Mid-Tier Companies Driving Mine Development with Variety of Capital Sources

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After the general decline in commodity prices that began in the third quarter of 1997, the last five years have seen a rebound and increased demand for commodities—as well as a correlating increase in commodity prices—driven in part by burgeoning economies in China and India. The last several years have given rise to a modern-day gold rush and opportunity for greenfield exploration and development companies.

Hundreds of exploration stage companies have tapped the private and public equity markets for vital cash to fund property acquisitions and exploration programs. Many have had success leading to large discoveries. Increasingly, junior and mid-tier companies have become involved with mine development and construction as consolidation within the mining industry, coupled with higher valuations for near-production and production stage properties, have led these firms to assume the risks and rewards associated with this activity. Mining majors such as Rio Tinto, BHP Billiton, Anglo, Newmont and Barrick, and many mid-tier mining companies are acquiring new reserves through mergers and acquisitions rather than greenfield exploration programs. According to recent report by Ernst & Young[1], global M&A transactions have increased to $68 billion in 2006 from $16 billion in 2004 *(Ernst & Young, Mining – Is Now the Time for Private Equity?, June 2007)*.

While majors are increasingly relying on revolving credit facilities and cash flow to fund expansion of production, a growing trend is for junior and mid-tier companies to finance mine development and construction projects using a variety of capital sources, including traditional project financing, bond financing, convertible debt financing, equity financing and even selling royalty interests on properties. The factors considered in the cost and availability of financing generally focus on risk management, control over the project, and collateral.

- **Bank Project Financing:** When majors elect to tap traditional bank project financing, they often negotiate very favourable terms. With increasing frequency, banks are providing project financing to junior and mid-tier companies with proven reserves to fund new mine development. Prior to seeking lender financing, a company should evaluate the following factors and issues (which lenders generally consider in determining the terms of financing and if a project is bankable) and design a strategy for addressing each in an organized, well-formulated manner.
- **Quality of Reserves:** This is fundamental to determining whether a project is commercially feasible and sustainable. A "bankable feasibility study" and mine plan from one or more reputable independent engineering experts is generally the first requirement for aquiring financing from major bank syndicates.
- **Quality of Title:** Many projects require that the operator obtain a variety of rights beyond concessions, leases and fee titles. Typically, lenders require legal opinions confirming that the company's mining rights are valid, contain no defects and are not subject to unknown third-party claims, royalties or reversionary rights.
- **Feasibility and Costs of Construction:** Construction and completion risks will affect the timing and structure of project financing. Management experience, project size and identified contractors will determine lender requirements for turnkey, fixed-price contracts with established engineering and construction contractors. Companies and lenders often rely on flexible financing arrangements, typically using a combination of contingent financing, equity, mezzanine and/or senior debt, to finance projects.
- **Realistic Cash Flow Model:** This is an important consideration, particularly when cash flow from the project is the intended source of loan repayment. Cash flow models take into account such projections as the timing and cash costs of production, life of the mine and sensitivity of the project to production costs or commodity prices.
- **Supply and Demand of Commodities:** Commodity price fluctuations can affect the terms of project financing. Lenders seek to mitigate risks through mandatory hedging strategies and borrowers seek to maximize revenue stream flexibility to take advantage of commodity appreciation in the super cycle, which many mining companies expect to drive commodity prices well above historical averages for many years. Lenders may require operators to secure long-term supply contracts for raw materials required to mine, process or refine the mined ore (i.e. fuel, electricity, tires, sulfuric acid, etc.) at fixed or indexed prices. In addition, lenders often require borrowers to maintain hedging programs or enter into off-take contracts designed to maintain a minimal level of cash flow to service debt and cover operating expenses.
- **Political Risk:** Lenders also consider the political environment of the country where a project is located. Political turmoil and uncertainty will affect the availability and terms of financing. Political risk insurance ,even though extremely complicated and expensive, may be required depending on the project's location.
- **Regulatory Regime:** Many new discoveries are made in jurisdictions where operators and lenders are inexperienced with the regulatory regime or requirements. Construction and operational requirements for new mines in these emerging jurisdictions generally require more lead time and due diligence to determine the requirements for taking security interests, bankruptcy and creditor requirements, title matters, environmental requirements, jurisdictional requirements and enforceability.

