Alternative financing for junior miners in South Africa

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The preamble to the Mineral and Petroleum Resources Development Act 28 of 2002 (MPRDA), the primary South African legislation governing the administration of and access to the mineral wealth of the country, sets out in understandably aspirational and idealistic tones the following:

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*"**Recognising** that minerals and petroleum are non-renewable natural resources;*
***Acknowledging** that South Africa's mineral and petroleum resources belong to the nation and that the State is the custodian thereof;*
***Affirming** the State's obligation to protect the environment for the benefit of present and future generations, to ensure ecologically sustainable development of mineral and petroleum resources and to promote economic and social development;*
***Recognising** the need to promote local and rural development and the social upliftment of communities affected by mining;*
***Reaffirming** the State's commitment to reform to bring about equitable access to South Africa's mineral and petroleum resources;*
***Being committed** to eradicating all forms of discriminatory practices in the mineral and petroleum industries;*
***Considering** the State's obligation under the Constitution to take legislative and other measures to redress the results of past racial discrimination;*
***Reaffirming** the State's commitment to guaranteeing security of tenure in respect of prospecting and mining operations; and*
***Emphasising** the need to create an internationally competitive and efficient administrative and regulatory regime,*
***be it therefore enacted** by the Parliament of the Republic of South Africa, as follows:-..."*

Without the need to delve into a treatise about how the common law position was altered by the MPRDA or the well-meaning intentions behind it, one runs the danger of having a piece of legislation which remains only aspirational or merely words on a page unless the access to capital re-enforces the ideals articulated therein. It is against this background that urgent and meaningful consideration should be given to alternate non-traditional forms of financing so that, for example, “the State's commitment to reform to bring about equitable access to South Africa's mineral and petroleum resources” can be given life and the South African socio-economic floor can start to rise.

Financing entry

Amongst a number of other factors, one of the most pressing, which maintains the bar to entry at a high level for novice and junior miners, is their access to capital for either acquiring or developing a mine in respect of which they have been granted or acquired a mining right. On the basis of little to no tangible balance sheet strength, such entrants to the industry will struggle to raise traditional debt capital from commercial banks.

Whilst streaming contractual arrangements have been a feature of the alternate mine funding landscape for a while, they are not always suitable for the type of miner hoping to be able to establish itself at a reasonable scale and pace. We have seen a variation on the streaming contract theme emerge, which provides an interesting alternative for miners lacking the requisite balance sheet capacity to attract traditional debt finance.

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The structure typically involves at least three but usually four parties, as follows:

- the owner of the mining right/producer ("Producer")
- the purchaser of the commodity produced by the Producer ("Offtaker")
- the financial institution funding the transaction ("Funder")
- the insurer issuing a performance guarantee ("Guarantor").

Invoicing

The Producer generates three to five years’ ("Term") worth of invoices (in respect of the commodity to be delivered by the Producer to the Offtaker) reflecting one certain future date for payment of all the invoices. The face value of each invoice is determined by reference to a fixed price for the commodity, multiplied by the quantity to be delivered for the relevant period.

The aggregate value of all invoices over the Term represents the gross funding potential of the transaction. On day one, the Funder purchases such invoices, on a non-recourse basis, from the Producer at a discount, such discount equating to the Funder’s margin and risk premium. The Producer enters into an offtake arrangement with the Offtaker on normal commercial terms for the Term, undertaking to deliver to the Offtaker over the Term the aggregate quantity of commodity which underpins the invoices sold to the Funder.

The Funder enters into an agreement with the Offtaker, essentially putting the Offtaker on terms that it will be collecting the aggregate face value of all invoices from the Offtaker at the Term, without any reference to whether the Producer has performed under the offtake arrangements; that is to say, the Offtaker will be obliged to pay the Funder at Term on a 'hell or high water' basis.

