;

Trade wars: Cash for traders in a stormy climate?

Jean-Francois Lambert, founder of Lambert Commodities, outlines the potential impact of trade wars and protectionism on commodity trading houses, and how the current geopolitical turmoil could prove to be a boon for savvy traders.

Jean-Francois Lambert (http://www.txfnews.com/Tracker/keyword/Jean-Francois Lambert)

CEO at Lambert Commodities (http://www.tagmydeals.com/Company/Details/13459) 1 August 2018

AGRICULTURE (/HOME/SECTOR/5852/AGRICULTURE) COMMODITY TRADE (/HOME/SECTOR/23/COMMODITY-TRADE)
COMMUNICATIONS (/HOME/SECTOR/5935/COMMUNICATIONS) ENERGY (/HOME/SECTOR/5853/ENERGY)
INDUSTRY (/HOME/SECTOR/5854/INDUSTRY) MINING (/HOME/SECTOR/5856/MINING) OIL & GAS (/HOME/SECTOR/5859/OIL-GAS)
POWER (/HOME/SECTOR/5858/POWER) RENEWABLES (/HOME/SECTOR/5861/RENEWABLES)
SOCIAL INFRASTRUCTURE (/HOME/SECTOR/5863/SOCIAL-INFRASTRUCTURE) TRADE (/HOME/SECTOR/5952/TRADE)
TRANSPORT (/HOME/SECTOR/5864/TRANSPORT)

Are trade wars and protectionism threatening world order? So far, the actual economic impact has been almost nothing: the US economy is growing this year at an emerging economy pace (4.1% in the three months to 30 June); world GDP is set to double in the next 25 years; and world merchandise trade grew faster than the world GDP in 2017 (4.7%).

Is globalisation at risk? The world economy is structured around intricate supply chains, production centres are highly decentralised, value chains form a complex web and trade is by and large is one of many semi-finished products. Can politics undo what economies have built out of efficient use of skills, technology and highly effective cost optimisation? Pascal Lamy, the former Director General of the WTO, says with such a high degree of interdependency of the world economies, the cost to undo globalisation is simply too high to afford. In other words, politics are bound to fail to create a new economic order.

This is the positive view. A grimmer picture would be that tit-for-tat measures could lead to more tensions, translating into geopolitical polarisations. What is shaping up for instance in the Middle East around renewed sanctions against Iran does not bode well. Very soon, not a single international company will be able to invest or trade with Tehran. How will the country react? This is everyone's guess – or worry. China's economy is showing some signs of slackening and will be affected by the trade measures taken by the Trump administration. So far, outright escalation has been carefully avoided, but already pressure points are felt, notably in the US where subsidies have been promised to farmers to cushion the impact of tariffs on soybeans.

To be sure, the current protectionist tensions will not be easily tamed and while one could expect a limited impact on growth, it would be naive to believe they will have no impact. Should tariffs be raised, productions channels will be re-assessed, with the potential re-shaping of some global supply chains. This will not happen overnight however, and while companies are planning for the worst, they're unlikely to over-react to measures that common sense leads to believe they have taken as part of a hard bargain, and are unsustainable in the long-run.

However, in the meantime, it is fair to say that disruptions will occur. Trade routes will have to factor in trade wars. Already some markets are clearly affected: the soybean complex for instance: China was importing 36 million tons of soybean from the United States, a bit more than one-third of its yearly requirements. With tariffs in place, this massive trade flow is no longer affordable. How easily can China switch to another producer? Already Argentina and Brazil supply the bulk of the balance of its 100mt requirements. Can China get to another source of protein? Maybe, but not on that scale and certainly not in the short term. Similarly, will China continue to import crude oil from the US? Over the first five months of this year, it has imported 16.3 million barrels. If either for political or other reasons this is no longer feasible, what will be the most efficient alternative? Iran? Middle East, West Africa? Conversely, would China be compelled to boost their US imports to rebalance the US' trade deficit? Many questions but few answers. This new normal is creating more uncertainty than ever.

Is uncertainty good for some?

Could this be good news for some? I cannot help but think that we might be at the dawn of a new golden age for traders. Before trade wars, very few would have bet on the long-term sustainability of commodity trading amid increased transparency, accuracy and spread of information, and lack of volatility. To be sure, the world has changed since Mark Rich's time: information is pervasive when nobody knew for certain who was buying what and when. Commercial margins are so thin that trading houses profits rely on an ever more sophisticated management of financial instruments on the back of physical trades, when 30 years ago, the bulk of profits was done on sheer market intelligence and commercial sagacity.

