MINING PROJECTS IN THE CIS: MEZZANINE VS. DEBT FINANCING

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Abstract

Mining industry in the CIS countries is intensively developing and constantly exploring new fields of natural resources. The opening, exploring and developing of the new fields is highly capital intensive, and requires considerable capital investments in the early stage of development. While large projects are mostly financed from the internal sources of the investors, smaller projects frequently offering high rates of return and requiring substantially less investments can attract groups of smaller investors through the specific financing instruments. Assuming the relatively high risk level of the projects realized in the CIS countries, the choice of the financing options is being substantially narrowed down. Mezzanine financing can be an option for the financing of the professionally prepared smaller mining projects in the CIS countries. The aim of the paper is to identify the differences between mezzanine, debt and equity financing in mining industry taking into consideration the specific conditions of the CIS market.

Keywords: mining projects, CIS, mezzanine financing, debt financing, private equity

1. INTRODUCTION

Incomes from the natural resources development play significant role in the structure of the economic growth of the most of the CIS countries. Most prospering CIS economies have benefitted greatly over the past decade from the rising high prices of raw materials in international market [1]. Due to the fact, that the sources of natural resources have a tendency to run out, the mining industry has to continuously explorer not only new fields, but also to new types of them. Rare ores and minerals are currently attracting the significant attention of the smaller mining companies because of the lower costs of the initial investments needed for developing them due to the higher prices of minerals. Large mining market players due to the ability to access the financial markets and sufficient equity are focusing on developing of the large projects. Smaller projects that are less interesting for the big players due to the lower absolute profit level require less investment, but are often offering even higher rate of return, especially if they are focused on the rare minerals and ores. Smaller private investors or investment funds, often with the origin out of the mining business, are able to provide sufficient capital for this type of projects. Financing of the smaller projects is challenging, but in case of intensively and carefully prepared projects several options of financing are available.

2. NATURAL RESOURCES DEVELOPMENT IN THE CIS COUNTRIES

Developing of the raw materials in Russia, Kazakhstan, Azerbaijan and other CIS countries is the power of their economies, and due to that a subject of intensive attention of the political representation. Mining related industry fields share in the GDP industrial structure is getting close to 56% in Kyrgyzstan, 38% in Tajikistan, 23% in Ukraine, and 17% in Armenia, varying between 12-13% in Russia, Kazakhstan and Uzbekistan [2]. The position of the foreign natural resources developers in Russia and other CIS countries varies. For instance the Russian Government on one hand offers some foreign companies stakes in the new fields but on the other hand, it has pushed some companies into a corner [3]. International giants like Shell or BP are able to challenge the market conditions in the CIS. But speaking about smaller projects it is quite obvious that due to the potential risk of substantial preferences for the local companies, and the ability of the locals to solve potential problems, investors would prefer to finance local companies in developing of the new fields.

Focus on natural resources creates merciless competition between the market participants searching for the most profitable opportunities. Financial barrier is the most significant one which is helping successful competitors to win the battle. Even assuming the fact that rich fields can mean substantial returns, we should state that opening, exploring and developing these field, and extracting the materials themselves is highly capital intensive and requires considerable early stage investments [1]. Strong financial planning and preparation is extremely important for mining projects development, taking into consideration that the project requires exact evaluation of the quality and quantity of the available material and possible investment into the transport and energy infrastructure [1]. Smaller mining projects require an individual approach as they have different conditions concerning total required capital, expected revenues, risks and possible profit. They are capable of attracting groups of smaller investors, which creates the possibility to use a wide range of financial products for smaller projects financing.

3. PREPARATION OF THE PROJECT FINANCING

In case that the project management team is planning to use the external sources for project financing, it must be able to finance the preparatory phase, including geological survey, infrastructure and mining operations planning, receiving the necessary state permissions to develop the field. Trustworthy confirmation that the field will be profitable will lower the risks for the investors and will widen the financial options, including the access to the debt market finance. It case that the project will seek financing on the debt market, it should meet basic capital market requirements and demands. The main criteria's important for successful debt market financing of the mining projects include the following:

- Developing permissions and license without issues, ability of the project management team to solve local political and administrative issues.
- Transparent project and shareholding structure, experiences management team, and reputable sponsor, sharing risk by investing own funds as equity [1].
- Existence of the long term offtakes.
- Potential profit estimates and the projected period of mining should indicate significant size of the project.
- Reporting must meet the International Financial Reporting Standards, and must be audited by the respectable company.

Projects with the potentially high production costs, legal or licensing issues, and potential problems with the environment protection, unexperienced management and insufficient initial financial support have substantially lower chances to get debt financing due to the outstanding risk level for the investors. Foreign investors usually expect the operation on the CIS market to have the higher risk level due to the poor market transparency, direct market interventions, control on export and import operations, poor protection of property rights and investment protection, high level of corruption and ineffective judiciary, potential political influence, legal and administrative barriers, and other unpredictable factors [4]. Investors will probably expect higher potential profits and will define more complex conditions in comparison this the projects realized in the stable political environment. Transparency in the shareholding structure and substantial financial involvement of the initial sponsors will increase the investor's confidence in the project.

