Navigating volatility: do you change your business or the way your business works?

The better the question. 
The better the answer. 
The better the world works.
Volatility has been an ongoing challenge for companies seeking to maintain a strong balance sheet and develop plans for long-term profitability. This is a challenge that management will need to deal with for some time.

Fluctuations in commodity prices have become more rapid and frequent as commodity demand has become increasingly unpredictable. The longer-term economic outlook is also volatile, leading to the possibility of substantial revisions to long-term metal price forecasts and making it hard for mining and metals companies to plan for the future.

The impact of China and emerging market demand is also difficult to understand or predict. So as prices fluctuate and there is limited pricing or demand visibility, management is struggling to plan operations and capex.

To facilitate business survival and growth, business strategy and investment decisions will need to be reviewed and adjusted as the long-term economic outlook and the associated long-range business forecasts (e.g., metal/energy prices, FX rates) are updated.

The following graph illustrates how copper prices and quarterly long-term consensus price forecasts have changed since 1 January 2000. The change in long-term forecast is of particular importance to senior management and corporate strategists, as investment decisions will need to be made and business strategy set such that they factor in the variability in outlook.
The key to success is to be agile; this requires a change in mindset and more importantly having a productive, well-managed and cost-effective end-to-end value chain. Our work with mining companies has helped us identify the following six focus areas that companies should consider in order to more effectively manage costs, release cash and position balance sheets for future growth.

**Six levers**

- Cost reduction
- Working capital
- Productivity
- Capital effectiveness
- Portfolio strategy
- Financing
Cost reduction
Creating sustainable and long-term value

During the mining boom, miners saw costs escalate in some cases by over 200% (such as fuel, energy and people). Initially higher commodity prices masked these costs, but as prices have fallen, these embedded higher costs have been impacting bottom lines. As prices declined, miners started eliminating costs from all areas of the business, including reducing capital expenditure and labor. There are, however, still a lot of opportunities to remove costs from the business, and miners need to maintain a focus on building a long-term sustainable cost base.

Understanding what cost reductions need to be made, how quickly they can be developed, what the payback period is and how long they can be sustained is key. Clearly the use of analytics can help miners to better measure and manage costs. By conducting both qualitative and quantitative analysis, miners can quickly identify opportunities for cost reduction, prioritize them and develop quantitative estimates of the value of cost reduction.

A willingness to challenge the models that emerged during the boom time is essential. Without this, stressed businesses could find themselves even more vulnerable to rapid market movements. Companies need to maintain focus to protect margins and to reduce exposure to current and potential future cost increases. We have already observed some miners being more inventive in their approach to cost reduction, including in the following areas:

1. General expenses
It is important that every activity in the business is challenged as the “long tail” of smaller costs is often overlooked in traditional cost cutting approaches. Even small costs should be pursued because – combined – they are often significant in number. For example, challenging the need for travel and instead considering increasing the use of WebEx and telepresence for meetings can save millions. We have also seen one company place its safety equipment in vending machines accessible by staff cards, allowing for a better “think before use” approach. This approach has accounted for several million dollars in annual savings and has resulted in safety equipment usage cuts by as much as 50% at some sites. Many miners have also set up suggestion boxes for employee ideas in their organizations – at Fortescue Metals Group, one simple idea to replace disposable plastic snack boxes with reusable ones has saved about US$100,000 so far, according to Chief Executive Nev Power.1

2. Low-cost country sourcing
Miners should consider low-cost country sourcing of direct and indirect materials such as maintenance repair and operating (MRO) supplies given that with some emerging markets, there is an increasing range of goods available that are of equal

Cost reduction measures need to be sustainable and cost reduction activities should not contribute to value erosion.

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quality but at cheaper prices. Recent contracts for one mining company have seen a 50% price reduction on track pads and 40% price reduction on truck trays when compared to the original onshore supplier. In addition, by reducing reliance on original equipment manufacturers, miners can achieve more competitive pricing by having a broader supply base.

3. Offshoring/outsourcing

Many miners have offshored support functions such as finance, IT, procurement and human resources to low-cost countries. There are two broad delivery models – either leveraging a captive shared service center that is owned and operated by the parent company or outsourcing to a third-party service provider.

