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Options with futures

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One look at the hikes in key metals prices over the last year illustrates how much Asias thirst for raw materials has supported the mining sector. Copper has registered a near 50% rise in 12 months, to almost $4.50 per pound. Gold is up over 30% and breaching $1,600 per troy ounce July 18. The Eurozone crises are making renewables and PPP bankers very nervous, but as long as Asian demand stays strong, and nervous investors pile into gold, mining lenders are looking cheerful.

The scramble to line up quality resources, following a crunch-led-slump in development, has brought many larger mining companies and trading houses into deals at an earlier stage, taking on project risk. Trading houses such as Trafigura and Glencore have been active equity investors, as have hedge funds, and streaming deals, which provide upfront payments to developers, remain popular, though activity is less frenzied than a year ago.

Digging deep

In the race for natural resources, Chinese investment usually comes in an all-encompassing package, bypassing commercial project finance banks, and including combined offtake and construction contracts. The terms of a Chinese-led financing can be less restrictive, though they often take time to document deals.

Asian countries have widened their search for mining investments and established participants such as Korea and Japan have played key roles in project finance deals through their respective ECAs. In favoured markets such as Latin America they can be just as aggressive as China. Sumitomo Metal Mining and Sumitomo Corporation agreed in May to buy a 45% stake in Quadra FNX $2.9 billion Sierra Gorda copper-molybdenum project in Chile, with the assumption the Japanese companies would source a $1 billion loan from JBIC. Failing financing by the ECA, the companies would have to raise $800 million themselves.

ECA involvement becomes more important in deals above $200 to $300 million, says Matthew Lewis, head of mining & metals structured finance at Barclays Capital. Below that I think you can still put together a fairly reasonable commercial bank deal ... anything above about $500 million, frankly ECAs are absolutely required, Lewis says.

One junior mining company which ended up calling on huge ECA support was Baja Mining on its Boleo copper project in the Baja peninsula, Mexico. The Boleo project was initially planned as a commercial bank-driven deal, led by UniCredit and involving Kexim, but it failed to raise funds in 2008. The copper/cobalt/zinc/manganese mine has 265 million tonnes of measured and indicated resources, including 85 million tonnes of proven and probable reserves, and 165 million tonnes of inferred resources. The project has a minimum scheduled mine life of 23 years and a NPV of US$1.3 billion, at an 8% discount rate.

The deal closed in 2010, and financing facilities comprise $823 million of project debt financing facilities and a $35 million equity cost overrun support facility. Canadas EDC provided $150 million and Korea Development Bank funded $90 million. US Ex-Im is lending $419.6 million at a fixed rate of 3.02% for the full 14 year term of the loan. It was the largest loan ever from US Ex-Im to a mining project, and Baja mining said in January the rate of the US Ex-Im loan, which covers over 50% of the debt facility, is among the lowest in recent history.

Baja sold 30% of the project equity to a group of Korean industrials, including Korea Resources Corporation (Kores), together with large industrial and manufacturing users LS Nikko Copper, Hyundai Hysco, SK Networks, and Iljin Copper. The Korean sponsors provided equity for the deal in return for offtake rights, and subsequently the Korean Development Bank provided $64 million of subordinated debt.

Following the crunch, the deal was much too big for just commercial banks to do on their own. We worked with ECAs to begin with, says David Street, managing director of debt finance at Endeavour Financial, which advised the developer. The roles of the ECAs underlines how countries such as US and Canada are aiming to boost domestic business, while others in Asia chase materials. They may be banking more on an untied basis. [US Ex-Im] is looking at it from more of a traditional tied basis, says one banker familiar with the deal. It was KDBs first overseas resources financing and Bajas proximity to the US led to significant supply from North American companies, while Canadas SNC Lavalin was one of the main contractors.

While the Korean consortium has offtake rights to 30%, Louis Dreyfus Commodities is to take the remaining 70%, over a period of 10 years. Louis Dreyfus provided a $35 million convertible cost overrun facility that, if drawn, converts into common shares of Baja. The project company issued warrants for common shares that are exercisable in the event that the facility is not drawn.

In a structure far removed from the pre-crunch proposition, a group of commercial banks comprised of Barclays Capital, Standard Bank, Standard Chartered Bank, UniCredit Bank and WestLB together provided $100 million of debt. ECAs usually rely on commercial banks to provide hedging on price risk. Amidst rising costs and prices since the downturn, this reliance led to the carving out of the commercial bank debt tranche on the Boleo project, says Barcaps Matthew Lewis. The agencies wanted the hedging to protect their ratios, but didnt have the capacity to do it, he says. The project purchased put options with a strike price of $5,291 per tonne and sold call options with an average strike price of $8,760 per tonne for 50% of the estimated copper production for the three-year period from January 2014 to December 2016. The remainder of Boleos copper production over its anticipated 23-year mine life is to be sold at spot copper prices. Boleos cobalt and zinc sulphate production will also be sold at market prices.

