WHITE & CASE

Client Alert

Global Mining and Metals Industry Group

March 2015

China poised to acquire distressed assets

First published in Mining Journal, March 13, 2015

As distress in the mining industry deepens, better quality assets are being pushed onto the market. Unlike many other assets on the divestment chopping block over the past 24 months, these assets are priced to sell.

And who – aside from private funds and distressed driven investors – has the capital, investment mandate and strategic outlook to take advantage of these opportunities? Chinese investors. But don't expect the undisciplined, overpriced acquisitions we saw during the boom years.

Despite China's 7.4% growth rate in 2014 being the lowest in 24 years, it is still the envy of developed economies.

Beijing's new policy direction is steering China from a credit-fuelled 'investment-led' economy to one that's 'consumption-driven'. However, China's commitment to growth will see continued investment in sectors that are important to its development – such as construction, transport and power infrastructure – all requiring a steady stream of commodities, particularly copper, iron ore and coal.

For example, demand for steel will be spurred by the expected movement of 200 million Chinese people into cities by 2020. The message came loud and clear from China's National Development and Reform Commission in January 2014, when it urged resources companies to acquire more overseas iron-ore assets.

In 2014, the combination of China's state-owned enterprise (SOE) restructuring reforms and anti-corruption campaign curbed spending by SOEs. But the Las Bambas acquisition, among others, is a strong indicator that Chinese SOEs will continue to acquire strategic assets.

There is also evidence that privately owned Chinese enterprises will continue to acquire mining assets, as evidenced by General Nice's acquisition of the Isua iron-ore project in Greenland from London Mining plc in late 2014.

White & Case at upcoming mining events:

Maxim Telemtayev, Astana based partner, will be speaking at **MINEX Central Asia 2015 Mining and Exploration Forum in Astana** 17-19 March 2015.

John Tivey, Hong Kong based Global Head of Mining & Metals, will be attending **Mines & Money Hong Kong** 23-27 March 2015.

Rebecca Campbell, London based partner, will be speaking at **Mergermarket Mining Capital Forum 2015 in London** 28 April 2015.

If you have questions or comments about this client alert, please contact:

John Tivey
Global Head of Mining and Metals
Partner, Hong Kong
T: + 852 2822 8779
M: + 852 6050 0225
jtivey@whitecase.com

Rebecca Campbell
Partner, London
T: + 44 20 7532 2315
M: + 44 79 1259 6131
rebecca.campbell@whitecase.com

Christian Pilkington
Partner, London
T: + 44 20 7532 1208
cpilkington@whitecase.com

David Li
Partner, Beijing
T: + 86 10 5912 9789
dli@whitecase.com

Sally Tucker
Associate, Hong Kong
T: +852 2822 8727
sally.tucker@whitecase.com

Distress creating tempting targets

At first it was junior miners, but the spectrum is growing. With falling commodity prices and pressure to maximise profits and deliver returns to shareholders, mining companies are shedding assets that are non-core to their strategy.

Even more dramatically, entire companies are finding themselves on the block or in the hands of their creditors as they crumble under the weight of debt taken on at the top of the cycle that they are no longer able to service or refinance.

In 2013 and 2014, mining M&A was plagued by a persistent valuation gap which occurs, for example, when share prices are below management's expectations leading them to reject an offer even when it is at a premium to the share price. This gap is largely irrelevant in distressed and forced transactions, which occur at very low values and are driven by a mining company's desire to take debt off its balance sheet or because creditors have taken control of the company.

In the past few years a number of producers, particularly mid-sized miners, have tapped into high-yield debt markets because equity capital markets – the traditional funding source for juniors and mid-caps – have dried up and bank finance availability is falling away. These companies with near-term high-yield debt maturities are now prime targets for opportunistic buyers.

The 'new normal' for Chinese M&A

In 1999 Beijing's 'go-out' policy encouraged aggressive expansion of Chinese companies into greenfield resource projects. This, in conjunction with the mining super cycle, led to the acquisition of overpriced, lesser quality assets or investment in projects that subsequently experienced significant development cost overruns.

This history is the main reason why Chinese investors are now increasingly sophisticated in their approach to acquisitions in the sector – with rigorous due diligence, a focus on return on assets, robust bidding and longer negotiations.

Of course the best projects will be sought: large-scale, high-grade, long-life projects that are more developed and connected to existing infrastructure in low-risk jurisdictions. But Chinese investors do seem willing to continue to invest in higher risk projects. There is still sufficient liquidity to bridge under-performing assets, but increasingly on the basis that risk is spread amongst multiple shareholders in a consortium.

There is also an ongoing appetite to invest in projects requiring infrastructure solutions – apparently due to the competitive advantage brought by China's access to capital, high-level government to government relationships and the appetite of China's construction and engineering SOEs to participate in mine-related infrastructure projects on a strategic basis.

Meanwhile, continued de-regulation in China has facilitated Chinese companies in their outbound acquisitions and investments. For example, in May 2014, approvals previously required for deals below US$1 billion were replaced with a simple registration requirement and requirements for centrally managed SOEs to obtain approvals from provincial and central governments for deals of US$300 million or less were removed entirely.

More recently on February 28, 2015 the State Administration of Foreign Exchange announced plans to scrap the requirement for its administrative approval for foreign exchange registration for outbound direct investments. Instead, from June 2015 Chinese investors can simply open foreign exchange accounts with authorised PRC banks.

These changes remove some of the key disadvantages that Chinese investors faced in competitive auctions or distressed situations which require participants to move quickly and commit with minimum conditionality.

Of course other forms of capital, such as private equity and distress-driven investors, will also be competing for quality assets at the bottom of the cycle. And they will make tough competition for Chinese investors. Distress-driven situations introduce an element of risk because truncated time frames don't always permit investors to complete Rolls-Royce due diligence. Distressed driven investors are used to taking calculated risks in these time frames, which is why the assets are so cheap.

To be successful, Chinese investors must be disciplined. In this environment that doesn't necessarily mean completing due diligence to the highest degree, it means accepting higher risk but at a much lower price.

Despite the competition for distressed mining assets, China will take a significant share. The sheer demand for resources to build China's infrastructure combined with access to capital, a policy of investing abroad, a willingness to take on risk to secure quality assets and the ability to bring government support to manage sovereign risk, will all ensure that Chinese investors have the appetite and the means to take advantage of opportunities that distress in the commodities sector is creating. And this time around, it will involve a more strategic and disciplined approach.

Beijing
White & Case LLP, Beijing Office
19th Floor, Tower 1 of China Central Place
81 Jianguo Lu, Chaoyang District
Beijing 100025
China
+ 86 10 5912 9600

Hong Kong
White & Case
9th Floor Central Tower
28 Queen's Road Central
Hong Kong
+ 852 2822 8700

London
White & Case LLP
5 Old Broad Street
London EC2N 1DW
United Kingdom
+ 44 20 7532 1000