have deterred investment with policies that might be characterised as resource nationalism.

Whether the improved price environment brought about by the confluence of these demand and supply considerations is sustainable in the face of potential trade wars and other market disruptions remains to be seen, but the charts

related to copper, iron ore and gold below show that commodity pricing has begun to recover from the trough of 2016 – albeit with some way to go to get back to the earlier peaks<sup>1</sup>.

### The challenge with mines

Mines are capital intensive and can only be developed when sponsors are able to mobilise funds first to explore for reserves and then to design, engineer and construct the facilities to exploit them.

As mines are developed in ever more remote locations, the cost of ancillary infrastructure, from power and water to rail and port facilities, has become more significant, inflating the scale of the required investment. In order to attract sufficient equity or debt, the sponsors of mines must address all of the challenges that have long burdened these projects, notably risks associated with:

- Host states changing mining laws or concession terms, resulting in higher risk or lower returns (or both);
- Heightened environmental and social standards, which can impose increased capital and operating costs;
- The scarcity of contractors able to take on sole responsibility for constructing mines, leaving sponsors to manage, and in many cases assume responsibility for, completion risk; and
- Projecting revenues, which is inherently uncertain because of the volatility and cyclical nature of commodity markets.

These challenges can be daunting, but for the right projects, they can be addressed. The wide range of mines that have been successfully financed by applying terms and structures honed over the past decades demonstrate that risks can

FIGURE 1 - COPPER PRICE (US\$3.11/lb on Mar 12)



Source: InvestmentMine, March 2018

FIGURE 2 - IRON ORES FINES PRICE (US\$71.0/t on Jan 31)



Source: InvestmentMine, March 2018

FIGURE 3 - GOLD PRICE (US\$1,326.97/ozt on Mar 13)



Source: InvestmentMine, March 2018

be identified, allocated and mitigated in a manner that will satisfy the requirements of investors<sup>2</sup>.

Although successful mines can be profitable, particularly when commodity prices are robust, and even where the related challenges have been addressed appropriately, investments in mining projects cannot entirely be insulated from risk.

Only investors that are able to assess the complex risk-reward paradigms in this sector are likely to be prepared to provide development capital.

For sponsors that can afford to invest their own capital in new projects, debt financing is attractive because it allows them to leverage their equity, and thus enhance their internal rate of return, and at the same time to share political and operational risk with others. For less well-capitalised sponsors, accessing both equity and debt from third parties is simply a precondition to undertaking a development project.

#### Project finance to the rescue

Senior secured debt is usually the least costly form of capital available, and the interest paid on it is generally a deductible expense for tax purposes. Limited-recourse project finance provided by banks and official credit agencies has been a natural source of such debt for mining projects.

Despite concerns that the capital adequacy requirements issued by the Basel Committee would lead to diminished bank appetite for longer tenor loans, there remains significant liquidity for well-structured deals. From the perspective of sponsors, among the principal attractions of project financing are that the lenders:

- Include export credit agencies and multilaterals that are willing to absorb (and whose participation may mitigate) political risk in emerging and frontier countries;
- Are able to fund only when their money is required, thus avoiding negative carry costs;
- Are prepared to extend loans with relatively long tenors;
- Offer pricing that has remained reasonably consistent throughout market cycles;
- Are generally able to assess and accept both technical and commodity price risk over the life of a deal; and

- Have demonstrated a willingness to work with sponsors (on a balanced basis) to reschedule principal payments when projects face difficulties, including those that follow when production falls below expectations or revenues drop with cyclical downturns in market prices.

However, executing and closing a project financing can be time consuming and costly as lenders require a high degree of diligence to be undertaken by technical, market, environmental, social and, dare we say, legal experts to ensure that the customary risks have been mitigated in a sensible fashion.

In recent years, this process has become even more demanding as activist investors and other organisations have pushed sponsors and lenders, both public and private, to insist on enhanced environmental and social compliance coupled with greater transparency in the application of government revenues.

Although market-tested financing terms are largely consistent across deals, there remains much detail to negotiate and, particularly where there are multiple tranches of debt, developing a consensus across lending groups that meets sponsors' objectives can be arduous.

But perhaps the most onerous requirement, particularly for sponsors that are less well capitalised, is that a significant part of the costs of a project must be funded by increasingly expensive equity, both to ensure that there is adequate commitment to the project and to sustain projected senior debt service coverage ratios.