• **Environmental Risk:** Environmental issues require special consideration for operators, lenders and credit agencies. Operators contend with time-consuming and expensive environmental permitting, bonding and reclamation requirements. Most projects require environmental impact statements and negotiation of several constituents (including public hearings) to develop an accessible environmental management plan. Increasingly, lenders are competing against alternative financing sources to fund capital-intensive mine development and construction projects. Lenders often modify traditional forms of project financing to accommodate changing industry and borrower circumstances and the needs of junior and mid-tier companies. Tenor, multiple tranches, draw-down conditions, cash sweeps, amortization, interest rates, collateralization, waterfalls and covenants are all subject to negotiation. Operators of multiple properties are increasingly cross-financing development and expansion projects to negotiate favourable terms, while mitigating risks to lenders across multiple properties. These trends in bank project financing increase the complexity of loan structures.

• **Public Debt:** Companies may also turn to high-yield bonds to finance new mine development. These high-yield bonds, also known as "junk bonds" due to low credit quality and high yield to investors, typically pay interest rates in excess of traditional bank financing, and many are issued without collateral arrangements, hedging requirements or operating restrictions. Many analysts question the sustainability of the junk bond market, and the recent difficulties in the sub-prime mortgage market could put a damper on the ability of junior and mid-tier companies to tap this market in the future.

• **Convertible Debt:** Convertible debt often offers advantages to traditional project and equity financing. Although convertible debt is convertible into equity securities of the issuer, the instruments are typically convertible at a premium to the market price of such securities at the time the debt is issued. Convertible debt financing may also have advantages to traditional project financing with lower interest rates and fewer—and sometimes zero—collateral requirements, operational restrictions, hedging requirements and/or subordination requirements. Convertible debt may include favourable terms for the benefit of the issuer related to early redemption and conversion features. In addition, convertible debt financing can typically be structured and closed in a matter of weeks. Its inherent disadvantage is obviously dilution to equity holders. Junior and mid-tier companies must weigh considerations such as share price, capitalization, interest rates, timing and other factors when evaluating convertible debt financing.

Finally, liberalization of the United States' securities laws at the end of 2005 has provided flexibility for "Well Known Seasoned Issuers" (satisfying certain US reporting and market capitalization requirements) that permit such issuers to engage in certain pre-marketing activities and to quickly draw-down on shelf registration statements. These changes increase the speed to market and reduce the time required to raise capital.

• **Equity:** Equity financing may be an attractive alternative for junior and mid-tier companies funding less capital-intensive projects.

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The recent run-up in resource company valuations, coupled with high demand for quality issuances, has provided opportunities for these companies to raise large amounts of capital in the private and public equity markets. Equity financing can generally be completed in a relatively short time, and provides management with the greatest amount of latitude and flexibility on operational matters, mine development and future production. The key disadvantage compared to debt financing is dilution to existing shareholders. Management will need to evaluate shareholder and market expectation, dilution, valuation, impact on capitalization, alternative sources of project financing and capital requirements when considering issuing additional equity.

• **Royalties:** The rise of royalty companies such as Royal Gold and International Royalty Corporation has created financing opportunities for junior and mid-tier companies to sell royalty interest in projects for cash that may be used to finance mine construction and development. The royalties are purchased based on projected cash flow models, commodity price and operational assumptions, and can be structured using sliding scale models. The royalty interests run with the land and royalty companies rarely become involved in operational matters, which provide great latitude and flexibility on operational matters and mine development decisions. The disadvantages of selling royalty interests are that they burden the property and future production, and typically do not provide sufficient financing to place a property in production.

• **Mergers, Acquisitions and Joint Ventures:** Mining companies have a tendency to accept a higher level of risk to reap higher returns for investors. Developing new mines is a high-risk proposition. Reserves on many properties in established mining areas are being exhausted, leading junior and mid-tier companies to undertake more aggressive exploration programs with higher political, geographical and technological risks. The challenge for mining majors is to expand output fast enough to take advantage of buoyant commodity market conditions and to place new projects into production on time and on budget. The evolution of exploration company to acquisition target is an honoured tradition in the mining industry that will likely continue, and companies with promising properties are prime candidates for mergers or acquisitions or even hostile tender offers. ■