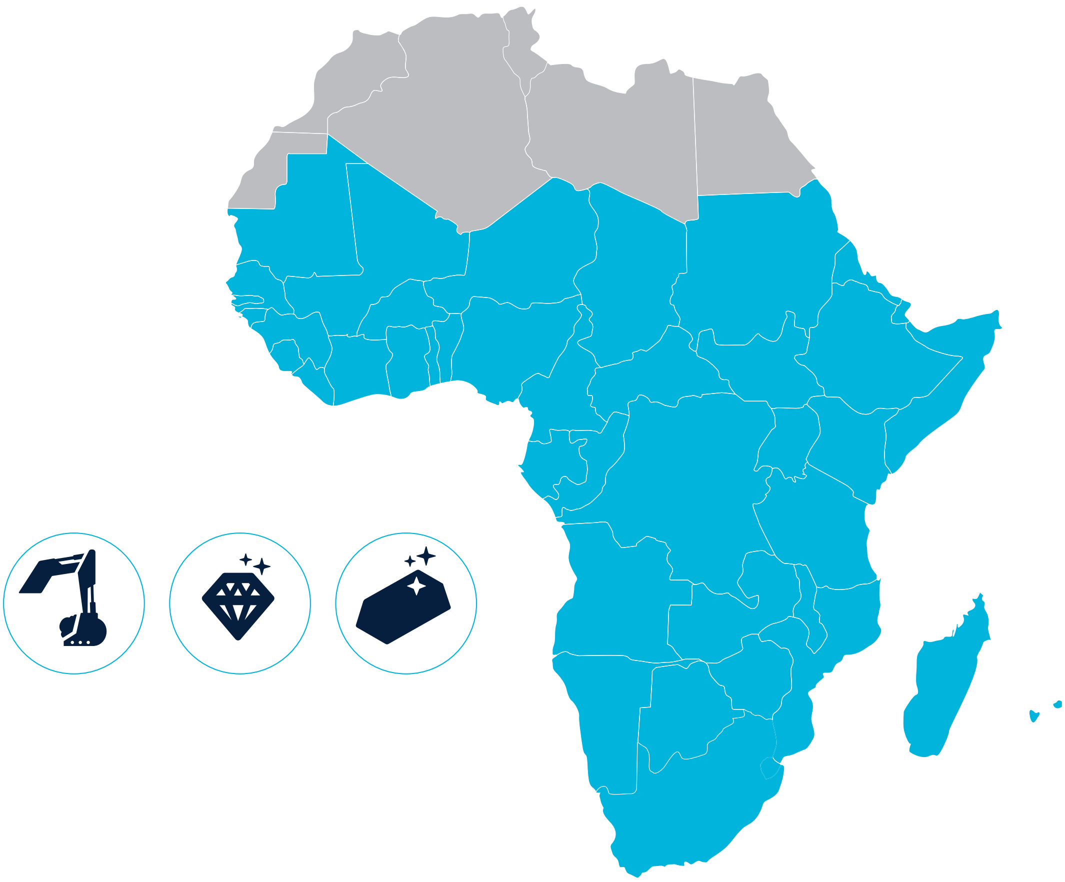
DIGGING DEEPER

Regional Report – Deconstructing country risk for mining investors in Africa



Sub-Saharan Africa continues to offer mining investors significant opportunities despite the broad and ever evolving range of political, economic and security risks that repeatedly hit the news headlines. With African governments all looking to secure higher economic growth rates in the face of lower commodity prices, now is the time to invest. In this report, Amy Gibbs from JLT's Credit, Political and Security risk team argues that there is no such thing as a 'bad' country - and that foreign investors can shape the risk environment in which they operate.

Mining companies worldwide have always been risk-takers. Willing to venture into territories that most industries would not even consider, for decades miners have been at the pointiest end of country risk. Indeed, most mining firms were operating in emerging markets well before there was a specialist insurance market dedicated to this niche category of risk. In short, mining firms take big risks, but the trick is they know how to manage them.

Risks in sub-Saharan Africa are certainly no exception. The problem is that 'country risk,' which includes risks from across the political, economic and security spectrum, constantly evolve and, following the global financial crisis, some of the key trends underpinning country risk have accelerated. As such, mining firms should be stress testing their risk management to ensure that procedures remain nimble, yet robust, to counter the new 'normal' – elevated country risks that can, if not managed appropriately, severely impact the balance sheet.

