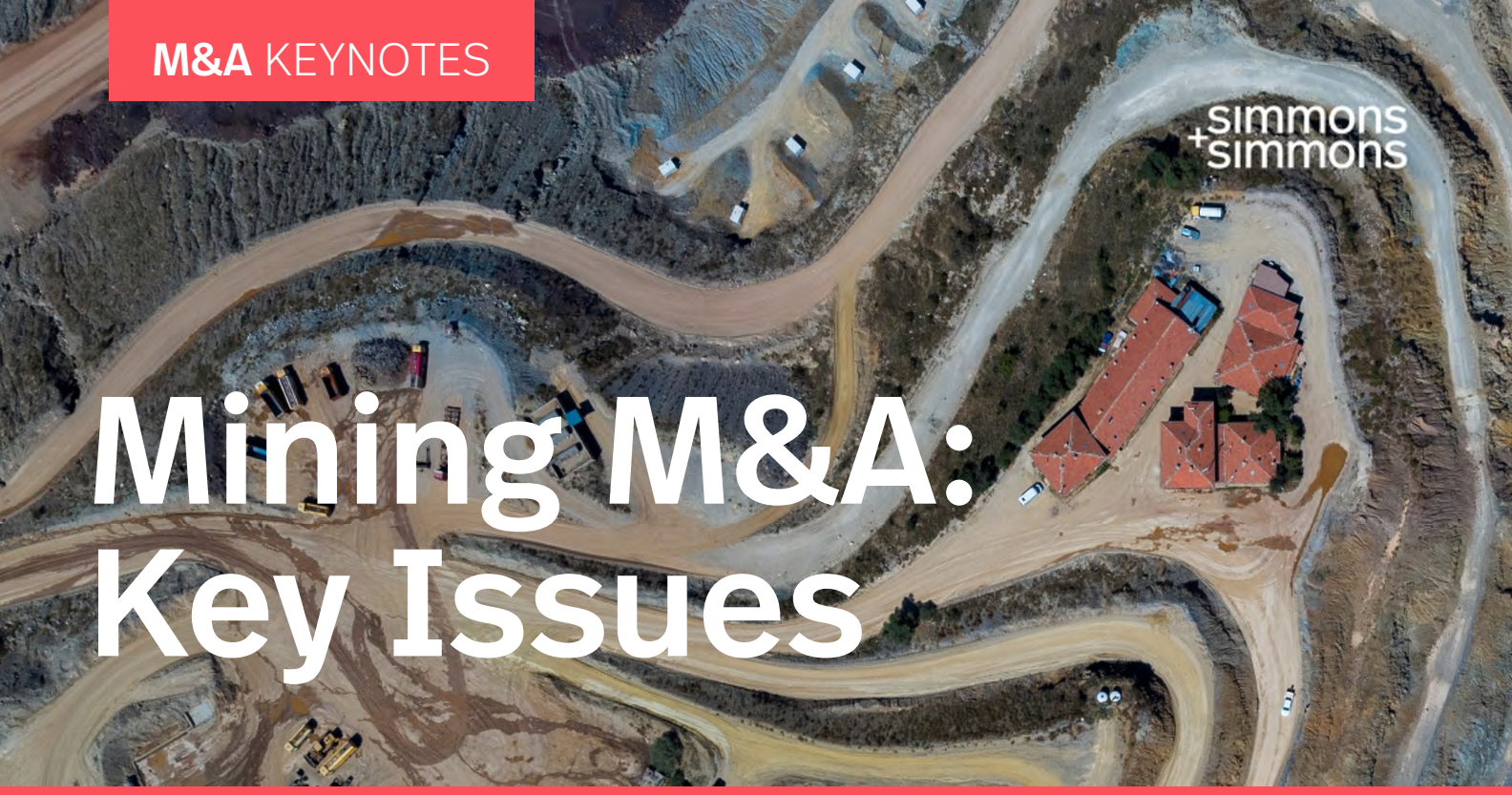


# Mining M&A: Key Issues

We consider some of the key issues which arise in the context of M&A deals in the mining and natural resources sector.

