Does cutting debt have to mean reducing your ambitions?

The better the question. The better the answer. The better the world works.
Snapshot on debt in mining

As we approach the half way point of 2017, the much-needed pricing recovery seems to be holding up. The sector continues to remain in good health, relative at least to early 2016. As many of the participants have been at pains to tell us during results announcements, there remains a firm focus on capital discipline and operational excellence.

In the first of a two-part series focused on the mining industry’s capital agenda, we look at debt levels across the sector and how leverage has been brought back under control. Using the top 50 global miners as a gauge on the industry’s health, we illustrate in this report with the following details that the sector is in far better health than perhaps investors give it credit:

- **25%**
  - The amount by which debt has fallen from peak levels, with the associated leverage down by 8 percentage points, back to 2013 levels.

- Cost of debt has increased, but balance sheet flexibility is much improved and miners continue to focus on retiring higher-cost, unsecured facilities, in order to bring debt costs down.

- Earnings momentum is strong, with the pricing environment much improved from 2016, which increasingly looks to be remembered as “bottom of the cycle.”

In the second of this series, we will look at what this means for the sector in terms of capital structure, growth prospects and the industry’s ability to satisfy the returns demanded from its investors. We will look at the returns being generated by our sample of companies and the extent to which these are sufficient for the sector to attract investment against competing industries. We will also look at dividend policy, share buyback programs and capital allocation strategies as a means for generating attractive returns to investors.

Our basis for analysis: This analysis is based on the top 50 mining companies in the world by market capitalization as of 31 December 2016. This excludes aluminium and steel companies, including backward-integrated metals producers with significant mining assets. The analysis is based on aggregated financial statements data from Capital IQ. For consistency, calendar years have been used across all companies. The definitions and treatment of the financial data are as per Capital IQ and may differ from other information sources. However, in this analysis, the overall trends are more important than the absolute numbers and any interpretation should be treated as such.
A relentless focus on balance sheet strength and productivity, supported by a recovery in commodity prices, led to a 17% reduction in net debt (approximately US$39b) among the top 50 mining companies in 2016. Debt levels in the mining sector had crept upward after the end of the super cycle in 2011, leading to record levels of leverage into 2015.
Gearing came down significantly in 2016 as companies focused on debt reduction. At the same time, improving market fundamentals led to gains in miners’ valuations.

Gearing for the top 50 miners in 2016, 8 percentage points below 2015.

34%
Debt reduction has been driven by proceeds from asset sales, capex curtailment and dividends suspension, allowing the sector to be less exposed to tighter lending criteria by financial institutions. The squeeze in traditional financing forced many players to seek innovative ways to finance operations; the popularity of alternatives sources of funding, such as streaming and royalties, increased as mainstream sources of capital diminished.

Bulk producers and the diversifieds accounted for the majority of the overall reduction in net debt in 2016. Buoyed by steep rises in coal and iron ore prices, bulk product miners prioritized strengthening of balance sheets in order to position themselves against future price volatility.

However, in the regions where some assets had been mothballed or were operating at very low utilization, the rebound in coal and iron ore prices actually gave players the impetus to recapitalize and boost production to take advantage of the price gains. In China, for example, several coal miners raised debt mainly from bond issues to start up operations and benefit from strengthening prices.

Base metals players saw the most modest reduction in leverage in 2016 as the pick-up in prices generally came later into the year and many had capital commitments on projects that were ramping into production. Price movements within the base metals complex were mixed, with zinc and tin prices rising strongly while nickel remained relatively weak. Average copper prices were actually down year-on-year despite strong growth over the second half of the year. Inevitably that led to mixed fortunes among the base producers as early signs of divergence in performance began to emerge. Diversifieds whose portfolios constituted mainly bulks and precious metals also performed relatively stronger than those biased toward base metals.

### Change in net debt, 2016 vs. 2015

<table>
<thead>
<tr>
<th>Category</th>
<th>CY2015</th>
<th>CY2016</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulks</td>
<td></td>
<td></td>
<td>-50%</td>
</tr>
<tr>
<td>Base</td>
<td></td>
<td></td>
<td>-44%</td>
</tr>
<tr>
<td>Precious</td>
<td></td>
<td></td>
<td>-19%</td>
</tr>
<tr>
<td>Diversified</td>
<td></td>
<td></td>
<td>-16%</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td>-19%</td>
</tr>
</tbody>
</table>

80% Bulk producers and the diversifieds accounted for over 80% of the overall reduction in net debt in 2016.

