Boom, borrow, build, bust–and bounce?

Amid ongoing realignment in the mining and metals markets, industry participants have already begun seeing and seizing extraordinary opportunities—including those created by companies reacting to the boom-bust cycle.

In recent years, the mining and metals markets have wended their way from boom to bust. Coal prices plummeted in 2013. After a decade-long boom, other commodities—including gold, nickel, iron ore—followed thermal and coking coal down the shaft.

Fortunes faltered. Participants felt the pressure even during the initial stages of the commodities crisis: three global mining companies replaced their chief executives; total write-downs soared toward the US$100 million mark; and balance sheets came under review across the board. Another set of buzzwords emerged (or reemerged): "productivity" and "shareholder returns" replaced references to "project development" and "growth" in boardrooms around the world.

Instead of being a blip, the downturn had exposed and exacerbated many industrial participants' latent vulnerabilities—inefficient production, reliance on ores of declining quality, newly emergent (but now enduring) oversupply, reactive management—and set the market on a long arc of depressed prices and stagnation.

From commodity to commodity

Coal companies haven't coped well. Oversupply is rife; not only do some consumers require less thermal and coking coal than they did a few years ago—and less than producers projected—but they're now able to procure coal from low-cost suppliers that entered the market during the later boom years.

Consumers in China, for example, now require less than half of the coal they needed a year ago—and the market wasn't booming then—and can buy coal from Mongolia or once-disconnected parts of China. In the United States and Europe, alternatives such as natural gas have cut thermal coal down as a source of energy.

Producers around the world have felt the pinch. Australian companies have struggled with lower demand for their coal, as well as underlying inefficiencies and costs that aren't tenable in the current context. The coal sector in the United States has seen a spate of mine closures and bankruptcies. Two dozen US-based coal companies have gone bust in the past five years; casualties in 2014 alone included Patriot Coal, America West, Trinity Coal, Frasure Creek Mining and James River Coal Co. and, at the time of writing, others such as Walter are reeling. Even global giants are running for cover: Vale, for example, has recently appointed Barclays to advise it on the sale of its coal-related business in Australia.

Gold has suffered as well since prices plummeted in 2013. Some of the sector's steadiest and most profitable players have become beholden to their debtholders. Petropavlovsk, a Russian giant and prolific producer of gold, is one such company. As dropping prices hindered its ability to repay debt, Petropavlovsk announced a tentative plan for an exchange offer for certain bondholders, who were to extend the maturity dates of their bonds to 2019 in return for an increase in the coupon from 4 percent to 7.5 percent (and some cash to be raised in a proposed rights issue).

The response was lukewarm, and Petropavlovsk's debtholders have since commandeered the company. In two years, the company has gone from giant to gnome; by the end of 2014, its market value dropped to as low as £44 million. Like others in the gold business, Petropavlovsk needs a boost—and soon. Although Petropavlovsk has managed to renegotiate with bondholders on nearly US$1 billion of debt previously due in 2015, the company will need more time—perhaps ten years—to fulfill obligations at current commodity prices even as it continues to churn out gold at an impressive clip.

And while circumstances vary from company to company and from commodity to commodity, sometimes business is just business. New World Resources (NWR), a European coal producer arguably more vulnerable than Petropavlovsk when the crisis began, managed to push a better deal through as the mining and metals markets collapsed. Believing that "drastic steps" were needed, NWR Chief Legal Officer Boudewijn Wentink adopted a creative and comprehensive strategy that included "renegotiating two sets of bank covenants," selling significant assets, launching complex balance sheet restructuring and persuading NWR's sophisticated bondholders to convert their debt into equity while injecting €185 million of new money into the company.

Iron ore producers could also struggle for the foreseeable future. Producers are already dealing with diminishing demand: Chinese consumers, who demand 70 percent of the world's seaborne iron ore, have decreased steel production and eased off on construction and transportation projects. They may also diversify consumption further, being in part enabled to do so by recent long-term shipping agreements between the governments of China and Brazil.