## Price adjustment and consideration mechanics

The basis on which the parties to a transaction agree the valuation for an asset or assets and therefore the price payable is fundamental to the purchase price mechanic in the acquisition agreement.

Key drivers for valuation are likely to include the available reserves at the mine, the level of any required capex, historic EBITDA, prices for the relevant commodity and also the arrangements under which the mine products are sold. (Therefore any offtake arrangements - whether with a third party, the seller or to be put in place with the buyer may impact on valuation.)

It is common to fix the price by reference to the financial position of the target asset /company as at a set date, being a date at which the buyer is typically able to carry out a thorough financial due diligence process. This then provides a baseline price. This is usually then subject to adjustments: the two main types of price adjustments are completion accounts and locked box mechanisms.

**Completion accounts structure**

The position at completion is compared with the position at the date the base price was set and changes in that position may feed into a price adjustment. This adjustment is frequently limited to certain accounting line items only. For example, the base price might have assumed a debt free, cash free position, or a set level of working capital, and the adjustment would then be made on the basis of the actual cash and debt (which may include cash and debt like items) position at completion. It is less common to run these types of adjustments on fixed assets whose position does not vary materially.

**Locked box**
A locked box mechanic sets the price as at the baseline date and thereafter the economic benefit (and risk) of the business goes to the buyer. The seller is typically compensated for this by some form of interest on the purchase price. The seller will usually give a series of covenants that since the baseline date it has not extracted value in favour of itself or members of its group. This protects the buyer against the seller removing value in the form, for example, of dividends or payments for services. There is usually a list of permitted payments, which the buyer would in turn be able to factor into its baseline price calculations - for example if there was a pre-completion dividend that the buyer had conceptually agreed that would usually be factored in as a deduction in the baseline price and on that basis would be permitted.

**Deferred considerations**
Parties often agree that part of the price payable will be in the form of deferred consideration. Deferred consideration may either be amounts which do not vary but are simply delayed in time, or amounts which are potentially variable, contingent and delayed in time. In the mining sector examples of the latter include deferred payments payable by reference to prevailing metal prices at the time of the payment, or to metal volumes shipped and metal prices over a period following completion, or payments which become due on other trigger events which might enhance the value of the mine asset, such as an improvement project or a life of mine extension.

Deferred payments may also be set off against any obligations to pay warranty or indemnity claims (see Risk allocation and W&I insurance below).

**Payment of consideration**
Typically consideration is received in cash, but a buyer which is a quoted company may wish to pay consideration in shares, or to issue shares to raise cash to pay for the acquisition. There are several issues to consider when structuring a transaction with share consideration, including:

- Lockup agreements – listed buyers will often require sellers to enter into these arrangements (especially where the shareholding is material). These are undertakings not to dispose of the consideration shares for a period of time (6-18 months), other than in certain very limited circumstances such as acceptance of a takeover offer. The scope of those exceptions is important to buyers, as is the duration of any lock up. Sellers will want to see whether the buyer can be persuaded to accept an "orderly marketing" commitment instead. "Hard" lock ups are often followed by these "orderly marketing" arrangements - an obligation to only dispose of the shares in consultation with the buyer's brokers; and

- The basis on which the number of shares to be received is calculated – typically this will be some kind of volume weighted average over a period before announcement of the transaction.

## Financing

Financing is a key part of any acquisition - mining assets tend to be large and costly. Sellers will favour buyers with sufficient cash resources to pay the consideration, but frequently buyers need to put in place financing to make an acquisition, and run the financing alongside the M&A process. The financing may therefore be a condition to completion of the acquisition.

