In a diverging market, what path will you carve?

Mergers, acquisitions and capital raising in the mining and metals sector – 2016 trends and 2017 outlook

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Key trends

A big sigh of relief can be heard across the industry that 2016 is behind us. While the year ended on a high, it started with serious financial distress and an incredibly bleak outlook. Throughout the year, global macroeconomic factors created huge uncertainty and volatility, and the disciplines instilled through this experience will no doubt continue to influence the strategies into 2017.

We see 2017 as a year for the sector to take stock, catch its breath and begin to put in place the foundations and strategies that will shape the next phase of growth for the industry. We are increasingly observing that the foundations need to be tailored to the particular commodities and markets that the participants choose to play – the sector no longer rises and falls in unison and this will mean the end of the herd mentality we saw in corporate strategy during the peak of the super cycle.

For example, restructuring of the coal sector will continue with the US participants adjusting to a new domestic landscape, and the factors that are increasingly disconnected to those in Asian markets supplying strategic consumers. What drives corporate activity in these coal markets will be, perhaps more than ever, disconnected to the factors that drive, for example, the copper market, where participants are beginning to think about the next wave of investment required to supply markets that many believe will be in deficit in the short term.

The discipline developed through 2015–16 will continue with a focus on cost optimization, balance sheet agility and productivity, limiting the amount of capital available for future growth projects. Further management will increasingly have an eye on returns to shareholders – both in terms of yield and share price appreciation – which will ultimately come from better growth prospects. We expect dividend policies to be reviewed and communicated to shareholders, with many seeking to link dividends to earnings and cash flow. Of course, the level of dividend payout needs to be strategically linked to the broader capital agenda, with consideration of debt levels, capital intensity and portfolio composition.

From a balance sheet perspective, we expect to see a continued focus on balance sheet strength, but perhaps with the focus on debt reduction shifting to a reduction in the cost of debt. This emerged as a trend in 2016, with Barrick Gold, Rio Tinto and others retiring relatively expensive bonds in order to reduce overall cost of debt and pay down upcoming maturities. With strong cash flows and improved balance sheet capacity across the industry, there is an opportunity to retire unsecured instruments in favor of lower cost, and more flexible facilities.

Inevitably, if markets continue to remain robust, a focus on growth develops, and this means a focus on raising capital. This will result in the following:

- Equity markets will remain tight, with primary capital still unlikely in the short term to any significant scale. However, we will see a significant increase in secondary fundraising, particularly if gold experiences a sustained period of price appreciation. The exception may be in some of the technology-led minerals, such as lithium, where investors have a greater appetite to invest with the potential upside reward sufficiently high to justify the risk.

- Debt markets will see less “demand” from the sector, assuming cash flows remain strong. The majority of bonds during 2016 were domestic issues in China, and this may continue, but ex-China the trend was actually declining in 2016 and we expect this to repeat in 2017. But as the year progresses, we will begin to see a greater demand on project financing across the base metal community, with management teams looking to finance the next wave of projects required to meet the looming supply deficit.

- We may also witness strategic funds providing finance through partnerships with operators that have a track record of bringing assets into production. While the Japanese will certainly continue to be a participant in the tier one and new-technology assets, we expect to see funds from the Middle East taking a renewed interest in the sector with a desire to diversify capital away from the traditional oil and gas assets, given the volatility experienced in that industry over recent years.

Of course, there will also be a role for mergers and acquisitions (M&A) in the future growth ambitions of the producers and those bringing assets into development. The “supply” of assets into M&A will continue to be portfolio realignment as a result of the changes in strategy, as well as the continuing financial restructuring, albeit we expect this to be less intense than how it was in 2016. Also, “demand” will be a driver of market activity, with management teams looking for growth via synergistic acquisitions and potential diversification – in both commodity and region. Examples of this toward the end of 2016 include the merger of Agrium and PotashCorp, as well as Nevsun and Reservoir Minerals. Finally, we will see an increase in deals focused on consolidation and production growth, most likely in the gold sector, and also across base metals and precious group metals (PGM).

We expect an interesting year ahead, with many different strategies being put into action, and a cautious return to deal making and capital raising. Volatility is not going away, and there is certainly the potential for more global economic shocks. So this means it’s also the time to lay foundations for sustainable growth, engender resilience to further economic shocks and drive future shareholder returns.

For miners, now more than ever is the time to continue focusing on portfolio optimization and achieving a balanced capital agenda. Making sure that you have the best assets in your arsenal will be critical in a changing macroeconomic environment. This means rigorously and regularly evaluating each asset individually for how they sit within the portfolio and wider company strategy. It may mean selling assets in the short term, or as the case may be, acquiring strong performing, strategically aligned assets for future growth. Being disciplined about this will also ensure that poor decisions in the deployment of limited capital are avoided.

