

Mining & Metals 2017: A tentative return to form

Miners look ahead to a new growth phase in the industry but remain alert to potential shocks



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With miners staging a recovery on equity markets in 2016 and China concerns easing, growth is back on the agenda. But the recovery is not without its challenges and uncertainties, explain **Rebecca Campbell** and **John Tivey** of global law firm White & Case.

Events in the global mining industry in 2016 are perhaps best characterised by one word: unpredictable. The stunning equity market rally that saw miners like Anglo American and Glencore rise more than threefold, the unexpected strength of Chinese stimulus which underpinned sizeable increases in prices for commodities like iron ore and zinc, and the surprise shift in Chinese policy on domestic coal production that resulted in an incredible price spike in coking coal, all encapsulate the mood of a buoyant 2016 which kept market participants on their toes.

Add to that the election of Donald Trump and 2017 has the potential to be similarly unpredictable.

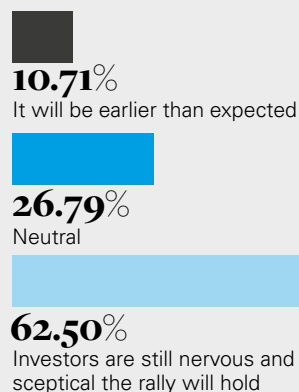
This time, however, the industry is in a much stronger position to navigate any such events. The pressing need to undertake balance sheet repair has subsided after almost two years of paying down debts which for many had ballooned during the boom years.

Glencore, for example, managed to cut a sizeable US\$10 billion of borrowings from its balance sheet last year through a combination of asset sales, spending cuts and the suspension of its dividend. Both Freeport and Anglo American are in similar positions. While BHP Billiton

and Rio Tinto, which both went into the downturn with stronger balance sheets than smaller peers, last year adopted more conservative dividend policies.

Now, against a backdrop of higher commodity prices, management teams are facing an unfamiliar dilemma largely absent from boardroom discussions in recent years: what to do with all that cash?

Figure 1: How has the rally in mineral prices in 2016 changed your thinking around the timing of such a pivot (from balance sheet repair to investing in growth)?



US\$10bn

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Whether more upbeat sentiment in equity markets will translate into growth strategies remains to be seen.

Recent analysis from UBS suggests the top miners will generate US\$55 billion of excess cash over the next three years, even after paying out dividends to shareholders.

The key question is, therefore, how long until companies pursue growth, and what form will that take?

To answer this and gauge the potential growth trajectory of the sector in 2017, we conducted a straw poll of 65 senior decision makers in the market. Our findings indicate that there is a high degree of scepticism surrounding the market recovery, with almost 63 percent saying they are doubtful the rally will hold when it comes to thinking around the pivot from balance sheet repair to growth. While just 10 percent say it will come earlier than expected (Figure 1), "the rebound is not real and is not underpinned by fundamental supply and demand," said one respondent. "There is still too much supply."

Trumponomics

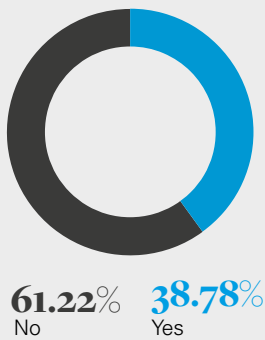
As of 20 January 2017, the world's largest economy is being led by Donald Trump. He has pledged to invest in the nation's ailing infrastructure, with some reports suggesting a commitment of up to US\$1 trillion.

Undoubtedly, such an investment plan would represent a seismic shift for global commodity markets and bring with it an abundance of opportunities for the industry. It is unsurprising then that in January, the chief executive officer of BHP Billiton, Andrew Mackenzie, and chairman Jac Nasser paid a visit to



The rebound is not real and is not underpinned by fundamental supply and demand. There is still too much supply

Figure 2: Will Trump's presidency and infrastructure promises have a material impact on global demand for commodities in 2017?



the then president-elect in New York. The primary commodities earmarked to benefit from the Trump infrastructure programme are zinc, copper, nickel and lead, while Trump's commitment to revitalise American coal and steel industries has also been well documented.