Typical financing arrangements can include one or more of:

- Acquisition financing from a bank or syndicate of banks – this typically has to run alongside the acquisition process with the banks taking reliance on the buyers' due diligence reports, and security over the assets being bought, and the documentation dovetailing to ensure that the monies can be drawn to pay for the target
- Issue of shares to investors to fund the acquisition – in the context of a private company this could be an issue to one or more investors. And in the context of a public company it could be a placing to one more institutional investors, or a rights issue or open offer to existing investors (or a combination of the two), which may or may not be underwritten
- Drawing on an existing bank credit line of the buyer
- Rolling over an existing financing the target has in place
- Royalty and stream arrangements

  Royalty arrangements - payment of a sum as a right to receive a payment in return which is based on a percentage of the minerals or other products produced at the mine or from the revenues/profits generated from the sale of those products.

  Stream arrangements - the payment of a deposit to the miner for the right to off take product over a future period of time at a set, discounted price until the deposit is exhausted
- Project financing for the development and construction of specific projects at a mine

Sellers will want to have certainty around the buyer's funding, and so will be keen to ensure that they understand any conditionality around financing arrangements. This may involve the seller reviewing, for example, the placing agreement for any institutional share placing.

## Impact of change of control

The impact of any proposed change of control as a result of the transaction will need to be given considerable thought. There may well be key contracts which would fall away on a change of control and where a buyer would wish to seek the agreement of the counterparty to the change of control. Examples of these would potentially include financing arrangements for the target, offtake or stream or royalty agreements.

It will be important to identify any such change of control issues in the due diligence exercise on the target and it may then be necessary to take forward discussions with counterparties, and even to make those counterparties' consent a condition to completion.

For example if a target mining asset was the recipient of external financing, if that external financing contained a change of control clause (which is usual) then on a transfer of the relevant entities that change of control clause would be capable of being invoked. The buyer will then need to seek a formal waiver and change of control consent from the relevant lender, unless it refinances the debt.

There may be other consequences of the change of control - these can include the levying of direct or indirect taxes or fees (see Direct/indirect transfer taxes and fees) and consent to the change of control from governmental authorities and regulatory bodies (see SPA conditionality and gap controls).

## SPA conditionality and gap controls

Common conditions in the acquisition agreement may include:

- Regulatory filings/approvals
- Merger control filings/approvals
- Lender consents/financing consents

These conditions may be mandatory in nature (typical of regulatory and merger control conditions), or waivable by one or other of the parties, depending on the nature of the condition.

Conditions require the acquisition agreement to cater for a gap between signing and completion to allow for the conditions to be satisfied, and to set out each party's responsibilities with respect to satisfaction of the conditions. Typically the acquisition agreement will include a long stop date by which the conditions must have been satisfied – after which the agreement will lapse or either party may exercise a right to terminate it.

During this gap between signing and completion, the acquisition agreement will set out covenants in relation to the conduct of the business – typically a requirement to conduct the business in the ordinary course as a minimum. Buyers will, also, usually wish to have consent rights in relation to certain material matters, such as material capex and opex, recruitment of senior personnel, changes to benefits and pensions, incurring additional borrowings or granting security. The seller will wish to limit the scope of these protections so that the restrictions are not overly burdensome. A frequent compromise is to provide that the buyer's consent may not be unreasonably withheld or delayed, and to allow the seller to take actions which are necessary in an emergency situation (such as to avoid water ingress or a safety incident at a mine).

The agreement may also contain express provisions relating to steps that must be taken between signing and completion.

### Repetition of warranties

One of the key areas of negotiation that arises in the case of a split signing and completion is whether the warranties are repeated at completion. The position may in part be dictated by the conditions themselves and the parties' responsibilities for satisfaction – for example if the only condition relates to the buyer's financing arrangements it would be easier for the seller to argue that the buyer should not expect repetition of warranties as the gap between signing and completion is caused by a decision of the buyer.

It is usual to repeat warranties as to title and capacity, but the position as regards repetition of any other warranties is frequently the subject of some negotiation.

The seller will wish to give the warranties at signing, with the buyer effectively taking the risk of the business from that point; whereas the buyer will seek only to take the risk of the business from completion.