#### The problem with equity

Mining companies have long turned to the Toronto, London and Sydney markets to attract equity capital, but it has become increasingly difficult for sponsors of greenfield projects to access the public markets.

Having been chastened by the impaired performance of mining companies during the recent commodity downturn, a number of investors are now deterred from assuming new commodity price risk.

Moreover, many institutional and private investors have shifted investment allocations from active fund managers to passive (and less expensive) funding strategies, such as ETFs, that tend to follow only the largest issuers in a sector.

Since these sort of investment vehicles are not well positioned to assess smaller developers, the result is a diminishing number of investors willing to invest in greenfield projects (with the remaining participants thus able to command a premium).

#### How to bridge the gap

Against this backdrop, sponsors have potential alternatives.

An increasingly attractive option lies with the growing range of royalty or stream investors that are prepared, in effect, to monetise resources even before they have been extracted from the ground.

Royalty investors will fund a specified sum upfront and, in exchange, receive over time amounts calculated by reference to a share in the production of the mine – either on a gross basis or after deducting smelter or other costs.

Streaming investors will fund a sum upfront to acquire the right to purchase a specified share of the mine's output at a fixed or discounted rate; the up-front payment is generally treated as a deposit that is repaid to the extent that the fixed or discounted price is below the then current spot price.

These basic transactions can be structured in such varied ways that the sceptical among us might imagine that the objective is to hide the substance of the deal; however, the reality is that the structure has likely been carefully tailored to minimise tax or adverse accounting treatment.

Many such arrangements involve one or more precious metal by-products from the mine, which the sponsor may have less expertise in marketing, but that is not always the case. Both royalty and stream investors will tend to share in the benefit if the mine outperforms the original projections, thus to that extent their interests may be aligned with those of the sponsor.

Royalties can in some cases, depending on local law, be registered on the title to the mine itself and will thus survive regardless of the identity or financial condition of the owner of the mine. Most streamers have a correlative objective of ensuring that their right to the resource will survive in all circumstances, including insolvency.

Although, as a legal matter, their contractual rights may not be as secure as those of a registered royalty holder, streamers may seek to replicate this level of legal certainty through agreement with the other principal creditors to the mine, generally being the senior lenders, as to how their claims will be treated in insolvency.

In order to ensure that their claims have priority in an insolvency over all unsecured creditors of the project company, a streamer may also seek to have its claims, at least as to the unrepaid deposit, secured.

Not all royalty or stream arrangements are the same. At one extreme, there are investors that are prepared to take a portfolio approach, investing in a range of projects and generally remaining a minority offtaker in each one while relying broadly on the sponsor to construct and operate the mine effectively.

From the perspective of a sponsor, this sort of arrangement can be attractive because it affords access to funding at a relatively early stage, often before other debt has been fully committed.

This can be particularly important where the sponsor wants to lock in equipment procurement and other capital costs before costs escalate. While many royalty or stream investors have access to relatively low-cost capital that allows them to price their royalty or stream on attractive terms, an investment of this sort is nonetheless likely to be priced at a premium to senior debt, and where it has been placed on a portfolio basis

it is unlikely to provide a fully funded finance plan. It will thus remain necessary for the sponsor to raise other sources of capital.

There are, however, other stream and royalty investors that may be prepared to provide greater levels of liquidity, sometimes by participating more actively across the capital structure including in the equity and in some cases in senior or subordinated debt, a combination that can make them one of the mining company's principal creditors.

As such, they will want to ensure that the actions of the sponsor cannot prejudice their interest in the project, and they may thus seek a significant degree of control over the management of the mine by the imposition of more detailed covenants. Moreover, as the quantum of their funding increases, and as the risk profile they assume is heightened, there can unsurprisingly be an increase in the relative cost of capital from these sources.

There are also private or closed-end funds that have been formed to invest in both commodity-based credits and the emerging markets. These funds will advance senior or subordinated debt or equity, and may even participate in stream and royalty arrangements, but many have the generation of yield as their prime objective, and can thus be costly, and many of them need to be able to return capital to their investors within a relatively short period.

Although these investors can take development risk, for a price - often quite high - they may not be a permanent feature of the long-term capital structure of a mining company, which means that their investment may have to be repaid or refinanced at a relatively early stage.

#### Can they all work together...

Of course, there is a long history of royalty, stream and fund investors both investing in existing mines and participating in the development of mines. What is a relatively new feature is that they are being invited to participate meaningfully along-side more traditional project finance lenders.

Although their participation is largely to supplement or replace equity, the objectives of a streamer, royalty holder or fund manager may make it challenging for senior lenders to view them as such.

