WHITE & CASE

Mining & Metals: Weathering the storm no more

Mining companies, including the sector's giants, need to act decisively and swiftly in order to survive and thrive

Will sustained stress unmake the mining & metals markets?

A year ago, the first wave of distress in the mining & metals sector provided the industry's major and mid-size players with something to think and talk about. It was interesting and important—but not imminent for them. But, as **Rebecca Campbell**, **John Tivey,** and **Anthony Elghossain** of global law firm White & Case explain, as the second wave takes hold, even the sector's giants must act surely and swiftly to survive and thrive.

After a decade-long boom, mining & metals prices across the commodities spectrum have now declined—sometimes steadily, sometimes sharply—for the past four years. Coal prices fell first. Other mineral commodities—gold, nickel, iron ore—then went down the shaft too, thereby exposing and exacerbating market participants' latent vulnerabilities: balance sheets geared for the top of the market, inefficient production, and managements' mindsets narrowly focused on growth.

In his recent book, former Rio Tinto and Norilsk Nickel chief economist David Humphreys asserts that the bygone boom 're-made' the mining industry. 'As a result of demand growth in emerging economies and the attendant forces of globalisation, mining companies bulked up to capture the opportunities of growing sales and to be better able to take on the sort of large—scale projects which future growth in demand seemed to warrant.'

'Increasingly,' he also notes while considering the commodities crash and its aftermath, 'it looks as though the boom was just another cycle, albeit a particularly strong and sustained one. However, if the market conditions facing the mining industry have come full circle, the industry is a very different place from what it was.'

As China—the engine that has driven the global economy and 're-made' the mining & metals markets in the new millennium—has spluttered, many once blessed by its boom have been bitten by its bust. In a stunning sign of the times, Glencore announced in early September its plans to bolster its balance sheet and reduce debt by US$10 billion. With the market seemingly bouncing from bad to worse, an altogether different question is now entering the minds of industry participants today: will sustained stress unmake the mining & metals markets, requiring even the strongest and most diversified industry participants to take steps they would not have contemplated under even the most conservative predictions 12 months ago?

The commodities crash: Lessons from the 'first wave' of stress

Boosted by the boom, companies with bad balance sheets, bad projects, and/or bad books went bust during the first wave of collapses: with fortunes faltering, companies doing business in coal, gold, and iron ore succumbed to stress in 2013 and 2014.

Coal producers felt the pinch almost immediately. Australian coal companies are struggling with lower than expected demand, and at least two dozen US-based coal companies have gone bust over the past five years (as alternatives such as natural gas overtake coal as the principal US energy source). Iron ore producers were also hit hard, as prices plummeted from a perch of US$190 per metric tonne in 2011 to as low as US$45 in 2015. Operators such as London Mining and African Minerals collapsed. Others, like Cliffs Natural Resources, teetered.

Iron ore producers are also struggling—and will struggle in the long term—with a particularly punishing sort of sustained stress: structural oversupply. Demand is down: Chinese consumers—who demand 70 percent of the world's seaborne iron ore—have cut steel production, construction works and infrastructure projects. And supply is up too: with investments made during the boom, producers have

> **"Battening down the hatches in 'survival mode' no longer cuts it**

added more than 400 million metric tonnes to the global supply. These are the makings of the far more serious ‘second wave’ of stress and distress that now befalls iron ore and steel producers globally.

Those who survived the first wave—worse for wear, but more or less intact—were willing and/or able to act proactively, comprehensively and decisively. Early on, the board members and senior management of each of these companies saw—and then did—what was necessary to survive. At New World Resources and Petropavlovsk Plc, they completed comprehensive balance sheet restructurings. At First Quantum, they launched a ‘precautionary’ rights issue. And at BHP Billiton, as part of a ‘core business’ strategy years in the making, they followed through with a spin-off of non-core assets that now comprise South32.

Weathering the storm no more: Survival requires action, and fast

During the first wave, deep distress in the mining & metals sector was interesting conversational fodder for the industry’s major and mid-size players, but not something that happened to them. Bright spots of activity allowed industry participants to harbour hope. In copper, a commodity that initially retained some of its shine as other commodities plunged, companies entered into the largest mining M&A deal of 2014, when a consortium led by 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 project under construction in Peru, from Glencore. Other copper growth-driven M&A transactions included First Quantum’s acquisition of Inmet and HudBay’s acquisition of Augusta. (Copper projects also continued to be the focus of greenfields and expansion projects to bring more capacity online.)

