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Mining Indaba: A Preview

A developing view on African opportunities

Above-ground engagement and structured financing are key themes

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Exceptional opportunities are developing in Africa for those prepared to engage in the right way. The continent's mineral landscape is highly prospective. Its rich geology carries with it the potential for very high returns, making it an attractive frontier for companies and investors alike.

Generally, it is defined by infrastructure and the funding backdrop. However, there are vast differences between countries. Investors are interested in opportunities in less 'risky' jurisdictions, with easily accessible (or limited requirement for) infrastructure and an ability to operate 'in the money' against an insecure pricing backdrop.

To be successful in Africa, mining companies need to ensure stakeholder satisfaction and deliver mutually beneficial arrangements where local communities profit, too.

Project funding will continue to evolve and adapt and as bank financing for new projects remains muted, new and increasingly innovative structures will become normal.

Infrastructure

Transportation, access to water and power are the key infrastructure concerns and significant expenditure has already been committed. Deloitte estimates that US$317.5 billion has been scheduled to be deployed into African infrastructure between 2003 and 2030 but, given long lead times, this capital's availability and affordability for new mining projects is still a long way off.

According to World Bank data there has been almost no increase in rail lines and a decrease in quality port infrastructure in Africa over the past few years.

In light of this, there are many large high-grade deposits that won't be funded nor developed for many years due to poor, prohibitively expensive or non-existent means of exploiting and moving ore from them. Because prices are low, mining projects with high infrastructure needs, such as iron ore, are struggling to survive.

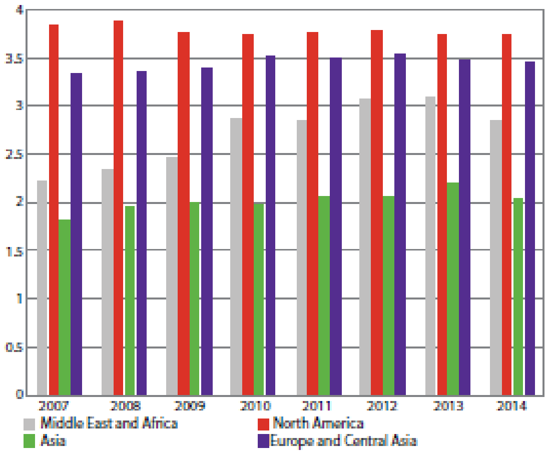
In 2010/11 there were 42 live iron ore projects, this has fallen to 15 live projects and 33 are on hold, closed or being restructured.

Politics

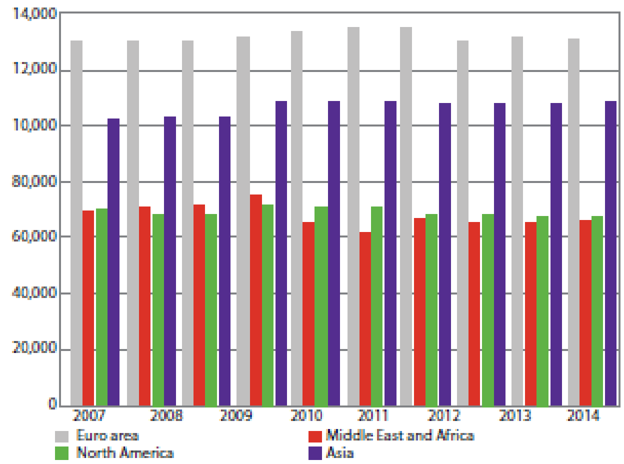
Resource nationalism reared its head in Africa during the commodities 'supercycle'. Country risk for mining companies should be viewed in terms of a country's attitude to mining, rather than in terms of its credit rating. Governments in two of the most prolific mining jurisdictions, Zambia and the Democratic Republic of the Congo (DRC), have made attempts to repatriate profits by seeking greater ownership or increasing taxes and royalties imposed on foreign entities.

This should always be viewed within the context of a government trying to ensure their country benefits from mining activity, in a form that largely follows the Australian example. Success stories in Africa, such as Randgold Resources, have always placed great importance in how they engage above ground.

A key theme when considering country risk is the spread of 'third termism'. Constitutions across the continent have been amended to allow a number of African leaders to remain in power beyond the previously defined maximum term. Limits on the time a leader can remain in office are intended to prevent abuses of power. The DRC is due to hold elections in January and November 2016 with Josef Kabila looking to run for a third term.



Quality of port infrastructure, WEF (1=low; 5=high)



Railway lines (total route km)

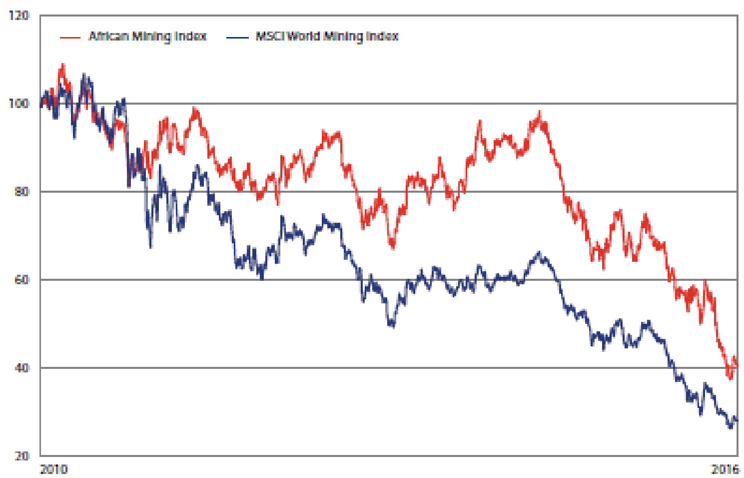
To place a frame around the gravity of this situation, in 2015 the DRC commanded the largest exploration budget of all African countries, totalling US$175 million or 2% of worldwide exploration budgets, according to SNL's Exploration Strategies.

