Mergers, acquisitions and capital raising in mining and metals

1H 2013
It will come as little surprise that M&A and capital raising activity over 1H 2013 has been subdued. If 2012 represented the peak of capital spend, then 2013 will come to represent a hiatus and period of retrenchment. Management teams across the industry are focused on cost containment, margin improvement and asset optimization at the expense of high-risk capital expenditure, acquisitions or exploration.

Investors have lost confidence in the mining and metals industry, which remains sensitive to short-term economic news flow. This trend is driving funds out of mining and metals equities and into other industries.

The tension between sellers’ and buyers’ expectations remains high. As such, a sign of sustained improvement in commodity prices may be the trigger needed to accelerate competitive buying activity of the many divested assets coming to market.

We anticipate greater consolidation at the junior and mid-tier level as critical mass becomes increasingly important for accessing project funding. And we anticipate the continued injection of capital from private capital, offtakers and specialist finance providers, who recognize the opportunity to invest now for value creation over the long term.

Note: The data is primarily sourced from ThomsonONE. $ refers to US dollars.
M&A trends

Low valuations, divestitures and cash-strapped juniors have set the stage for a buyer’s market. However, mining and metals companies remain risk-averse in an environment of macroeconomic and geopolitical uncertainty, pointing to the third consecutive year of declining deal volumes for the sector. The reversal in cross border activity so far this year also highlights the trend of companies to minimize risk exposure by investing domestically.

In 1H 2013, a handful of mega deals (>1b) boosted deal value, including the first $10b-plus deal since the 2008 global financial crisis. However, this is unlikely to be a sign of things to come, given that Glencore International and Xstrata’s all-share $37.4b merger accounted for nearly half of the sector’s total deal value in 1H 2013. We saw 10 mega deals (80% of total deal value) complete in the first half, compared with 12 mega deals (30% of total deal value) in 1H 2012. Of the 10 mega deals completed, 8 were announced in 2012 but took time to complete amid increased shareholder scrutiny, regulatory hurdles and mismatched expectations on valuations. Deals completed in 1H 2013 were largely driven by efforts to create value in a depressed market by capturing unique value drivers via M&A.

North America was both the preferred destination and the most active acquirer, with largely domestic consolidation in Canada and the US. North American deal activity was characterized by mergers among smaller companies to pool resources and the acquisition of assets in familiar low-risk territory.
The CIS region witnessed a surge in domestic deal activity driven by private investor interest, particularly in coal and gold.

In contrast to 1H 2012, Asia-Pacific saw less deal activity by Chinese state-owned enterprises (SOEs), most likely due to new leadership reforms in the country. Even so, China continued to be the top acquiring country for the sector (in value terms) despite a slowdown in domestic consolidation and only small-scale outbound deals. The pullback in China's overseas deal activity impacted the country’s major target destinations: Australia and Africa. While China was notably quiet in 1H, this will be short-lived, with a number of potential deals already in the pipeline.
Activity was subdued across commodities as buyers wait for commodity prices to stabilize. Gold was the most targeted commodity in 1H 2013, with deal value increasing y-o-y, driven by domestic deal activity in Russia. However, gold deal volume declined 23% y-o-y at a time when the price of gold witnessed a significant downslide.

Continuing weakness in the price of coal largely limited coal deal activity to sales of minority stakes to release capital. Copper deals were also few and far between in contrast to the rush for scarce assets seen last year, as a substantial volume of new supply is set to enter the market from 2013 onwards, while short- to medium-term demand prospects become increasingly uncertain. In 1H 2013, copper deal value was primarily driven by First Quantum Minerals’ $5b takeover of Inmet Mining.

M&A outlook

An industry-wide focus on capital optimization and debt reduction is driving divestment of non-core and high-cost assets. However, many companies are struggling to find buyers at acceptable valuations as commodity prices are trending low, and equity markets are increasingly difficult to tap for funds. This could lead to distressed asset sales, benefiting bargain hunters with mid- to long-term investment horizons.

Many of the assets earmarked for sale by senior producers come packaged with supporting infrastructure (e.g., rail lines and port facilities) and the latest technology (e.g., block-caving and automation). Producing or near-production assets are the most likely to find corporate buyers and interest from privately managed capital. For well-capitalized mid-tier miners, such acquisitions hold the possibility of near-term earnings and upward re-rating, while the privately held investors can buy at perceived low valuations and wait for the upturn before exiting at a premium.