### Net debt/EBITDA ratio

<table>
<thead>
<tr>
<th>Category</th>
<th>CY2015</th>
<th>CY2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulks</td>
<td></td>
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</tr>
<tr>
<td>Base</td>
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<td>Precious</td>
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<tr>
<td>Diversified</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td></td>
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</table>

Note: Trailing EBITDA on year-end net debt position has been used for this analysis.
Did financing costs peak in 2016?

Financing costs increased significantly at the beginning of 2016 due to poor credit ratings and a negative outlook on the sector. Anglo American, for example, saw its credit rating downgraded in early 2016, albeit its outlook has recovered strongly since.

22%

Decline in capital raised in debt markets globally in mining in 2016, ex-China.

Consequently, miners in most regions of the world faced great difficulty in accessing conventional capital. China was an exception, however, as state banks appeared to provide some relief, perhaps to stimulate slowing industrial growth. In fact, though capital raised in China spiked during 2016, the rest of the world excluding China, saw capital raised decline by around 22% year-on-year in 2016.
Interest expenses increased in 2016 despite falling proceeds, highlighting the rising cost of capital in the industry as lenders viewed the sector as high risk. Though total debt declined, interest expense as a percentage of total debt shot up, reflecting higher costs of new debt in 2016. It is important to note that the majority of existing credit facilities were not linked to credit ratings but new loan terms were affected by poor credit ratings in 2016, making borrowing costs higher.

Borrowings were mainly used to finance the rise in working capital (see next section on working capital) and refinancing existing facilities.

As commodity prices started to rise, cash generating producers began to execute bond buyback programs to reduce their cost of capital. In addition, the sector targeted near-term maturities to increase balance sheet flexibility, and sought to make covenant terms as light as possible within debt instruments.

Opportunities still remain in 2017 for mining companies to retire unsecured instruments in favor of lower cost and more flexible facilities, supported by an improving credit outlook for the sector.

<table>
<thead>
<tr>
<th>Interest expense/total debt</th>
<th>Changes in credit ratings (Moody's)</th>
</tr>
</thead>
<tbody>
<tr>
<td>5.5% 5.0% 4.5% 4.0% 3.5% 3.0% 2.5% 2.0%</td>
<td>8.4 9.0 9.0 8.8 8.6 8.6 8.4 8.2</td>
</tr>
</tbody>
</table>

Note: This is the average net debt over the year, rather than year-end position.
Further debt reduction is possible in 2017

While the industry has hinted at reduced asset sales in 2017 for the purpose of de-leveraging, further debt reduction could still be driven by higher cash generation. The relatively stable metals price environment, compared to that experienced in the first half of 2016, is expected to further boost earnings in 2017 and with it, cash flow.

30%

The amount by which overall EBITDA is forecast to climb year-on-year in 2017.
Consensus 2017 forecasts see strong earnings performance for 2017, with overall EBITDA expected to climb by over 30% year-on-year. Even with an expected increase in production volumes across most metals, the earnings momentum is supported by supply-side risk on existing production, lower costs across the industry and greater discipline among the producers.

Due to payment of near-term and extension of debt maturities, for the top 50 mining companies, forecast 2017 EBITDA is enough to cover debt commitments over the next five years.

Should the mining sector continue to pay down debt at the same rate as last year, net debt would reduce by around 20% in 2017 and the net debt/EBITDA ratio would fall below 1 for the first time in five years, based on consensus earnings.

A reduction of debt of this magnitude, while offering enough cover and flexibility for cyclical in earnings, raises questions on the efficiency of the capital structure of the mining industry. With the balance tipped toward equity funding, it remains to be seen whether mining companies will begin to restructure their financing arrangements with the ultimate aim of lowering cost of capital. Shareholders will certainly be looking at changes, as the returns on equity remain relatively lower than that of other sectors.