There are a number of potential compromises such as the repetition of a smaller number of key warranties. The seller may seek a right to rescind or terminate the agreement if it will be closing into a material warranty breach that it will need to compensate the buyer for. Another compromise position is repetition of warranties, subject to a further disclosure exercise by the seller. This puts the buyer in the position of having information about any warranty breaches but does not achieve the transfer of risk to the seller for the pre-completion period – buyers therefore frequently seek a right to rescind or terminate the agreement in the event of serious warranty breaches (a quantum could be applied here).

**M&A clause**

Another issue that arises is whether the agreement contains a "MAC" or "MAE" clause. This is an additional condition to completion that in the period after signing and before completion the business has not undergone a "material adverse change". Inclusion of these clauses is much less common practice in English law governed deals than in New York law governed deals. The scope of any such clause is important – references to forward looking measures carry much greater risk for sellers, and general market events would usually be excluded (eg a collapse in the global copper price).

## Risk allocation and W&I insurance

Once the buyer has identified key areas where contractual protections (such as warranties and indemnities) are required, it is important for the parties to understand who on the sell-side will be able to stand behind these protections from a legal and financial perspective.

The buyer will be keen to ensure that there is a payment covenant with appropriate strength to meet any warranty and indemnity claims. In particular issues can arise where the seller is an intermediate holding company - in which case the buyer would usually seek some sort of seller guarantee from an entity within the seller group. Where the seller is not part of a large conglomerate, for example where the seller is a company backed by a fund and a management team, it is likely the seller entities will have very little financial strength after completion as the proceeds would be distributed out to the various investors in this situation, and the fund investors typically have limited appetite for assuming W&I risks. This leaves buyers exposed - buyers may seek some sort of delayed or deferred payment structure against which warranty and indemnity claims may be set off or some kind of escrow or retention arrangement where monies are held aside for the purposes of meeting warranty claims.

Another option is to consider the use of W&I insurance policies, which are becoming increasingly common. Increasingly coverage is available for transactions in the mining and natural resources sector, and in a wider range of jurisdictions, but this coverage may require payment of a higher premium than W&I coverage in other sectors.

W&I insurance does not, however, necessarily take all risk off the table for the seller, and the buyer may require the seller to continue to be on the hook for certain fundamental matters or for any 'gaps' in the W&I coverage, or the buyer to assume that risk itself. It is worth noting that W&I may not cover all or some environmental risks but that there are a range of other insurance products which may be able to cover these risks.

Where W&I insurance is contemplated by the parties, underwriters are likely to require evidence of a comprehensive due diligence exercise and robustly negotiated acquisition agreement.
In particular, the underwriter will be looking for the buyer and its advisers to engage in Q&A and test the information provided by the seller.

For more information on W&I insurance, please refer to our KeyNote – W&I Insurance KeyNote

## Minority stakes

If the mining M&A transaction is an acquisition of minority interests only and not an outright sale, the parties will also need to agree and negotiate the joint venture or shareholder agreements that will apply to govern their ongoing relationship.
Key points include:

- Composition of the board
- Any reserved matters requiring the consent of all shareholders or holders with a specified percentage of shareholdings
- Future funding obligations
- Default provisions
- Share transfer provisions – eg lock ins, drag and tag, put/call, pre-emption/ROFR, ROFO

## Offtake arrangements

The offtake arrangements in place for a target mining asset will be important to both buyers and sellers. In particular buyers may take minority stakes in assets with a view to securing offtake arrangements.

Sellers may have intragroup offtake arrangements in place which they may wish to stay in place for a period. These may impact on the overall valuation if the buyer could find an alternative offtaker at a better price point.