But sustained stress and the latest market developments of 2015 are now transforming the mining & metals markets. China’s faltering economy has brought about the double whammy of subdued Chinese demand for imports and, perhaps even more significantly for sectors such as steel, massive net exports of production.

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> **Decisive and comprehensive action is necessary to survive and thrive**

Those who evaded the first wave are now succumbing to sustained stress—the prolonged pain of low prices, depressed demand and/or oversupply—creating a second wave of activity as companies are forced into action to survive. And with their buffers eroded, companies are being tipped over the edge by sudden liquidity shocks or sharp price drops. Witness, for example, the fate of Alpha Natural Resources, which in August 2015 lost its qualification to self-bond rehabilitation obligations, triggering an immediate US$400 million liquidity shock, which was a key factor in its filing for US Chapter 11 bankruptcy.

Companies with attractive assets, steady production, decent revenues, and sound management—like iron ore producer Fortescue Metals Group—have now found it necessary to take such decisive steps in a struggle to survive. Achieving its ambition of becoming a ‘new force in iron ore’, FMG went from producing its first ore in 2008 to becoming the world’s fourth-largest producer of iron ore by 2011. But FMG borrowed major money to do so. Amid falling prices and lower-than-predicted demand, FMG’s net debt ballooned to more than US$7 billion by 2015. The company responded rapidly: it restructured debt and cut costs. After an unsuccessful attempt to refinance in April 2015, in May 2015 FMG sold US$2.3 billion in high yield bonds to repay its near-dated bonds and bolster its liquidity buffer. But the price was high, with FMG paying a previously unfathomable 10.25 percent all-in and giving bondholders security over assets for the first time. FMG managed to reduce costs significantly, ultimately achieving US$40 per tonne (down from US$60 per tonne). And, yet, FMG’s annual profits plunged by around 90 percent in 2015 anyway.

US$156bn

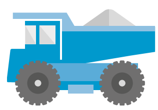
Drop in combined market value of the top 40 mining companies in 2014

Source:
PwC 2015

71%

Glencore’s shares slumped from 335.87 on 29 September 2014 to 99.22 on 25 September 2015, making them the worst performer in the FTSE 100 index

Source:
LSE, Financial Times



US$45

Iron ore prices plummeted to US$45 per mt in 2015 from US$190 in 2011

Source:
Thomson Reuters

Elsewhere, between rock-bottom prices and a hard pile of debt, shareholders are scrambling to the bunker of balance sheet protection—and dragging management with them, most notably Glencore CEO Ivan Glasenberg. They’re bracing for what Glasenberg, perhaps sardonically, describes as ‘doomsday’ or ‘Armageddon’. Doing big business in copper, which has now crashed to 50 percent of its 2011 peak price, Glencore has been operating at a loss through the first half of 2015. In that time, the company has seen earnings, market capitalizations, and market confidence—especially regarding its mountain of debt, now at US$30 billion—collapse. So, in September 2015, Glasenberg shut two massive mines (a move that will take 400,000 tonnes of copper off the global market), scuttled dividends, declared that he plans to shrink debt to US$20 billion within 16 months and executed a US$2.5 billion rights issue.

Across the way, Anglo American is hot on Glencore’s tail: the company has just sold unprofitable platinum mines in South Africa and is rumoured to be contemplating a rights issue of its own. Armageddon, indeed…

Battening down the hatches in ‘survival mode’ no longer cuts it in these markets; decisive and comprehensive action is necessary to survive. ‘The mining industry’, Dr. Humphreys says, ‘was slow to grasp the enormity of what was occurring in China 15 years ago and the scale of its impacts on commodity markets. Today, it is at risk of underestimating the severity of the downturn and the length of time it will take for markets to find a solid floor. Some smart people are calling the bottom already. It seems to me they are a little early. There are no very obvious drivers for an imminent recovery’.

Silver lining? Opportunity near the bottom of the bust

As pressures persist, mining companies will try to renegotiate, restructure and/or reorganize. But, in more than a few instances, usual remedies won't be enough. Companies will have to resort to drastic—even desperate—measures: they'll cut costs; curtail capex; sell or spin off assets; freeze other investments; file for bankruptcy; solicit buyers; entertain suitors; reduce or withhold dividends; issue new shares; and otherwise prepare themselves for the worst. Paying ever-closer attention to their duties, directors will convene regular board meetings, review liquidity reports and obtain advice—legal and financial—to understand their exposures and options.

