Juan-José Zentner and Michael D'Agostino, Herbert Smith Freehills, USA, discuss the outlook for mining projects in Latin America, and identify emerging themes, new players and key challenges facing the sector in 2019.

GATHERING MOMENTUM

After a largely stagnant 2018 due to China-US trade tensions and falling commodity prices in 3Q18, miners in Latin America are looking to 2019 with cautious optimism. After reducing debt levels over the past few years, the primary focus of miners is returning value to shareholders – although stabilising copper, gold, silver and zinc prices will provide potential for capital to be allocated to brownfield expansions and select new greenfield projects.

Miners will also be seeking a more robust risk transfer to those contractors engaged on capital projects, and the increased involvement of private equity and generalist investors will potentially bring new ideas to bridge CAPEX gaps and plug funding shortages.

Social licence to operate

The concept of corporate social responsibility is nothing new for miners. Engagement with local communities has been a core component of mining strategies for a long time, and miners are acutely aware of the importance of sensitively and appropriately managing all stakeholders affected by mining operations.

Recent trends across Latin America – and particularly in Mexico, Peru and Chile – are showing that a 'one-size-fits-all' approach to corporate social responsibility is insufficient to win buy-in from local communities. Industry players are now widely predicting that a social licence to operate, from both local communities and end users, will be the biggest issue facing miners in 2019. Supporting this view is that obtaining a social licence to operate has moved up from number seven to number one in EY's 2019 - 2020 top 10 business risks facing the mining and metals industry, with operating delays caused by social conflicts potentially costing miners more than US$20 million per week.[1]

In Mexico, President Andrés Manuel López Obrador has recently blocked Invecture Group's US$250 million Los Cardones gold project for environmental reasons and fear that the project could have a negative impact on water and wildlife in the Sierra de la Laguna nature reserve.

The environmental approval for Teck Resources' Quebrada Blanca Phase II project in Chile has recently been challenged by the Aymará indigenous association of Chanavaya. The basis for the challenge is that no anthropologic study was done to inform the view that the project will have no environmental impact (which was used to justify excluding the Aymará indigenous association from the consultation process).

Newmont Mining's US$4.8 billion Minas Conga gold-copper mine and Zijin Mining's US$2.5 billion Río Blanco copper-molybdenum property, both located in Peru, have

been cancelled due to social conflicts during the procurement phase. The Tía María copper mine owned by Southern Copper has also been significantly delayed due to environmental protests.

While the evolving and ever more complex stakeholder landscape will continue to be a critical challenge for miners, one perspective is that increased formal consultation processes could lead to greater transparency and, ultimately, stronger engagement with local communities. Miners that are able to recognise this as an opportunity to create shared value between their projects and the local communities will have a clearer path to delivering projects, whereas approaching community engagement as a formal compliance process will continue to be less and less effective (and perhaps even fail entirely and permanently in some circumstances).

Another emerging trend linked to a social licence to operate – especially in the battery materials industry – is a growing end user base that is concerned with the provenance of materials from the mining industry. Socially conscious millennials that are consumers of battery materials and other metals in smart phones (which contain 62 different metals) and drivers of electric vehicles (which rely heavily on lithium, graphite, copper, titanium, aluminium, nickel and cobalt) are increasingly questioning if their metals and minerals have been sourced ethically. This presents a new challenge for miners.

Miners working together

The increased responsibility to integrate with and capture value for local communities, as well as to minimise environmental impacts, cannot be achieved by miners in isolation. The higher cost of a social licence to operate, combined with prevailing macro uncertainty regarding commodity prices, is creating further incentives for miners to work collaboratively to pool resources and spread risk to tackle their projects.

In 2015, Canadian miners Teck Resources and Goldcorp agreed to combine their assets in Chile into a single 50/50 gold-copper joint venture known as NuevaUnión. The project combined two development assets – the US$4.5 billion Relincho and US$3.9 billion El Morro projects, both of which had been previously postponed due to environmental issues and unfavourable market conditions. The two assets are located 40 km apart, and planning to develop the projects together has allowed Teck and Goldcorp to consolidate their planned infrastructure to reduce costs, reduce the aggregate environmental footprint of the two assets and provide greater returns than either project alone. NuevaUnión includes a single desalination plant, transmission line, concentrator and a common tailings facility, and provides a blueprint for potential future collaboration in the region.

The theme of collaboration among miners continued into 2018 with two of the most significant greenfield projects only being pushed forward after increased minor equity participation – Mina Justa (Minsur sold 40% of the project to Copec for US$200 million) and Quellaveco (Mitsubishi Corporation increased its minority stake from 18.1% to 40% in a sell-down by Anglo American).

It is expected that this theme of collaboration will grow in 2019, with Teck already announcing the sale of a 30% stake in its Quebrada Blanca Phase II project to Sumitomo Corporation and Sumitomo Metal Mining.

In an environment where the appetite for large deposit greenfield opportunities is limited and commodity prices are cautiously stable, in 2019 and beyond, miners will have the opportunity to work collaboratively to bring capital-intensive greenfield projects into production. This is particularly relevant at this point in the cycle where its widely tipped there could be a lack of meaningful future supply (particularly in copper) due to subdued CAPEX investments and slashed exploration budgets over the past few years.

Non-traditional investors and funding structures

Falling commodity prices in 3Q18, and a lack of headline deals in Latin America generally, cooled involvement of traditional sources of project finance (commercial banks and export credit agencies) in 2018.

