Strategic business risk report 2009

Mining and metals

Executive summary

Ernst & Young
Quality In Everything We Do

Strategic business risk report 2009

Organizations that succeed, do so because they are best able to optimize the risk and reward equation for both strategic and operational issues.

Underlying strategic risks do not vary significantly from year to year. However, the acuteness, and hence the priority of these risks, changes depending on the economic environment. The changes are subtle but significant enough to sometimes change the drivers of these risks as they develop along with the market. Between 1 July 2008 and 1 July 2009, the London Metals Exchange index fell 40% (from 4,017 to 2,384) and the value of the top 30 mining and metals companies fell 27% (from US$1.5t to US$1.1t). The landscape has transformed dramatically and priorities have therefore morphed from boom-related restrictions on supply to those risks directly affecting cash flow.

The global financial crisis has created some new risks that threaten the near-term survival of a number of mining and metals companies. But, at the same time, there are opportunities for well capitalized companies to position for the upturn. State-owned enterprises of nations concerned with resource security are taking advantage of the lower metal price environment and the fall in asset valuations to expand their overseas portfolios. Similarly, vertically integrated metals enterprises are looking to the current environment as an opportunity to build more certainty into their business models by acquiring more upstream reserves.

Recent research[1] has found that a permanent change has been made in risk management by 50% of miners globally to be more responsive to a rapidly altering market. And as a result of this change, 90% of miners have increased investment in risk management and many are now reviewing it on an enterprise wide basis. They are increasing the frequency of reporting on risks and they have developed scenarios to better identify them. However, while the global economic downturn may lead to a slowdown in mining and metals activity into mid-2010, those that survive will benefit from the favorable longer-term fundamentals, such as increased demand and higher prices.

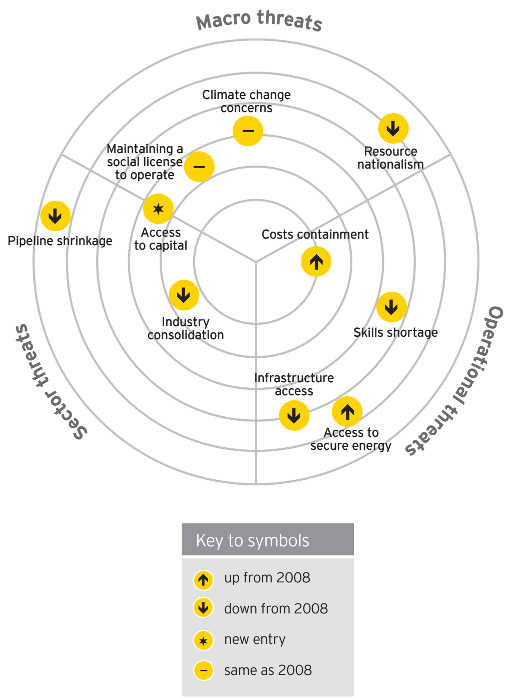
Although gold producers have exposure to these very same risks, they have a partial hedge in that their product rises in price when a number of these strategic risks increase. Not withstanding the uniqueness of the commodity, it is equally important that gold mining companies follow a similarly rigorous risk management to ensure the unique characteristics of their product are fully considered and debated within their organizations.

The Ernst & Young strategic business risk radar:

The Ernst & Young risk radar is a simple device that allows us to present a snapshot of the top 10 business risks for the mining and metals sector.

The risks that appear at the center of the radar are those that we believe pose the greatest challenges to the mining and metals sector in 2009/10.

The top 10 strategic business risks in mining and metals



[1] Opportunities in adversity, conducted by the Economist Intelligence Unit on behalf of Ernst & Young, 2009.

Below the radar

11. Price and currency volatility
12. Exposure to distressed counter-parties
13. Scarcity of water
14. Increased regulation
15. New communication vehicles for community activism
16. New technologies
17. Capital allocation

The top 10 strategic business risks for the mining and metals sector are as follows:

1. Cost containment

The spectacular fall in commodity prices has caused an even greater reduction in margins. Boom-time ‘production at any cost’ attitudes have left an unsustainable level of costs for mining and metals companies. However, cost reduction activities should not contribute to value erosion. Cost containment needs to be urgent and, most importantly, sustainable.

2. Industry consolidation

Lower asset prices and the industry’s thirst for alternative sources of capital have provided an opportunity for investors with a long-term investment horizon and access to capital to make strategic acquisitions. A new class of investor, comprising Asian mining and metals companies, has been exploiting these opportunities.

3. Access to capital

The global credit squeeze and resulting global recession has severely limited mining and metals companies from freely accessing both the debt and equity markets to fund ongoing operations during a period of low or negative margins. As a result, funding of new projects or refinancing of maturing arrangements can be challenging. This is an active risk for a sector that relies on a constant stream of risk capital. Sovereign wealth funds, private equity, Islamic funds and Middle Eastern and Asian banks have emerged as new sources of capital for the sector.

4. Maintaining a social license to operate

There is great pressure on companies to reduce capital and operating costs, making the need to maintain a social license to operate more difficult. Mine closures or staff reductions can negatively impact on a community’s and government’s perception of a mining company. Therefore, a balance needs to be struck between cost optimization and environmental and community investment.

5. Climate change concerns

As a major user of energy and a primary user of land, climate change is a major issue for the mining and metals sector which risks its reputation and social license to operate. Companies are introducing new initiatives to combat climate change, including using new sources of energy, improving water management, and developing new technology to harness carbon emissions and reduce energy consumption. There is also an increasing need for companies to respond to increased regulation of emissions including mandated carbon reporting and emissions trading schemes.

6. Skills shortage

While a drop in demand resulting from the global financial crisis has checked industry growth, the long-term fundamentals, and hence chronic constraints on the expansion of supply, remain. With an inadequate supply of skilled workers and professionals for the sector, the challenge of recruitment, retention, development and deployment has become a significant strategic threat to the industry. This may delay future project development and production.

7. Infrastructure access

Lack of sufficient infrastructure is creating bottlenecks in getting product to market in many countries. Traditional mining and metals companies are increasingly tempted to invest in infrastructure to solve the problem. If they don’t keep pushing forward infrastructure development, when demand returns, they will not be able to capitalize on the recovery.

8. Access to secure energy

Mining and metals production is energy intensive and requires reliable, sustainable and efficient energy supplies. Under-investment in critical infrastructure by host governments is putting pressure on the reliability of existing supply, and limits the supply available for mine expansion or new projects.

9. Resource nationalism

During the boom, host countries owning the mineral resources were challenging whether they were extracting enough of an economic rent for the right of a mining company to exploit that resource. While predictably economic rents increased during the boom, there has been little change in the basis for these economic rents since the fall in commodity prices. In some instances, governments are looking to replace other areas of lost revenue with further imposts on the mining and metals sector.

10. Pipeline shrinkage

Exploration is the life blood of the mining and metals sector, as known reserves waste with production. The general decline in exploration has been exacerbated by the drought in risk capital. The lack of exploration today will limit discoveries tomorrow and production in the years to come.

Ernst & Young's Global Mining & Metals Center

With volatile metals prices, ongoing uncertainty about demand and restricted capital markets, the global mining and metals industry is facing a new era of both challenges and opportunities.

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, transaction and advisory services.

The Center works to anticipate market trends identify the implications and develop points of view on relevant industry issues. Ultimately it enables us to help you meet your goals and compete more effectively. It's how Ernst & Young makes a difference.

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