While the long-term impact is yet to be seen, the market took a quick view, for example, sending copper prices to their highest in more than five years and further propelling mining stocks to early gains in 2017. In December, Trump's comments about the need to expand America's nuclear weapons capabilities was enough to boost a host of uranium stocks.

However, while Trump has stolen the headlines, China remains the most important market for base metals and bulk materials, and its demand picture will continue to dominate the demand outlook this year. For example, US demand accounts for less than 10 percent of base demand compared with more than 50 percent in China, with Chinese imports of oil and iron ore hitting record highs last year.

Respondents to our survey remain unconvinced of the impact Trump will have, with 61 percent saying they don't expect a material impact on demand this year (Figure 2). One

respondent said that "Trump is all bluff and bluster and that his push to Make America Great Again will end up being mired in politics," while another said that the timeframe required to start infrastructure projects is going to have "limited impacts" in 2017.

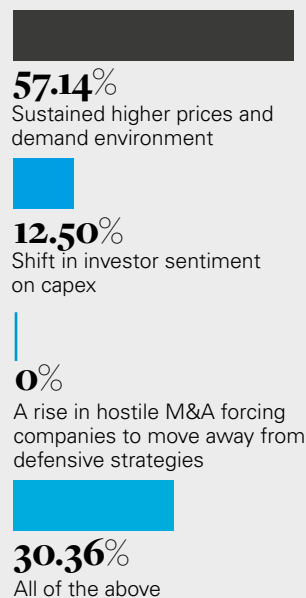
Chinese policy makers have said guarding against risks to the country's financial system and avoiding asset bubbles will be priorities for 2017.

This augurs well for commodity demand, but as seen last year with coal production curbs, there remains scope for significant policy shocks on commodity markets.

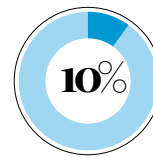
M&A fizzle?

Chinese companies dominated mining and metals M&A in 2016, with China Molybdenum's US\$4 billion of copper and cobalt and niobium acquisitions two of the more notable examples. This came against a backdrop of the biggest

Figure 3: What is required for the mining industry to pivot from balance sheet repair to investing in growth?



The primary commodities earmarked to benefit from the Trump infrastructure programme are zinc, copper, nickel and lead



Say that M&A will be a key focus in 2017.

diversified miners looking to sell non-core assets to shore up balance sheets rather than look to add new mines themselves.

The commodity price recovery that started in 2016 has now removed much of the balance sheet pressure to sell assets, and companies are likely to look for full value in any disposals this year. Anglo American, for example, has shelved its asset sale plan as the rebound in prices made once unattractive assets more appealing.

The shock of 2015 is likely to continue to shape management's approach to M&A, with shareholders reluctant to sanction aggressive corporate growth. Fifty-seven percent of respondents to our survey said sustained higher commodity prices were required before companies pivoted towards growth policies (Figure 3).

There's "unlikely to be big capital allocated to greenfield or brownfield development but it is likely there will be increased M&A for growth," said one respondent.

Debt reduction will remain the key focus for companies, according to our survey, with just 10 percent saying that M&A will be a key focus in 2017. With established mining names likely to remain on the sidelines this

year, Chinese and private equity firms will drive deals, with 69 percent of respondents saying it is now time for private equity to invest in the sector.

Yet, given that many companies are still looking to reshape their portfolios and discard non-core assets, there is likely to be significant opportunities to pick up individual assets. Indeed, nearly 94 percent of our respondents said opportunistic asset-driven deals would be the most frequent type of M&A activity this year (Figure 4).

