WRITING THE MINING FINANCE CHEQUE

IN THE CREDIT BOOM THAT PRECEDED THE FINANCIAL CRISIS, THE MINING INDUSTRY, FUELLED BY SEVERAL YEARS OF SUSTAINED HIGH COMMODITY PRICES, ADDED SIGNIFICANTLY TO THE OVERALL LEVEL OF INDEBTEDNESS ON ITS BALANCE SHEET. BY CHIRAG SANGHRAJKA, CHRISTOPHER HALL AND CHRISTOPHER LANGDON, LATHAM & WATKINS.

Aggregate net debt increased at an annualised rate in excess of 25% and average gearing reached as much as 58% by 2008, according to a 2009 Ernst & Young industry report. This debt was applied primarily to fund a series of significant acquisitions, culminating in late 2007 in Rio Tinto's all-cash acquisition of Alcan Inc, backed by a US$40bn syndicated loan facility.

However, as with many other sectors of the economy, the availability of credit to the mining sector was severely curtailed following the financial crisis and during the subsequent period of retrenchment in financial markets. As a result, a number of mining companies were left with substantial debt on their balance sheets at a time when the debt markets were closed to all but the strongest of borrowers or issuers. The super-majors and other established producers turned to the equity markets to strengthen their balance sheets: in 2009, the largest 40 mining companies together raised US$33bn in equity, including a US$15.2bn rights issue by Rio Tinto.

However, for explorers and smaller mining companies, access to debt or equity financing has not been straightforward since the financial crisis: banks have generally been focused on refinancing or restructuring existing investments rather than advancing new funds, and many equity investors remain wary of committing capital to the industry at a time when the global economy continues to face uncertainty in the short and medium-term.

As a result, a number of such mining companies have turned to unconventional sources of capital to fund themselves, including sovereign wealth funds, state-owned enterprises, private equity, hedge funds and export credit agencies, which are becoming increasingly important and sophisticated sources of capital for the mining industry.

Sovereign funds and state-owned enterprises

Sovereign wealth funds were quick to identify opportunities to provide equity funding to overstretched mining companies following the financial crisis. A high profile example of such a deal is the US$1.5bn private placement by Teck Resources Limited (Teck) to China Investment Corporation (CIC) (acting through its special purpose vehicle, Fullbloom Investment Corporation) in July 2009. Teck had been struggling under the burden of US$9.8bn of bridge and term debt incurred in connection with its US$14.1bn acquisition of Fording Canadian Coal Trust in October 2008. The proceeds of CIC's investment, combined with the proceeds of asset disposals and a bond issuance, helped Teck to reduce that debt to US$2.7bn. The success to this investment can be measured in Teck's share price, which tripled over the course of the following year.

For sovereign wealth funds such as CIC, long-term and strategic investments such as the investment in Teck can offer relatively high rates of return at a time when quantitative easing and other loose monetary policies in Western economies have pushed down yields on traditional sovereign wealth funds investments in developed market-listed equities and government bonds.

In addition, for the sovereign wealth funds and state-owned enterprises of the resource-hungry Asian economies, and in particular those of China, these investments offer the opportunity to further the political and economic interests of their respective sovereigns by securing supplies of resources for their domestic industries. As a result, it is not uncommon to find investments by the sovereign wealth funds and state-owned enterprises of those nations to be accompanied by long-term off-take arrangements.

A good example of this is the A$644.8m private placement by the Australian Fortescue Metals Group Ltd (Fortescue) to China's Hunan Valin Iron & Steel Group (Valin) in February and March 2009.

Valin agreed to subscribe for an aggregate 260m new shares issued by Fortescue and, at the same time, the parties entered into a co-operation agreement pursuant to which Fortescue agreed to increase its supply of iron ore to Valin under an existing off-take arrangement from an amount up to 1m tonnes per annum (MTA) to an amount up to 4MTA and to use reasonable endeavours to negotiate a new supply arrangement with Valin's parent entity for the supply of up to a further 6MTA of iron ore.

In addition, the co-operation agreement provided for the parties to progress a feasibility

study to investigate the commercial and technical feasibility of raw ore processing opportunities in China and also granted Valin the right to participate in any of Fortescue's future project opportunities.