Additionally, securing the optimal financing balance will be key to growing businesses and successfully executing strategies. As debt and equity markets return to favor, companies will need to consider the challenge of packaging these traditional sources of finance with the newer alternatives we have seen in recent years. Achieving the right mix of capital will be crucial for securing the success of projects and ultimately the capacity to return value to shareholders in the longer term.
In a diverging market, what path will you carve?

The expectation for 2016 was that we would see diversified selling of assets at bottom-of-cycle prices, providing a great opportunity for corporates, sovereign funds and private capital to snap up bargains. As it turned out, measures to restructure balance sheets were executed quickly and efficiently, and as the year progressed, commodity prices gained a surprising and strong recovery, with equities following suit.

Persistent volatility made executing deals incredibly difficult, as did the ever-changing macroeconomic environment; it was a tough year to get deals done and this is reflected in the nature of transactions executed. While volume of deals increased from the low-base of 2015 by 33% to 477 deals in 2016, the y-o-y deal value dropped by 9% to US$44.3b, the lowest levels we have seen since 2004.

Strategic restructuring and sovereign security drove some of the major deals through the choppy waters. This resulted in a marked increase in high-value transactions in the last quarter of the year, including the completion of Alcoa’s Arconic spin-off4 and Freeport-McMoRan’s sale of its Tenke Fungurume mine5, which when combined had a deal value of US$6b, representing 14% of the total for the year.


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5 “CMOC to Acquire Freeport’s Indirect 56% Interest in Tenke Fungurume for US$2.65 billion,” China Molybdenum press release, 9 May 2016.
China outshone other countries both as a target and acquirer this year as a result of consolidation in the metals sector, with the Baosteel and Wuhan mega deal also on the horizon. It will be interesting to see if this trend continues, with many spectators suggesting a tightening of capital policies in China ahead, despite a desire to secure higher quality inputs in order to reduce the environmental footprint of the sector.

The country more than doubled the value of domestic and cross-border acquisitions it made in 2016. 4 of the top 10 deals were undertaken by Chinese acquirers. China Molybdenum’s activities accounted for US$4.2b worth of acquisitions this year – just under 10% of the overall deal value in the sector – with the acquisition of Freeport’s Tenke Fungurume mine in DRC and Anglo-American’s niobium and phosphate assets in Brazil.

Includes where region is the target and/or acquirer

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“China’s Baosteel, Wuhan to merge to create largest steelmaker,” The Australian, 22 September 2016.


Who’s buying? Who’s selling?

Deals were overwhelmingly driven from the sell-side, with divestments being the driver behind the majority of the largest transactions to realign portfolios and reduce debt. The largest transaction by value was Alcoa’s US$3.4b spin-off of its manufacturing business, signaling a reversal of the vertically integrated model previously adopted into one that enables investors to better price the very different market dynamics influencing the upstream and downstream activities.

Divestment activity enabled a number of mid-tiers to consolidate their positions this year, with Kinross Gold, Boliden and New Hope undertaking acquisitions of divested assets that fit strategically within their portfolio, arguably at a time when such strategic assets would not otherwise be available.

The value of deals involving financial investors, including private equity, stayed largely in line with that of the prior year. This may be surprising given the valuations at the start of the year, and willingness of many producers to divest assets. While some deals were successfully executed, many others were stalled as a result of shifting expectations from vendors or failed as valuations from strategic buyers simply couldn’t be matched.

Share of deal value by acquirer type

US$3.4b

The largest transaction by value was US$3.4b in 2016.

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What are they buying?

Copper assets were at the core of deal activity, comprising 3 of the top 10 deals for the year, by value. This is reflective of longer term positive demand fundamentals for the commodity and a number of assets coming to market in the first half of the year that wouldn't typically become available without the prevailing distress felt in the industry at the time. This provided an opportunity for strategic buyers, such as China Molybdenum and Sumitomo, to secure offtake from world-class assets.

There was a significant drop-off in exploration assets, demonstrating the preference for established or near-ready projects that can easily be added to portfolios without substantial additional capex. The biggest jump was in aluminium deals, which rose from just US$244m in 2015 to US$3.4b in 2016. Aluminium, like steel, has been subjected to environmental crack-downs and cuts due to overcapacity in China, driving consolidation in the sector. Although, up slightly in volume, the value of coal deals dropped by 39% during 2016. Almost all of the major diversified and largest energy pure-players successfully closed divestments of coal assets during the year, particularly in Australia and the US. With more Australian coal assets up for sale and potential coal reforms in the US, we are expecting to see interest from traders and private equity in acquiring opportunistically on low valuations.

