Mergers, acquisitions and capital raising in the mining and metals sector – 9M 2012
Steadying the ship

Mining and metals companies are operating in a turbulent and changing environment of cost inflation, slowing economic growth, heightened geopolitical risk and volatile prices. With returns squeezed, companies are under pressure to control costs and allocate capital wisely. This requires a shift in priorities: from “growth for growth’s sake” to a committed focus on capital optimization.

Following a period of significant capital investment in organic growth, the uncertain outlook and price volatility in 2012 compounded the impact of cost overruns and delays that few have succeeded to avoid. The possibility has now emerged that, despite strong balance sheets in 2012, production and internal cash flow might not be sufficient to fund the immense planned capital outlays, or maintain coveted investment grade ratings.

Equity markets have been pricing in the risk impact of capex intensity and cost inflation on free cash flow and capacity for shareholder returns. Conversely, there is demand from credit markets keen to support companies that have sustainable cash flows, strong liquidity and projects close to production.

The industry is responding with a shift in priorities: cost control, credit quality and disciplined growth focused on near-term returns to shareholders.

This shift, in the context of a persistently challenging environment for valuations, is shaping the mergers & acquisitions (M&A) and capital raising environment in 2012:

- Synergistic acquisitions that bring more than market share, such as improved productivity, lower average costs or improved asset utilization.
- Non-core divestments as companies shuffle portfolios and face the decision of whether to invest capital in higher cost operations or find alternative owners.
- Smaller, “lower risk” domestic deals – and conversely, fewer large cross-border deals.
- Strategic foothold stakes in quality juniors, with M&A also being a source of finance.
- Continued capital flows from Asia and the Middle East to secure supply of key minerals.
- A structural shift from equity and loans to the resurgent bond markets.
- Opportunistic and strategic financing from a more diverse range of sources.

While companies may be taking stock, this does not herald a dearth of activity; instead we will see smarter, value-enhancing dealmaking. Few can afford to miss opportunities in an era of intense global competition for scarce resources.

Data primarily sourced from ThomsonONE. $ refers to US dollars unless stated otherwise.
Mergers & acquisitions (M&A) activity

Global economic uncertainty and market volatility made M&A decisions difficult in the nine months to September 2012 (9M 2012), resulting in subdued deal value and volume. Cost control, risk management and capital allocation have moved to the top of Board agendas.1 As a result, many companies (including the majors) are actively assessing their portfolios. This is reflected by the rising incidence of divestments and non-core asset sales in 3Q 2012, a trend that is likely to continue through the remainder of 2012.

Lower valuations and asset disposals present attractive buying opportunities for those with cash. Increasingly this cash resides with the private wealth community, including Chinese state-owned enterprises and Japanese trading houses, making transformational deals in the public-to-public market unlikely. In line with this view, deal activity in the first nine months points to opportunistic and synergistic M&A. There were 24 megadeals (>$1b) in 9M 2012, up from 21 in the same period last year. Yet, average deal size for the period witnessed a notable decline (year-on-year).

Cross border deal share increased in the first nine months, despite a domestic consolidation drive in some commodities (coal and steel). Much of this increase in cross border activity was driven by BRIC2 and emerging market acquirers in their quest for resource security. This emerging trend will undoubtedly serve to intensify global competition for resources.

Regional overview

The Asia-Pacific region was the preferred destination and the most active acquirer in 9M 2012, with China dominating deal activity by value, and Australia by volume. Chinese deal value was driven by a surge in domestic consolidation and an increase in outbound deal activity, particularly targeting frontier nations in Africa for resource security. Australian deal volume was primarily driven by domestic consolidation and inbound investments, particularly from Asian acquirers.

Africa emerged as the second most targeted region, despite higher risks. South Africa was the top African destination. Majors with a strong presence in the region took advantage of divestments in South Africa to consolidate stakes in existing assets relevant to their portfolios. DRC, Sierra Leone and Namibia followed as preferred African destinations – targeted for copper, iron ore and uranium respectively.

