Latin American Mining Deal of the Year 2005

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The $893 million Cerro Verde copper mine project financing for Phelps Dodge gives the sponsor a degree of flexibility in how it operates the mine that is rarely seen in such transactions – this is a project driving a financing rather than the other way round.

Most notably, the deal, which closed on 30 September 2005, introduces to the market an innovative type of completion test that instead of rigidly tying the sponsors to output levels, allows them to buy down some of the debt if they miss certain targets. This gives the sponsors greater flexibility than normal to choose what ore deposits to mine, enabling them to more easily get the best out of prevailing market conditions.

Such an arrangement was only achievable because of the sponsor's strength – Phelps Dodge (with a 53.6% interest in the mine) is the world's second largest copper producer and has enjoyed a long standing relationship with Citigroup, its financial adviser, as well as most of the lead arrangers. Phelps Dodge's main partners, Sumitomo Metal Mining Co and Sumitomo Corporation (together 21%), were also key to JBIC's involvement in the deal.

However, another important reason why Cerro Verde's management were able to get such a flexible deal was because the financing was done on a very low gearing. Total project debt was $450 million while the equity amounted to $443 million. It is easier for bankers to be relaxed about how a project is run when they know the sponsors are laying their own money on the line.

The debt consists of three tranches: a $247.5 million JBIC A and B loan facility (30% of which is B loan with a JBIC political risk guarantee) through Sumitomo Mitsui Banking Corp as agent bank and Bank of Tokyo-Mitsubishi UFJ; a $180 million commercial debt facility lead arranged by Royal Bank of Scotland, Calyon, Mizuho Corporate Bank and Scotia Capital markets, each underwriting $45 million; and a $25 million loan from KfW. The tenor for all three tranches is 10 years with a 2.5-year grace period.

The $180 million commercial debt facility is also split into a $90 million term loan and a $90 million private placement with local pension funds and insurance companies. The lead arrangers act as backstop investors for these bonds, which have yet to be issued, and will only commit funds if they can't get buyers for all the notes. This arrangement brings local stakeholders into the project, hopefully lessoning the risks associated with operating in a continent undergoing a political transition.

Phelps Dodge was able to raise the capital needed to put Cerro Verde on a low gearing by selling much of its own equity stake, thereby introducing some complexity into the project's ownership structure. As well as bringing in Sumitomo, Phelps Dodge sold interests in the project to Compañía de Minas Buenaventura S.A., a local mining concern which now owns 18.2% of the project, and local shareholders who hold the remaining 7.2%.
First drawdown on the debt took place on 17 December after the sponsors complied with all the conditions precedent.

Situated 19 miles south-west of Arequipa, Peru's second largest city, Cerro Verde is a brownfield mining project that has been operating since the mid-1800s. The mine came into Phelps Dodge's possession in 1999 when it acquired Cyprus Amax, which had bought the mine in 1994.

The project's expansion will enable the mining of sulphide ore deposits located beneath the oxide ore that is currently in production. Mining of the sulphide ore is expected to begin later this year. It will see Cerro Verde's copper output initially

increase from current levels of 100,000 tonnes per year to approximately 300,000 tonnes per year.
An offtake agreement with Sumitomo Corporation accounts for 51% of the Cerro Verde copper output, while Phelps Dodge has agreed to buy 20% of its copper concentrates and 70% of copper cathode production. Together these offtake agreements cover 70% of the mine's copper output.

Phelps Dodge and Sumitomo Metal Mining have a history of working together in partnership, the latter also having been involved in Phelps Dodge projects in Arizona and Chile.

As well as copper, the mine also produces cobalt, which is one of the reasons why the flexible completion test was introduced – the sponsors may decide it makes more economic sense to mine cobalt and divert resources away from the copper production, which it wouldn't be able to do if targets had to be met. Although copper prices are high, cobalt prices are even higher at present, making it sensible to give the sponsors some flexibility on how they operate the mine.

Although standard practice in mining projects, there are no hedging covenants on Cerro Verde. Hedging made very little sense given the high copper prices. However, and despite the logic, there are not many sponsors that would be accorded the level of trust given to Phelps Dodge to market their output as they see fit.

This is a deal that probably could not have been done two or three years ago – it is structured much less tightly than lenders are usually comfortable with. Even in today's highly liquid market, it is hard to see many other financings leaving as much freedom to the project's management, especially if the sponsors are not willing to match debt with equity. Nevertheless, the buy-down mechanism, in Cerro Verde is an interesting twist on traditional mine finance and will likely reappear in other projects in some form.

Cerro Verde
Status: Closed 30 September 2005
Size: $893 million
Location: Arequipa, Peru
Description: Brownfield copper mining project to extract sulphide ore deposits situated beneath oxide deposits already under production
Sponsor: Phelps Dodge; Sumitomo Metal Mining, Sumitomo Corporation; Compañía de Minas Buenaventura
Debt: $450 million
Equity: $443 million
Lead arrangers: Calyon; RBS; Mizuho; Scotia Capital; KfW
Multilateral lender: JBIC
Financial adviser: Citigroup
Sponsor counsel: Rodrigo Elias & Medrano; Debevoise & Plimpton; Sullivan & Cromwell
Lender counsel: Millbank Tweed; Morrison & Foerster