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Gold or fool's gold?

By mid-2014 the consequences of several years of significant liquidity constraints in the traditional sources of funding for the mining sector, combined with depressed commodity prices, became increasingly evident.

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Official corporate announcements and market rumours appeared sporadically at first and then with disturbing regularity as major and mid-tier companies began selling "non-core" assets and juniors tried to sell themselves or entered into insolvency proceedings when that was not an option. This increased level of distressed transaction activity in the mining sector which began in 2014 looks set to continue through 2015.

Though depressing news for many, an increase in distressed transaction activity is not viewed negatively by all.

Some view an industry in distress as an opportunity for bargain acquisitions. But how do you know whether you are looking at real gold or fool's gold? What are the unique characteristics of mining companies and assets which can create traps for unwary debt investors analysing a proposed restructuring or considering a loan-to-own strategy, or equity investors looking at asset or corporate purchases?

Age-old traps

As those steeped in the industry know well, the fundamental prerequisite for any mining project is the certainty of its mining rights. Almost equal in importance is the status of all required permits to develop and operate the mine and related processing facilities. In addition to holding valid permits, the softer issue of the validity of a mine's social licence will also affect the ability of a mine to operate profitably. Finally, certainty of access to needed infrastructure, such as power, water and transport, at a sustainable cost is fundamental to the economic viability of a mine.

The status of mining rights can generally be easily verified in traditional mining jurisdictions. In jurisdictions with less history with the industry, verification can be tricky and uncertainty may be difficult to eliminate. Additionally, in certain jurisdictions careful diligence to ensure compliance with local and international anti-corruption legislation is particularly important to mitigate the risk that future challenges to mining rights on such basis will be successful. Finally, the likelihood of resource nationalism issues arising must be considered.

A mining asset's location is as important to the ability to establish certainty about the mining rights as it is to the ability to obtain and maintain all necessary permits. In the case of permits, however, it is not only a question of the country in which the mine is or will be located, but also whether it is near any particularly sensitive environmental area such as a national park or in a particularly populated region. The method of mining proposed and the form of processing can also result in a controversial permitting process. Understanding the status of all existing permits, including any near-term expiry or renewal dates, is very important. Careful diligence is clearly required to determine the viability of the business plan particularly if the target property of your "loan-to-own" strategy or the one on which you are bidding in a 363 auction uses or proposes to use a controversial form of mining and is located near one of the only remaining old growth forests on the continent. It is also essential to remember that, in chapter 11, permits may not be assignable to an asset purchaser without the consent of the governmental issuer of the permit.

Ascertaining the state of the social licence of a company or project is a less legal and precise process. One can speak with regulators and obtain diligence records regarding violation citations received (or not received). Equally important, however, is determining the history of the relationship with the relevant local communities. Unlike the capital structure and contractual arrangements which can often be reformed under the applicable insolvency regime, even wiped clean, the social licence cannot be so easily rehabilitated.

Finally, it is often important to understand the contractual and other arrangements in place for power, water, transport and other infrastructure. This is especially true when the infrastructure is not owned by the mine but provided by third parties and where alternate sources are not readily available. In such cases, it is important to ascertain the extent to which the mine has been complying with its contractual obligations and whether the relevant contracts would permit termination (and thus provide a renegotiation option to the infrastructure provider) due to such non-compliance. It also is important to determine the legal framework within the jurisdiction in the case of insolvency, including whether material contracts could be terminated upon an event of an insolvency of the company (which typically is not the case in US chapter 11 proceedings), or whether the contracts are capable of being assumed and assigned to a purchaser in an applicable insolvency proceeding (which often is the case in US chapter 11 case proceedings).

To ensure a transaction concludes with the acquisition of gold and not fool's gold, it is critical to carefully diligence both the age-old fundamentals of the mining business such as mining rights, permits, social license and infrastructure access, as well as the impact of newer developments such as alternative sources of finance and traditional and exotic hedging products.

Brand new traps

In addition to the above age-old traps, new challenges to separating attractive distressed mining assets from unattractive ones and accurately valuing such assets have arisen in recent years. These new challenges developed out of the same liquidity constraints now pushing companies and assets to the auction block.

As traditional funding sources contracted and competition for their remaining dollars increased over the past 8-to-10 years, mining companies large and small turned to the so-called alternative finance sources and structures. Thus the capital structures of a number of mining companies include, and the assets of various projects have attached to them, streaming/royalty finance arrangements, commodity-linked financing contracts, private equity or hedge fund investments and the like. Often these arrangements are bespoke and their terms have both intended and unintended consequences on the valuation of the mine, the borrowing capacity of the company and the flexibility of the company to negotiate a sale or restructuring.

At least in the US, certain of these structures may be entitled to safe harbour protections under the bankruptcy code, which means that the non-debtor counterparty may terminate the arrangement and foreclose on collateral even though a non-debtor counterparty would normally be prohibited from doing so after bankruptcy. Understanding the nature of these arrangements, the rights and remedies of the holders and the likely treatment of such instruments in an insolvency can be important in determining if a distressed acquisition is likely to be successfully executed at an acceptable price.

Similarly, understanding the commodity, currency, interest rate and other hedging arrangements, if any, which may be in place is equally important. The cost of unwinding such arrangements can determine the success and attractiveness of a distressed transaction.

Hidden value

Not all the news is cautionary; distressed mining assets can also present opportunities to unlock hidden value which can be sold, leveraged or otherwise used to reduce debt or restructure the business. That hidden value can come through the monetization of metal or other by-products or of non-mining assets. For example, non-core infrastructure assets such as a port or a power facility which can provide services to the mine and other customers can be an attractive acquisition for infrastructure funds and other purchasers which are uncomfortable with commodity risks. Finally, mining assets which have an alternative use and can co-exist with the mining operations can be developed.

If available, a US bankruptcy of distressed mining or related assets can be a particularly efficient legal vehicle to unlock hidden value for a purchaser. Acquirers of assets or whole businesses as a going concern pursuant to a 363 sale or plan of reorganisation have the opportunity to 'cherry pick' the attractive assets and leave unwanted assets and liabilities behind. For example, in a 363 sale, unwanted contracts and real property leases can be rejected by the debtor, and certain liabilities of the debtor such as bank or bond debt need not be assumed by the purchaser. The opportunity to leave behind assets and avoid assuming certain liabilities cannot be achieved with the same efficiency, if at all, in an out-of-court acquisition. Care must be taken, however, if the unwanted liabilities are environmental in nature as certain types of environmental liabilities may not be avoided.

Conclusion

An increase in distressed activity in the mining sector seems inevitable, given the continuing liquidity constraints despite the relief seen in other sectors, as well as the probable near-term depression of commodity prices. To ensure a transaction concludes with the acquisition of gold and not fool's gold, it is critical to carefully diligence both the age-old fundamentals of the mining business such as mining rights, permits, social license and infrastructure access, as well as the impact of newer developments such as alternative sources of finance and traditional and exotic hedging products.

The traps for unwary investors can be managed by focusing on the fundamentals and understanding the impact, in bankruptcy and out, of recent funding products on the value, debt capacity and business flexibility of your target.

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