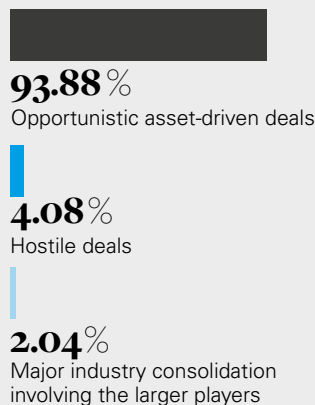
Project finance rebound

A good barometer of the looming pivot towards the beginnings of a new growth phase in the mining industry is the outlook for project financing debt. A total of 70 percent of survey respondents foresaw a relative increase in project finance debt in the sector this year (Figure 6). This typically reflects a growth phase of the cyclical mining industry.

This year will see aspiring global potash market player Sirius Minerals work towards finalising a financing package of more than US\$2 billion for its ambitious project, which involves extracting the fertiliser component from underneath the North Sea off the Yorkshire coast. Indicative of perhaps a greater willingness of lenders to engage in the sector was the fact that 15 banks participated in early-stage talks with the company last year.

In May, emerging copper producer First Quantum signed a new US\$1.8 billion finance facility that will help progress its giant US\$5.5 billion Cobre Panama project towards first production in 2018. The second phase of project finance is underway, and the company says it is expected to be completed within 12 months.

Figure 4: What sort of M&A do you expect to see in the sector in 2017?



Gold crush

Unlike base metals, precious metals continue to be driven by US monetary policy, with global geopolitics taking a back seat. After a strong start to 2016, the political shock of Trump's election, continued instability in the Middle East, and terrorist attacks in Europe had little impact on the price of gold.

After Trump's election, gold had its worst quarter in more than three years as the Federal Reserve raised interest rates for only the second time since 2006. The prospect of further rate rises by the Fed is likely to continue to put downward pressure on gold in 2017 and again raises the question of how gold miners deal with lower prices.

The gold producers have enacted significant balance sheet repair in the past few years, however, with industry grades continuing to decline and much of the costs already removed, there



US\$1.8bn

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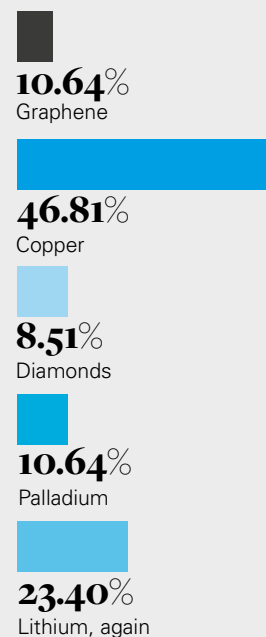
are questions about how producers will withstand lower prices. Increased M&A in the gold space, especially among mid-tier producers, is likely to be one response we see, with the recent confirmation that Acacia Mining and Endeavour Mining are in discussion for a US\$4 billion merger being a strong example.

Gold miners are likely to continue their reluctance to hedge production as investors have been clear that they want exposure to metal prices. The exception to this will be individual project finance deals in which lenders demand price protection and distressed producers who require refinancing.

Copper bottomed?