From Australia or North America every role offshored generates savings in the range of US$40,000–50,000 per role. In addition to labor arbitrage, service providers are offering 20% to 60% productivity over the life of a five-year contract. Outsourcing has moved beyond the typical support function with many technical areas now being delivered from offshore. These newer areas include maintenance scheduling, seismic/geological data analysis, engineering and technical drafting, spare parts catalog management and strategic sourcing.

The generous conditions of the past no longer reflect market reality today. In the boom times, miners were the price takers and now they need to be the price makers.

4. Procurement

Miners have had a strong focus on procurement in the last three to five years; however, the pace of reform has not been fast enough, and there are still a number of areas they can consolidate and transform to achieve far greater value. It is also time to consider next-generation procurement technology, where the business case is strong. We believe there are such opportunities in three main areas as follows:

a. Automation and consolidation of operational procurement

Many miners have spent considerable time and investment on systems transformation; however, they are yet to fully institute and realize benefits of the simple automated solutions that are readily available in their existing systems. For example “hands-on” purchasing still remains very high with many miners sitting on > 60% free text purchase orders (i.e., raising of manual purchase orders, which requires several steps in the purchasing process). This carries a significant productivity impact but also leads to non-compliance with contracted items, and can also impact “shadow inventory” buildup, as buyers operate outside contracted catalogs and “bills of materials.” There are a number of simple low-cost solutions to shift manual purchasing to “hands-off” channels that can easily be executed with a viable business case.

Increased automation in the buying process will enable further consolidation of operational procurement activities. Many miners still have high-touch onshore buying personnel, who purchase site-specific goods and services with little leverage across geographical regions. Those who have offshored or consolidated their services have still allowed shadow functions to pop up onshore and at site level (often staffed with expensive contractors). Offshore functions are often still large. There is an opportunity to adopt a revised model whereby base activity (that has not been automated) is centralized/offshored, allowing greater visibility and further consolidation of common goods and services. These functions can then be combined with some lean in-country support (possibly outsourced) as required.

b. Strategic procurement

Many miners have had a strong focus on cancelling existing contracts and renegotiating new arrangements. Even with this focus, it is evident that letting go of the old mindset and procurement strategies that were built against a backdrop of supply shortages has not been easy or quick enough for some. Payment terms, for example, are still too generous in some markets, and alternative supplier strategies are not being aggressively pursued. This focus should continue, with much greater speed, and more discipline around outcomes in set time frames and accountability for the institution of new arrangements.

Much of this activity could be outsourced. Many miners still carry large strategic procurement organizations that could be more aggressively challenged in an era of greater supply and increased automation.

c. Next-stage innovation and procurement service

Now is the time to aggressively explore innovations that can further streamline procurement activities and enable greater visibility and control of spend to access the associated benefits – such as increased leverage and buying power; reduction in maverick spend; reduction in scope creep; and more control over services and consulting expenditure.

Availability of smart technology and mobility solutions can further accelerate the automation of many basic ordering, buying and procurement activities. Digital solutions around automatic replenishment and guided buying are becoming more readily available. Digitization of information also creates the right environment to explore other areas, such as Smart Contracting, to reduce the time taken to contract and to automate the contract and vendor management processes. Miners have been aware that some of their large contracts (operational and in areas such as IT) are not performing according to original terms, with significant value lost. At the moment, such situations are addressed by forensic audit services to identify issues such as overcharging, duplicate invoicing, and purchase order and invoice divergence. Automated solutions combined with the right managed service can deliver the ability to reference contracted pricing, at terms, at the point of transaction.
Mining companies focused on working capital have typically achieved reductions of 30% or more. For larger mining companies, this can mean reclaiming hundreds of millions of dollars of capital back into the business.

In our recent report, *Making working capital work for you. Unlocking ‘cash’ in the mining sector*, we analyzed the working capital performance of 80 of the largest mining companies globally. This analysis showed that many miners had still not actively focused on working capital as a lever to improve cash flow, reduce costs and improve shareholder returns.