In this way, the bust will create opportunities and enable new participants to enter the market—and new forms of participation to evolve. New and old participants—activist investors, private equity firms, hybrid investment vehicles (pairing the expertise of specialist mining & metals investors with the major money of larger funds)—will see and seize extraordinary opportunities, including those created by companies reacting to a faltering market. Some investors could see a 'sweet spot' for activity in 2015, according to Mick Davis, former CEO of Xstrata and mastermind behind X2 Resources (a private equity group with a US$5.6 billion war chest). Others have already moved in on the market: Carl Icahn, a titan of activist investors with US$20 billion to his name, disclosed in September 2015 that he controls 8.5 percent of Freeport-McMoRan. Now the leading shareholder in an integrated commodities behemoth built for the boom, Icahn may push to cut capex; revisit executive compensation packages; curb high-cost production; and shed at least some non-core businesses, maybe in the energy space or non-copper mining units.

And, in a deeper sense, a simple truth endures: opportunity is opportunity. Sensible industry participants, and perhaps a few of the more adventurous or aggressive sort, will engage in new enterprises, acquire assets and enter into joint ventures—not least of all because a market that has bottomed out, or may be bottoming out, will allow participants to do good deals. In September 2015, Randgold Resources—a gold producer with significant operations in Africa renowned for a lack of debt on its balance sheet—has proposed a partnership with Anglogold Ashanti to reopen, revamp and ramp up production at the Obuasi gold mine in Ghana. They've got big plans, according to Randgold CEO Mark Bristow, to ultimately turn a 'world-class resource' into a 'world-class mine'. With the market in a malaise, Bristow's bid evokes memories of another deal done during a downturn: in 1984, BHP Billiton bought Utah International—a General Electric subsidiary that was principally a coal producer but had also, in a joint venture, uncovered a copper prospect in northern Chile. That prospect was Escondida, which has since become the world's largest copper mine.

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>
> David Humphreys

From 1980 to 2040: Back to basics—and back to the future?

In the long run, of course, these markets will continue to move. A couple of years after the boom, they're already evolving again—and, in some ways, are reverting back to the way they were for nearly half a century. With the industry's lack of lustre restored, only the most disciplined, prudent and efficient companies will survive and thrive in what may once again be a low-margin high-risk industry. As they did in the decades before the supercycle, miners will scrape to extract value from their highest-grade assets at the lowest possible costs. Global giants and companies at the upper echelons of the industry will survive—somehow, some way. Smaller companies, including many built by the boom, may fail to cut costs fast enough, operate with the requisite efficiency for long enough or churn out enough product to survive. Even the most efficient of these companies (like FMG) tend to sit higher on the cost curve than the giants (like Rio Tinto or BHP Billiton); moreover, because they possess fewer production sites and less-diverse product portfolios, these companies will be more exposed to market forces—drops in demand, gluts in supply—that will affect specific sub-sectors or particular commodities once in a while.

As Dr. Humphreys argues in his book (and elsewhere), the boom's consequences have already outlasted—and may far outlast—the boom years themselves: consumers and producers in emerging markets have shifted the industry's center of gravity; a new cast of characters, including companies, governments and funds, has entered the scene; mineral host states have become more active in shaping the direction of the industry. But more broadly, he asserts, 'the dynamics of commodity cycles have remained unchanged, and companies are having to reshape their organisations and adapt their strategies to address the new market realities.'

But what was true for the boom will be true for the bust—no matter how long the markets' malaise continues. And in the years and decades to come, miners and managers may perhaps see the boom as the blip. For, just as the boom remade the market, the bust—and the sustained stress to come—will remake it again… or unmake it.