There has been an absence of interest from the majors, and only few mid-tier buyers with adequate financial means. Non-traditional investors are increasingly targeting the resources sector as a means to diversify their portfolios, hedge against rising inflation risk and potentially generate significant capital gains. This is good news for the most attractive assets on the block, increasing the likelihood of healthy competition and consequently minimizing the valuation gap.

Asian SOEs will remain strong contenders for mining and metals assets of strategic interest. Minority stake sales and consolidation are expected to be continuing trends among mid-tier and junior companies as they struggle to survive difficult market conditions.
Capital raising trends

The capital raising environment in 2013 is marked by volatility and appears to be punishing the mining and metals industry more than others.

The S&P 500 Index recovered to record highs in July, which, along with the prospect of rising interest rates in the US, is signaling the possibility of a shift in investor preferences back to equities from fixed income. This recovery is also supporting a tentative revival in global IPOs.

By contrast, global mining and metals equities are continuing on a steep downward trajectory, underpinned by a lack of investor confidence both in the global demand outlook and in companies’ ability to deliver acceptable returns. Continued commodity price weakness, particularly in gold, has further undermined confidence.

Relative index performance (2012–1H 2013)

Source: Thomson Datastream
Explorers and the equity markets

For juniors, this has translated into a catastrophic withdrawal of equity capital, particularly for those at the early exploration end of the industry. Mining IPO volumes and proceeds have fallen to unprecedented lows – 12 IPOs in 1H 2013, raising just $459m – while equity proceeds from follow-on equity issues by juniors have nearly halved y-o-y, to just $2.9b. Average proceeds raised by juniors fell to just $1.6m – fundraising for survival in desperate times.

Majors and the debt markets

There is a clear contrast in the bond markets where the industry’s investment grade companies continued to meet with strong investor demand and were still able to price issues on extremely competitive terms. Freeport-McMoRan Copper & Gold’s jumbo $6.5b bond program to fund its oil and gas acquisition is a case in point.

Bond proceeds raised in 1H 2013 have fallen 12% y-o-y but remain high at $50b. Syndicated loans have shown a 46% y-o-y increase, primarily due to some large-scale refinancings by the majors. However, the bond markets have also seen significant volatility, primarily in relation to interest rate rises in the US and uncertainty surrounding quantitative easing. This volatility has also hampered the ability of sub-investment grade juniors and mid-tiers to raise capital in the high yield market.

Rio Tinto responded to the market conditions with its $3b of bond issues in June by opting for shorter tenors (less than five years) and including floating rate tranches, reportedly to satisfy changed demand from investors keen to avoid being locked in to low rates.1

This may be a sign of things to come. The prospect of increases in the US benchmark interest rate may reduce appetite for bonds and cause investors to seek greater compensation on tranches with longer-term maturities. Companies will need to be discerning about the timing, pricing and structure of new bond issues in order to optimize maturities and cost of capital.

Advanced juniors, mid-tiers and alternative finance

We are seeing liquidity in the sector, and lenders tell us that capital is available – but it is much more difficult to come by. Strategic investors and traditional lenders alike will invest only in assets of proven quality, with proven management teams to match.

Determined developers and mid-tiers are getting creative in the variety of funding structures and sources being used – and in sourcing and attracting capital providers that recognize value and bear risk where the markets cannot. Given depressed equity valuations, companies are seeking options that avoid further dilution unless long-term strategic value is attached. Streaming and royalty deals, development funding, offtake-linked pre-financing, mergers, joint ventures, divestments or a combination of these approaches have thus continued to fund mid-tier industry growth in 2013.

Capital raising outlook

Equity markets are sentiment-driven and difficult to predict. We may need to see a sustained improvement in commodity prices before equity investors (particularly speculative ones) return to the industry. Confidence will need to be restored in the majors before it filters through to the mid-tiers and then the juniors in the form of equity risk capital.

We may also be witnessing early signals of tightening in the bond markets, which has potential implications regarding the availability and cost of capital, both for new issuance and for future refinancing.

This in all likelihood means continued pain in the short term, particularly for juniors. But cyclical downturns can create opportunities. Where the majors remain absent, we continue to see a window of opportunity for private, specialist investors – high-net-worth individuals and entrepreneurs who understand the industry, some of whom will have emerged from industry-wide management shake-ups.