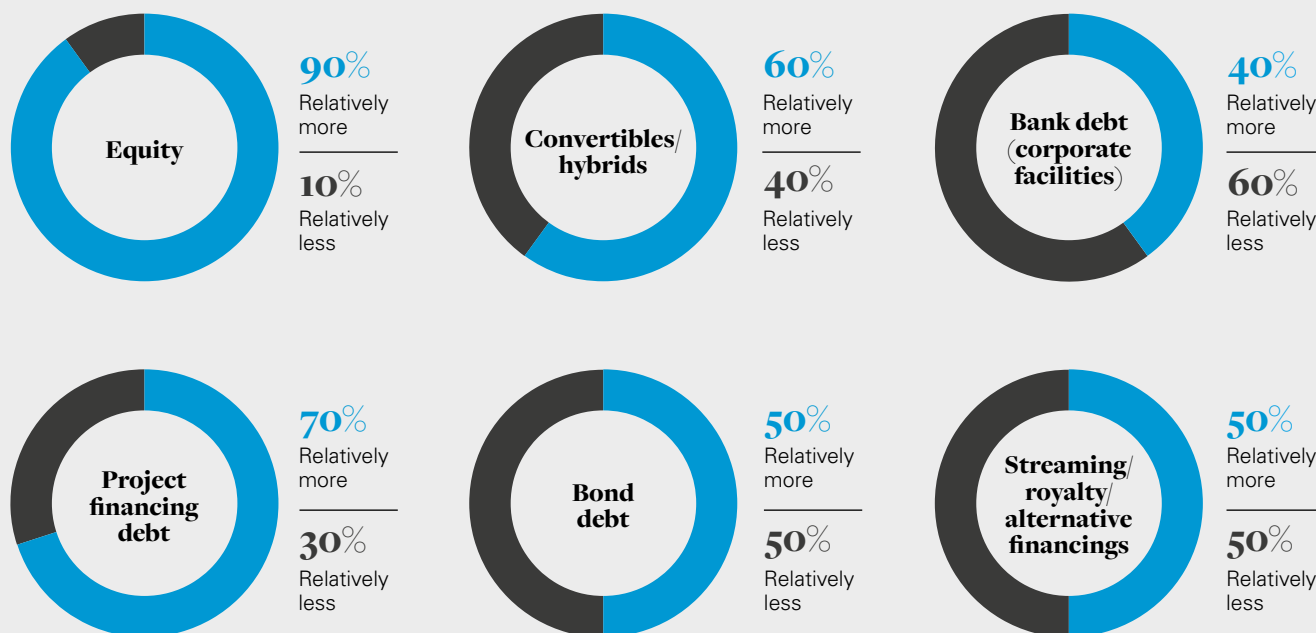
The red metal failed to participate in the commodity price rebound for much of last year before staging a late move to end 2016 about 20 percent higher. The much-mooted

Figure 5: After lithium in 2016, what could be the next "hot" commodity in 2017?



Precious metals continue to be driven by US monetary policy, with global geopolitics taking a back seat

Figure 6: Do you foresee a shift in how the financing needs of mining and metals players will be met in 2017?



swing from a copper market glut to a deficit has failed to eventuate, capping prices. Yet, perhaps given its underperformance last year, survey respondents tip copper to be the commodity of choice this year (Figure 5).

While the pipeline of new copper projects through to the end of this decade has been well documented, the survey response suggests market participants see an upside in demand conditions. Imports by China, responsible for almost half of global demand for the metal, were a record through the first 11 months of 2016, helping to bolster copper prices so far this year.

The opportunities that existed for distressed investors in 2016, such as the US coal sector, in which a number of producers filed for bankruptcy, have taken some unexpected turns as prices have rebounded. Whole tranches of debt and equity that were underwater at the outset of these bankruptcy processes rapidly swung back into the money.

"Investors who purchased coal assets in 2015 will now look to monetise and then will sit out until the

next downturn," one survey respondent said. "Short-sellers have likely been burned by the rally and will be hesitant to reengage for at least a short while."

Turn around

The remarkable reversal of fortunes experienced by those in the global metals and mining sector serves as a reminder of the potential for the industry to be shocked by unpredictable events.

In a January report, Barclays analysts highlighted the potential for myriad "Black Swan" events to hit commodity markets this year.

There were significant examples of such events in 2016. For example, China's surprise curbs on coal mining that sent coking coal above US\$200 a ton. While more recently, Indonesia's clampdown on the nickel industry and a subsequent easing of its new rules has spurred significant price volatility in the price of the metal.

"Commodity market black swan events come in many forms, and the market may take years or an instant to price them in," the report said. "The new politics of populism and



It will be the Chinese economy and Chinese policymakers who will shape 2017

protectionist trade policies have the potential to disrupt global supply and demand assumptions for various commodities."

While the world's eyes are on the White House, once again it will be the Chinese economy and Chinese policymakers who will shape 2017 for metal markets and the miners.

Should last year's rally hold, the critical question will be how the mining industry deploys its ever-growing cash pile. Further debt reduction and returns to shareholders are set to be the first priorities, but the industry's track record shows that M&A is never off the radar for long.

The data quoted in this report is sourced from a White & Case survey of 65 senior decision makers in the mining market carried out in January 2017.

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