Non-bank debt finance arrangements

However, equity investments may not be appropriate for certain potential investee mining companies. From the perspective of the investee mining company, the magnitude of the required investment may mean that an equity issuance would be unpalatably dilutive of the holdings of existing shareholders. From the perspective of the sovereign wealth fund or state-owned enterprise, an equity investment would leave it exposed to all of the downside risk in the event that the investment did not turn out as expected. In addition, as an equity investor it may be difficult for the sovereign wealth fund or state-owned enterprise to exercise the requisite degree of control over the investee mining company without taking a majority stake.

These concerns may be addressed through "non-bank" debt financing arrangements. In this case, the sovereign wealth fund or state-owned enterprise invests through a loan facility or bond instrument with customary covenants that provide the relevant sovereign wealth fund or state-owned enterprise with contractual controls over the ownership, management and operation of the investee mining company.

If the debt financing is entered into on a secured basis, the sovereign wealth fund or state-owned enterprise will also have direct recourse to the assets of the investee mining company and, in the worst case, will be likely to rank ahead of equity investors in an insolvency. At the same time, the sovereign wealth fund or state-owned enterprise can retain exposure to the potential upside of gains in the investee mining company's equity through an option to convert its debt to equity or an "equity kicker" (as further described below).

The US$500m secured convertible debenture issued by SouthGobi Energy Resources Ltd (SouthGobi) to CIC in October 2009 is a good example of just such a non-bank debt financing. The 30-year debenture bore interest at 8%, comprising 6.4% cash pay interest and 1.6% payable in SouthGobi shares (where the number of shares to be issued to CIC was calculated on the basis of the 50 day volume-weighted average share price of SouthGobi) and was secured over all of SouthGobi's assets.

In addition, subject to certain conditions, the debenture gave CIC the right to nominate one director to SouthGobi's board, pre-emption rights and a right of first refusal with respect to any sale of SouthGobi shares by Ivanhoe Mines, SouthGobi's then 79.1% shareholder.

Private equity, hedge funds and ECAs

Private equity firms and hedge funds have also identified opportunities in providing non-bank debt financing to mining companies. In 2010, an Africa-focused minerals exploration and development company announced the arrangement by two Canadian investment firms of a short-term secured high-yield loan facility in an amount up to US$500m to fund the first phase of construction of its iron ore project.

In this case, the equity kicker was structured into the commitment fee in respect of the facility, which comprised both an amount payable in the form of shares in the investee mining company and warrants to subscribe for additional such shares.

At around the same time, Detour Gold Corporation (Detour) announced that Paulson & Co Inc (Paulson) had agreed to purchase US$250m of unsecured convertible notes as part of Detour's US$500m seven-year unsecured convertible note private placement.

The balance of the notes were purchased by a syndicate of underwriters led by BMO Capital Markets and including RBC Capital Markets and UBS Securities Canada Inc.

Paulson's investment comprised US$175m of notes convertible into common shares in Detour at a specified conversion price and US$75m of notes convertible into, at the election of Detour, common shares in Detour or the cash equivalent of the market price of the relevant number of common shares in Detour. Detour stated its intention to use the proceeds from the private placement to finance the development of its wholly-owned Detour Lake gold project in north-eastern Ontario.

Export credit agencies have also taken on a larger role in financing mining projects to fill the gap left by the reduction in availability of bank debt. A remarkable example of this is the US$823m debt facility signed in September 2010 by Minera y Metalurgica del Boleo SA de CV, a project company 70% owned by Baja Mining Corp and 30% by a syndicate of South Korean industrial companies.

The purpose of the facility was to fund the construction and development of a copper-cobalt-zinc-manganese project located in Mexico, comprising 265m tonnes of measured and indicated resources, including 85m tonnes of proven and probable resources.

The project also benefited from a January 2010 NI 43-101 compliant updated technical report to a 2007 definitive feasibility study that confirmed the economic viability of the project.

Despite these credentials, a syndicate of five major commercial banks were prepared to advance between them a total of US$100m only; three export credit agencies, Export-Import Bank of the United States, Export Development Canada and Korea Development Bank, provided the remaining US$723m of the total commitments under that facility.

Key features of non-bank debt financing

As sovereign wealth funds, state-owned enterprises, private equity, hedge funds and export credit agencies (each a on-bank lender) are

all likely to have different objectives and funding strategies from one another and from traditional bank lenders, it is perhaps unsurprising that each non-bank debt financing tends to have a number of deal-specific features and considerations. A few of the more common features and considerations are outlined below.