As both royalty and stream obligations are related to the production of the mine and the offtake from it, the effect is that the return payable to the investor may be available before, and without reference to whether, debt service is funded.

Where the investor has imposed comprehensive covenants, the sponsor and the senior lenders may need to seek its concurrence on specified waivers and amendments. To the extent that the investor wishes to preserve independent enforcement rights, it has the potential to remove the sponsor and disrupt the operation of the mine and thus the stability of cashflows available to service senior debt.

Although the security granted to the investor may be stated to be subordinated to senior debt on enforcement, if the investor requires that the royalty or stream survive a transfer of ownership, particularly if it seeks to influence the identity of the successor owner – to ensure its capacity to operate the mine – it could reduce the value that can be extracted by senior lenders on enforcement.

Traditional project finance senior lenders certainly have experience navigating the intricacies of intercreditor relations across different tranches of senior debt, and there are customary means to address the contingent rights of additional creditors, such as hedge providers, but there is relatively little experience of negotiating terms with hybrid participants who seek what in the leveraged finance market might be characterised as mezzanine debt rights.

In the context of natural resource deals, the particular challenge lies in navigating the conflicting objectives of affording streamers and royalty-holders adequate protection for their investment while subordinating those protections sufficiently to the rights of the senior lenders to enable them to treat the deposit or other upfront payment as quasi-equity – and thus, although in many cases effecting a deduction to potential net revenues, not otherwise equivalent to senior debt when calculating key debt to equity and debt service coverage ratios.

The extent of the challenge may differ depending on the core objectives of the streamer, royalty-holder or fund manager. Where it is investing on a portfolio basis, it may require independent rights to take enforcement action against the miner only in limited circumstances, and may be willing to subordinate its enforcement rights to those of the senior lenders.

For lenders who can assess this sort of arrangement by ignoring the share of a mine's production that is dedicated to, for example, a streamer (and thus see its impact as simply reducing the revenue available to service the senior debt of the project), negotiating intercreditor terms can be relatively straightforward.

However, where the investor is taking a larger exposure to the project, it may feel that there are a core basket of covenants, the breach of which should allow it to initiate enforcement steps, even where the senior lenders are being paid or are otherwise willing to forebear.

Given the absence of “market” terms for these sort of hybrid intercreditor arrangements in natural resource deals, for now and for some time to come, it is likely that they will be highly bespoke and vary depending on the specific circumstances of each deal.

Issues such as how to create and perfect security for a contingent and subordinated claim of this sort can be complex in many jurisdictions, making it more challenging to craft solutions.

However, recent deals are beginning to provide a framework for how broader issues, such as

what tolerances may be afforded to senior lenders to “drag” stream, royalty and fund investors along in respect of waivers, the length of “standstill periods” for breaches of specific covenants, which group controls enforcement actions and the terms on which the stream or royalty will survive on transfer of ownership, can be resolved if the parties are willing to compromise.

#### Bond solutions

At the other extreme, sponsors that have access to equity and own operating mines or can manage completion risk may find the capital markets to be an attractive alternative to traditional loans.

A recent example of this was FQM's decision to proceed with a US\$1.8bn bond issuance – issued at the corporate, not project, level – even though it had successfully syndicated a US\$2.5bn export credit agency-supported financing for its Cobre Panama copper project, which notably featured an agreement to accommodate a large-scale streaming transaction as part of the overall finance plan.

As a structural matter, the benefits of a bond issuance can include rapid and relatively low cost execution, access to fixed rate debt and the imposition of less intrusive covenant packages.

The corresponding burdens associated with a bond issuance can include the negative carrying costs attributable to the borrowing of funds before they are required to meet costs, no-call protections that preclude, or at least increase the cost of, refinancing, and the need to disclose to a broad range of potential investors significant information about the project and its business.

The bond markets are broadly liquid, but the cost of a bond issuance, and the tenors that may be available, will depend in large part on market conditions at the time of issuance and the credit rating of the issuer.

Thus, issuers with less than an investment grade rating, in particular, may incur both shorter tenors – potentially exposing the sponsor to refinancing risk – and a higher margin over the cost of funds than they might in a traditional project financing.

Where the balance between the benefits and burdens warrant, bonds can be issued alongside more conventional project finance loans, as the intercreditor terms on which these two types of debt can co-exist are, while not completely settled, largely capable of being resolved on what are now viewed as customary terms.