## Incentivising a management team and key persons

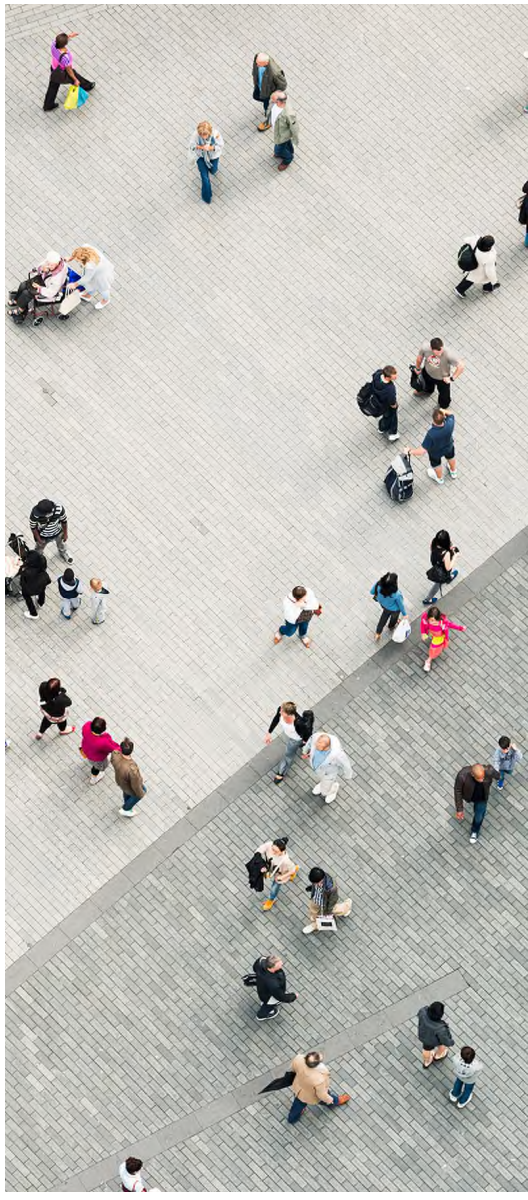
The skills and experience of the management team and key persons can be vital to the success of a mining operation post acquisition.

Buyers will need to evaluate whether they are inheriting a management structure which means that they have a stand alone mine or whether they will need to recruit all or part of a senior management team. This may be largely dependent on the nature of the buyer and the nature of the asset being sold. For example, mining investors will typically back a management team who they will recruit or pair up with to acquire an asset, and the large mining conglomerates will typically have many appropriate people who they may wish to deploy to head up their newly acquired asset. Similarly, where a mine is being sold by a large multinational miner, key managers may be retained by the seller.

Ensuring that key persons are incentivised to remain post acquisition is crucial. This may involve a combination of:

- new employment/service agreements;
- bonus plans including bonuses for staying for a period post-acquisition
- share incentive schemes
- earn-outs
- assimilating key individuals into the buyer's management and/or shareholding structure

As well as these mechanisms where a buyer is recruiting a new management team or pairing up with one to do an acquisition, buyers will frequently look to incentivise key persons through shareholding based arrangements.



These arrangements are often a material additional workstream sitting alongside the acquisition workstream and will need to be resolved in a similar time frame. Typical incentive arrangements would include some form of ability for management to invest. Where management subscribe at a discounted value, leaver provisions would typically apply - these types of provisions operate to incentivise the management team to stay with the company. Typical leaver provisions would distinguish "bad" leavers from "good" leavers (typically those who resign versus those who retire, but the detail is often the subject of discussion), and provide for some or all of the bad leavers' equity to be, in effect, forfeited (usually redeemed at nominal value or repurchased). Good leavers are typically permitted to remain shareholders or to be bought out at a fair market value. Leaver provisions also frequently include "vesting" concepts, which increase the amount of shares held by the leaver which can be retained rather than forfeited increasing over time.

It is also common for shares held by management to be structured as incentive shares such that on an exit their right to share in the proceeds depend on the internal rate of return or multiple on investment earned by the main investor.