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1. Capital Confidence Barometer: Mining and Metals, Ernst & Young, October 2012
2. Brazil, Russia, India and China
M&A outflows for key nations

Deal values in $b

- Canada: 1.3
- US: 7.7
- Mexico: 3.3
- Colombia: 2.0
- Argentina: 2.3
- Chile: 1.5
- South Africa: 0.9
- Namibia: 7.1
- Greece: 1.3
- Belgium: 2.3
- Germany: 1.4
- Switzerland: 1.2
- Japan: 10.2
- Russia: 1.5
- Ukraine: 2.0
- Papua New Guinea: 0.3

- Domestic (bubble size = deal value)
- Outbound (bubble size = deal value)
Commodities

Coal dominates M&A activity

Although coal deal activity declined y-o-y, it remained the most targeted commodity in value terms at $14.8b (20% of overall deal value) for the following reasons:

- Cost inflation is driving domestic consolidation in Australia in order to achieve synergies and economies of scale.
- The Chinese Government is pushing for domestic coal consolidation in a bid to form 20 state-controlled coal mining companies by 2015 – a move aimed at centralizing control over the industry and improving its competitiveness.
- Power utilities and trading companies have been buying assets to secure supply.

Looking ahead, an energy crisis in India earlier this year highlights the country’s acute shortage of coal, making it a strong contender for coal assets overseas in competition with China, Japan and South Korea.

Copper was the second most sought after commodity at $12.5b in 9M 2012, driven by strong demand fundamentals and competition for scarce, quality assets.

Gold was the most targeted commodity in volume terms (227 deals) and the third most targeted commodity in value terms at $9.1b. Historically, domestic consolidation dominated gold M&A activity but, interestingly, 2012 has seen a shift in focus to outbound growth.

Steel, rare earths/lithium and uranium were among the few commodities that witnessed y-o-y increases in deal value. Steel deal activity was characterized by strategic moves to protect margins and remain competitive, including access to high growth markets, consolidation and vertical integration. Vertical integration was also a key driver for deals targeting rare earths/lithium. Expectations of a rebound in demand for uranium over the medium term triggered deals for resource security.
M&A outlook

Global macro-economic issues and resource nationalism will continue to make M&A decisions difficult for public company boards protecting shareholder returns. Greater shareholder scrutiny on investment returns will force management to adopt more sophisticated bid tactics and focus on synergies and unique competitive advantages. Balance sheets and credit ratings are unlikely to be put at risk. As a result, we expect to see the following trends:

- The dealmakers in this environment will be companies with strong balance sheets, which are able to work with volatility and remain bullish on long-term commodity fundamentals.
- Revenue and margin pressures are forcing companies to streamline existing portfolios and re-evaluate investment decisions. The resulting non-core divestitures and strict capital discipline will mean M&A will be slow despite low valuations in present conditions.
- Mergers among smaller companies are likely to continue as they look for synergies from pooled resources in an inflationary cost environment. A preference for M&A in familiar territories during volatile times is also a key driver for domestic consolidation.
- Volatility and uncertainty has led to lower risk appetite and a difficult financing environment. This is expected to drive strategic partnerships (minority holdings and JVs), especially between the majors and juniors. While juniors will benefit from funds to advance projects, the majors can secure future growth options by acquiring manageable stakes, particularly in higher risk assets/geographies. Existing production/brownfields are typically lower risk assets, as are assets located in jurisdictions where political risk is low.

Capital raising activity

Global annual capital raising activity is set to decline for the first year since 2009, with a fall in proceeds in all asset classes except bonds in 9M 2012. The 37% fall in y-o-y proceeds to $174b reflects a combination of challenging equity markets, and a significant withdrawal globally from the commercial loans market.

Market conditions in 2012 have consolidated a volatility-led structural shift in investor preferences from equity to fixed income instruments. Investment-grade majors (and to a lesser extent, high yield mid-tiers) are taking advantage of this to raise record levels of proceeds from corporate bonds, largely on highly favorable terms.

Equity, by comparison, has become expensive and dilutive, favored only by those with limited alternatives or an urgent need to de-leverage.

Meanwhile, the commercial loans market continues to tighten as banks prepare for Basel III, reducing the availability of large-scale bank debt and pushing up the cost of borrowing.

Capital continues to flow from Asian and Middle Eastern investors via strategic investments (debt and equity) to secure control over key minerals.

Proceeds raised by asset class ($b)

![Graph showing proceeds raised by asset class ($b) from 2007 to 2012]
IPOs in retreat

The value and volume of IPOs in 2012 look set to retreat to 2009 levels: a year-on-year 47% fall in volume and 82% fall in proceeds (even excluding Glencore) in the first nine months indicates the severity of uncertainty and risk aversion on equity markets. Many IPOs have been postponed due to lack of investor demand or unwillingness on the part of boards to issue at the valuations indicated by the market.