The implications of this structure are that:

- The Funder will want to know that the Offtaker is of sufficient balance sheet strength to be able to meet its payment obligation at the Term.
- The Offtaker will want to know that the Producer is capable of producing/processing the required quantity of commodity to enable it to make sufficient sales to meet its payment obligation to the Funder at Term.
- The Producer will have all its cash upfront (pursuant to the sale of the invoices to the Funder) to acquire and/or develop the mining asset.
- The Offtaker will be able to trade and sell commodity for the Term without having to have paid for it upfront and will, therefore, be able to employ whatever treasury functions it deems fit to ensure it can make the payment to the Funder at Term and retain any potential treasury upside.

The offtake arrangements need some careful attention from the Producer and Offtaker as, depending on real time price fluctuations of the commodity (and absent any ISDA protections), the Offtaker’s ability to meet its payment obligation to the Funder at Term is dependent on the market price of the commodity over the Term, bearing in mind the invoice face value will have been determined and set by reference, perhaps, to a ten your average for the commodity in question.

The offtake arrangements can be structured to ensure that the Producer is obliged to 'over-deliver' a certain quantity of commodity in the face of a price drop, such that the Offtaker can make up the difference occasioned by such price drop by being able to sell more commodity.

In the case where the price rallies and the Producer continues to deliver the contracted quantity, the parties may agree to split the resultant upside on a basis agreed between them.

Whilst the above arrangements can be enshrined in contract, the real risk, particularly faced by the Offtaker, is the failure of the Producer to perform under the offtake arrangements. The risk could be more acute in circumstances where the Producer is a novice or junior miner not experienced in the kind of operations it undertakes to manage, a risk ultimately which the Offtaker will be carrying. A good deal of these kind of issues would need to be ventilated at the due diligence phase but, needless to say, the due diligence exercise can only take the Offtaker so far in offsetting its liability into the future.

The Guarantor

At this stage, enter the fourth party to the structure, the Guarantor, typically a highly rated insurance company comfortable with and experienced in issuing performance guarantees in the mining industry. The Guarantor would undertake to the Offtaker that, to the extent that the Producer has failed to deliver sufficient quantity of the commodity to the Offtaker at the Term such that the Offtaker is unable to make payment to the Funder of the aggregate face value of the invoices, the Guarantor will make payment of such shortfall to the Funder. It may be that the Funder would insist that it has security over the performance guarantee and is endorsed on the underlying policy. This is so that it has clear line of sight into the performance guarantee and the claim to the proceeds of any call under the performance guarantee.

Outside of the premium payable to the Guarantor for the performance guarantee, and dependent on the Producer's assets available for securing any indemnity it may give to the Guarantor for a call under the Performance Guarantee, the Guarantor may require a cash collateral account to be funded. This would be structured on a claw-back basis such that, as commodity is delivered to the Offtaker and all parties have acknowledged that such a delivery by the Producer has (part) fulfilled its obligation under the offtake arrangements, a corresponding part of the cash collateral can be clawed back by the Producer for its working capital purposes.

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By the issuance of the performance guarantee, the Funder and the Offtaker are de-risked against default of delivery of sufficient quantity of commodity by the Producer, at the Term which would enable the Offtaker to meet its payment obligation to the Funder when the Funder comes to collect under the invoices.

Risk committee

Given the inter-connected nature of such a structure, it is advisable to establish a risk committee composed of members of all four stakeholders, namely Funder, Producer, Offtaker and Guarantor, to meet at regular intervals. This would ensure that the performance of the Producer over the Term can be sufficiently monitored (and, as appropriate, the cash collateral can be released back to the Producer) and that all parties can remain on top of their respective risk profiles throughout the transaction.

A successful implementation of this structure ensures that the novice or junior miner will have access to sufficient cash upfront to acquire, operate and generate profit from a mine in circumstances where it could not have done so from normal debt capital sources on account of its relative balance sheet weakness. In this way, the possibility at least arises of the ideals of the Preamble to the MPRDA being given economic life, but there would need to be a willingness of the disparate parties to such a transaction to co-operate closely over the life of the transaction, a feat made easier if all such parties share the same values in wishing to see the minerals of South Africa being used as vehicle for socio-economic upliftment.

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