Researches generally recommend the project management team the strategy of the proper planning of the projects, including a high quality communication strategy, due to the fact that potential investors receive a variety of possible investment proposals, and only creative and well prepared solutions may distinguish the project from others. PricewaterhouseCoopers analysts recommend to [1]:

- provide results of the geological analysis in time to enable investment decisions;
- control the local management and operations team;

- ensure a proper subsoil license is obtained without issues;
- comply with the lender's regulations, like sustainability conditions, etc.;
- underpin the funding needs with a proper financial model and reasonable assumptions from the very beginning;
- send technical advisors to perform early site visits;
- secure the confidentiality of all information;
- set up workable investment structures.

4. MINING PROJECTS FUNDING OPTIONS

Developers of the new mining projects have a wide array of potential financing options. They might use the following sources of the private and public markets:

- equity financing, including venture capital, business angels and IPO;
- traditional debt financing, including bonds and senior loans;
- mezzanine financing.

Equity financing is represented by an initial investment into the common or preferred stocks. Equity financing might be ruled out, either because venture investors assuming the high risk level of the deals in the CIS countries will expect more substantial guarantees, or more equity than the sponsor (project management team) are prepared to surrender. Mining projects usually require substantial initial investments, where initial public offering can be applied. Unfortunately IPO also means high registration and other transaction costs. Speaking about the IPO investor must take into consideration, that initial public offering especially for complicated young projects may be severely underpriced if it's being taken public prematurely, so the existing owners of the project basically bear this price difference. The greater the uncertainty about the project, the greater the disparity between the intrinsic value of the equity and the price paid by the investors [5]. Other forms of financing, including mezzanine financing, can supply the interim funding until the project has overcome the startup difficulties, may postpone the IPO and potentially bring substantial profit in the future, when we stock price will be close to the real value.

Debt financing is represented by traditional senior loans, including term and revolving loans, and bonds. Unfortunately for many of the new mining projects especially in the CIS countries long-term straight debt financing may be either unavailable, or the required interest rate may be too high, and also may impose other terms that are unacceptable for the owners [5]. In these cases mezzanine financing representing a relatively new option, which combines equity and debt financing often being called the quasi-equity financing may help.

5. MEZZANINE FINANCING

Mezzanine financing fills the gap between low-risk collateralized debt provided by the traditional lenders (usually banks) and high-risk equity investments (venture investments, business angels). Mezzanine debt is subordinate to the senior loans, and may have varied structures, depending on industry, market, and regulatory issues, and actually refers to an array of financing instruments, including junk bonds, unrated debt, unsecured notes, zero-coupon bonds, deferred interest debentures, and convertible loans [6]. **Fig. 1** represents the positioning of the mezzanine investments in relation to equity and debt financing.

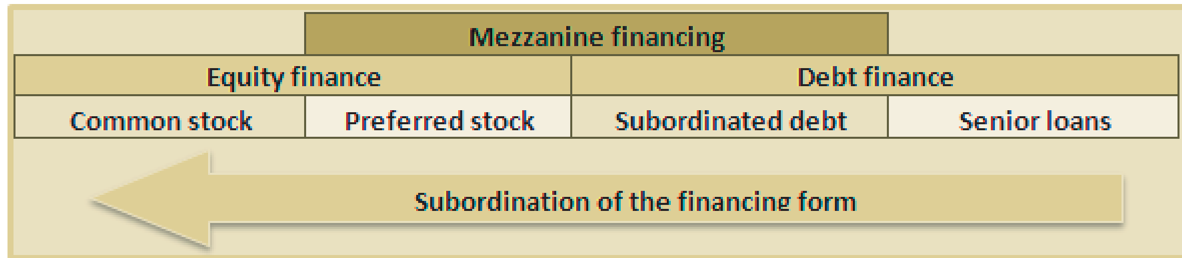

Fig. 1 Mezzanine financing in relation to the equity and debt financing

The history of the mezzanine financing goes back to the 1970´s, when it was offered by a limited number of institutions (insurance companies, savings and loans associations) in the US as both alternative and an addition to traditional secured bank financing [7]. Currently mezzanine financing market is represented by mezzanine investment funds, including pension and hedge funds, which appeared in 1990s. Average mezzanine deals in the US reach the level of $50 million. The European mezzanine market has now shown itself capable of funding large transactions in the range of 300-400 million EUR [7]. Mezzanine financing becomes very popular in the last decade. For instance during 3 years from 2004 to 2008 mezzanine financing for the corporate deals had increased approximately 125 times, since senior lenders were less willing to loan as much money for commercial projects [8].

The specific feature of the mezzanine financing is that it usually offers the long term capital at the substantially lower affordable price in comparison with the debt or equity financing. It can be called a win-win position on the financial market, offering the lender higher return rate in comparison with the straight debt financing and lower risk level in comparison with the equity financing. In most mezzanine financing deals, the debt comes with warrants to purchase equity later. Sometimes warrants are replaced by the preferred stocks or convertible bonds. The main difference between mezzanine and venture investments is in the amount of equity surrendered by owner, which rarely exceeds 15% [5]. **Table 1** summarizes advantages and the disadvantages of the mezzanine financing for the borrower.