THE 'NEW' RESOURCE NATIONALISM

The financial crisis demonstrated that economic instability breeds risk. Growing resource nationalism has become more than a cyclical occurrence linked to rising commodity prices and is now an instrument of populist government policy and the default position of many newly democratising African nations. In the boom years, host governments forced unilateral restructuring of contracts, hiked mining taxes, or altered concession agreements. In some instances ownership structures were forcibly revised to deprive the foreign investor of a majority stake holding in a project, transferring the controlling interest to the state.

When nations embark on the transition from civil conflict or military rule to civilian democratic governance, it raises the highly subjective concept of 'legitimacy'. Governments which ascend in a post-conflict context or succeed a non-representational regime will often reject the legitimacy of their predecessor. Under such circumstances, investors who continue to operate under contracts signed with a disavowed government are liable to be forced into renegotiations or have concessions annulled. For example, rather than respecting contracts freely entered into by their predecessors, administrations in Guinea, Liberia and Sierra Leone have all renegotiated contracts, usually with the result of securing better terms for the host government.

In the Democratic Republic of Congo (DRC), the government set up a review panel in 2009 to examine 61 foreign and local mining contracts. This later led to the cancellation or renegotiation of a number of large foreign copper and cobalt project contracts. Reasons for cancelling included alleging the non-payment of royalties from investors; ultimately the reviews had been on the cards since the elections in July 2006. New President Joseph Kabila maintained that equality had to be restored, since many of the contracts had been signed when the DRC was in the midst of its civil war.

Election periods can be particularly volatile times in sub-Saharan Africa, not only in respect of the risks of political violence, but often because nationalist sentiment is whipped up, leading to election pledges that are tinged with a populist edge. As such, a new regime will seek to differentiate itself from the previous by reviewing contracts signed with foreign investors in order to meet election pledges and to garner early popular support.

In Zambia, taking advantage of popular anger over working conditions in the mining sector, corruption and persistent poverty, the late Michael Sata and his Patriotic Front (PF) secured a sweeping victory in the 2011 presidential election by campaigning on an agenda of anti-corruption, labour reform and promising to renegotiate the state's position vis-à-vis the mining sector. Taxes were increased in November 2011, with copper royalties doubling to 6%.

Guinean President Alpha Condé, elected in November 2010, announced plans upon taking office to force mining investments to have at least a one third holding assigned to the government. Condé promised to review a host of contracts signed during the interim military rule to ensure they were 'fair to the state.' Even this was a compromise, as previously the Condé administration had planned on scrapping all mining contracts with foreign companies.

Even in Ghana, which has enjoyed a relatively long period of stable democracy since the adoption of a new constitution in 1992, the lack of legislative experience and expertise can create contractual instability. In 2012, an election year, the country achieved its highest earning from mining in its history; with gold production of 4.3m ounces, and export revenues of USD 5.6bn, mining contributed 27% of government revenue. While gold prices were at a peak, new corporate tax rules were introduced, which hiked corporate taxes on the mining sector from 25% to 35% for those companies without 'stability agreements.' Mineral royalties were also raised from 3% to 5%.

Governments during commodity price boom years had impressed upon their people that foreign investors were often not sharing the wealth from resources and that action must be taken, either by tax hikes, revisions of mining laws or renegotiation of contracts, to level the playing field and to extract increased revenue streams. Workers in the mining sector also occasionally took up the cause directly; a series of violent strikes occurred in in 2012 as mining employees sought to have working conditions and pay levels improved. In Zambia, striking workers protesting against delays in pay increases, rioted at the mining site. One of the site's Chinese managers was killed by a mob and mining operations were disrupted. In South Africa, strikes at Lonmin's Marikana mine turned violent, leading to police opening fire on demonstrators, killing 34 striking workers.

In terms of mitigating the risks arising from resource nationalism, Murray Ross, Underwriting Manager at ACE Global Markets, says:

"Mining companies should be careful relying solely on international arbitration because it can be extremely difficult to enforce in some countries. Companies also need to be aware that the more profitable a mine becomes, the higher the risk of discriminatory action, such as rising taxes and royalties."

ZAMBIA

Taxes were increased in November 2011, with copper royalties **doubling to 6%**.

