CLIFFORD CHANCE

Briefing note

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Alternative financing structures in the oil, gas and mining sectors

Against a backdrop of falling commodity prices, access to finance has become one of the key challenges facing many industry participants in the oil, gas and mining sectors. Solutions in the form of innovative financing structures and new sources of funding are becoming more and more prevalent. This briefing note examines recent trends and several transactions where novel strategies were employed.

Difficulties in accessing traditional financing

Participants in the oil, gas and mining sectors have been squeezed by a multiyear downturn in commodity prices that gathered pace last year. Oil price benchmarks for instance have fallen by almost 75% in the last 18 months to a 13 year low, while natural gas prices have fallen to their lowest prices in 16 years. The price of iron ore has fallen by almost 70% over the last two years.

In a market characterised by volatility and uncertainty, many industry participants have had difficulty accessing finance from traditional sources. Project finance and market placements of equity capital have almost evaporated as a result of the uncertain outlook and the continued constraints on lending since the global financial crisis.

In response to these constraints, solutions in the form of innovative financing structures and new sources of funding are becoming more and more prevalent. We set out below some recent examples.

Customer pre-payments used to support acquisitions

Commodity buyers have long played an important role in the financing and development of major resource projects. The bankability of new projects commonly depends on contracted future cash flows from foundation customers. Increasingly, however, resource companies and investors are working with customers to identify and finance resource investment and development, including acquisitions with upfront support.

Customer support was a key feature of the 2015 acquisition of Apache Corporation's Australian oil and gas business (now renamed Quadrant Energy) by a consortium of private equity funds managed by Brookfield Asset Management and Macquarie Capital.

The consortium worked with Alcoa of Australia, one of Western Australia's largest gas customers, to develop a long term gas supply agreement providing for 120 terajoules per day of natural gas over a 12 year period commencing in 2020. As part of that arrangement, Alcoa agreed to make an upfront pre-payment on future gas supply of US$500 million. The arrangement provided the purchaser with long term certainty of cash flows, in addition to upfront funding to finance the acquisition.

Collaboration with key stakeholders in restructuring

Contractors and suppliers have also been significantly impacted by falling commodity prices, especially those dependent on specific projects under financial stress.

In April 2015, rapidly falling iron ore prices saw miner Atlas Iron Limited enter into a trading halt and commence discussions with a number of its stakeholders. Despite much scepticism from the market, Atlas was able to continue its operations through an equity raising, debt to equity conversions by contractors in respect of substantial payments in arrears and an innovative collaboration agreement with its key contractors to assist in significantly lowering its production costs.

These agreements allowed Atlas to lower its breakeven costs and continue operations at each of its three sites, ramping up production overall. Under the collaboration agreement, the contractors can receive an uplift in their rates as the iron ore price rises, and receive a total of 25% of applicable positive net operating cash flows. Atlas subsequently reported that this combination had allowed it to deliver positive operating cash flow. However, further falls in the iron ore price have significantly affected the cash flow position of Atlas, despite the described arrangements.

Streaming arrangements to unlock capital

In essence, streaming involves companies exchanging future revenue, and the potential upside in prices, for an injection of funds by selling rights to purchase physical future production (as opposed to royalty arrangements which typically involve the grant of an economic interest based on future revenue or profit).

This financing method allows resource companies to capitalise on proven reserves before production is commenced and can be an attractive source of funding as it is non-dilutive, allowing the company to retain its borrowing capacity, with less restrictive terms. It is not treated as debt or equity.

While this provides opportunities for investors looking to benefit from upside in production and commodity prices over the life of an asset or license, there is a risk that bankruptcy of the mining company may (depending on the structure and security arrangements in place) result in the value of their royalty or streaming investment being written down to zero.

A recent prominent example is Glencore entering into a streaming agreement with Canada's Franco-Nevada in early February 2016 to sell its rights to the future silver and gold output from its Antapaccay mine in southern Peru (the primary reserve being copper). Under the streaming agreement, Franco-Nevada provided Glencore with an upfront payment of $500m in return for the project's future production of silver and gold. In addition, Franco-Nevada will make ongoing royalty payments of 20% of the prevailing gold and silver prices, for precious metals delivered under the agreement.

Multisource non-traditional financing for development projects

New development projects are beginning to use a combination of non-traditional sources of funding to finance substantial and capital intensive greenfields projects. A good current example of this is Ophir Energy plc's Fortuna offshore FLNG project in Equatorial Guinea. Current announced plans to fund the project include an oil services company receiving equity against project development costs, deferred cash payment terms to contractors (until the project is cashflow positive), long term pre-paid gas sales, vendor financing and divestments of assets.

These multi-source funding structures that bring together a variety of stakeholders to fund the development of a project may potentially see significant projects completed without resorting to traditional bank finance at all.

Working capital finance for producers

In the case of producers, commercial banks have long offered products such as borrowing and reserve base lending and repurchase agreement structures, that offer attractive lending rates relative to more traditional vanilla working capital finance products. The common feature of these lending structures is that the lenders look to the inventory and/or receivables (supported by security over or title to these assets) to support working capital finance lines.

In recent times, a number of offtakers and commodity trading houses have entered this funding market either in partnership with lenders or as stand-alone working capital providers with products such as prepaid offtake finance facilities (structured as revolving loans rather than a discounted up front lump sum payment on the offtake).

These arrangements are often highly beneficial to all parties involved, allowing lenders to look through the balance sheet of the producer to what may well be an offtaker with a stronger balance sheet, offering the producers cheaper finance or finance that would otherwise not be available as well as marketing and sales support and allowing customers to secure supply of product and increased returns.

Other trends

A range of other alternative capital providers have either entered or signalled an interest in entering the market to take advantage of the funding gap facing the oil, gas and mining sectors.

A good example of this trend is the many fund investors with a variety of strategies who have raised significant funds to deploy across a wide range of novel finance products and investments, or with strategies to buy and hold cash constrained operations or projects.

We have assisted a number of fund investors to arrange and subscribe for complex, bespoke convertible note issuances tailored to the needs of particular mining companies at various stages in the project lifecycle. As these providers become more prevalent and established in the market, we expect the range and sophistication of these alternative funding sources to continue to expand and increase.

Traditional financing for oil, gas and mining companies remains difficult to obtain and, where available, may be uneconomic. In the current environment, companies and projects that understand and are able to access new funding sources will have greater chances of success.

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