Market expectations of working capital have been shifted following the success of working capital programs at BHP Billiton and Rio Tinto:

- Rio Tinto has realized about US$3b reduction in working capital since 2014 and reduced cash-to-cash (C2C) from 44 to 33 days. "Any dollar that we tie up in working capital unnecessarily is a dollar that we either put to work in growth or give back to our shareholders," says Rio Tinto CFO Chris Lynch.²

- BHP Billiton is on track to realize US$2.5b reduction of working capital, with US$1.3b savings in 2015 and a further US$1.2b estimated for 2016.³ Based on the half year results, it is also estimated that the company has reduced C2C from 21 to 14 days in the first six months of 2016.⁴

There is new recognition that managing cash to improve the balance sheet is critical, and shareholders will be expecting a renewed focus in this area.

The supply chain is a rich vein for working capital improvement. Key strategies wherein working capital has been successfully released include:

- Using supply chain as a source of finance, with a number of global miners extending supplier payment terms by using tailored strategies by supplier category or geography, and by improving the controls over early supplier payments and use of non-standard terms. Miners who have successfully applied this strategy have had strong controls in place to ensure that payments to government, regulators and indigenous groups are not impacted and that changes to trading terms are carefully and clearly communicated to both internal stakeholders and suppliers.

- Using supply chain financing instruments, where financially viable, to delay payment while enabling earlier payment to suppliers. In some cases, leading businesses can use accelerated payment to negotiate further price reductions in addition to accounts payable benefit.

- Reconfiguring logistics and supply chains to make them leaner and more agile, and allowing sharing of inventory spare parts across mining operations. Supply chain management processes have not changed fast enough — some are still operating on a "production-at-any-cost" basis. For example, there are many remote mine sites with significant levels of inventory spares, all bought in the past 12 months. If production slows, those spares can be stuck in remote locations, being hard to sell and expensive to move. During the boom, with demand scarcity and no delays wanted, it made sense to have a pile of spare truck tyres, but that scenario doesn't make sense in today's environment.

Processes and systems across the supply chain, particularly with regard to spare parts inventories, are the single biggest area for gains to be made.

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• Improving planning, buying and inventory management processes so that working capital levels are set relative to business activity and periodically reviewed.
• Changing asset maintenance strategies to move away from life cycle to condition- or risk-based models results in better quality information about part criticality and breakdown likelihood, enabling a more targeted investment in inventory.
• Taking a closer look at customer trade terms, order processing and delivery scheduling so that longer-term orders are processed at the beginning of the month and Letters of Credit orders are scheduled for the end of the month.
• Reducing work in progress stockpiles that have historically been set aside due to grade or quality.

We still see a number of critical improvements that many of the miners will need to carry out in order to release cash from working capital, including:
• Cultural changes such that all employees who can influence working capital understand what they can do to better manage cash across inventory, receivables and payables
• Reconfiguration of supply chains to better control and manage the purchase and deployment of inventory spares
• Better insights from systems and data on the operational drivers of working capital, not just the financial outcomes

The next wave of improvements will require cultural change and data analysis.

How to quickly release cash

1. Establish a global steering committee with representation across functions and business units – reporting to leadership
2. Obtain a clear mandate with clear sponsorship and communicated to the whole business
3. Apply dedicated resourcing (internal and external) for the program management office
4. Quickly analyze all of the working capital levers and identify if an opportunity exists
5. Set working capital reduction targets that are signed off and monitored by leadership
6. Establish working capital dashboards that use transactional data to monitor and make decisions
7. Increase visibility of the program and control from the center to gain momentum, e.g., through a cash war room
8. Apply a strong focus on sustainable change management at the front line, as they control the levers

Our analysis and experience in the sector confirm that miners who have taken an enterprise-led approach, combined with a bottom-up change management program focused on the front line, have released cash flows totaling tens of billions of US dollars. Given that the aggregate levels of working capital in the sector amount to more than US$200b, there remain plenty of opportunities to further release cash.
Productivity remains the number one operational challenge in the mining sector, with many still struggling to make an impact. Gains to date have been realized via tactical short-term solutions, but to really achieve sustainable gains, the focus needs to be on the long term. In our experience, most of the obvious opportunities across operations have already been addressed – it’s finding the next 10%-20% of productivity savings that can be difficult and complex.

We believe a relentless focus on the elimination of loss at all levels is needed for the next wave of sustainable productivity improvement. When we define loss, we define it as any gap between the achieved output and the potential productivity of an asset or a system of assets. It includes elements of reliability/availability, utilization rate and quality. Whether the objective is a rapid uplift in productivity, or a long-term sustainable change, the principles remain the same. We believe that companies need to embed sustainable loss elimination practices through employee engagement and an integrated end-to-end approach for long-term sustainable improvement in productivity.

