Deloitte.

RS Sector Outlook Series
Bringing industry challenges to the surface

Mining – Finding the Balance

March 2016

The catchphrase for the commodities supercycle at the start of the century was **“stronger for longer”** as the industry predicted prolonged growth underpinned by China’s expected continued growing demand for raw materials. Since 2002, China has been the main engine of global demand consuming approximately 50% of global commodities[1]. During this period, miners spent freely on both capex and acquisitions ensuring the supply of coal, oil and metals fulfilled emerging market demand, led by China.

However, since 2011, we have seen a consistent decline in commodity prices as large investments launched at the start of the century, in the good times, started delivering increased supply to the market. This increase in supply has coincided with a change in dynamic in China, as it moves away from an investment and export led economy to a consumer-driven one, which has resulted in reduced demand. In 2015, **China’s growth slowed to its lowest level in 25 years** while **commodity prices fell back to their 1999** levels (Figure 1), as if the Chinese-driven bull market never happened.

Some have noted this marks the end of the commodity supercycle, while others are questioning whether there is still further to fall. Specifically looking at metal commodities, **metal prices declined by 30% in 2015** and are expected to **fall by a further 9% in 2016**[2]. However, since the start of February 2016, we have seen metal prices climb as a result of both the Chinese and EU governments’ commitment to further economic stimulation. Whether the current rally is sustainable or whether it has simply slowed or stopped the metal price decline remains to be seen.

Whilst metal prices are expected to continue their decline by 9% in 2016, the price rally of the last few weeks puts this rate of decline in question.

Figure 1. Back to square one

Commodity supercycle runs its course

240
220
200
180
160
140
120
100
80
60

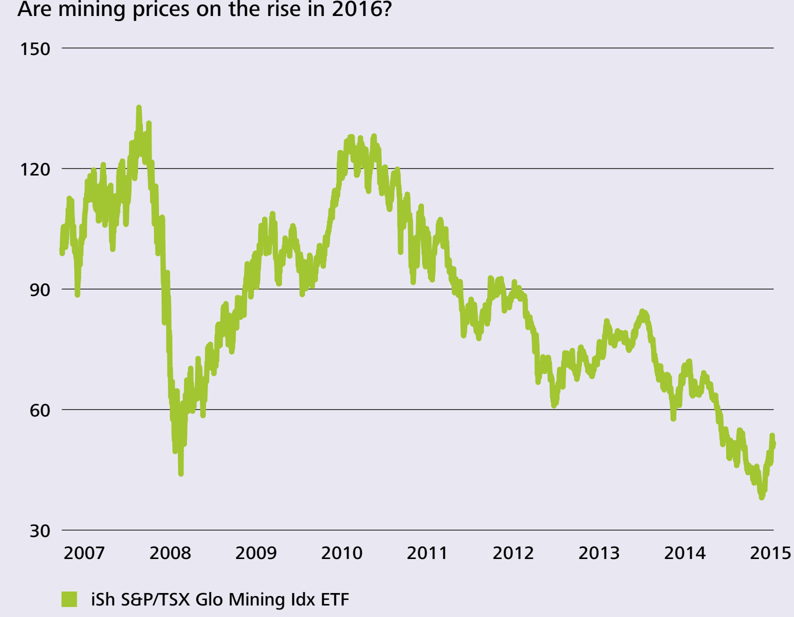
1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014 2015 2016

Bloomberg Commodity Index

Source: Bloomberg

Figure 2. Global Mining Index

Are mining prices on the rise in 2016?



Source: S&P

1 IMF
2 IMF Commodity Special Feature October 2015

Forecast continued decline expected in metal commodity prices, at least through 2016, and general uncertainty about when this downward cycle will reach its floor means mining companies are having to recalibrate their businesses in order to survive.

Working with our Deloitte global mining experts, we have identified the key challenges that mining companies face over the next 12–24 months:

1. Market oversupply

The oversupply of commodities in the market is a result of the combined impact of **reduced demand**, driven in large part by a slowdown in the Chinese economy; and an **increase in supply**, driven by the impact of capex projects initiated at the start of the century that have now come online. While the natural response to this is for mining companies to reduce production, this is often not straightforward and other market factors are influencing decision making:

- Some mining companies have announced plans to **mothball operations** and/or **sell off mines** in an attempt to prevent losses and cut costs. In 2015, we saw coal mines and steel plants closed or downsized in the US, UK and across Europe. In Africa, mining majors closed copper and platinum plants as low market prices no longer justified production.
- However certain big mining companies are continuing to produce in order to drive down unit costs and/or to drive out competitors, similar to behaviour in the oil sector.
- **FX is also impacting decisions** as mining costs are incurred in non-dollar denominated currencies but sold in dollars. As the US dollar strengthens against other major currencies, this reduces incentives for mining countries to stop producing.

