# What comes first - production or the purchase?

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While commodity prices are currently favourable, the general volatility of commodities in the South African market has often presented a barrier to mining companies accessing traditional forms of financing to enhance their liquidity.

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**Streaming contracts**

Streaming contracts involve an upfront payment to the mining company with the financier being granted the right to purchase a percentage of the production of the mine in the future at an agreed price. This structure presents an advantage whereby the mine is advanced the money upfront, which it can then utilise to produce, mine or process the commodity in order to perform under its various sales contracts.

The use of streaming contracts has, however, not been favoured by South African mining companies as the cost of doing a streaming transaction or a metal prepayment transaction is higher in the local market than other available financing options and because there appears to be a negative sentiment from South African shareholders towards streaming transactions . This is due to their quasi-equity nature, as well as the mining company's commitment to sell a specific percentage of future production from a particular mine to the buyer at an agreed price for the next 10 to 20 years, as opposed to agreeing to sell a specified amount.

## Hedging

Recently, mining companies have utilised hedging or forward sales agreements in respect of commodities. Typically, this structure involves the conclusion of an ISDA Master Agreement with subsequent ISDA confirmations in respect of particular transactions. These contracts are typically concluded on a short-term basis (three to nine months) and provide for the sale of a specified amount of a commodity at a predetermined price. This is calculated by reference to a pre-set formula, which references the spot price of the particular commodity on the actual delivery date. In this type of agreement, the majority of the purchase price will be paid to the mining company in advance and on each actual delivery date, a top-up payment or a repayment will be calculated having regard to the published spot price on the applicable delivery date.

The financier may require the mining company to agree to certain covenants, including the following:

- to provide either the operating companies as guarantors or a parent company guarantee (if the operating company is already the seller);
- to prohibit the mining company from entering into any other forward sales contracts in relation to that particular commodity for the duration of the transaction, or to restrict the percentage of its production which the mining company may commit to any forward sale (including by way of metal prepayment facility, streaming or otherwise). Some financiers may also require the mining company to enter into a hedging contract in respect of the commodity price, and this hedging contract may include a floor and cap in respect of the commodity reference price.

## Indirect pre-export financing

As an alternative, mining companies may elect to adapt the tried and tested prepayment financing structures otherwise known as indirect pre-export financing. This financing structure is not limited to exchange traded commodities. In this form of financing, the mining company and the financier enter into a prepayment agreement, which provides (as with streaming contracts and forward contracts) that the mining company will receive an upfront payment to enable it to produce, mine or process the commodity. Simultaneously, the parties will enter into a distribution agreement which sets out the terms under which the financier will purchase the pre-approved allocation of the mine's commodity production as against the financier's ability to market, export (where applicable) and sell the commodity to a customer by means of a sales agreement. It is essential in this structure to identify and allocate the risk to the party best placed to bear such risk. The mine's monthly repayment obligations will be set-off against the end customer's payment of the purchase price.

In respect of set-off, the following requirements must be met, namely:

- the obligations must be between the same parties;
- must be due and payable;
- must be of the same kind; and
- both debts must be liquid. It is important to remember that when it comes to cross-border transactions, parties must comply with any applicable exchange control requirements of the Financial Surveillance Department of the South African Reserve Bank.

## ABOUT THE AUTHOR

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