With the DRC holding more than twice the exploration budget of any other African state, there is a huge amount at stake if investors perceive that his seeking of a third term is a signal that sovereign governance is at risk.

Guinea Conakry has made strong advances in encouraging mining activity by lowering taxes to 30% and cutting taxes on bauxite production.

In Sierra Leone, in spite of Ebola, the government has been proactive in making it an attractive jurisdiction for international companies. Tanzania's President John Pombe Magufuli has promised to improve governance since entering office in 2015 and has begun to lay the foundations for a much clearer regulatory environment for mining companies.

Other African nations, particularly those that are oil-dependent, are trying to boost activity in other extractive industries and this is likely to become a theme. The newly appointed mining minister in Nigeria, Kayode Fayemi, is tasked with building an investor friendly regulatory environment for mining. It is unclear how this will play out, but it has been interesting to read that his government is explicitly encouraging the export of 'un-beneficiated' ore to international markets.



The African Mining Index vs MSCI World Mining

Equity (PE) funds and, while we have seen deals materialise, such as Greenstone's US$12 million commitment to North River in Namibia, these have not been large. The first half of 2015 saw just US$173.2 million of PE investment in African mining projects.

The larger generalist funds, which have invested in African infrastructure, will be intrigued by increasingly low asset valuations within the mining sector.

Deals otherwise have increasingly complex structures driven by the ongoing lack of able mineral rights, as well as enforceable contract legal regimes.

Another opportunistic strategy is emerging. Long-term investors are looking for option-like strategies where projects that require a modest capital outlay are acquired. These have minimal carrying costs and certainty that investments can be held until markets improve. For this kind of strategy to be successful, security of tenure will be paramount.

A recent example of deal meeting these criteria was announced in 2015: Interalloys

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Funding dynamics

Falling commodity prices have pushed major companies to cut capital expenditure and place a number of projects on hold. Anglo American, among others, announced a radical restructuring and we can expect more than US$1 billion of capex cuts from them. There was also Glencore's high-profile divestment of its non-core 23.9% stake in Lonmin.

Foreign direct investment for independent mining companies has fallen along with valuations. It is worth noting that the African Mining Index marginally outperformed the MSCI World Mining Index during both 2015 and over the last five years (*see above, right*).

Investors will continue to search for and invest in projects with low infrastructure requirements, driving funds initially towards precious group metals and gemstones, followed closely by base metals. For vanilla financings, companies profitable at current commodity prices with a diversified asset base across Africa should continue to attract finance from public market investors. Notable success stories that meet these criteria include Randgold Resources and Petra Diamonds.

Two years ago, the focus was on the amount of 'dry powder' held by Private available bank financing for mining projects – 21% of global mining PE deals executed in the first half of 2015 also gave investors commodity exposure via a royalty or stream.

Past failures in structured financing deals happened because there was an excessive transfer of risk onto investors, who were left with no downside protection. In the future, there will be more sharing of risk between parties. These structures allow the borrower to avoid further ownership dilution and the lender to generate a return profile that is commensurate with the risk.

These arrangements create a strong alignment of interest between lenders and borrowers to ensure that production is maintained. Other advantages have contributed to the growth of this sub-set of financing, including:

- Potential to participate in price recovery;
- The distancing of operational risk;
- The flexibility in structuring the arrangement;
- Potential capital structure reporting benefits; and,
- The transferability of such structures.

However, for Africa to participate in this flexible financing sector, there needs to be sound principles of asset ownership, inalien- Trading acquired the Mayoko-Moussondji iron ore project in the Republic of Congo for A$5 million. The consideration is not payable until a number of conditions are met by Equatorial Resources (the seller) securing Interalloys Trading production over an eight-year initial mine life, producing at 2.5 milion tonnes per annum. There is potential for further capital to be deployed if prices recover.

There is still a lot of work to be done to improve Africa's infrastructure, but mining activity will continue nonetheless. Projects that achieve the delicate balance of profitability and local stakeholder requirements are likely to achieve the greatest success. From a funding perspective, increasingly structured deals will dominate and both mining companies and investors must ensure their interests are aligned to deliver a favourable outcome.

The China-Africa investment theme, so prevalent over the last two years, appears to have taken a back seat. In the first half of 2015, Chinese investment in Africa fell 84%, according to fDi markets. This change will not be permanent and China will surely return as a significant driver of activity in the African mining sector. How this develops will have implications for both infrastructure and local community engagement.

Arabella Burwell, Director at Hannam & Partners. She has strong relationships with key European institutional investors and has worked closely with a number of natural resources companies listed in both the UK, Canada and Australia. She has extensive experience with capital raising and private placements.