The TSX Venture Exchange attracted the highest number of IPOs at 28 (down from 33 in the same period in 2011). Average proceeds on the junior exchange reached just $1.4 m.

Hong Kong raised the highest proceeds, at just $688 m, including the largest mining and metals IPO, China Nonferrous Mining Corp (CNMC). CNMC, spun out of state-owned China Nonferrous Metals Group, has producing copper assets in Zambia, and represents the first Africa-based miner to list on the Hong Kong exchange. This may set a precedent for similar IPOs as alternative vehicles through which Chinese investors and state entities can gain access to Africa’s rich resources.

Despite the uncertain outlook, IPO drivers – and consequently the pipeline – remain strong. Spin-outs may drive a recovery in IPO volumes as companies seek to raise capital for project development and focus on optimizing portfolios. We expect to see pre-IPO private funding options explored as a stop-gap, until conditions improve sufficiently.

Follow on equity: difficult markets, difficult choices

Widespread risk aversion culminated in a 60% reduction in secondary equity proceeds (traditionally the lifeblood of junior funding) to $17 b, and a reduction in average proceeds to just $4 m (from $6 m in 9M 2011).

Boards of junior miners have faced difficult choices in 2012: issue of equity is a tough sell to existing shareholders resistant to further dilution of ownership and future earnings per share. But the risk of a missed opportunity, or worsening financing conditions down the line, may be too great to chance.

Despite the negative market conditions, there was evidence of strong demand for quality stories, including oversubscribed and upsized issues.
Convertible bonds: gaining momentum

The volume of convertible bonds increased y-o-y to 82 issues, reflecting a wider pick up in the global market for convertibles. But the low proceeds, at $2.6b in total ($2.3b in 9M 2011), reflected the shift in function towards junior-end financing.

Convertibles can present attractive investment options in periods of volatility, providing downside protection but also the potential for participation in future upside. The convertibles market is also open to unrated issuers – and given the squeeze on other sources of financing, it is perhaps inevitable that mid-tiers and advanced juniors are turning to these hybrid instruments. Australian companies in particular have taken advantage of demand, accounting for a third of proceeds and volume.

Convertibles are not without their risks and costs however. Investors are demanding higher coupons to compensate for the additional risk associated with unrated issuance, while companies face risk of default if they are unable to meet the principal repayments when the debt matures. A number of companies returned to the markets in order to raise emergency capital for looming repayments on existing convertibles.

Corporate bonds: a virtuous cycle

2012 will be a year of record bond proceeds, as the industry continues to diversify away from its past reliance on bank lending. Proceeds of $87b raised in 9M 2012 have already exceeded 2011’s annual total of $84b. The corporate bond market is witnessing a virtuous cycle of low benchmark rates encouraging demand for yield from investors, which in turn is reducing borrowing costs for high grade issuers. The average coupon on 10-year US dollar notes issued by investment grade mining and metals companies fell to 4% (from 5% in 2011), masking yields as low as 1%. In addition to favorable pricing, demand is enabling issuers to refinance existing debt and extend maturities.

The high yield market was more of a volatile and opportunistic play, with postponements and success stories. But average spreads on high yield debt (the premium investors demanded above the government benchmark rate) widened considerably in the period compared with 2011.

Emerging markets issuers, particularly from Brazil and Chile, took a higher share of the corporate bond market, accessing demand for emerging market debt from international investors through US dollar and Euro issuance.

Bond proceeds and volume (2000 – 9M 2012)
Syndicated lending withdrawal

9M 2012 saw a 57% fall in loan proceeds and a 43% drop in volume as credit tightened in the wake of Basel III and as companies turned to the bond markets. “Extends and amends” drove the highest proportion of volume, usually on improved terms. While some $30b of bank debt made its way to the mid-tiers, relatively few new funds flowed in for project financing in the third quarter.

For some groups, the risk of default in the current environment is all too present. Volatility and uncertainty can in fact reinforce the importance of maintaining banking relationships. Compared with fickle bond investors, banks may be more willing to quickly extend or restructure if the relationships are strong.

