IS INNOVATION IN FUNDING THE ANSWER?

27 July 2015 | Global
Legal Briefings – By **Andrew McLean** and **William Breeze**

With volatility in commodity prices persisting, mining companies are finding it increasingly difficult to access traditional forms of financing, both in equity and debt markets.

As a result, companies seeking funding are exploring alternative financing arrangements to fund projects. Traditional forms of debt financing are being combined with more flexible financing instruments, such as royalty financing and metal streaming, in order to bridge the funding gap many companies are facing. These alternative forms of financing not only give miners access to capital that would not otherwise be accessible, they are also often on less restrictive terms than standard financing structures.

METAL STREAMING

Metal streaming is an agreement between a producer and an investor for the investor to purchase of all or part of the producer's production of a specific product. The streamed product is often a by-product of the producer's main operations—for example, precious metals as a by-product of base metals. Under the streaming agreement, the investor makes an upfront capital payment (or a series of payments) to the producer in exchange for the option to buy all or part of the streamed product for the life of the mine at the lower of market price and a fixed price. Where the funding is used for mine development, the funding will often be staged in line with construction milestones.

The upfront payment is typically structured as a deposit. Any positive difference between the market price and the discounted price paid for the product will be credited against the deposit until the balance of that deposit is reduced to nil. Once the deposit has been effectively repaid in that manner, the product will typically still be subject to the streaming arrangement, with the lower of market price and the fixed price payable—in that context, any future discount that the investor receives against the market price for the product will be profit to the investor.

RECENT TRANSACTIONS

Recent streaming transactions include the metal streaming facility provided by SilverStream SEZC to Minera Gold Ltd in 2014, under which SilverStream agreed to provide US$5 million to Minera in four instalments in exchange for Minera agreeing to sell the greater of 70 million oz or 10% of its monthly gold production to SilverStream for the life of its mine. Earlier this year KBL Mining Limited entered into a streaming agreement with Quintana Mineral Hill Streaming Co. LLC under which Quintana agreed to provide US$23 million to KBL over several instalments in exchange for the right to purchase a percentage of KBL's base metals, gold and silver production.

KEY BENEFITS

As the streamed product is often a by-product of other operations, streaming can be used alongside other financing arrangements. This allows the producer to access funds without reducing its broader borrowing capacity. Streaming is a relatively quick and low-cost form of funding. Although investors will typically undertake detailed due diligence before entering into the streaming agreement, the agreement itself will generally be less restrictive on the producer than in traditional forms of debt financing, allowing the producer to retain greater control over the project's overall operations.

KEY ISSUES

As the funding under a streaming arrangement will usually be provided in return for a percentage of a mine's production, with ongoing payments for the product in addition to the initial 'deposit', both parties have an interest in maximising production. The interests of the producer and the investor are therefore generally aligned, as both parties typically benefit where production is higher than forecast. However, where production is higher than expected or where new discoveries are made, the investor can receive a windfall without adequately compensating the producer for that benefit. To mitigate this risk, the producer may seek to cap the volume of streamed product to which the investor will be entitled.

Further, although streaming allows the producer to access funds before the mine enters production, there is a risk to the producer of entering into a streaming agreement which prices the streamed product too low, particularly where the market for that product is volatile. An inadequate streaming price floor can reduce the overall value of the project, so producers should seek to include an option to buy all or part of the stream back from the investor in the streaming agreement.

Where the stream investor requires asset security, intercreditor issues will arise if the stream is to sit alongside other secured debt. A streaming investor may be willing to rank behind a debt financier, on the basis that the streaming investor looks to production for its return, its primary intercreditor focus being to ensure the streaming obligations continue at all times when the mine is producing, including following a sale of the relevant project on enforcement of any senior debt security.

ROYALTY FINANCING

Royalty financing is an arrangement entered into between an investor and a producer in which the investor makes an upfront capital payment in exchange for a royalty entitling it to share in the future revenue of the producer's project. The royalty payments are made by the producer to the investor at regular intervals over the life of the project. There are different ways in which the royalty can be calculated, although a typical approach is a percentage of net revenue.

RECENT TRANSACTIONS

Royalty financing has been utilised recently by miners such as Avanco Resources Limited, who last year announced a US$12 million royalty transaction with BlackRock World Mining Trust plc comprising 2% on copper, 25% on gold and 2% on all other metals to be produced from certain mining licence areas. Similarly, earlier this year Vimy Resources Limited agreed to issue a 1.15% royalty on all revenue from the Mulga Rock uranium project to Resource Capital Fund VI L.P. in exchange for US$10 million in cash, subject to the satisfaction of certain conditions precedent.