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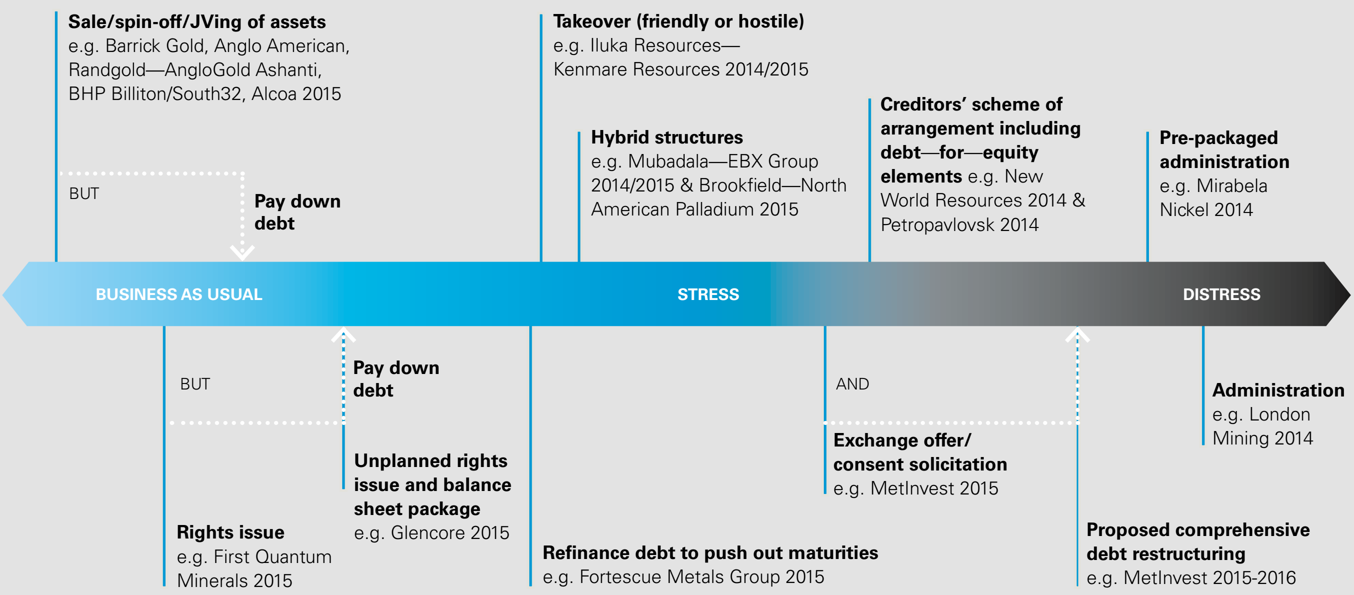
The distress continuum

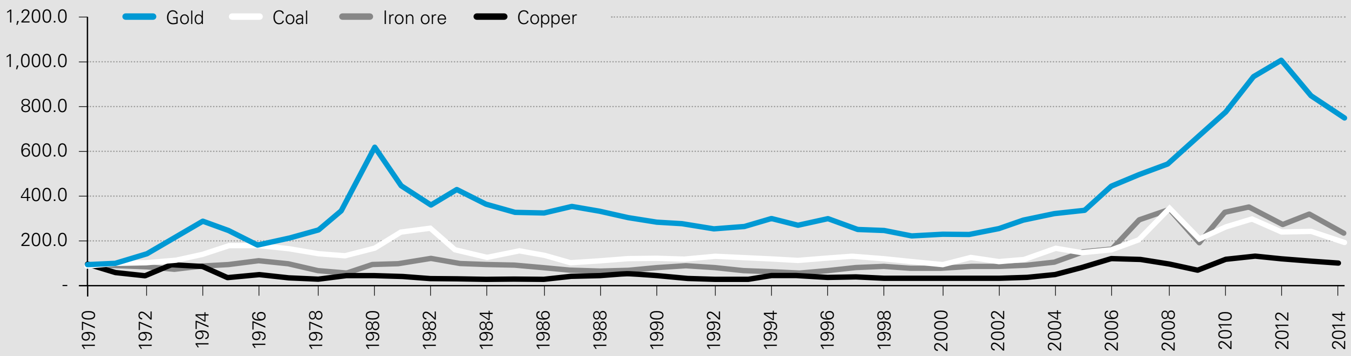


Transaction options for the bottom of the cycle

Transaction options	Significant deleveraging	Certainty	Flexibility	Cost/Speed	Court involvement in process
Share placement or rights issue	✓	✓	×	✓	×
Sale/sell down of assets to pay down debt	✓	✓	?	✓	×
Farm-in arrangement to pay down debt	✓	✓	×	✓	×
Takeover (friendly or hostile)	?	×	×	✓	×
Hybrid structures such as mezzanine or convertible debt	✓	✓	✓	✓	×
Exchange offer/consent solicitation	✓ (will at least push out maturities)	✓	✓	✓	×
Creditors' scheme of arrangement	✓	✓	✓	?	✓
Pre-packaged administration	✓	?	✓	×	✓
US chapter 11 proceedings	✓	✓	✓	?	✓

Commodity prices: Back to the future?

(1970=100, real US$ values)



Source: World Bank Commodity Price Data

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