<table>
<thead>
<tr>
<th>Long-term maturity debt</th>
<th>32</th>
<th>22</th>
<th>24</th>
<th>28</th>
<th>23</th>
<th>130</th>
</tr>
</thead>
<tbody>
<tr>
<td>2017 consensus EBITDA forecast</td>
<td>163</td>
<td></td>
<td></td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>

### Does cutting debt have to mean reducing your ambitions?
Working capital performance has improved significantly in recent years. As expected, however, the rebound in activity in 2016 led to an overall rise in working capital investment during the year.

With cash optimization – a strong focus among miners in recent years – significant gains have been realized since 2014 leading to a reduction in working capital investment. The increasing shift to leaner and more agile just-in-time manufacturing methods, geared toward reducing inventories, has aided in reducing wastes that would otherwise have been tied in working capital. The supply chains for mining companies are also undergoing transformation with some efficiency gains already realized from the digitization of the mine. This trend could potentially lead to even more savings on working capital performance in future.

Key initiatives to reduce working capital commitments have considered a wide array of items including:

- Efficient raw material sourcing to improving demand forecasts and enhancing supply chain planning
- Deploying lean and agile manufacturing
- Driving working capital synergies through post-merger integration programs

Efforts geared toward efficiency improvement contributed to gains in working capital performance.
The sector is not out of the woods just yet, with continued volatility expected across most metals and the strong pricing in iron ore and metallurgical coal, in particular, expected to soften. But the industry has significantly restructured; balance sheets are far more robust, supported by a stronger outlook in earnings.

For now, capital discipline remains the focus, with limited appetite for M&A or capital investment in anything but the lowest risk projects. Whilst this is understandable, there is a very real risk that the pendulum swings too far. If there is a lack of investment, balance sheets will become inefficient and the sector could fail to generate appropriate returns in the future.

### Working capital ratios

<table>
<thead>
<tr>
<th></th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2 year change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Days inventory outstanding (DIO, days)</td>
<td>65.5</td>
<td>65.4</td>
<td>64.9</td>
<td>-0.9%</td>
</tr>
<tr>
<td>Days sales outstanding (DSO, days)</td>
<td>29.8</td>
<td>29.1</td>
<td>30.2</td>
<td>1.1%</td>
</tr>
<tr>
<td>Days payable outstanding (DPO, days)</td>
<td>40.3</td>
<td>38.4</td>
<td>40.7</td>
<td>1.2%</td>
</tr>
<tr>
<td>Cash-to-cash cycle</td>
<td>55.1</td>
<td>56.1</td>
<td>54.4</td>
<td>-1.3%</td>
</tr>
<tr>
<td>Working capital ratio</td>
<td>1.64</td>
<td>1.49</td>
<td>1.54</td>
<td>-6.4%</td>
</tr>
</tbody>
</table>

The effectiveness of working capital management processes can be attributed to the focus on cash, costs and capital discipline adopted by the industry in recent years. Each day saved on cash-to-cash cycle days by the industry can run into billions of dollars by value. The squeeze in credit supply to the industry by financial institutions has also justified the senior level attention that the working capital management has received as a new strategic initiative to optimize cash flows and reduce the cost of capital by avoiding more short-term borrowing to sustain operations.

**What’s next for mining companies**

The sector is not out of the woods just yet, with continued volatility expected across most metals and the strong pricing in iron ore and metallurgical coal, in particular, expected to soften. But the industry has significantly restructured; balance sheets are far more robust, supported by a stronger outlook in earnings.

For now, capital discipline remains the focus, with limited appetite for M&A or capital investment in anything but the lowest risk projects. Whilst this is understandable, there is a very real risk that the pendulum swings too far. If there is a lack of investment, balance sheets will become inefficient and the sector could fail to generate appropriate returns in the future.
How EY’s Global Mining & Metals Network can help your business

With increasingly positive sentiment in the sector, miners are focused on restoring balance sheet strength and liquidity in preparation for growth. The sector’s key opportunity is still productivity. Although many have made productivity improvements, the critical next wave of gains needs a strong focus on loss elimination, with digital being a key enabler.

EY has significant experience in assisting companies to evaluate and implement strategic initiatives, with deep sector knowledge to support you on finance initiatives, such as portfolio optimization and capital planning, and through to operational improvement programs, such as productivity and digitalenablement.

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