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Columns

Eye on Business

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Why go to a banker when you can go to a buyer?

Off-take agreements are helping potash companies move their projects ahead

In recent years, it is has been widely reported that a burgeoning population, ever-growing demand for food and decrease in the availability of arable land have led to intensive farming practices that rapidly deplete nutrients to leave soils unsuitable for plant growth. As a result, the demand for fertilizer products continues to increase. Of these, potash is recognized by analysts as a high-margin product subject to increasing demand on a global scale.

Canada is one of the few countries that have identified potash deposits of commercial significance. Our potash deposits lie mainly in the Prairies, particularly in Saskatchewan, with a few outlier deposits in New Brunswick. With the Prairie potash horizon generally occurring at a depth of 900 metres or lower, costly and technically challenging underground mine development is required for potash extraction. In Canada, the cost of taking a potash project from greenfield to commercial production can exceed $2 billion and take more than seven years.

Given the significant upfront capital expenditures required, it is not surprising that many junior potash companies lack the capacity to raise the necessary capital to take their deposits into production. Traditional financing methods involve significant downsides such as massive dilution through equity financings or, if obtainable, expensive and inflexible senior project debt.

Recently, however, some junior potash companies looking for development capital have begun to enter into off-take/financing agreements with strategic partners as a novel means of financing. For example, in November 2009, Allana Potash Inc. announced that it had secured a strategic off-take/financing agreement with China Mineral United Management Ltd. to take its potash project in Ethiopia to production. China Mineral had initially participated in a $2 million private placement, and Allana's November 2009 press release disclosed that China Mineral will commit to funding 35 per cent of the project costs (totalling approximately $280 million) in return for 20 per cent of Allana's future potash production. China Mineral will acquire the potash at a price that, although discounted as compared to the market price, will allow Allana to recoup its operating and shipping costs plus a profit margin.

Once China Mineral recoups its funding, the price will be renegotiated based on international potash market price benchmarks. With Potash One Inc. and Amazon Potash Corp. also publicly disclosing their intent to search for similar strategic partnerships, it appears that the trend towards off-take agreements will continue and is not limited to junior potash plays.

For both project developers and off-take partners, off-take/financing agreements offer numerous and significant commercial advantages over traditional forms of financing. Perhaps the most significant advantage of such an arrangement for a project developer is that it allows them to obtain a portion or all of their required capital while usually avoiding the large fees, establishment costs or dilution associated with a large equity-raising or project financing exercise. In addition, the repayment of any funding (including interest thereon) is usually deferred for a period of time, often until the commencement of production, and does not commence on a drawdown of the funding.

Like most commercial arrangements, off-take/financing agreements also have some drawbacks. Project developers who harbour aspirations of ultimately being the subject of an accretive transaction in which their shareholders receive a premium can risk reducing their attractiveness to other players seeking to enter the potash market if they commit too much future production to an off-taker.

If significant advances of funding are to be made, the off-taker may well want some form of security over the project with some of the features and covenants that are common to project financing (e.g. first ranking security, control on application of funding, independent engineers, etc.). Such security may impede or complicate subsequent attempts to obtain traditional project financing or negotiations with project financiers. Potential project financiers will undoubtedly require the off-taker to subordinate its security, while the off-taker may try to insist on certain inter-creditor protections. The difficulty in anticipating the negotiations required between the off-taker and the project financier makes the concurrent negotiation of the two facilities desirable.

With other commodities (e.g. precious and base metals), this requirement can often be accommodated as the off-taker is often looking for a commodity stream that is not the principal commodity being produced (e.g. a silver stream from a copper project) and the off-taker's security only extends to the by-product that it is off-taking. That is not the case with potash.

An additional difficulty with off-take/financing agreements is that certain provisions, particularly those relating to price, must be drafted so as to cope with market changes over a lengthy period, usually decades. The off-taker will often want a product to be priced at a discount in perpetuity. Even if they are willing to settle for a fixed-period discount, they will want to revert to market price at the end of any discount period. Regardless of the pricing structure adopted, it should reflect changes in production costs, the value of money, exchange rates, taxation and the price of competing products, and the likely short- and long-term demand of the off-taker. Reconciling the usually conflicting commercial aspirations and requirements of the project developer and the off-taker around these issues can be challenging.

Despite some of the challenges referred to above, the benefits of off-take/financing agreements to junior companies lacking access to traditional sources of development capital are significant. In a global economic climate that continues to seek alternatives to traditional financing methods, solutions such as off-take/financing agreements could become increasingly popular among junior potash companies seeking to move their projects towards production.

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