KEY BENEFITS

Like streaming, royalty financing is relatively quick and low cost and can be used alongside other, more traditional forms of financing. Its terms are often less restrictive on the producer than traditional debt financing. Additionally, while the full amount of the payment from the investor is generally made to the producer upfront, the producer is not required to make any payments to the investor until after production has commenced. This can be a significant advantage for the producer to monetise reserve value.

KEY ISSUES

As with streaming, a royalty arrangement can adversely affect the overall value of the project. If the producer is seeking debt financing in addition to the royalty financing, the debt financier may be concerned with the impact of the royalty on the value of its security. The payment to the royalty holder will also need to be factored into forecasts of cashflow available for debt service. Additionally, if the producer fails to meet key development and production milestones this will often trigger a default under the royalty agreement and a right to repayment of the upfront payment. These matters can be controlled through the structuring of the royalty and intercreditor arrangements.

PRE-EXPORT FINANCE (PXF)

STRUCTURE OF PXF

A pre-export finance (PXF) structure is more closely aligned to a traditional debt financing arrangement than streaming or royalty financing. Under PXF arrangements, the financier (or a syndicate of financiers) advances funds to the producer to assist it in meeting its working capital or capital investment requirements. Once the project enters production, the producer sells its product to an offtaker. Payments from the offtaker in respect of the sale of the product are credited into a specific account over which the financier will typically take security and the amounts credited into the account will be used to repay the loan.

RECENT TRANSACTIONS

Earlier this year Hillgrove Resources Limited announced a PXF facility of US$14 million (plus up to a further US$6 million, subject to conditions) with Ventures Australia LLC. The funds raised were to be used, among other purposes, to refinance Hillgrove's existing debt facilities.

KEY BENEFITS

PXF transactions are generally viewed by financiers as a type of secured financing, although security is generally not granted over the producer's assets other than the offtake contracts and the account to which the sale proceeds are deposited. The financing is therefore available at a lower cost than would be available to that producer on an unsecured basis. From the financier's perspective, its exposure to the producer's credit risk is mitigated by the financier taking security over cashflows which are due to the producers under the offtake agreements (ie it takes the credit risk on the offtaker).

KEY ISSUES

If production and delivery levels decline, the producer's ability to repay the loan is compromised. As a result, the producer will need to ensure that the cashflows under the offtake agreements are sufficient to repay the loan. Additionally, the terms of the offtake contracts will also need to be acceptable to the financier, as will the identity of the offtakers, and this will generally require cooperation from the relevant offtakers during due diligence and on an ongoing basis.

PREPAYMENT FACILITY

Under a prepayment facility arrangement, the offtaker is essentially the financier. The offtaker purchases the product in advance and the producer delivers the product to the offtaker as reimbursement for payment. This type of arrangement is particularly appealing to offtakers looking to secure long-term supply of the relevant product, although conventional financiers also operate in this space.

RECENT TRANSACTIONS

Last year Pacific Niugini Limited announced it had entered into a gold prepayment facility with Commonwealth Bank of Australia, requiring fixed repayments with physical gold. Also last year, Metals X Limited entered into a gold prepayment arrangement with Citibank, N.A. under which Citibank advanced $40.45 million in cash in exchange for Metals X agreeing to deliver 1,250 oz of gold per month for 24 months.

KEY BENEFITS

Prepayment facilities give producers access to funding which is directly linked to production and delivery. Additionally, where the offtaker is a trading partner, it will typically be more agile than banks in execution, and the underlying documentation will be more streamlined than in a traditional financing. Further, the offtaker may offer better financing terms under the prepayment agreement compared with other types of financing, due to profitability on the trading side.

KEY ISSUES

Prepayment facilities can present particular timing and market risk issues for any back-to-back debt financing that an offtaker has procured to provide the prepayment. Unlike traditional debt financing, the prepayment facility requires 'payment' with product when it is available, rather than in accordance with strict scheduled repayments. As a result, late delivery of product can impact any loan repayments the offtaker is obliged to make at that time. Tied to this is the risk to the offtaker of reconciling payments in product, which are subject to product price fluctuation, with scheduled loan repayments and interest, which are generally charged on the basis of a reference rate (such as LIBOR) plus a margin. This is addressed by having a minimum cover ratio (of product to reimbursement obligations) of (typically) 125% and an obligation to 'top up' deliveries of product if the cover ratio falls below the required level.

CONCLUSION

The market has recently seen producers adopt innovative approaches to deal with the challenging price environment they are currently facing. As well as cost management measures, the imperative to innovate across operations grows stronger as market challenges persist. Access to capital is no exception—as traditional sources of financing have dried up, alternative forms of financing (including those that can sit alongside traditional finance structures) are likely to become increasingly prevalent. The products examined in this article, while not necessarily mainstream, are tried and tested financing structures, with established participants and market precedents. The innovation required therefore may not necessarily be in product creation—rather, the willingness of producers to test all options in considering the composition of the operation's funding structure.

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MORE INFORMATION

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