Loan proceeds and volume (2000 – 9M 2012)

Capital raising outlook

Volatility can create opportunities, and we expect companies to take advantage of changing investor sentiment in capital markets. For the majors, this will be from a position of relative financial strength, with a focus on diversified and flexible sources of funding to drive efficiency and optimize capital structure.

The movement of hedge funds from equity to debt investments can provide short time opportunities in the high yield market. Mid-tier companies may increasingly take advantage of such opportunities to raise capital for project development.

For leveraged steel producers and mid-tiers, any further deterioration in market conditions could threaten credit ratings and potentially debt covenants. This may lead to forced de-leveraging through asset sales or rights issues, or indeed restructuring through the loans markets.

Advanced juniors will continue to seek alternative funding structures and providers, particularly strategic investors in for the long term. Each is not without its risks however, and juniors need to explore multiple options in order to raise finance at the right price on the least onerous terms. Early stage juniors are faced with limited options, and we expect to see examples of companies raising capital however they can. However, this may come at some sacrifice to financial flexibility and control over their project.

Asian and Middle Eastern funds will continue to flow into the sector, particularly where major infrastructure projects are involved given EPCM contracts can be provided out of China.

Competition for funding for any other than the highest rated companies will be intense in a constrained capital environment. The priority for all should be preparation, through a thorough understanding of the range of financing options available and their associated strengths and risks. Flexibility and agility to respond to fickle changes in investor sentiment will be critical to securing funding on the best terms and avoiding missed opportunities.
Ernst & Young’s Global Mining & Metals Center

With a strong but volatile outlook for the sector, the global mining and metals industry is focused on future growth through expanded production, without losing sight of operational efficiency and cost optimization. The sector is also faced with the increased challenges of changing expectations in the maintenance of its social license to operate, skills shortages, effectively executing capital projects and meeting government revenue expectations.

Ernst & Young’s Global Mining & Metals Center brings together a worldwide team of professionals to help you achieve your potential – a team with deep technical experience in providing assurance, tax, transactions and advisory services to the mining and metals sector.

The Center is where people and ideas come together to help mining and metals companies meet the issues of today and anticipate those of tomorrow. Ultimately it enables us to help you meet your goals and compete more effectively. It’s how Ernst & Young makes a difference.

Area contacts

Global Mining & Metals Leader
Mike Elliott
Tel: +61 2 9248 4588
michael.elliott@au.ey.com

Oceania
Scott Grimley
Tel: +61 3 9655 2509
scott.grimley@au.ey.com

China and Mongolia
Peter Markey
Tel: +86 21 2228 2616
peter.markey@cn.ey.com

Japan
Andrew Cowell
Tel: +81 3 3503 3435
cowell-ntrw@shinshinornjp

Europe, Middle East, India and Africa Leader
Mick Bardella
Tel: +44 20 795 16486
mbardella@uk.ey.com

Africa
Wickus Botha
Tel: +27 11 772 3386
wickus.botha@za.ey.com

Commonwealth of Independent States
Evgeni Khrustalev
Tel: +7 495 648 9624
evgeni.khrestalev@ru.ey.com

France and Luxembourg
Christian Mion
Tel: +33 1 46 93 65 47
christian.mion@fr.ey.com

India
Anjali Agrawal
Tel: +91 982 061 4141
anjali.agrawal@in.ey.com

United Kingdom & Ireland
Lee Downham
Tel: +44 20 7951 2178
ldownham@uk.ey.com

Americas and United States Leader
Andy Miller
Tel: +1 314 290 1205
andy.miller@ey.com

Canada
Bruce Sprague
Tel: +1 604 891 8415
bruce.f.sprague@ca.ey.com

South America and Brazil Leader
Carlos Assis
Tel: +55 21 3263 7212
carlos.assis@br.ey.com

Service line contacts

Global Advisory Leader
Paul Mitchell
Tel: +86 21 22282300
paul.mitchell@cn.ey.com

Global Assurance Leader
Tom Whelan
Tel: +1 604 891 8381
tom.s.whelan@ca.ey.com

Global IFRS Leader
Tracey Waring
Tel: +613 9288 8638
tracey.waring@au.ey.com

Global Tax Leader
Andy Miller
Tel: +1 314 290 1205
andy.miller@ey.com

Global Transactions Leader
Lee Downham
Tel: +44 20 7951 2178
ldownham@uk.ey.com

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