GHANA

Gold production in 2012 was **4.3m ounces**

COMMODITY PRICES DROP, POLITICAL RISK INCREASES

Several years on, the economic outlook in sub-Saharan Africa has changed. Nationalist rhetoric used to be typically associated with periods when commodity prices were high; with governments seeking to secure greater revenue streams from foreign investment projects. However, the fall in global commodity prices that started in 2012 has now dented the fortunes of many countries that rely heavily on hard currency earnings from the sale of commodities ranging from metals, to oil, to softs. With many governments pegging their public finances to the price of commodities, prolonged price dips have left many governments with budgetary shortfalls. The 'new normal' in the post financial crisis world, is that resource nationalism is set to continue.

Ghana, which relies on oil and gold to underpin its economy, has been hit hard by the fall in prices for gold. Over the course of 2013, the international price of gold fell 28%. Today, the price remains suppressed. The result has been rapid currency depreciation, with the cedi falling by around 23%, a rise in the budget deficit and an increase in unemployment in the gold mining belt as mines lay off workers. In September 2014 it was announced that the government would be renegotiating the stability agreements in place with several key investors after a committee established in 2012 concluded that the agreements were misguided inclusions which unreasonably favoured investors. These stability agreements had previously buffered some foreign investors from the 2012 tax increases.

The copper mining industry has also had a difficult year. Since China accounts for 40% of global demand for copper, Zambia's fortunes, given that half of all copper extracted in the country is shipped to China, are tied closely to Chinese demand for copper. Prices have fallen around 10% so far this year alone and are currently at the lowest levels seen since 2010. Zambia's currency has fallen around 10% as a result of the price slump, acting as a drag on economic growth rates.

The issue here is that the Zambian government has failed to respond decisively to falling copper prices and has continued to drag its feet over spending cuts. Inconsistent policymaking has dented the investment reputation too. The introduction of capital controls in 2012 heighted risks of currency inconvertibility and exchange transfer for mining investors looking to repatriate profits, and as such, the decision to lift these controls in March 2014 was welcomed. Yet the U-turn highlighted that fickle policy-making in a currency crisis should ring alarm bells for investors. President Sata also followed through with his 2011 election pledge in mid-2013 by announcing plans to renegotiate power supply contracts with mining investors. After one investor had already mooted plans to cut workforces on account of declining productivity due to frequent power outages, the government threatened to revoke the company's operating licence.

Such threats are not unique to Zambia, says Ross.

"Another good example is the dispute over the Simandou North project. While the Guinean government is probably correct that BSGR obtained the license illegally, the process of revoking it has now led to multiple parties suing each other. Vale was said to be innocent, but it still lost its share of the licence. And ultimately, once a licence is cancelled, there is little prospect of getting it returned or reinstated – no matter which party is in the wrong."

South Africa's platinum mining investors have experienced upticks in political violence that are indicative of the 'new nationalism' across sub-Saharan African mining countries. Platinum prices had remained fairly flat from 2009 until 2012, while production costs due to labour intensive mining practices and sharply increasing wages were rising. Economic growth in South Africa had only reached a meagre 2.5% in 2012 despite the peak in gold price and living standards were deteriorating as inflation rose. Strikes in the platinum industry that lasted five months in 2014 cost the industry an estimated USD2bn after 70,000 workers downed tools to demand wage increases. The success of the workers in achieving pay rises while holding the industry to ransom is likely to cause copy-cat strikes in other South African mines. For investors, the pay deal enabled the industry to resume production, but investment freezes and asset sell-offs have been the real price paid.

GHANA

Over the course of 2013, the international price of **gold fell 28%**

SOUTH AFRICA

Strikes in the platinum industry lasting five months in 2014 cost the industry an estimated **USD2bn**

RISKS BEYOND GOVERNMENT INTERFERENCE

These examples of what we would categorise as traditional ‘political risks’ are indicative of the levels of resource nationalism that continue to confront mining investors in sub-Saharan Africa. Yet the role of the financial crisis in causing economic instability that leads to upticks in risk is not limited to nationalism. The slowing growth rates and gaps in revenue that many African mining states are currently experiencing can lead to other risks that can also impact foreign investors. Infrastructure gaps are not being addressed at the speed that the mining investment community requires, while upticks in political violence, from protests to terrorism, also present challenges in respect of protecting property and personnel. Finally, the methods currently being utilised by some sub-Saharan African countries to make up revenue shortfalls, namely the issuance of sovereign debt, is also a concern. The continued lack of progress toward industrial diversification means that the reliance on mined commodities will persist, leaving countries even more vulnerable to international price shocks and investors forced to deal with heightened country economic risks.