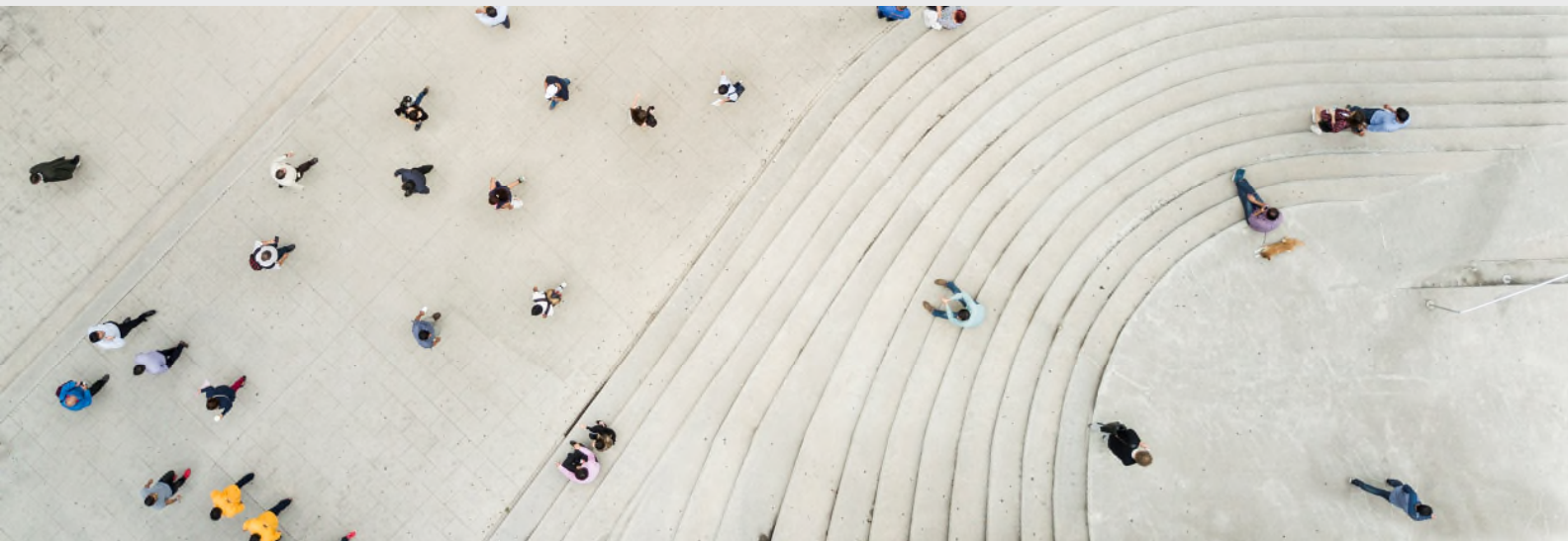
Buyers may also look to prevent key persons from leaving by negotiating non-compete restrictions. However, the legal enforceability of these restrictions, particularly in cross border transactions, needs to be carefully considered – long time periods and extensive geographies are problematic.

## Management teams and governance arrangements

Where an investor is backing a management team as part of an acquisition, thought will need to be given as to the governance arrangements which will apply to the acquisition vehicle and other entities in the structure. Typically the management team would be empowered to do the majority of the day to day activity but the institutional investors will seek key protections. It is would be usual to have a reasonably extensive list of matters which cannot be carried out other than with the agreement of the investor and potentially a smaller number of matters which require the agreement of the investors and a pool of the managers.

These arrangements with managers would also typically address other matters such as the parties' respective ability to transfer shares. A majority investor will want to be able to control an exit and to drag along the minority investors and managers, and in turn, those managers and minority investors will want a right to "tag along" (ie participate ) on any disposal by the majority investor.

The agreement may also address the parties' respective obligations with respect to the giving of any warranties on an exit. Private equity style sellers tend to resist giving such comfort and would seek to rely on the managers do this.



## Integration and separation

This is a post completion issue but needs to be thought about at the beginning and throughout as it has an impact on due diligence and the contractual documentation.