Mining companies continue to produce despite market oversupply

2. Efficiency and cost cutting

Energy accounts for 15–30% of mining costs and falling energy prices have helped miners to partially offset reduced revenues. However, from the majors to the juniors*,the key to survival will be on **increasing productivity efficiency** and **containing costs:**

- **Capital Austerity** – In contrast to many years of investment, miners now need to focus on ways to preserve liquidity. In addition to closing loss making mines, mining companies also need to reduce spend on new projects which cannot be economically justified even if there is sufficient capacity to take on new commitments. Figure 3 shows the pace and volume of reductions in capex spend of the mining majors over the past 5 years. While the large miners have lower operating costs, stronger balance sheets and more flexibility, the **smaller miners will struggle to cut both costs and investment** while still remaining viable.

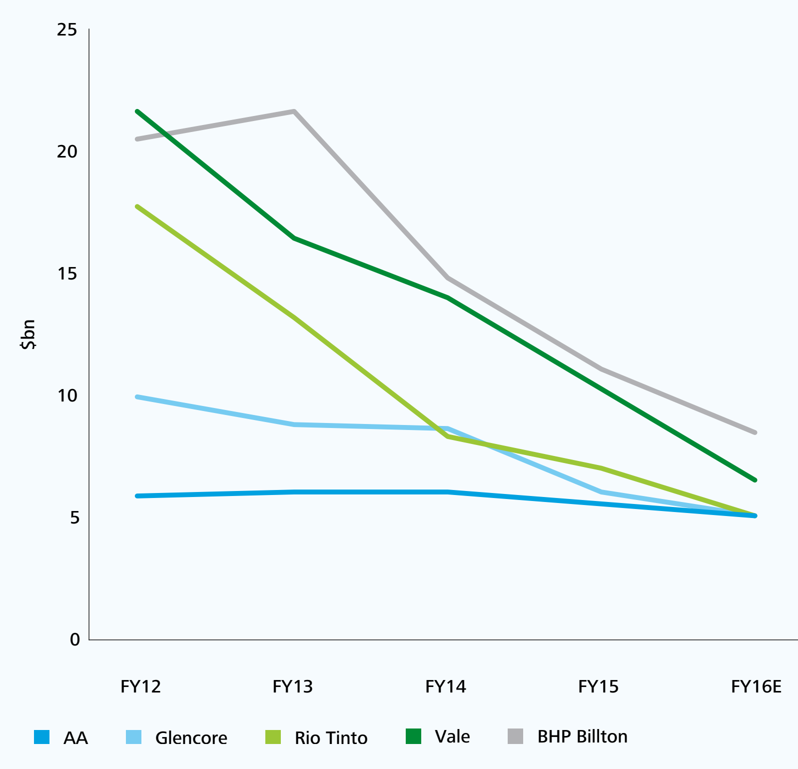
- **Labour** – As **40–50% of mine costs relates to labour**[3], this is an area where miners should consider in their push for efficiency. However, reducing staff numbers has associated political, economic and social risk, requiring open communication between management teams and labour groups.

- **Innovation** – Investing and participating in game changing technology and analytics may enable companies to improve productivity and could be determining factors in who the industry winners and losers will be. Examples of areas where **innovation is transforming the mining industry** includes 3D printing and modularization which allows companies in remote locations to custom manufacture critical parts on demand, reducing costly delays and the need to hold inventory. There are also enhanced asset management practices which allow mining companies to track and analyse data on equipment in use, minimising maintenance costs and improving asset efficiency. For further examples, please see Deloitte's Tracking the Trends Report – 2016.

*Junior mining companies (c. <$15m market capitalisation) tend to be high risk, high reward opportunities for investors. Major mining companies (c. >$1bn market capitalisation) are typically lower risk with predictable rewards.