MINE TO MARKET INFRASTRUCTURE GAPS

While mined commodity prices will eventually regain some sustained upwards momentum in the medium term, for now it means that many sub-Saharan African governments are experiencing a vicious economic cycle; ordinarily mining revenue would be utilised to address crucial infrastructure gaps that will, over time, help attract new investors. Africa’s infrastructure deficit is estimated to be around USD75bn per year, with an additional funding gap of around USD35bn per year. That translates to around 12% of the entire continent’s GDP.

Without addressing power, telecommunications, roads, ports, terminals, and water infrastructure deficits, mining investors will face production stoppages or delays. In Zambia chronic, power blackouts can occur for days at a time. In Mozambique, coal miners have to contend with only one operational rail link from the remote coal fields to the export gateway of Berira. While in South Africa, an impending water shortage will make even routine operations far more costly and inefficient. Platinum miners have already been warned to restrict water use.

With low commodity prices already putting a strain on miners' margins, and with many banks reducing their project finance lending levels in preparation for greater regulatory pressures in 2017 with the incoming Basel III legislation, the additional headaches caused by sub-standard infrastructure can be a make or break factor in an investment decision.

AFRICA
Infrastructure deficit is estimated to be around **USD75bn per year**

SPECTRUMS OF POLITICAL VIOLENCE

Political violence risks, which range from strikes and protests, to terrorism, to war and civil war, will continue to present major operational challenges to mining investors in sub-Saharan Africa. While occasionally it will be the mining companies themselves at the centre of the risk of political violence, ordinarily strike action, there may also be circumstances when mining investors are impacted by acts of political violence that are unconnected to their operations.

"For example, there are political violence risks posed by outbreaks such as Ebola," says Ross. "In West Africa, villagers rioting about Ebola have virtually shut down roads and the government has enforced a curfew, which is preventing goods getting to and from mines."

There may be general anti-mining sentiment in local communities that are concerned about the environmental impact of a project, such as in northern Mozambique where political unrest has emerged as villages are bulldozed in preparation for new coal mining projects. Foreign investors are yet to begin operations in some of these regions, but governmental mismanagement and lack of communication to local communities can mean that investors will be forced to bear the brunt of public anger. In this particular example, opposition party Renamo actually capitalised on this anti-mining sentiment, and called on the local people to blockade the vital rail routes that ferry coal from the mines to the ports.

Political violence that impacts investors may of course be triggered by a number of factors. The global financial crisis in particular has led to an increase in protest action in many emerging market countries as governments have had to rein in spending. Particularly since the fall in international commodity prices, governments' inabilities to create jobs to address rising levels of unemployment (particularly amongst Africa's growing youth population) in combination with unsustainable public spending on subsidies for food and fuel means that protests in urban cities are likely to continue to occur with relative frequency. In 2011, Ugandans took to the streets in 'walk to work' protests triggered by the rising cost of fuel. In South Africa there has been a marked escalation of protests to accompany the upticks seen in industrial unrest as living standards decline, Mozambique saw protests in September 2010 as food prices rocketed by 30%, while in Nigeria in 2012 a government decision to cut fuel subsidies was received with widespread protest. Investors may find, given the under-developed nature of road, rail and air infrastructure in sub-Saharan Africa, that protests in a capital or large town can hinder travel to project sites, that local offices can be impacted by collateral damage or, that personnel are put at risk.

Terrorism risks have also evolved across sub-Saharan Africa. For mining firms the risks posed are primarily focused on personnel, rather than property. For example, Burkina Faso offers few property targets for terrorist groups, making mining personnel operating in the regions bordering Mali and Niger clear targets. With al-Qaeda in the Islamic Maghreb (AQIM) easily able to traverse porous borders into Burkina Faso, investors must be mindful, when considering terrorism, that risks span borders, and that even in the absence of terrorist groups in a project country, that does not necessarily mean that the terrorism risk is benign.