- *Convertible debentures or loan agreements with equity kickers* – One of the first questions that must be answered in any non-bank debt financing is how that debt financing should be structured. The most popular structures are convertible bonds and loan agreements with warrants.

Loan agreement terms will typically provide the non-bank lender with far more detailed insight and control over the investee mining company than a convertible bond. For example, it would not be uncommon for the investee mining company's ability to draw funds under the loan agreement to be made contingent on satisfactory progress of an underlying mining project relative to schedule and budget from time to time, as certified by an independent engineer or model auditor.

In addition, loan agreements will typically include a suite of reporting covenants and operational covenants that give the non-bank lender substantial control over the business and expenditures of the investee mining company, especially in the context of out of ordinary course activities such as borrowing, issuing guarantees, new acquisitions and investments, making loans to third parties, and other actions that might otherwise prejudicially affect the non-bank lender.

Convertible bonds, on the other hand, would not typically be issued serially in small units corresponding to the progression of development of a mining project but all at once at the outset (although it is possible to issue convertible bonds into escrow subject to a pre-agreed release schedule, this is usually prohibitively expensive due to the negative arbitrage between the return that the investee mining company will earn on the escrowed funds and the coupon that the investee mining company will be liable to pay on the convertible bond).

This puts the full amount of the non-bank lender's investment at risk from the start and as a result reduces the non-bank lender's leverage in the event of subsequent financial difficulties (though there may be certain circumstances in which the financial needs of the mining project justify an upfront drawing of the full amount of the non-bank lender's investment). In addition, a market standard bond covenant package would typically be expected to provide more limited protection against leakages of cash from the investee mining company or other actions prejudicial to the interests of the non-bank lender.

The principal benefit of the convertible bond structure from the perspective of the non-bank lender is that they are generally more liquid, especially when listed on a recognised exchange. The minimum unit size for a convertible bond is small (for regulatory reasons, usually €100,000 equivalent), which is significantly lower than the market standard minimum transferable unit for loans (US$1m or more, though following the credit crisis minimum transferable units of US$500,000 are not uncommon).

Whether this presents a material advantage for convertible bonds over loan agreements will depend on the relevant non-bank lender's intentions and exit strategies: if the investment is intended to be a long-term strategic commitment to the investee mining company and accordingly is likely to be held to maturity, it may be the case that liquidity is not a material factor in the non-bank lender's considerations (except, perhaps, in the downside scenario in which the non-bank lender may seek to limit its exposure on its investment by selling participations in the investment to third parties).

- *Convertibility and equity kickers* – The convertibility or equity kicker feature is an extremely important element of most non-bank debt financings, and is often the most heavily negotiated. The purpose of this feature is to give the non-bank lender exposure to the equity of the investee mining company in order to benefit from future gains in the investee mining company's share price should the investment prove successful.

Where the non-bank debt financing takes the form of a loan facility, the equity kicker is usually structured as a separate warrant; in the case of a convertible bond, access to the equity of the investee mining company is built in through the ability to "convert" the bond into the equity of the investee mining company. The warrant structure is more flexible: warrants are separate negotiable instruments that can typically be traded separately from the underlying loan.

In addition, a warrant can be structured so that upon exercise the warrant-holder has the option of either cancelling an amount of the underlying loan equal to the strike price or funding the strike price separately (if, for example, the warrant-holder is not a holder of the underlying loan); in contrast, it is inherent in the nature of a convertible bond that the strike price on conversion is "funded" by a cancellation of a principal amount of the convertible bond.

Notwithstanding these differences, a number of the key negotiation points apply equally to warrants and convertible bonds, including matters such as the level of conversion premium or strike price premium that should be payable on conversion or exercise of the warrants; and whether the warrant or convertible bond will be listed. A listing improves liquidity for the non-bank lender but the investee mining company (to the extent that it is not already subject to a similar compliance and reporting burden in respect of its other securities) may be wary of the compliance and reporting burden associated with listing its warrants or convertible bonds.