But what about now? The current turmoil can prove to be a bonanza for savvy traders. For Shorts, consumer requirements are clearly identified and not bound to change at least in the short-term, which is the time span of commodity trading. Longs on the other end, are immediately affected by trade wars or geopolitical polarisations: sanctions, embargos, and tariffs will disrupt – if not dislocate – supply chains, commercial routes and stress relationship between buyers, sellers, and risk takers. A situation trading houses will be able to take advantage of compared to integrated supply chain managers as a sense of anticipation, market intelligence, flexibility and creativity are their forte. When supply is stressed, two things happen: volatility jumps and commercial margins become more attractive. This plays in the hands of trading houses.

A more attractive playground is certainly shaping up in both the agri and energy sector. In agri, the bulk commodity sector, it has been so difficult to trade over the past few years, and it will probably bring interesting opportunities to traders (drought in Argentina

was already bringing some disruption before the trade wars' effect), a much-needed bit of good news for some who's independence was challenged, amid back-to-back years of unattractive results. In the energy sector, Iranian crude will have to be replaced whereas US exports may need to be redirected: very good trading opportunities, potentially. In metals, steel and aluminium are at the centre of the US concerns so prices and premia are already dislocated.

Will all traders benefit from such market conditions? This is hard to tell, but – and this could be an unexpected change of paradigm, we can't rule out that the nimblest amongst them (those with a relatively light asset base) would be in the best position. For a long time, the market has not been as uncertain as it is now. Optionalities are shifting. This will create new opportunities for the most flexible trading houses providing they maintain a very liquid position and are not too heavily invested.

A golden age for trading? Maybe not in the long run but politics have just started to disturb trade and are unlikely to backdown anytime soon. It's not quite an attractive enough landscape for us all to be sure.

Commodity trading houses will beg to differ as they make sure, come rain or shine, that strategic supply remains available. Like Formula One racers, traders like rain, and the current geopolitical landscape is just providing a good measure of it. Quite an unexpected outcome of the US elections, was it not?

Fruta del Norte: Lundin Gold's multi-sourced debt debut

Ecuador's rehabilitation in financing markets begins with a complex deal for Lundin Gold's Fruta del Norte mine. The financing combines a stream, a prepay, commercial PRI and a rare raw material guarantee from Finnvera.

Tom Nelthorpe (http://www.txfnews.com/Tracker/keyword/Tom Nelthorpe)
27 July 2018

Lundin Gold signed the $350 million senior debt financing for its Fruta del Norte gold project in Ecuador on 6 July. The non-recourse greenfield project financing is the first for Lundin Gold, whose main asset is Fruta del Norte, but it draws on the wider experience with project finance of the wider Lundin Group, which is based in Sweden and has interests in mining, oil & gas and renewables.

The senior debt is notable for featuring the first appearance of a raw material guarantee from Finnvera since 1999, when the Finnish ECA wrapped a $100 million tranche on the $1.32 billion Antamina copper-zinc mine financing in Peru. But the wider financing for Fruta del Norte combines senior bank debt with commercial political risk insurance, the Finnvera-wrapped bank piece, a streaming facility and a gold prepayment facility.

The financing is a remarkable turnaround for Fruta del Norte, which Kinross Gold had attempted unsuccessfully to develop in the face of changes to the Ecuadorian tax regime. The successful debt raise, with a strong reception from commercial banks, indicates that Ecuador's promises to make itself a more attractive destination for mining investment are starting to bear fruit.

Blending commercial PRI, ECA cover, a stream and a prepay

The senior debt comprises two tranches, both featuring commercial banks: a $250 million tranche A carrying commercial political risk insurance (PRI) and a $100 million tranche B carrying the Finnvera guarantee. Tranche A is priced at 505bp over Libor, plus a 200bp PRI premium, while tranche B is priced at 250bp over Libor, plus a 315bp guarantee premium.

Both tranches have a term of eight years, begin amortization in 2020, and benefit from a common terms agreement, though they have separate facility agreements. The initial mandated lead arrangers, which received credit approval for the loans in January this year, were ING, Societe Generale, Cat Financial, Bank of Nova Scotia and KfW IPEX-Bank, while Bank of Montreal and Natixis joined the financing in April.

While the debt has signed, the deal still has to meet its conditions precedent, which include the sponsor spending its equity, and the closing of a cost overrun facility. The lack of a cost overrun facility at signing is another unusual feature of the financing, but Lundin Gold agreed with the lenders to make this a condition precedent to first draw on the senior debt. Lundin Gold says it is in discussions with potential providers of this facility, which will need to close before scheduled first draw at the end of the first quarter of 2019.