Kenya offers a further pertinent lesson on terrorism risks. It was the Kenyan government's support of an international effort to push back al-Shabaab in neighbouring Somalia that made the country a target. The scale of backlash was highlighted by the Westgate shopping mall attack. While mining investors are less at risk due to the abundance of higher profile targets, the impact of terrorism has broader repercussions for investors. Military action has caused tensions between Kenyan nationalists and Somalis living in the border regions; raising fears of future inter-ethnic clashes. In short, a badly managed or ineffective government counter-terrorism response that heightens tensions between ethnic, tribal or religious groups can mean that political violence can evolve into broader regional instability. Such instability poses risks to personnel and property alike, and can make projects untenable.

"A noteworthy recent development has been the ability of non-state actors to seize and control much larger areas of territory – and to take it much quicker than anticipated," says Mathew Albrecht, Underwriter, Zurich Financial Services. "This development has been most prevalent in post-colonial states that lacked a pre-colonial national identity, such as Syria, Iraq, Libya, Nigeria, Mali and the Central African Republic. Mining companies may find that they invest considerable effort in developing relationships with local communities and authorities, only to see those authorities quickly swept away by such events."

Finally, in respect to war risks, some investors in sub-Saharan Africa are exposed to security threats posed by rebel and militia groups. In the DRC, mining investors operating in the gold and mineral-rich eastern provinces used to encounter security threats from rebel group M23. While the risks from that conflict have receded on account of the recent peace deal between M23 and the DRC government, the presence of rebel groups elsewhere will continue to pose risks to mining investors operating in remote regions of countries such as the Central African Republic.

SOVEREIGN DEBT ISSUANCE

A number of sub-Saharan African countries have issued sovereign debt this year, with the intention of using bond money to fund infrastructure projects. Nearly every one of the sovereign debt issuances in 2014 have been over-subscribed; Senegal received offers equal to eight times the USD500m it raised, Ivory Coast attracted USD5bn on a ten year USD750m bond and in June, Kenya received USD8bn of orders on a USD2bn issuance – the largest debut sovereign bond in Africa.

With interest rates low, the opportunity to refinance short term debt has proved attractive to African governments needing additional funds in the wake of lower commodity prices. The concern is that some of these countries may be over-committing to unsustainable levels of debt, which could in the medium term raise economic risks for investors. Some issuances have been based on the assumption that natural resources wealth will act as a guarantee on the debt. Yet for those countries that may see further security threats, political instability or further delays to developing the essential infrastructure required to capitalise on natural resources wealth, these new debt obligations may become drags on future economic growth. As demonstrated by developed economies in recent years, over-borrowing on credit can eventually catch-up on a country – with significant economic repercussions.

KENYA

received USD8bn of orders on a **USD2bn issuance** – the largest debut sovereign bond in Africa.

SENEGAL

Received offers equal to eight times the **USD500m it raised**

SHAPING RISK ENVIRONMENTS

Yet despite perceptions to the contrary, there is no such thing as a ‘good’ or ‘bad’ country. Trade flows to high-risk countries, such as Guinea, Burkina Faso, DRC and others remain significant, despite perceptions that they are dangerous places to do business. We recognise today that foreign investors can shape the risk environment in which they operate, and that country risks can indeed be managed. Since political risk is not generic across a region, or even within a country, investors must analyse the specific environment in the specific region of the country for their particular project, as well as the effect the project may have on the country, and conduct relevant due diligence. Such due diligence should include a review of security on the ground, legacy issues, reputational risk, social impact, environmental impact and relations with the current and potentially future political decision-makers in the host country.

The adoption of a coherent political or country-risk strategy can neutralise potential sources of risk and reduce, or at least identify, those that cannot be satisfactorily managed. The different range of stakeholders and their respective interests must also be clearly recognised to effectively minimise country risk for a project. Stakeholders are not limited to contractual counterparties and investors - they include the host government, local government, community groups or tribes, project sponsors, lenders, off-takers and Non-Governmental Organisations (NGOs).

Finally, for those risks that cannot be entirely mitigated, Political Risk Insurance (PRI) offers an effective safety net against licence cancellation, selective discrimination (such as tax hikes), currency inconvertibility and transfer risks, expropriation, forced abandonment and loss of equity or default of debt as a result of strikes, protest risk, war risks, terrorism, to name just several of the coverable perils.

Undoubtedly any decision to invest in emerging markets requires considerable planning, especially while political risks appear to be heightened across the board. Yet today’s risk environment is set to remain challenging in the long-term; the risks hitting the headlines today are those representing the ‘new normal.’ With an effective, multi-pronged political risk management process in place, mining opportunities can be secured today, and can remain extremely profitable, even in the face of continued volatility.

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