However, the most difficult issues usually arise in relation to the extent of anti-dilution protection that the non-bank lender should receive. It is generally accepted that warrant-

holders and convertible bondholders should benefit from protection under the terms of the relevant warrants or convertible bonds against a loss of economic value in the investee mining company's shares arising out of corporate actions such as share splits, rights issues or distributions.

In some cases, the adjustment should be straightforward: if the investee mining company engages in a share split, for example, this can often be adjusted for through a corresponding reduction in the strike price or conversion price per share of the relevant warrants or convertible bonds. In other cases, the nature of the adjustment may be more complex: for example, the non-bank lender may seek an adjustment to compensate it for any capital distributions (in cash or in specie) whereas the investee mining company may argue that adjustments should be confined to "abnormal" dividends so that it can pay out a certain level of dividends to its shareholders without triggering an adjustment.

Takeover protection may be the most tricky adjustment of all, as the non-bank lender will wish to ensure that it has an adequate suite of options to ensure that it is compensated for loss of intrinsic and time value of its option in the event of a bid for the investee mining company (which may include a share for share bid, or a part share and part cash bid) whereas the investee mining company will be concerned to ensure that the terms of the relevant warrant or convertible bond do not amount to a poison pill that may deter potential acquirers or fall foul of applicable laws and regulations.

In addition to the warrant and convertible bond structures described above, equity kickers can also be embedded into other features of the non-bank debt financing such as the interest rate, commitment fee or, as was the case on a recent proposed sovereign wealth fund investment in the gold mining sector, a bespoke equity cure right.

Unlike conventional equity cures, which are usually exercisable by the shareholder of the borrower group, in this case the equity cure right was exercisable at the option of the non-bank lender in the event of a breach of a maintenance financial covenant and, upon exercise, required the investee mining company to issue additional equity to the non-bank lender at a substantial discount in order to reflect the occurrence of the breach of that financial covenant. The subscription proceeds in respect of such additional equity were required to have been applied in prepayment of the non-bank lender's debt.

- *Covenant package* – When assessed on a total return basis, including both the return on the debt financing component and the potential for upside on the equity kicker, non-bank debt financings tend to be high yielding investments for the non-bank lender. Accordingly, it is customary to offer investee mining companies a greater degree of flexibility on the debt financing covenant package than would typically be the case in the context of a project financing, for example.

Such flexibility is often also necessary as the investee mining companies may be seeking investment at a developmental stage when the investee mining company does not yet have the benefit of the full suite of, among other things, feasibility studies, technical reports and environmental assessments that would customarily be important parts of a bankable project financing.

- *Funding basis* – Another point for the non-bank lender and the investee mining company to consider is the basis on which the interest rate chargeable on the non-bank debt financing should be determined. Market standard bank lending documentation usually ties the interest rate payable on a bank loan to a benchmark rate that is intended to reflect the cost of borrowing for prime banks in the relevant interbank market for the same currency and for the same period as the interest period in respect of that bank loan.

In contrast, this benchmark rate may be of little relevance to non-bank lenders, and sovereign wealth funds in particular, whose cost of funds may be unrelated to an interbank market benchmark rate. Investee mining companies may therefore justifiably question the rationale for a floating interest rate based on a relevant interbank market benchmark rate, as it exposes them to the fluctuations in interest costs without any corresponding benefit to the non-bank lender.

In practice, however, unless the non-bank lender intends to hold its investment to maturity, the non-bank lender may wish to retain an interest rate based on an interbank market benchmark rate in order to maintain the marketability of the non-bank debt financing to future investors (as future investors may not wish to take interest rate risk, at least not without a compensating uplift to the interest rate). If a floating interest rate based on interbank market benchmark rates is retained, the parties will also wish to consider carefully which of the various "standard" yield protection provisions, such as mandatory costs and market disruption, should be retained in the context of the funding strategies of non-bank lenders.

Concluding thoughts

Bank financing remains an important source of capital for the mining industry, as recently evidenced by the US$1bn revolving credit facility signed by First Quantum Minerals Ltd with four commercial banks and the African Export-Import Bank as mandated lead arrangers in January 2012 and the US$412.2m refinancing facility provided to African Minerals Ltd by Standard Bank of South Africa Ltd in February 2012. However, given the challenges facing the banking industry in the form of increases in capital costs and further regulation of banking activities, non-bank lenders will remain an important alternative source of capital for the mining industry in the near future. ■