This issue arises frequently because mines which are sold out of one of the large mining conglomerates will typically not be completely stand alone and will depend on the parent company for certain administrative functions (such as payroll, and some management functions) and there may also be intragroup agreements in place. This represents an opportunity for buyers who are buying out of one of the large mining conglomerates but who do not have themselves the same layers of administration and central costs recharges. However a form of transitional services arrangement would usually need to be put in place from the seller group to the buyer to provide support for a period of time until the operations are made stand alone. Similarly buyers may be keen to ensure they get certain members of staff as part of the transaction. When a buyer is discussing a transaction where there are a number of people it does not require the costs of those people will be an element of the negotiations and it will also be important to ensure that the transaction is compliant with any local law requirements as regards redundancies and consultations, in particular where there are unionised workforces - which is not unusual.

Key points to consider in the context of separation and transition include:

a. Systems
b. Reporting lines
c. Name change/branding

## ESG and health and safety

These issues are of increasing importance to buyers in part because of the pressures placed on companies by institutional investors. They also represent an opportunity for buyers - for example buyers may look to acquire assets which they believe have been less well run (and this may include issues with health and safety) with a view to improving governance and management of a mine, as well as health and safety and its record on environmental, social and governance issues. So this is an area where certain types of buyers can add value, in particular those which seek to buy mines for investment and then on sale.

Whilst institutional investors who invest in the sector (and particularly in the shares of the large quoted miners) accept that there is risk involved in the extraction of natural resources, they are increasingly applying pressure to ensure that they are not investing in assets which have ESG and health and safety issues. For example, pension funds will be reluctant to be the ultimate backers of projects where they perceive that poor health and safety has led to excessive deaths or the collapse of key elements of the mine, such as tailings ponds collapses leading to consequential material environmental damage or other destruction of sensitive areas or habit.

These are reputational issues, but they also impact directly on the owners' finances because the cost of rectification of a material issue will be very significant.
Buyers will therefore wish to ensure that their due diligence process on an acquisition includes a thorough review of health and safety and takes into account relevant ESG issues.

**In the mining sector these can in particular include:**

- relationships with the local community such as job opportunities,
- not carrying out activities which are perceived to or actually clash with the ability of local communities to continue to earn their livelihoods in a traditional manner,
- providing benefits to the local community,
- dealing with any activity by local people who are seeking to avail themselves of unofficial mining opportunities in an appropriate and humane manner whilst reducing risk to such persons,
- provision of educational and economic opportunities,
- ensuring a robust health and safety system which will protect the local community from pollution or other damage by egress from the mining activities,
- ensuring that health and safety applied meets appropriate international standards.

## Direct/indirect transfer taxes and fees

Many jurisdictions levy taxes or fees in connection with the transfer of concessions or disposal of real estate assets and rights. As these can be considerable sums, it is important for the parties to consider the impact of these on the transaction and their respective responsibilities for making payment. For direct taxes and fees it is usually the case that law and/or market practice dictate responsibility for payment.

Indirect taxes and fees are more complex - it may be less clear on whom the burden of payment falls (or it may fall on the target company or group of companies).

Careful structuring of the acquisition vehicle and its holding vehicles may also mitigate the impact of these taxes and fees. For example, if it is possible to take advantage of a double tax treaty or other bilateral or multilateral investment treaty, it may be possible to use these to mitigate the tax impact.

## Political risk

In our experience political risk can be a factor in the context of these types of taxes and fees, particularly those which are levied indirectly - ie where instead of a transfer of the concession or assets at a local level the transfer is of a holding company of the company in which the assets or concession is held.

This is because the state in which the assets or concession are situated will wish to be the beneficiary of the relevant taxes or fees, irrespective of whether the transfer is done at a local level or at the level of a holding company which sits above that level. There is therefore a risk that irrespective of what may appear to be the position in an investment treaty or even where the local legislation appears only to cover a local transfer that the state in which the assets or concession are situated will attempt to levy the relevant indirect tax or fee.

The parties will need to consider the impact of these taxes and fees in the context both of transaction structuring and also of the apportionment of risk for payment of these taxes and fees should they arise.