Shadow finance

Traders form part of a ballooning group of companies chasing resources from smaller and less developed mines. This demand has created a range of funding choices for developers, which include royalty or by-product stream financing. Silver Wheaton now has by-product purchase agreements with 13 miners, covering 16 operating mines and three development stage projects. The price of silver has increased by around 120% in the last year to just over $40 per troy ounce.

Silver Wheatons portfolio includes a $625 million deal with Barrick Gold, signed in September 2009, for the rights to 25% of the silver output at the Pascua-Lama gold project, situated on the border between Argentina and Chile. Pascua-Lama has proven and probable reserves of 17.8 million ounces of gold, and 671 million ounces of silver.

Streaming deals help sponsors raise capital by selling future secondary metal production through an upfront payment. They would typically be repaid from the project revenue streams, ahead of debt. Developers weigh the benefits of higher leverage against such alternative financing, but bankers say they are wary of more complicated intercreditor terms brought about by the streams. Usually the royalty streams are sold before the senior debt is done, so they tend to have a bit more leverage, says one.

There can also be a gap between the developers price assumptions for royalty streams, compared with those the senior lenders are comfortable with. The stream can also impact potential refinancing decisions, another banking source adds. To the extent that it attaches to the asset if you were to realise security [in the project] then it is a big consideration, he says. Some lenders have suggested that streaming deals exploit short-term gaps between the cost of capital for the offtakers and for developers. But this arbitrage opportunity, if that was the case, has so far been highly profitable for the offtakers, given recent runs in commodity prices.

Bond ambitions

Rising interest from capital markets in mining deals has suggested bond investors could be more active in greenfield projects. While bond activity has mainly been restricted to operational projects, last years financing to reopen the Swedish Dannemora iron ore mine showed that capital market deals can be done, if in rather specific areas. There are early signs that those kinds of instruments may be available again, says Endeavours Street, who advised the sponsor, Dannemora Mineral.

The project closed a $120 million bond issue in February 2011, and the process of working with bond investors went so quickly that the project may be able to realise a start-up date of early 2012, ahead of the sponsors initial expectations and potentially benefit from high iron ore prices.

The bond loan has a five-year tenor, 11.75% coupon, and the company has the option to repay after two, three or four years at rates of par of 106%, 104% and 102%, respectively. The coupon is 11.75%.

Dannemora placed SKr150 million ($23.0 million) in equity as a private placement in March. The demand for high-yield bonds has fluctuated and the sponsor had to be prepared to go to market when the time was right, Street notes. We progressed with a project financing and in parallel we progressed with the bond, Street says.

Project banks wanted offtake contracts in place, while bond investors were comfortable with the company continuing offtake talks with steel companies, given the current market conditions for iron ore, he says. The short construction period on the project made it more bond-friendly than some other deals, and it may be more difficult to persuade bond investors to invest in a country with higher political risk. In Streets view, a mining deal would typically need to be in excess of $75-100 million for bond investors to be comfortable, since they want sufficient liquidity to trade in and out of the instrument.

The Dannemora transaction, if rather Scandinavia-specific, was closed when interest from the bond market was high, but this appetite seems to have ebbed since the first half of the year, as broader market conditions deteriorated.

Pitching the curve

Metals prices may be at stellar levels, but a general trend towards lower grades, higher labour and construction costs, longer lead out times, and the continuing demand from Asia, has pushed up project costs. Second and third quartile projects should do well throughout the cycle. Fourth-quartile projects that are coming through, predicated solely on the basis of higher prices going forward, thats still the risky end of the market, says Barcaps Matthew Lewis.

If prices stay at or near current levels, the current pipeline of projects looks fairly constant over the next two or three years, with post crunch exploration turning into concrete deals, he says. Global growth rates remain unclear, but prices for iron ore, the key material for steel, remain above $170 per ton, around three times the price of the commodity in early 2009. Concerns over delays to new iron ore production may provide more opportunity than futures indicate. Guilherme Cavalcanti, Vales chief financial officer, said in early July that he expects iron ore prices to remain above $150 for at least the next five years, as miners struggle to match demand from Asia.

Northland Resources Kaunisvaara iron ore project in Sweden should attract the attention of project finance banks this year, as it looks to close a deal led by Societe Generale, UniCredit and WestLB. The project would develop three magnetite iron ore deposits Tapuli, Sahavaara and Pellivuoma. The mine would feed to a single, multi-line processing facility in Sweden, producing up to 5 million tons per year of a high-grade, high-quality magnetite iron concentrate.

The project received final credit approval in January from Societe Generale, WestLB, UniCredit and Caterpillar Financial for $175 million of commitments to a senior loan of up to $400 million. The project has since signed an agreement with Metso for the long-lead items and first draw-down is expected in mid-2012.