Capital markets issuances have long been viewed as a useful refinancing route, both partial and complete, once projects are up and running, and thus have established a credit profile, but for sponsors that can absorb much of the completion risk of a project, the advantages of an initial bond issuance, when the bond markets are open, may outweigh the disadvantages.

How can project finance be made better?

In any event, for most sponsors, traditional project financing can have an attractive place in their

funding plans, but it is important to find ways to reduce the cost and time associated with closing transactions. What can be done to accomplish this?

First and foremost: preparation. Given the number of deals that have closed, sophisticated sponsors and financial advisers should have visibility on what terms are likely to clear the market in any particular jurisdiction or market.

Approaching the market with an acceptable term sheet and a well advanced commercial contractual structure will go far to reducing the time associated with negotiation. Likewise, an early recognition that lenders require comprehensive disclosure and analysis supported by independent expert reports will allow sponsors to prepare their presentations to the financial markets.

However, care must be taken to ensure both the independence and suitability of the experts and the reports they produce, for example by seeking prior approval from potential lending parties of the experts' identity, terms of engagement and scope of work.

There does, however, remain scope to provide sponsors with greater advance certainty on the requirements for a successful project financing, particularly given the lack of clarity and consistency in the interpretation of internationally accepted environmental and social standards.

There is no doubt that mines can be disruptive to both the environment and local populations. Those disruptions cannot be wished away, but they can be managed and mitigated recognising that what is enough mitigation is more art than science.

Well documented cases of abusive practices have raised sensitivities, and many public and private investors are fearful of finding themselves subject to criticism for acquiescing in such abuses.

The IFC and the Equator group of banks have done much to establish comprehensive standards, but how they are to be applied in any particular case can be the subject of debate.

Merely by way of example, those standards call for ensuring that mine projects are not only constructed and operated in a sensitive manner, but that mine reclamation be planned for and funded. How does a lender who will be repaid well before the end of the mine life provide for such assurance? Is it sufficient for it simply to rely on the host state to enforce its own mine reclamation regime?

As more projects come to market, a greater degree of consensus will likely emerge as to how matters such as these should be addressed. However, it will be important for the multilateral and export credit agencies, in particular, to provide leadership in ensuring that acceptable standards of conduct are established, but without placing impractical burdens on sponsors.

The leading technical and environmental/social consultants can also do much to frame sensible positions, although absent clear guidance on relevant parameters from the lending community they will have a natural tendency to be reluctant to take on the role of arbiter.

Mine sponsors also bridle at covenant constraints that restrict their commercial flexibility. The economics of specific resources and mine plans can vary over time, and miners may wish to delay production in certain circumstances or undertake accelerated exploitation or expansions in others.

Faced with the uncertainties of market conditions, they may feel that the restrictions on changes in operations, marketing plans or debt incurrence customarily imposed by project finance lenders may be too constraining. There is frequent debate on whether fundamental changes will be permitted when objective standards, such as forecast debt service ratios, can be met.

Mining precedents have featured mechanisms of this sort, and there is substantial experience with them in downstream oil and gas projects, and sponsors (particularly those that have contributed significant amounts of equity to their projects) will undoubtedly seek to apply the more favourable among these precedents in order to afford themselves greater flexibility.

To gain comfort with more flexible covenants, lenders will need to be adept at assessing even more complex financial models and running even more sensitivities based on even more scenarios involving even more variables.

To facilitate such analyses, it will be incumbent on sponsors and their financial advisers to provide transparency in the assumptions underlying their financial models and on lender groups to defer to some degree to the views of particular lenders or outside financial, technical and market advisers when it comes to assessing ratios and decisions that are keyed off the financial model.

#### Making optionality work for all

Sponsors will likely review all of their options in framing their funding plans. The cost of funds will undoubtedly be a major consideration, but it will be weighed against factors such as the availability of funding, ease of execution, and flexibility of terms.

As funding plans evolve to include a broader range of participants, it will be incumbent upon all capital providers (and again, dare we say, their lawyers) to work together to fashion sensible intercreditor and other terms to make complex, multi-sourced financings work. Assuming that the commodity markets remain strong, there is ample incentive for all of them to come to agreement so that the current inventory of, and future, deals can progress. ■

#### Footnotes

1 - Metal Prices and Price Charts, InvestmentMine, March 2018

2 - For a discussion as to how risks are allocated in natural resource project financings, see Borisoff & Fletcher, Predicting the Unpredictable, International Financial Law Review (IFLR) November/2016