At the same time, modest returns on cash assets have motivated investors to look to infrastructure funds for higher returns, which have exploded in the last few years. For example, I Squared Capital closed the US$7 billion ISQ Global Infrastructure Fund II (up from initial target of US$5 billion) in 2018, and Macquarie has recently closed the US$5 billion Macquarie Infrastructure Partners IV fund. Fund managers raised a record US$85 billion in 2018 for infrastructure investments, and Reuters predicts infrastructure funds globally have a record US$172 billion in capital yet to be invested.[2]

The combination of these two factors, and the promise of high shareholder returns in the mining sector for 2019, is slowly pulling generalist investors and private equity into mining in Latin America. These alternative sources of funding and equity are bringing new ideas (mainly driven by shorter investment horizons), and could play a vital role filling the funding gap across the sector. Mining is traditionally an asset class that has been largely ignored by private equity globally, so its involvement is relatively new. How private equity firms choose to structure deals from both an investment and exit perspective will create significant opportunities in the sector over the coming years. In turn, these non-traditional investors bring non-traditional debt and equity structures with them.

One theme that is predicted to grow for 2019 is the continued rise of streaming transactions (especially for battery materials) as an alternative source of funds for smaller non-traditional investors, or junior mining companies that are backed by private equity that do not have the robust balance sheets of traditional miners. Streaming is a financial transaction whereby a streaming investor provides an upfront payment to a miner in return for a claim on a percentage of the mine's production or its 'stream'. Traditionally used in the precious metals sector, the streamer is taking more risks than a traditional financier as it is tying its return to the production of the relevant asset.

From a miner's perspective, streaming has the benefit of shifting a proportion of production and commodity price

risk to financiers, and it allows an owner to crystallise its revenue stream earlier in the development cycle (which is an important requirement of private equity). It can also be used to monetise by-products from primary mining operations, such as silver.

2018 saw streaming largely move into battery materials for the first time, in particular lithium and cobalt. Vale announced that it had agreed to sell 75% of its cobalt stream from its Voisey's Bay nickel mine to Wheaton Precious Metals and Cobalt 27, and Orion Mine Finance II LP has purchased 14.5% of the lithium steam from Nemaska Lithium's Whabouchi lithium mine for US$150 million. Both of these transactions were in Canada, but this trend is particularly encouraging for lithium miners in Latin America, as lithium projects have typically struggled to attract traditional forms of project finance (and have generally been balance sheet funded). It will be interesting to see if streaming has a role to play in solving the funding puzzle for lithium projects in Latin America during 2019.

Off-balance sheet transactions

Another transaction structure that can solve funding gaps for miners is build-operate-transfer (BOT) contracts. BOT contracts are a form of project financing whereby a private company will finance, construct and operate an asset for a concession period in return for operation and maintenance payments to cover the upfront capital cost and the operating costs of the plant. At the end of the concession period, the asset is transferred back to the host entity for free (typically, a government entity, or in this context, state-owned miners).

In response to uncertainties regarding funding and competing strategic priorities, Chilean state-controlled copper giant Codelco is tendering for the construction of a US$1.2 billion desalination plant originally planned as part of the US$5.4 billion Radomiro Tomic mine sulfuros expansion project under a BOT contract.

Higher risk transfer to contractors

In response to lower headcounts in owner project teams and the significant cost overruns that were encountered during the last high price cycle, miners are increasingly looking to outsource greater responsibility (and risk) to contractors.

The shift away from the traditional model of engaging an engineering, procurement and construction management (EPCM) contractor post-design, and towards securing fixed 'turnkey' or EPC contracts, is likely to gather momentum in 2019. There are a number of reasons for this, some of which are being driven by miners and others that are increasingly becoming requirements of financiers.

The key difference between the EPCM model and turnkey contracts is that turnkey contractors are ultimately responsible for delivering an asset of a certain quality, to a fixed programme and budget, subject to very limited exceptions. The majority of events that can lead to cost and time overruns will be at the contractor's risk, and in return for a risk premium, the owner has essentially outsourced the procurement and construction management function that would usually sit with the owner's team (or be supplemented under an EPCM model).

This can be contrasted with EPCM contracts, where the contractor will assist the owner with the management of subcontracts and delivery of the project, but carries little risk for events that are outside the EPCM contractor's control (e.g. interface issues between subcontractors, geotechnical conditions and changes in expected quantities and scope).

One of the primary benefits of a turnkey model is that it reduces the pressure on the owner's team and transfers the management of construction risks to an expert better equipped to manage that risk.

The fixed quality, cost and time nature of turnkey contracts also make projects more digestible for investors and financiers. Increased time and cost certainty makes the risks associated with procurement and delivery far easier for investors and financiers to quantify. The enhanced transfer of construction risks to a turnkey contractor also means that there is an additional layer of protection (for sponsors and financiers) where an event or risk is realised that is traditionally uninsurable (e.g. geotechnical and subsurface conditions departing from expected conditions, encountering unexpected contamination and quality issues with local contractors).

Not only do turnkey contractors accept a broader class of risks than compared to traditional EPCM models, but the current market trend is also moving towards turnkey contractors accepting a higher quantity (in dollar terms) of overall risk exposure. Under certain negotiating conditions, much more robust liability caps are being achieved with turnkey contractors, well above the liability caps typically agreed by EPCM contractors.

Moving forward

A focus on reducing debt levels for miners over recent years will hopefully mean traditional market participants and new non-traditional investors are well placed to take advantage of mining opportunities in 2019 and beyond. Challenges remain in the region and the sector – particularly obtaining a social licence to operate – but new sources of funding and stronger risk transfer to contractors should enable brownfield expansions and greenfield projects to gather momentum in Latin America during 2019. GMR

References

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Note

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