1. Focus on the assets: an end-to-end view

We believe that to achieve the next level of productivity improvement, mining companies need to move beyond point solutions, and adopt an end-to-end solution to transform the business. Each element of the business, from the resource in the ground to the product being delivered to the client, needs to be optimized, not on its own but as part of a business system. We have titled the lack of this optimization as an “integration gap.” In our recent report, Productivity in mining: now comes the hard part, a number of the executives we surveyed highlighted this gap and their desire to close it. A key component of this change is to ensure companies understand the potential of their equipment, or its overall equipment effectiveness (OEE), rather than use the more traditional approach of measuring against plan.

We heard many anecdotes from survey participants about the lack of communication between the functional departments and how a silo mentality has crept into the management of mining companies. Analysis and mapping of communication networks by researchers at the University of Queensland show how severe these problems have become at some mines. In one study at a large mine, operations and maintenance employees were asked to nominate people who they regularly involved in problem solving. When these connections were turned into network maps, it showed that very little communication existed between these functions. On some whole-of-mine technical problems, such as water management, no direct connection between the functions was found, which revealed a hidden operational risk for the business.
Ensuring integration is a key challenge for improving productivity and requires an approach that breaks down these silos and adopts an end-to-end perspective. Optimizing an operation now requires a more complex balance of four core dimensions: safety, costs, productivity and license to operate. This may end up with operations investing more in enabling capabilities to drive system reliability to drive productivity to deliver shareholder value.

2. Relentless pursuit of loss

Loss needs to be transparent, understood and acted upon. In our experience, reasons for loss fall under four major categories as follows:

- **Reliability** – e.g., equipment and material supply losses
- **Utilization** – e.g., labor supply and integration losses
- **Throughput** – e.g., payload and rate losses
- **Quality** – e.g., ore quality and ore to waste losses

There is evidence of significant productivity improvement and value creation through the adoption of a manufacturing mindset. This changes the focus from traditional productivity efforts to establishing the capability and environment to enhance materials flows and equipment effectiveness. This is supported by productivity metrics, in particular the use of OEE to drive throughput. Production uptime can quickly be increased by up to 5%, and revenue enhancements can typically be delivered in the range of 10%–20% without significant investment.

Through stable and predictable operations, productivity, particularly around operations and maintenance activities, is also increased. Operations would spend less time firefighting, creating opportunities to support continuous improvement efforts. As a result, this approach also translates to improved safety, better forecasting and advanced integrated activity planning.

Many sectors outside of the mining sector have been extremely successful in eliminating loss by embedding manufacturing excellence across the organization. Procter & Gamble (P&G), for example, is leading this space through their Integrated Work System (IWS) from which it has made manufacturing operations a competitive advantage. IWS uses a set of operational reliability-centered methods, tools and advanced analytics to identify and eliminate losses in operations and create a predictable and stable operating environment. This approach has proven highly successful in eliminating loss, and has enabled them to achieve y-o-y savings of US$1.2b over the past three years.  

To achieve end-to-end focus, mining companies need to consider:

- **An integrated governance structure across productivity initiatives**
- **Optimal asset utilization via loss elimination analysis and practices**
- **Data analytics to provide quality information to support effective decision-making and productivity gains** – the increase in availability of computational power and agility combined with the lowering of the unit cost of technology means that miners can now use predictive analytics to identify where equipment failures or plant bottlenecks is likely to occur and react before production is impacted. This focus on asset performance together with other targeted areas such as fuel analytics has enabled some miners to achieve an overall reduction of up to 25% in opex spend.
- **Engaging the whole workforce** – ensuring targets drive the right behaviors

Most mining companies have already adopted an end-to-end approach for back office functions such as finance or procurement, but not for service functions like asset management or core functions like mineral processing. Yet we believe that using a process model to achieve and sustain an end-to-end approach is where the true enablers of productivity gains can be achieved.