Figure 3. Mining majors

Capex FY13 – FY16E



Source: Annual accounts

"The suggestion is not to pursue innovation for its own sake, but to look for ways that innovation can unleash the next wave of productivity and cost cutting.

– Andrew Swart, Global Mining Innovation Leader, Deloitte Canada

3. Stakeholder demands

A key challenge for miners is in managing the **divergent demands of the many stakeholders** they deal with. There are significant political and social considerations in this sector. Balancing these differing interests is becoming increasingly challenging:

- **Shareholders are imposing pressure** on mining companies to reduce debt levels while still demanding dividends in this low price environment. In 2015, Glencore, Anglo and Vedanta suspended their dividends as market conditions deteriorated but not all mining companies followed suit. BHP and Rio Tinto both paid dividends in order to keep shareholders happy, however, both have been put on credit watch negative by S&P in February 2016 as a result of their continued dividend payment policy.
- Despite challenges in the sector, **governments have not adjusted their expectations** and demands of mining companies. Miners still need to obtain environmental approvals, adhere to regulations and pay royalties and excess taxes which weigh on their already diminishing profits.
- **Disputes between miners and labourers** remain front page news due to the significance of mining operations to local and often national economies. As mining companies struggle in the current climate and are forced to close mines and lay-off staff, tensions will likely remain high between these two parties.

4. Financing challenges

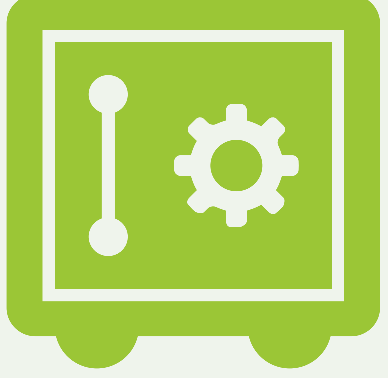
Debt levels in the mining industry have grown out of control. As of the end of 2014, metal and mining majors held over **US $690billion of net debt**, representing 64% of their combined value[4]. High debt levels are placing companies under greater pressure at a time when they need the support the most:

- Many **traditional lenders stopped lending** to the industry following the collapse of Lehman and have not yet returned.
- **Investors are by-passing** the sector looking for more stable returns while private equity has not yet entered the fold.
- In 2015, the primary source of funding to companies in the industry was from the **equity market**, available to only the listed mining companies.
- Junior miners have **limited conventional financing options** and in order to remain viable will need to seek out unconventional options.

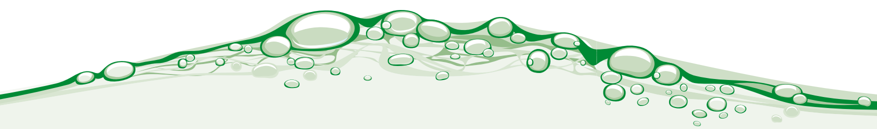
Looking ahead
Predictions for the mining sector

In the medium term, we expect to see a variety of trends in mining as the industry recalibrates:

- Increased focus on **strengthening the balance sheet** through capital austerity, cost savings, working capital management and reduced dividends.
- **M&A activity is expected to increase** given cash constraints and the need to generate efficiencies across the industry. This includes asset divestments, distressed sales and strategic bolt-on deals. (eg. Anglo is currently downsizing by approx. 40% and disposing of its loss making assets while Glencore is downsizing to return value to shareholders as dividends are no longer an option).
- Further **polarisation and consolidation** of the sector as those with strong balance sheets are best placed to acquire while smaller players are squeezed. BHP and Rio, the two companies still paying dividends, albeit at reduced amounts, are both well positioned with strong balance sheets to be acquisitive.
- Shift in source of demand as other developing countries, most notably **India, take over from China**. This will require a rebalancing of customer relationships and distribution channels.
- Challenging lender dynamics as existing lenders are asked to amend and extend facilities and wait for the commodity cycle to turn. This could also lead to increasing use of alternative funding options such as royalty streaming or equipment financing.

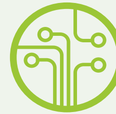


Greater focus should be on strengthening the balance sheet through capital austerity & reduced dividends



The mining industry faces significant challenges over the next 12–24 months however there are some positive indicators that could help alleviate some of the pressure.

- Project cancellations, capital cuts and mine closures/output cuts should improve the supply/demand imbalance.