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Rebecca Campbell, partner, White & Case, London

In the long term, iron ore businesses will grapple with structural oversupply. While mining companies have added more than 400 million metric tonnes to the global supply of iron ore in the past few years, demand has declined in absolute terms—and in relation to higher supply. From a perch of US$190 per metric tonne in 2011, the iron ore price fell to the US$50 to US$60 range in 2015.

While companies have already cut costs significantly, major producers will continue supplying the market in excess of expected consumption and may actually increase production and supply as prices flounder. Occupying the low end of the cost curve and having invested heavily in expansions over the past few years, these producers will try to preserve (or improve) their respective market shares—and avoid the high costs of closures—by continuing to churn out lower-cost production.

Sustained and systemic, iron ore’s oversupply will affect the host of small and mid-size companies that account for a significant portion of the world’s seaborne iron ore. Even the most successful of these companies sit higher on the cost curve than the giants. With fewer production sites and less diverse product portfolios, they are often more exposed to market forces in sub-sectors.

Fortescue Metals Group (FMG), for example, has seen singular success but may nevertheless suffer in the future. Producing its first ore in 2008, FMG soared to become the world’s fourth-largest producer of iron ore by 2011. Like many companies during the boom years, FMG borrowed significant sums of money to establish itself as “a new force in iron ore.” By 2015, amid falling prices and low demand for its chief product, FMG’s debt obligations tripled to more than US$7 billion. Initially, FMG sought to sell securities due in 2022 to sustain itself as prices declined. As part of the proposed plan, FMG would have issued US$2.5 billion of securities in March 2015 to repay notes due in 2016 and 2018 (to the tune of US$1.4 billion) while buying back hundreds of millions of securities due in 2019. But buyers wanted higher yields and the price of iron ore kept falling.

After nearly a year, FMG sold US$2.3 billion in high yield bonds to help repay its 2017 and 2018 debt in full, refinance US$450 million—less than half—of its 2019 debt and keep an

additional US$350 million to bolster its books. To get the deal done, however, FMG committed itself to repaying the extended notes at 9.75 percent (to yield 10.25 percent). Although FMG has survived, it will require a sustained rally in iron ore prices to thrive once again.

Striving to survive—and thrive?

With the market struggling, many companies have already diverged within—and across—their tiers and segments. Encouraged by the positive results of cost-cutting and recent realignments, some majors have adopted a leaner, nimbler approach to meet the challenges of the boom-bust cycle.

"The majors have had encouraging results in cost-cutting," says Carlos Urquiaga, head of structured mining debt for BNP Paribas in the Americas, "in driving through synergies and improving operations."

BHP Billiton, for example, has spun off non-core businesses—around US$26 billion worth of aluminum, coal, manganese, nickel and silver—to create a new company: South32.

BHP Billiton's CEO, Andrew Mackenzie, has positioned this spin-off as part of a strategy of simplicity; his company will opt for flexibility and agility over sheer size and scale. With a leaner portfolio, he argues, BHP Billiton will be able to maximize the value of prime assets while allowing South32 to unlock value in its assets.

After BHP Billiton executives announced the move in late 2014, the company's board unanimously approved the demerger, and shareholders voted overwhelmingly in favor of the move in May 2015. If the titan set the stage for growth-driven mergers and acquisitions during the past decade of boom, this may foreshadow a focus on streamlined, profit-maximizing management in a forthcoming decade of potential gloom.

Others have pursued very different strategies to grow and diversify. For example, throughout 2014, Glencore wooed Rio Tinto's larger shareholders in an effort to acquire the latter, complement its existing portfolio and form the world's largest mining company. While many industry participants seek to minimize or otherwise manage their exposure to iron ore, Glencore is trying to enter the iron ore business, possibly to get in on the cheap—or what passes for "cheap" these days—while positioning itself for the long haul. The move could also open up other possibilities: spin-offs during the prospective purchase or unanticipated consolidations elsewhere in the market.

Glencore is expected to revisit its bid sometime in 2015 or 2016, once a freeze mandated by relevant takeover laws ends. The potential merger would create the world's largest and most diversified mining group (with market capitalization of US$160 billion).

