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Cash-strapped mining companies look for innovative sources of funding

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The notoriously cyclical nature of mining, particularly the low commodity prices and weak equity markets of recent years, have made it difficult for junior and exploratory mining companies to secure financing at the levels required to meet their growth-driven financing requirements.

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The resultant lack of funding from traditional capital sources, such as equity investments and debt financing, has made it necessary for mining companies to access alternative sources of funding.

Production-based financing, where companies secure funding by selling a right to future production at a mine, has become an increasingly common feature in the market, through which the funding gaps currently left by traditional capital providers are filled.

These complex models have become more flexible in recent years and have led to innovative departures from the traditional funding model; but still require a carefully thought out legal, commercial and practical strategy to ensure a keen ability to navigate the multi-faceted regulatory, finance, corporate and tax requirements.

Streaming arrangements

Streaming transactions have become a significant source of capital for listed and mid-cap mining companies.

A typical streaming arrangement entails a finance provider prepaying an amount (the deposit) to the mining company and agreeing to purchase a percentage of future production of a mining operation at a pre-agreed price. The deposit is usually applied by the mining company to fund its mining operations.

Structuring of the streaming arrangement is critical from a regulatory perspective to strike a careful balance between preserving the mining right and ensuring the finance provider remains entitled to such future production.

Future mineral deliveries to the finance provider are applied by the mining company in set-off against the deposit, with 'top-up' payments normally made by the finance provider in respect of such deliveries at the pre-agreed price.

Since the price for the minerals is pre-agreed, the finance provider benefits from any price increase. In turn, since the portion of future production to be purchased by the finance provider is typically expressed as a percentage of total production, the mining company benefits from flexibility and protection afforded by the non-fixed (i.e. percentage based) production obligations in favour of the finance provider.

We are aware of four significant streaming arrangements in South Africa.

Royalty finance

A royalty finance transaction typically involves a lump-sum upfront capital payment by a finance provider (the royalty holder) to the mining company, similar to the deposit paid in a streaming arrangement, in return for a contractual right to receive a percentage of the minerals produced at a mine, or of the future revenue generated from the sale of such minerals.

There is no obligation to repay the capital and it does not bear interest (in contrast to debt funding). Although a royalty financing can be a useful source of start-up capital for junior or exploratory mining companies, it is more common in cases where the mining company already owns operating assets and has established and consistent revenue streams.

Since the mining company is under no obligation to pay any royalties or to deliver specified volumes of production, in each case, unless it generates revenue, royalty finance transactions offer a degree of flexibility that has proven to be particularly useful in times of reduced output due to Covid-19, labour unrest or lower revenue due to weak mineral prices.

In turn, the royalty holder gains equity-like exposure to commodity price increases without an obligation to make any further capital contributions. To a large degree, the royalty holder is also unaffected by increases in mining production costs, since the royalties are calculated as a percentage of revenue. Once again, the structuring of the royalty transaction is key from a regulatory perspective and requires detailed consideration of all aspects.

Tax aspects for consideration

Parties contemplating entering into any of the above transactions, should carefully consider the tax implications upfront, as the tax position of both parties will ultimately determine how each transaction is structured.

Insofar as the transactions are structured as a forward purchase of commodities, any upfront payments/ deposits made under either a streaming or royalty financing could result in an immediate tax liability for the recipient mining company.

A deduction for future expenditure could possibly be claimed against the upfront income received in advance, provided the requirements of the Income Tax Act are met. A careful analysis of the underlying transaction agreements is key.

The VAT implications are complex and often rulings may be required from the South African Revenue Service to provide clarity to taxpayers.

Where there is a clear obligation on the mining company to repay the capital advanced, these transactions could constitute funding arrangements; in which case, it is important to consider the interest withholding tax implications where the investor is non-resident.

Foreign investors should also be mindful where the receipt of the royalty could constitute income from a South African source, which would require the foreign investor to register and pay income tax in South Africa.

It is advisable for the parties to consider the impact of these funding transactions on the mineral royalty tax calculations of the mining company.

Exchange control approval is often required where the streamer / royalty providers are not South African tax and exchange control residents.

Looking ahead

The ongoing Covid-19 pandemic resulted in capital flooding to traditional safe-haven investments, such as gold and platinum. This would have ensured that streaming and royalty finance arrangements that pre-date the recent surge in the prices of these minerals delivered significant upside to the finance providers party thereto.

However, the price outlook for a number of minerals remains depressed, with financing challenges expected to continue for many in the market and capital flight expected in many commodity markets (such as coal, copper, aluminum, lead, nickel and iron ore).

Alternative financing transactions will continue to be relevant in meeting the funding needs of relevant entities in commodity markets that, at the moment, are not fully attracting the attention of investors, whilst offering opportunities to finance providers to capitalise on an eventual upturn in the commodity price cycle.

ABOUT THE AUTHOR

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