The mine has a total capital expenditure of $730 million, plus another $85 million in pre-production costs, but Lundin expects to bring in $131 million in pre-production revenues, and the total also includes a $68 million contingency, only 27% of which was used as of the end of May.

The senior debt facility, stream loan and gold prepay credit facilities, together with the proceeds of a $400 million equity raising that closed in March 2018, more than meet the project costs. The stream and prepay signed in May 2017, and comprised a $150 million stream and $150 million gold prepay agreement. The providers were Orion Mine Finance Group, a familiar name in mine finance and the Blackstone Tactical Opportunities Fund, which is a less familiar name.

The prepay is to be repaid with 19 installments of 11,500 ounces of gold, while the stream gives the providers access to 7.75% of Fruta del Norte's gold production and 100% of its silver production, up to 350,000 ounces of gold and 6 million ounces of silver. Half of each loan funded at signing, with the rest drawing in stages up to January this year. The stream loan and gold prepay credit facilities are subordinated to the senior debt facilities in terms of security interest - a complex interaction that was one of the main challenges in closing the financing.

Resurrecting a project in Ecuador

Working with both sets of lenders was probably the result of the aggressive timetable that Lundin had to meet under its agreement with the Ecuadorian government.

The history of Kinross with the mine was an unhappy one. Kinross had bought the mine for $1.2 billion in 2008, when it bought the original developer (and still the project company for Fruta del Norte) Aurelian Resources. When Lundin agreed in October 2014 to pay $240 million in cash and equity, with the Lundin Group turning acquisition vehicle Fortress Minerals into Lundin Gold, Kinross took a $750 million charge against the asset.

While Ecuador's changes to its capital gains tax in early 2015 required some careful scrutiny, by the end of the year, Lundin was able to note that it was making progress on negotiating an exploitation agreement and investment protection agreement with the government, and was able to highlight Ecuador's interest in promoting more investment in the mining sector. Names as big as Anglo American, Barrick and BHP are all now active in the country.

Still, for project finance lenders, Ecuador's occasionally hostile posture towards private infrastructure operators like Quiport, which runs the country's main airport, or the OCP oil pipeline, gives them pause for thought. But by December 2016, Lundin was able to sign a 25-year exploitation agreement with Ecuador that called for a $65 million upfront advance royalty payment and a 5% royalty over the life of the agreement. With the signing of the exploitation agreement, the government and Lundin were able to sign an investment promotion agreement that taxed the project at 22% and did not impose a tax on repayments to offshore lenders.

> "This was a complex multi-faceted transaction. The $750 million all-in financing, a first of a kind in Ecuador, considerably de-risks the project and is a very good outcome. A world-class ore body helps, but so does a strong management team and supportive shareholders."

Lundin Gold hired Endeavour Financial as its financial adviser early in the project development and financing process with the aim of assembling a multi-tranche and phased financing approach. This began soon after Lundin Gold reached agreement with the Ecuadorian government on the terms of the exploitation agreement. The initial financing was put in place and drawn in line with the project development process and structured in such a way to allow the senior debt to be brought in further along in the cycle.

Lundin also attracted a $100 million equity commitment from Orion and $250 million in equity from Newcrest Mining, which together with $50 million from Lundin family trusts, made up the 2018 private placement. Support from the Lundin Group was key, with Zebra Holdings and Investments, the Lundin trust investment vehicle, putting up a $35 million bridge loan for Fruta del Norte in January 2017.

Strategic interest

A key element of the senior debt financing, which was crucial to the Finnvera tranche, was the signing of an offtake agreement with Swedish smelting firm Boliden. Boliden and operates smelters in both Sweden and Finland, the latter of which was the hook for the Finnvera raw material guarantee. The guarantee is similar to the UFK product that Germany offers to suppliers of raw materials.

Throughout the process, Lundin was able to persuade lenders that it could dispense with gold hedging. It was helped by the strength of the project resource, which features 4.9 million-ounce gold reserve, and estimated costs of $609 per ounce.

"This was a complex multi-faceted transaction," says Paul Stevens, a director at Endeavour Financial in London. "The $750 million all-in financing, a first of a kind in Ecuador, considerably de-risks the project and is a very good outcome. A world-class ore body helps, but so does a strong management team and supportive shareholders."

Lundin's legal advisers were Norton Rose Fulbright (international) and Lexim Abogados (local) while the senior lenders' legal adviser was Milbank and Orion and Blackstone used Shearman & Sterling.