Table 1 Advantages and the disadvantages of the mezzanine financing for the borrower

Advantages	Disadvantages
Mezzanine financing is often treated by traditional debt lenders like equity on a company's balance sheet, and is also being called a quasi-equity financing	Mezzanine investors may require companies to give up some independence, including lender vote on the board of directors [6]
Standard operational bank financing may be easier to obtain in case of mezzanine financing	Company may be forced to purchase goods and services in the companies related to the lender, or by more expensive accounting and audit services
Projects can be partially financed by straight debt financing in combination with the mezzanine financing	Higher price in comparison with the straight debt financing
Mezzanine financing has generally lower price in comparison with the equity financing	Obligation to cash out the equity position
Mezzanine financing can be usually faster arranged comparing to the IPO or debt financing	

In case of the default of the project, mezzanine investor's requirements are settled right after the first line creditors, as senior loans, employees and state. Mezzanine debt is generally senior to the equity of the borrower. Unlike a traditional bank loan, a mezzanine lender does not hold real assets of a company as collateral but instead has an indirect link to the company's equity in case of default [6].

6. COMPARISON OF THE FUNDING OPTIONS

Every project has specific aspects that can determine the most suitable form of financing. In most cases startup mining projects realized in the CIS countries will have more complicated access to the standardized forms of financing due to the risk level and other factors. Project sponsors and project management team should compare all available options using all possible criteria's.

Table 2 presents the basic comparison of the equity, mezzanine and debt financing, including emission of bonds and senior loans. The biggest advantage of the equity financing is the easier access to the standard bank loans for the operational needs due to the zero initial debt level, which is compensated by the high IPO costs, possible initial underpricing and loose of control for the owner. Mezzanine financing is cheaper, first owner remains control over the company and this form is the only one which can be available for the risky mining projects in the CIS countries. The biggest disadvantage of mezzanine financing is its limited availability and high competition between projects.

Table 2 Comparison of the different funding options

	Equity	Mezzanine financing	Debt financing	
			Bond	Senior loan
Advantages	- Long term financing - Easy access to the bank loans (no initial debt financing)	- Mid to long term financing - Usually no sharing of control - Available financing form for the risky projects - Possible access to the bank loans (quasi equity) - Lower capital costs in comparison with equity - High flexibility	- Long term financing - No sharing of control - Strong demand on the bond market in Russia - Local currency (RUR) - Lower interest rates	- Potentially long term financing - No sharing of control - Lowest price - Possibility to combine with state guarantees
Disadvantages	- Sharing of control - IPO of the new project may be severely underpriced - Capital market requirements - The most expensive type of financing - High initial costs - Young or non-existing local CIS stock market - Not a local currency	- Capital market requirements - Limited availability	- Capital market requirements - Long time needed - High initial costs - Strict covenants - Substantial involvement of the owners capital needed	- Insufficient funds on the local bank market - Strict collateral requirements - Strict covenants - Substantial involvement of the owners capital needed - High interest rates offered by the local banks

Bond debt financing is one of the cheapest forms with the relatively high demand, the bonds can be issued in local currency and the owner doesn't have to share control over the company. On the other side this form is quite expensive, usually requires strict covenants and substantial involvement of the owners capital. Bank loans are the best choice, they are cheap, can be combined with state guarantees and don't require any control sharing. Unfortunately receiving bank financing of the mining projects in Russia and other CIS countries will be the most challenging form due to the weak CIS bank market, insufficient available funds and high interest rates.

CONCLUSION

Mining industry in the CIS countries is intensively developing and constantly exploring new fields of natural resources. The opening, exploring and developing of the new fields is highly capital intensive, and requires considerable capital investments in the early stage of development. While large projects are mostly financed form the internal sources of the investors, smaller projects which require less investment, but offer even higher rate of return, can attract groups of investors out of the mining business using specific financing instruments. Financial barrier is the most significant for the new mining projects. Opening, exploring and developing new field is highly capital intensive. Strong financial planning and preparation is extremely important for mining projects development. Successful projects must have significant size, transparent shareholding structure, experienced management, all developing permissions without issues, ability to solve local political and administrative issues.

Assuming the relatively high risk level of the projects realized in the CIS countries, the choice of the financing options is being substantially narrowed down. Equity financing might be ruled out, due to the high risk level, and especially the IPO of the startup projects can be severely underpriced. Other forms of financing that can supply the interim funding until the project has overcome the startup difficulties, may postpone the IPO and potentially bring substantial profit in the future, when we stock price will be close to the real value. Long term debt financing for many of the new mining projects may be either unavailable, or the required interest rate may be too high, and also may impose other terms that are unacceptable for the owners. Mezzanine financing, which combines equity and debt financing, often being called the quasi-equity financing, can be an option for financing of the professionally prepared smaller mining projects in the CIS countries. The specific feature of the mezzanine financing is that it usually offers the long term capital at the substantially lower affordable price in comparison with the debt or equity financing. This form is the only one which can be available for the risky mining projects in the CIS countries. The biggest disadvantage of mezzanine financing is its limited availability and high competition between projects.

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