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Outlook for 2017
We expect a continued upward trend in the volume of deals during the year ahead, but with a continued absence of the multi-billion dollar transformational deals that characterized growth strategies during the super cycle. The potential exception will be large-scale consolidation across the Chinese domestic producers. Portfolio realignment and structural changes across certain industries, such as steel, coal and aluminium, will be the drivers of deal activities. The lack of exploration spend as a result of limited access to capital, will inevitably contribute to a future supply deficit and may trigger a return to financing across the juniors towards the end of 2017.

Early signs of market bottom will encourage those who've successfully strengthened their balance sheets to start considering strategic acquisitions. Mid-tiers will be consolidating their positions through all-equity-based transactions, with a view of becoming major players in their respective commodities at the peak of the next cycle.
Conventional finance dries up as risk aversion grips the industry, but improving pricing environment offers hope.

Mining companies across the world continued to face challenges in accessing conventional finance in 2016. However, aggregate capital raised in the sector increased by 9% y-o-y to US$249b in 2016, primarily driven by China, which decoupled from trends in the rest of the world.

The capital raised domestically in China doubled to US$100b in 2016 from the previous year. The bond market performed strongly in China, accounting for 90% of the total capital raised at US$90b. This is likely due to the strong influence of speculative retail investors in a sector where sophisticated institutional investors were generally wary of extending credit. In addition, state-owned Chinese banks reportedly continued to pump liquidity into the market through corporate bond purchases as stimulus for slowing industrial growth; but it remains unclear to what extent they contributed to the huge rise in mining capital proceeds.
“There was a marginal rebound primarily driven by a steep rise in domestic bond issues in China … however the total capital raised in the rest of the world actually continue to decline, falling by 16% in 2016.”

Hopewell Mauwa
EY Global Senior Mining & Metals Analyst

Excluding China, the capital raised across global markets declined by 16% to US$149b in 2016. Generally, all sources of capital remained subdued in major markets of Europe, North America and Australia. It was more positive in the equity markets, with follow-on equity raising recording significant growth since resurgent commodity prices provided support for sector players to issue more equity as investor confidence improved.

Rebounding commodity prices set to improve miners’ options for accessing capital

In 2016, corporate credit rating agencies maintained a negative outlook for the mining sector. Meanwhile, commodity prices continued to pick up over the course of the year, positively impacting cash generation for many players. The improved outlook was also bolstered by ongoing cost cutting measures and, in some cases, further deleveraging using proceeds from divestitures of non-core assets.

The expected continued consolidation of commodity prices in 2017 will positively impact the sector outlook and strengthen investor confidence. As a result, options for access to capital will improve though the industry is likely to continue to exercise capital discipline, prioritizing the retiring of high-cost debt accumulated through the distress period in order to reduce cost of capital, which had risen to elevated levels in the recent years. Indeed, 2016 has already seen cash-generative major players such as Anglo American, Rio Tinto and Barrick Gold set the tone with bond buyback transactions aimed at lowering the cost of capital. The trend is likely to continue in 2017 as the sector cautiously gauges the sustainability of the recovery in commodity prices while preparing for the next growth cycle.

In a diverging market, what path will you carve?

Outlook for 2017

Mining companies started 2016 at distressed levels but most benefitted through the year from a focus on cost cutting and deleveraging, supported by an earlier-than-expected boost in commodity prices. During the period of distress, most miners faced few options other than to take on higher priced debt with minimal covenants as solvency remained a priority in the face of heightened volatility. While the net capital raised in the sector is unlikely to rise significantly in 2017, miners are expected to refinance existing term loans rather than expand credit as they sought to deleverage while limiting growth capex.

Loans

Loan proceeds continued to fall in 2016 as providers remained cautious about the outlook for the mining sector. The year saw a second consecutive y-o-y fall in loan value of -16% (-27% in 2015) to US$103b, the lowest level since 2009. Despite a pickup in commodity prices in 2016, slow credit restructuring in the mining sector led to risk aversion by loan financers as credit rating agencies maintained a negative outlook on the industry. Consequently, while the volume of transactions improved in 2016, the average value per deal fell significantly as risk-averse banks preferred to allocate new credit to other sectors with a more positive outlook.

Outlook for 2017

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As industry fundamentals bolster in 2017, driven by tightening supply-demand balances, recovering prices and the realization of ongoing cost reduction programs, the return to growth will also see some miners reconsidering funding-shelved projects ahead of strengthening demand.