- China's shift to consumer goods and high technology should support demand for copper and other base metals.

- Lower prices for oil, equipment and freight costs should help currency depreciation in producing countries.

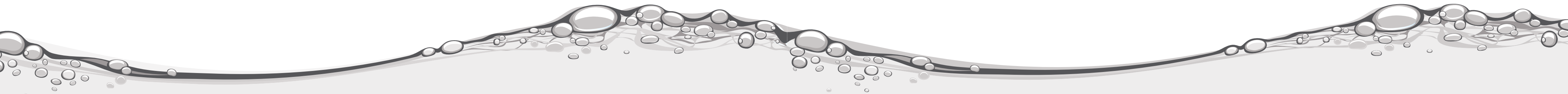
While all mining companies, both big and small, face challenging times, there are key characteristics which will distinguish the winners from the losers through this cycle. Mining companies with strong balance sheets, lean and efficient operations, a cohesive stakeholder group and a clear strategy for navigating the short term without crippling long term growth, will not only survive, but will thrive at the cost of those who are unable to balance these factors.

Figure 4. Predictions for key commodities

Commodity	Short term	Medium term	Long term
Gold	Orange	Orange	Green
Platinum group metals	Red	Orange	Green
Iron ore	Red	Red	Orange
Coal	Red	Orange	Green
Base metals	Orange	Green	Green

Figure 4 illustrates our predictions on the health of some of the key commodities in the short, medium and long term. With the exception of iron ore, there are reasons to be optimistic if companies can withstand the short term pressure.

> "It is common and in fact sensible for miners to focus on operational and cost optimisation, particularly in times of suppressed commodity prices. In the current market, many miners are finding themselves faced with the harsh reality that unless drastic changes are made such as closing unprofitable mines, or cancelling development projects, their businesses will simply not survive.
>
> Many such decisions may become irreversible and it is therefore critical that miners find the right balance between cost cutting and investing in the future so they can remain competitive when the market turns. And it will turn."
>
> **Neil McKenna, Director, Venmyn Deloitte**



Metals & mining credentials

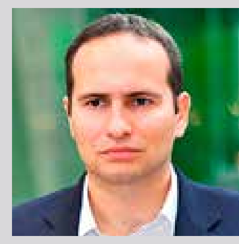
Lonmin	NWR	African Minerals	DML	Buma	UK Coal
• Financial Restructuring	• Debt Restructuring	• Insolvency $500m debt	• Insolvency	• Debt Restructuring $800m debt	• Creditor Advisory • Debt Restructuring

Contacts

Ian Wormleighton
Metals and Mining Lead,
Restructuring Services
+44 (0) 20 7007 2511
iwormleighton@deloitte.co.uk

Neil McKenna
Director,
Venmyn Deloitte*
+44 (0) 20 7303 6930
nemckenna@deloitte.co.uk

Debbie Young
Partner,
Restructuring Services
+44 (0) 20 7007 7466
deyoung@deloitte.co.uk



Philip Goldstein
Director,
Restructuring Services
+44 (0) 20 7007 0084
phgoldstein@deloitte.co.uk

*Venmyn Deloitte provides professional services to the global minerals industry, bridging the disciplines of mining and finance, and emphasises Deloitte's commitment to the global mining industry.

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited (“DTTL”), a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.co.uk/about for a detailed description of the legal structure of DTTL and its member firms.

Deloitte LLP is the United Kingdom member firm of DTTL.

This publication has been written in general terms and therefore cannot be relied on to cover specific situations; application of the principles set out will depend upon the particular circumstances involved and we recommend that you obtain professional advice before acting or refraining from acting on any of the contents of this publication. Deloitte LLP would be pleased to advise readers on how to apply the principles set out in this publication to their specific circumstances. Deloitte LLP accepts no duty of care or liability for any loss occasioned to any person acting or refraining from action as a result of any material in this publication.

© 2016 Deloitte LLP. All rights reserved.

Deloitte LLP is a limited liability partnership registered in England and Wales with registered number OC303675 and its registered office at 2 New Street Square, London EC4A 3BZ, United Kingdom.
Tel: +44 (0) 20 7936 3000 Fax: +44 (0) 20 7583 1198.

Designed and produced by The Creative Studio at Deloitte, London. J1127