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*“How wonderful would it be if the drilling operator knew that by drilling the right hole size and the blaster knew that by blasting it right so it’s not oversized, that there will be no downstream impacts. That by not doing it right it can impact the shovel operator and the truck driver. The challenge is trying to get them to understand how they all fit in.”*

Survey participant

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3. Focus on leadership and culture

Productivity is an issue on the CEO’s agenda and needs a CEO solution to be resolved. The productivity journey requires a change of mindset, enabling and empowering operations to pursue losses. Leadership plays an important role in making this happen. The critical role people will play in the productivity transformation cannot be overstated — productivity improvement is the role of everyone in the organization. Relentless pursuit of loss, like ensuring zero harm, can transform the business entirely.

There are three key areas miners can focus on to address integration and in turn improve productivity:

1. **Engagement** — visibly felt leadership and significant investment in culture and capability are critical to reach the next level of productivity. Productivity improvement is the role of everyone in the organization — embodied by relentless pursuit of loss — and it can have a significant impact on transforming the performance and capability of the business. Telling people what’s important is empowering — people need to understand the importance of improved productivity and the role they can play in achieving it. The integration challenge can be met head-on by increasing connectivity, emphasizing the importance of communication and fostering an end-to-end view across the organization.

2. **Measurement and reward:** What gets measured gets done — mining companies have the opportunity to measure and reward the actions of their staff to improve productivity and the way people go about delivering this. Productivity improvement through loss elimination is further driven by relevant and timely team metrics. Mining companies should therefore gauge their teams on true measures of productivity such as heightened output, improved safety and loss elimination. It is equally important to recognize and reward teams and leaders who collaborate well across business units, keep other groups informed and involved and break down the silos.

3. **Ongoing talent management** — managing talent post the super-cycle is a major consideration for mining companies. The “war for talent” has not ended just because labor market conditions have eased. There is a greater need than ever before for “systems thinkers” who can manage complexity and see improvements across the whole value chain. In addition to emerging talent bringing new ways of thinking, retaining the wise, senior and experienced talent will be a key competitive advantage. They have the right skills to realize productivity gains considering they were in the sector pre-boom and therefore have the experience of a leaner, more efficient operating model, culture and mindset.

CEOs are in the unique position of being able to drive and lead end-to-end solutions and transform a business, in a way that functional general managers cannot address. But to truly integrate, the entire leadership team needs to be engaged.

While the business’s objectives may not have changed, a refresh or review of the operational strategy can be an excellent tool in not only changing the focus of the business, but also in initiating a change in culture. A new operational strategy is a great way to drive a common sense of purpose and unity within a leadership team and focus it on resolving the critical issue of integration to transforming a business.
A program built on the back of good asset management fundamentals will work as a platform to drive productivity and manage risk.

Extracting more value from existing assets presents an opportunity to improve asset management capability. This can help to drive productivity and manage risk in a cost-constrained environment.

**Key areas miners can consider for ensuring capital effectiveness**

1. **Advanced asset management**
   - Productivity at the right cost

   Asset management excellence requires a fine balance between productivity, cost and risk. The traditional focus of improving equipment availability has not translated into increased throughput or productivity. Calendar-based maintenance is the predominant scheduling method, but is often wasteful and cost prohibitive in the current environment. By moving from calendar- to condition-based maintenance, we have seen some companies achieve a 15%-25% reduction in maintenance costs. Metrics need to be based on OEE to allow waste to be identified, measured and addressed. We have observed companies achieving a 3%-5% increase in revenue with no additional capital when using OEE metrics. By using integrated data like advanced scheduling (to improve maintenance and production schedules) and predictive analytics to provide advanced warning of equipment failures, asset values can be improved to the full end-to-end life cycle.

2. **Sustaining capital**
   - Many are cutting, but should they?

   In many companies, sustaining capital is a buffer rather than a process that effectively manages asset-driven critical risks. Accountability for sustaining capital can often fall through the cracks – between operations, maintenance and projects. Incentives and KPIs are often misaligned and do not link asset management performance with financial and business outcomes. With the drive to lower costs, many companies have cut back and de-prioritized sustaining capital expenditure. This has had the short-term effect of reducing the demand for cash; while the overall impact will be lower medium- to long-term productivity.

   As decisions about asset and equipment replacement become more time-critical, traditional approaches of site-based lists, substitutions and “pet” projects will result in poor capital allocation and ineffective management of risks.