Meanwhile, we may find that alternative forms of financing, such as offtake, factoring, streaming and royalties, have peaked in terms of value provided to the industry, as traditional and cheaper forms of credit become more accessible, but will no doubt continue to be an important form of finance for the sector to consider alongside more conventional capital.

US$103b

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Bonds

Bonds were the most transacted capital raising instrument by mining companies in 2016. Proceeds increased by 51% in 2016 (+32% in 2015) to a total of US$116b. China was responsible for the growth as bond proceeds in the country more than doubled to US$90b (+140% y-o-y), possibly supported by retail investors rather than cautious institutional investors. It is also possible that Chinese state banks were offering liquidity to the market to stimulate growth. Bonds have been the major source of capital for miners in China, whereas deal proceeds in the rest of the world (ex-China) actually declined from US$39b in 2015 to US$26b in 2016. Skepticism by investors saw the yields on miners’ bonds higher than that on peers’ in different industry sectors but same credit tier. Nevertheless, improving cash flows saw several miners buying back bonds to address investor concerns on balance sheet health and commitment to cost reduction. Rio Tinto offered to buy back as much as US$3b while Barrick Gold and Anglo American completed US$2.5b of bond repurchases in 2016.14

Outlook for 2017

The overall bond market outlook has been impacted by the US Federal interest rate rise effected in December 2016. In the mining sector, bond market activity will be supported by strengthening industry outlook. However, players are expected to prioritize the recalling of maturing high-priced notes issued during times of distress. In China, improved accessibility to other financing instruments may potentially result in 2017 bond proceeds retracting from the highs seen in 2016. However, in the rest of the world, favorable credit outlook for mining companies may yet attract investors again to a sector perceived risky in the previous years. Miners’ appetite for more capital will be driven by a shift toward executing long-term growth projects, though any rise in long-term capex commitments is likely to be gradual as miners gauge the sustainability of future growth.

Convertible bonds

Convertibles rose to US$2.2b in 2016, up by 53% from previous year and driven by China, with ex-China value remaining largely flat y-o-y. Proceeds remained under a third of value transacted at the peak in 2013, highlighting continued cautious approach by investors and increased availability of alternative sources of finance. Indeed, the volume issued actually fell by 11% to 69 transactions, the third consecutive year of decline, with transactions in 2016 less than half the levels seen in 2013.

**Outlook for 2017**

Convertible bonds remain among the least used capital raising instruments in mining, accounting for just 1% of new capital raised in 2016. While investors may perceive this instrument as less risky as commodity prices pick up, some mining companies may still prefer to protect future upside in equity returns. As such, any increase in issuance of convertible bonds, though probable, is likely to be limited in relative terms when considering the overall funding landscape.
Initial public offering (IPO) activity remained negligible with only US$122m raised from 15 listings, a decline in value of 65% y-o-y (2015, -78% y-o-y) driven almost entirely from a decline ex-China, with domestic issues in China largely flat y-o-y. This was likely driven by a lack of appetite in new issues, with investors looking to recover losses on existing positions before increasing their exposure through new issues.

IPO volume and proceeds (2012–2016)

Outlook for 2017

The market-held consensus is that commodity markets have bottomed; this is supported by the strengthening of activities seen through the course of 2016. Industry fundamentals are expected to continue to improve in 2017. As such, IPOs are expected to pick up in 2017, albeit marginally, reflecting the cautiously optimistic sentiment that continues to grip investors.

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<th>Year</th>
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<tr>
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<td>2016</td>
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Follow-on equity

A total of US$28b was raised in 2016, a modest 3% increase from 2015 levels. The volume of transactions increased from 2Q16 through to 4Q16, with an average of at least US$7.4b raised per quarter, up significantly from the average US$4.8b raised in each of the previous three quarters. The rise in proceeds mirrored the upturn in commodity prices which provided a supportive environment for some miners to seek equity investments. While China saw a decline in proceeds from follow-on equity, the rest of the world markets actually witnessed a rise in transactions as miners capitalized on improved valuations fueled by a strengthening market outlook.

Other mining companies preferred to raise capital through rights issue not only as a means to minimize dilution but also as a strategic signal to attract investor confidence in their revised turnaround strategies.

**Outlook for 2017**

The share of capital raised through equity placements declined over the past five years, from roughly 15% of new capital raised in 2011 to around 11% in 2016, as commodity markets headed south reflecting a falling Chinese demand. The postponement of capital projects saw mining companies mainly seeking short-term funding, with proceeds sourced from loans and bonds. Any future issuance of equity placements is likely to be across those in development or exploration stage, rather than those with positive cash flow, where the cost of debt is typically much higher than through debt. The return to growth in 2017 is likely to see a steady rise in transaction volumes as miners resume funding long term capital expenditure projects.
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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.

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