Operators of alternative funding sources, such as streams and royalties, will also be looking to take advantage of the prevailing weakness in equity capital markets.

Commercial banks still have a healthy appetite for quality assets and are increasingly offering mezzanine financing to help companies raise the equity requirements of project finance.

Options for early stage companies are extremely limited. Companies that are not well-funded are retrenching through widespread job cuts, asset disposals, placing high-cost or underperforming assets on care and maintenance, or even outright exit from the sector. The grim – and perhaps necessary – reality is that we are likely to see many marginal projects shelved for the foreseeable future.

Capital raising snapshots by assets class

**IPOs**

- **12** Number of IPOs: a 69% y-o-y fall in volume
- **$459m** Proceeds raised: a y-o-y decline of 35%
- **94%** Proportion of IPO proceeds raised by the two largest IPOs alone

**Follow-on equity**

- **$11b** Total amount raised in 1H 2013
- **$2.9b** Amount raised by juniors: 53% fall from 2H 2012
- **$1.6m** Average proceeds in May 2013: compared with 12-month high of $4.6m in October 2012

**IPO proceeds and volume (2007-1H 2013)**

**Follow-on issues by month (2012-1H 2013)**

**Largest IPO:** Chinalco Mining Corporation, the Peruvian copper assets spun out of Chinalco, on the Hong Kong Stock Exchange.

**Exchanges:** the TSX Venture and Australian exchanges had the highest share of volume at 5 and 4, respectively (compared with 19 and 12, respectively, in the same period a year ago).

**Debt reduction:** it was a dominant reason for equity issuance at the top of the industry, particularly among steel producers, including ArcelorMittal, which raised $1.75b through a share issue in January.

**Privatization:** the Government of India sold significant stakes in Steel Authority of India and National Aluminium Company (NALCO) as part of a wider divestment program.
**Convertible bonds**

- **$5.9b** Proceeds raised from convertible bond issues in 1H 2013
- **210%** Year-on-year increase in proceeds
- **88%** Proportion of convertibles issued by junior companies (by volume)

**Bonds**

- **$50.3b** Proceeds raised from bond issues in 1H 2013: $7b short of 1H 2012
- **$8.7b** High-yield bond proceeds, compared with $9.0b in the previous six months
- **3%** Average coupon on US dollar and Euro investment grade bonds of 5- to 10-year tenor (vs. 3.9% in 1H 2012)

**Convertible bond proceeds and volume (2000-1H 2013)**

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<th>Year</th>
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**Bond volume and proceeds (2000-1H 2013)**

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**Largest issue:** ArcelorMittal issued mandatorily convertible subordinated notes worth $2.25b to reduce its debt.

**Rise of the convertible bond:** This asset class has seen a strong recovery globally. Junior companies have been able to raise funds in this market. Coupons on bonds issued by unrated or high yield juniors averaged 9.1%.

**Competitive coupons:** Rio Tinto paid 1.375% on its $1b notes maturing in 2016, the lowest coupon on equivalent bonds by the sector in the year to date. Freeport-McMoRan Copper & Gold and Barrick Gold paid just 5.5% and 5.8%, respectively, on 30-year maturities.

**Volatile high yield market:** Record European high yield issuance (all sectors) over the first five months was rapidly replaced by record fund outflows in June. Coupons on US dollar and Euro notes by mining and metals issuers averaged 7.7% (vs. 8.2% in 2012).
Syndicated loans

$89b  Proceeds raised in 1H 2013, a 46% y-o-y increase

$10b  Value of project finance closed in 1H 2013

Largest deal: an exceptional deal by Glencore Xstrata in the form of $17b of revolving credit facilities with a syndicate of 80 banks – reportedly one of the largest European loans this year (in all sectors).

Spreads: borrowing costs appear to have increased over the period. The average spread to benchmark for mining and metals borrowers has increased by 74bps in 1H 2013 compared with 2012 on leveraged loans, and by 27bps on non-leveraged loans.
11

Mergers, acquisitions and capital raising in mining and metals 1H 2013 | 11
EY’s Global Mining & Metals Center

With a strong but volatile outlook for the sector, the global mining and metals sector 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.

EY’s Global Mining & Metals Center 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. 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.

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