3. **Capital productivity**
   - Not a one-off exercise
We would consider better practice to be the adoption of a top-down approach to create criteria to be applied to the existing asset base that covers:

- **Identification** – asset condition and economic replacement will build a portfolio of opportunities and reduce surprises when equipment fails in service
- **Prioritization** – a consistent risk-based prioritization method linked to financial costs increases the effectiveness of sustaining capital projects
- **Execution** – integrating with production and maintenance will improve capital effectiveness of sustaining capital projects

### 3. Capital productivity

Productivity of invested capital is a key issue for CEOs across the global mining sector. In a recent EY report, *Opportunities to enhance capital productivity*, we analyzed 108 mega projects (>US$1b) in the sector and found that cost overruns and delays were the norm, with an average budget overrun of a staggering 62%. New perspectives are essential to turn around this trend and deliver to boards and investors the predictability and confidence they require.

Miners can release cash through greater understanding of capital portfolio and management of individual projects.

Effective use of capital will be driven by:

- **Focusing on the right projects** – reviewing projects so that they meet the current investment criteria
- **Focusing on doing the right projects well** – we believe that a formalized capital productivity approach at pre-feasibility; feasibility and construction stages will enable miners to deliver within scope and at the lowest cost
- **Ensuring information flows** between these two processes to create an iterative loop
- **Comparing competing project designs on the basis of capital risk exposure**. Development strategies such as staging allows incremental capital to be invested when the business conditions are supportive and withheld when conditions are difficult. The ability to defer a portion of capital investment into the future can create value for investors and reduce their capital risk exposure.
Empirical research suggests that companies that actively and dynamically manage their portfolio of assets achieve better longer-term returns than companies with a buy-and-hold strategy. The evidence shows that an efficient portfolio of assets can be achieved by holding assets within the portfolio with different risk, return and correlation to achieve better return for the same level of risk or lower level of risk for the same rate of return.\footnote{Based on the Harry Markowitz Model.}

For the mining sector, with capital decisions played over such a long period of time, and profitability so intrinsically linked to broader macroeconomic factors, effectively managing portfolios is an incredibly difficult task. This is made even harder with the heightened level of volatility currently being experienced. Consolidation and diversification during the super-cycle has left many corporates with unwieldy portfolios and management more aware than ever of the need to manage portfolios. For some, we have seen this begin to play out, such as BHP Billiton’s divestment of South32 and both Anglo American and Freeport-McMoRan announcing significant portfolio realignment.

Portfolio management will remain a key priority in constructing an optimum portfolio. Some of the factors that miners need to consider are as follows:

- **Making a decision to be diversified or a single commodity operation:** We believe more companies will start looking outside their existing commodity focus or leveraging existing operations to explore other opportunities where they can leverage proprietary operational skills, technology or infrastructure. Being able to create synergies that are unique will be a critical factor in staying ahead of the pack and ensuring returns are maintained.

- **Ensuring country risk is properly factored into asset valuations:** Geographical diversification is every bit as important as commodity diversification and needs to be understood across the portfolio. Detailed modeling may show that country risk affects the type of target project (e.g., large capital investment vs. smaller sequential project investments) for a portfolio and the preferred ownership structure.

- **Establishing a single basis of risk and return comparison for capital investments** regardless of whether it is an expansion project, an M&A opportunity or indeed a capital raise through sell-down of infrastructure or mining properties. This is an incredibly difficult and time-consuming exercise, but is essential in understanding the relative impact on risk and return of the portfolio of competing capital decisions.

- **Recognize impact of long-range forecast uncertainty on strategic business decisions.** The possibility for changes to long-range FX rate and metal/energy prices forecasts over time should be reflected in the decision-making process. Project design, financing and ownership choices, and portfolio decisions can all be structured to maintain optionality and manage and mitigate risk for the investor when dealing with forecast uncertainty. Investment decision insights and the quality of information supporting a business decision can be improved by explicitly recognizing how project and portfolio decisions may vary across a range of business environments.
Our view is that capital allocation and portfolio strategy are critically linked. As a result, mining companies need to:

- Complete regular and rigorous portfolio reviews to determine the highest-performing investment projects and identify where to focus capital
- Understand the embedded optionality and capital intensity of individual projects is a key determinant in deciding what assets form the optimal portfolio to achieve growth aspirations
- Examine underlying liabilities associated with assets to protect against unforeseen risks that may have been previously underestimated or remain beyond their control without any financial limit. An example would be non-operated joint ventures
- See that projects previously considered core may become best suited for divestment if growth opportunities are limited and do not fit with the new strategic direction of the company

We have seen a significant level of divestments among diversified producers, with capital proceeds typically being used to pay down debt or returned to shareholders as cash or in specie. Many of these divestments have focused on higher-cost mines or mines with limited long-term growth, as corporates look to position themselves as far down the cost curve as possible. They keep future expansion optionality within existing assets rather than having to look at new-build or M&A options.