Industry participants, then, are already creating the conditions for the next wave of activity within the sector in their reactions to the market's malaise. Glencore's push for growth and BHP Billiton's strategy of streamlining have both resulted in acquisitions, divestments and spin-offs that have driven activity in the sector. And as others follow suit, so too will more such activity: business entities and project sites peripheral to the business of one company or conglomerate might be well within another entity's core focus—or could emerge as stand-alone participants in the market—regardless of why and how they've emerged.

"Seeing some assets as steady or underperforming before the collapse," explains John Tivey, head of White & Case's global mining and metals industry group, "these participants now see such assets as distressed or primed for sale. On the one hand, market participants' ongoing realignment has led to cuts at companies and consolidations or contractions within the industry. On the other hand, however, these moves have created a new class of available assets: companies, projects, sites and rights."

Digging deeper...

Amid this ongoing realignment, industry participants have begun seeing and seizing extraordinary opportunities—including those created by companies reacting to an otherwise faltering market. And after a couple of years of waiting or reacting, investors may find a "sweet spot" for making bets in the mining sector in 2015, according to Mick Davis, former CEO of Xstrata and the mastermind behind private equity group X2 Resources. (The latter sits atop a vast war chest of some US$5.6 billion and seems ready to jump on attractive opportunities too.)

Possible targets include companies now crumbling in the hands of their creditors, businesses burdened by debilitating debt taken on at the top of the cycle but operating in a market that has bottomed out, or projects and portfolios that do not fit within a company's strategy toward the changing market.

"Equity capital markets—the traditional funding source for juniors and mid-caps—have dried up, and bank finance availability has fallen away over the past few years," explains Rebecca Campbell, a London-based mining and metals partner at White & Case.

"In response, many producers have been tapping into high yield debt markets. With near-term, high yield debt maturities, some of these companies are now prime targets for opportunistic buyers. Those buyers are now making, or will soon make, themselves known; for instance, private funds and distress-questing investors are prepared to pounce at the right opportunity."

State-owned enterprises (SOEs) may seek to invest in the mining and metals industry—especially because many prospective sellers are already feeling the pressure to turn loose assets, recoup money and cut costs more generally. Operating with funds accumulated over decades and with mandates that extend beyond the pursuit of profits, Asian and Middle Eastern SOEs will be especially active in this space.

After a decades-long boom, officials in Beijing are adopting policies to transform the nature of such growth: while international consumers and investors have driven growth in China for decades, Beijing is building balance by encouraging

domestic enterprise and consumption. In so doing, these officials must embark on sweeping construction, transportation and power initiatives. China will continue to require steady streams of commodities: copper, iron ore, coal and so on.

Middle Eastern states are looking to diversify their economies domestically—for instance, parlaying their relatively cheap energy, emerging financial centers and prime shipping locations into industry-specific roles and investments such as aluminum smelting or precious metal trading. Meanwhile, Middle Eastern SOEs with deep pockets and long views will invest in mining ventures abroad—as they have done in oil & gas, telecoms and real estate.

...and digging out

As they continue striving to survive, international investors, SOEs and realigning mining companies are likely to see their interests and strategies dovetail.

In 2014, for example, MMG Limited—a base metals mining company listed on the Hong Kong Stock Exchange with majority Chinese SOE ownership—acquired Las Bambas, an immense copper mine in Peru, from Glencore. Glencore was seeking to execute some tactical divestments while attempting to enter markets elsewhere. Meanwhile, despite a depressed market and relatively significant regulatory requirements, MMG acquired the massive mine because its managers looked beyond the current turbulence and toward their goal of growth.

"The circumstances of the sale were unique," says Nick Myers, general counsel for MMG. "It is rare that an asset like this would come up for sale. The project will be one of the top three copper-producing mines when it comes on stream. It was a transformational deal for our company."

While many see Las Bambas as the last of the mega deals, it also speaks to an enduring truth: opportunity is opportunity. Despite the bust—and, in some instances, because of it—large corporations, smaller firms and state-owned entities alike have begun positioning themselves for a recovery.

Although most companies may have trouble trying to do more than survive, others will try to thrive. Global or local, risk-embracing or risk-averse, miners and other market participants will respond to risk—according to each of their needs and ambitions—and reposition themselves for the future.