We are also seeing a number of corporates taking a view on what commodities the portfolio should focus on and, perhaps more importantly, what commodities they wish to exit. This inevitably interplays with regional diversification as the divestment strategy will certainly alter the country risk of the portfolio and that in turn is creating an investment requirement to re-weight the portfolio from either a country-risk perspective or into new commodities.

Institutional shareholders respect good management teams that deliver good results. They don’t care if that’s in a diversified portfolio, or a single commodity. They value delivery and credibility. As long as you communicate the journey you are on, and your actions make sense, they will continue to follow you. Standing still in the current environment is not an option for many.
While there is a significant level of debt across the sector, and leverage is high on the back of lower earnings, a large proportion of debt is covenant lite and many corporates have taken action to push out maturities and reduce servicing costs. The associated distress, therefore, is perhaps lower than might otherwise be expected in such difficult market conditions.

High financial leverage clearly isn’t sustainable in the long term, and if volatile markets persist, it will ultimately crystallize formal insolvency situations, albeit this is some way off in the majority of situations. There are, however, some markets that have been hit hard, with the coal sector being the most prominent as it grappled with the impact of relatively high US dollar-denominated cost base in a very depressed US coal pricing environment. Balance sheet flexibility remains critical during this period of volatility, and so does the associated “right-sizing” of debt levels to the underlying profitability of operations.

Changes in industry net debt, EBITDA and implied multiple

Of course, balance sheet flexibility isn’t just a case of paying down debt, but can take various forms, many of which have been put in place across the sector in recent years:

- **Pushing out the maturity of debt, and removing covenants to make the instrument more flexible.** Typically this has been done via refinancing, but there is an increasing willingmess from lenders to discuss renegotiation of debt terms in order to provide the underlying operations with increased flexibility.

- **Business combinations, such as mergers or joint ventures, executed via share issuance rather than cash.** Assuming such a strategy is well executed, it may be possible to improve the leverage of the resulting business combination, which can in turn lead to a more flexible balance sheet or indeed the financial leverage to negotiate debt terms with lenders.

Leverage is at an all-time high, but this doesn’t necessarily indicate widespread financial distress across the sector.

Corporates will continue to look at different ways to release capital in order to pay down debt.
Mike Henry – President Operations, Minerals Australia, BHP Billiton

“The most surprising part of the new job has been how much opportunity is left out there” to keep bringing down costs and boosting productivity, including in iron ore, where he’s confident that BHP can go below its target for US$15 a tonne cash costs.⁹

Our advice to companies operating in an uncertain environment:

- Consider all six levers we have discussed in this paper, not just one, as they are all important and should be dealt with concurrently
- Break free of pro-cyclical, short-term behavior and instead consider the impact of your actions on long-term productivity and future growth
- Look to other sectors for ideas of business optimization
- Don’t forget the importance of people as success requires leadership and tone from the top – lead by example and others will follow
- Always consider the reaction of shareholders and stakeholders
- Don’t limit your thinking to what’s possible

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How EY’s Global Mining & Metals Network can help your business

With a volatile outlook for the sector, the global mining and metals industry is focused on how to maintain a strong and flexible balance sheet while preparing for future growth. The sector is also faced with the increased challenges of improving productivity, access to capital, dealing with increased transparency, maintaining license to operate and cybersecurity.

EY’s Global Mining & Metals Network is where people and ideas come together to help mining and metals companies meet the issues of today and anticipate those of tomorrow by developing solutions to meet these challenges. It brings together a worldwide team of professionals to help you succeed – a team with deep technical experience in providing assurance, tax, transactions and advisory services to the mining and metals sector. Ultimately it enables us to help you meet your goals and compete more effectively.

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