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Mergers, acquisitions and capital raising in mining and metals – 2018 outlook

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Key trends

Will stronger balance sheets fuel miners' growth ambitions?

The focus for most of the sector in 2017 was consolidating balance sheet strength and maintaining capital discipline. Mining and metals equities were attractive to investors due to:

- Decreasing financial risk mainly achieved through debt reduction; we estimate sector net debt declined by at least 15% in 2017
- Improving margins bolstered by buoyant commodity prices, fueled by supply restraint just as global demand for various commodity end-use sectors recovered

Mining and metals companies were also focused on optimizing portfolios in 2017. Divestments remained a significant driver of M&A transactions during the year as non-core assets were spun off in favor of leaner, more consolidated portfolios.

As expected, strategies diverged significantly by region and by commodity. For example, consolidation continued in the US and Chinese coal sectors to rein in excess capacity. In the gold sector, North American players began to expand geographically in search of lower risk jurisdictions.

Environmental regulations and the electric vehicle (EV) revolution ignited various players to consider investment into the future supply of commodities used in battery technology. As a result, lithium and cobalt assets across the world have seen increased interest from diversified miners and niche players alike, as well as from financial investors. Focus remains on quality of assets, and 2018 will likely see a handful of larger transactions in anticipation of greater competition for the commodities of the future.

Stronger financial health has also enhanced companies' options in accessing financing for growth through consolidated and strategic transactions. The healthy outlook for the mining and metals sector has not only boosted access to debt but also improved the ease of raising finances via equity markets.

Caution still remained in 2017 regarding executing transactions for both acquisitive and organic growth projects. Instead, excess cash proceeds bolstered companies' resolve to clarify their dividend policies and cash was returned to shareholders.

Focus shifts to shareholder value creation

With strong cash generation, sector capital allocation decisions are increasingly investment focused, rather than geared toward financial resilience. With significant levels of cash returned to shareholders during 2017, the focus will now shift to growth with a balanced capital agenda. Moreover, this balanced capital agenda will cater to both the short-term needs of shareholders and the long-term sustainability of shareholder returns.

The ease of securing funding for the growth agenda has also improved markedly. Financing options will not only be limited to traditional sources: innovative financing solutions are being structured to address newer risks posed by increasingly popular investments in lithium and cobalt. Key to competitiveness and sustainable value creation will be achieving the right mix of capital, which balances near- and long-term liquidity with flexibility and at an optimal cost.

Ultimately, the quality of assets will be a key consideration in executing the growth agenda. That said, the quality of pipeline projects at the exploration stage continues to erode, and the allocation of financing for new exploration mandates has been limited. As such, junior players with proved resources ready for development will be of interest to both producers and financial investors. However, the reduced inventory of exploration and development stage projects may limit investors to buying producing assets in order to increase output volumes.

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Note: The date includes completed deals only and is primarily sourced from ThomsonONE.

> "With the rise in demand for EVs and battery storage, portfolios are beginning to shape themselves towards new technologies. Companies with an eye on growth should start to consider how these minerals could fit into their portfolios."
>
> **Lee Downham**
> **EY Global Mining and Metals Transactions**

Understanding future demand to plan for growth now

EV and battery minerals

Many of the world economies are introducing measures to reduce the reliance on internal combustion engines.

In response, car manufacturers have been shifting their focus to the development of EVs and investing in battery technology. In a landmark move, Volvo announced in 2017 that all new Volvo cars from 2019 onward will be partially or completely battery powered.[1] Other major carmakers, including Renault-Nissan, BMW and VW, have also set ambitious targets. EV demand has accelerated, and sales of electric cars are forecast to exceed diesel cars as early as May 2019.[2]

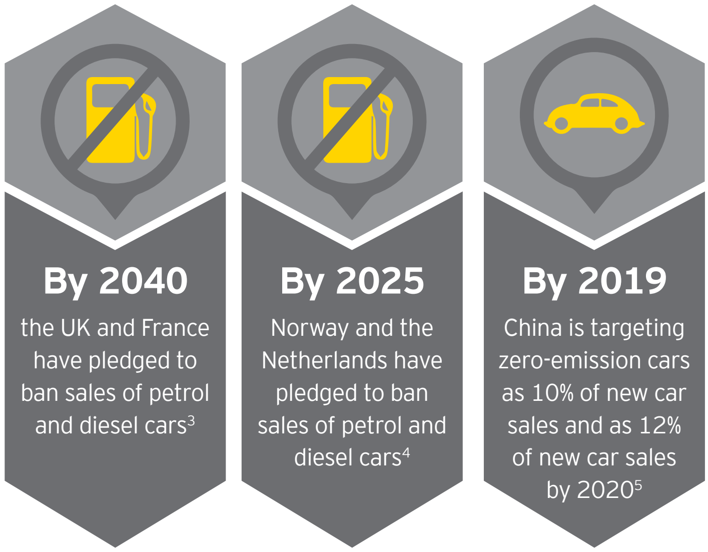
Key metals in the batteries powering these EVs are cobalt, lithium and nickel. Supply of these metals is not expected to meet forecasted demand. Cobalt, in particular, faces significant supply challenges due to the location of mineral deposits and limited number of mines coming online. Cobalt supply is heavily reliant on the Democratic Republic of Congo (DRC), which currently produces 65%[6] of global supply and holds almost half of the world's reserves.[7] However, political instability in the DRC and the challenge of ethically sourcing cobalt have made it a less attractive but still necessary investment region.

The supply of lithium is not as constrained. Lithium is extracted from hard rock in Australia and from brines in South America (major producers include Argentina, Chile and Bolivia). Future pricing will be quality-led and likely to go through demand cycles.

The scarcity of supply of cobalt has led to more adventurous mining techniques, including deep sea mining. Canadian firm Nautilus Resources is intending to send machines to harvest deposits rich in gold, copper, manganese and cobalt from the sea bed of Papua New Guinea. Research is also underway into batteries that use less cobalt and more nickel.

Increased interest is expected in assets producing fourth generation metals from car manufacturers that are looking to invest in mines to source materials for their EVs. For example, Toyota indirectly invested in Australian-listed lithium producer Orocobre through its trading arm Toyota Tsusho.[8] Chinese car company Great Wall Motors Company invested in Pilbara Minerals, an upstream lithium supplier, to support its lithium-tantalum project via offtake agreements, equity and debt finance.[9] Pala Investments has launched a US$150m fund to invest exclusively in metals used in EV battery technology (cobalt, lithium, vanadium, rare earths, nickel and tin).[10]

Policies are boosting the rapid acceleration of EV demand

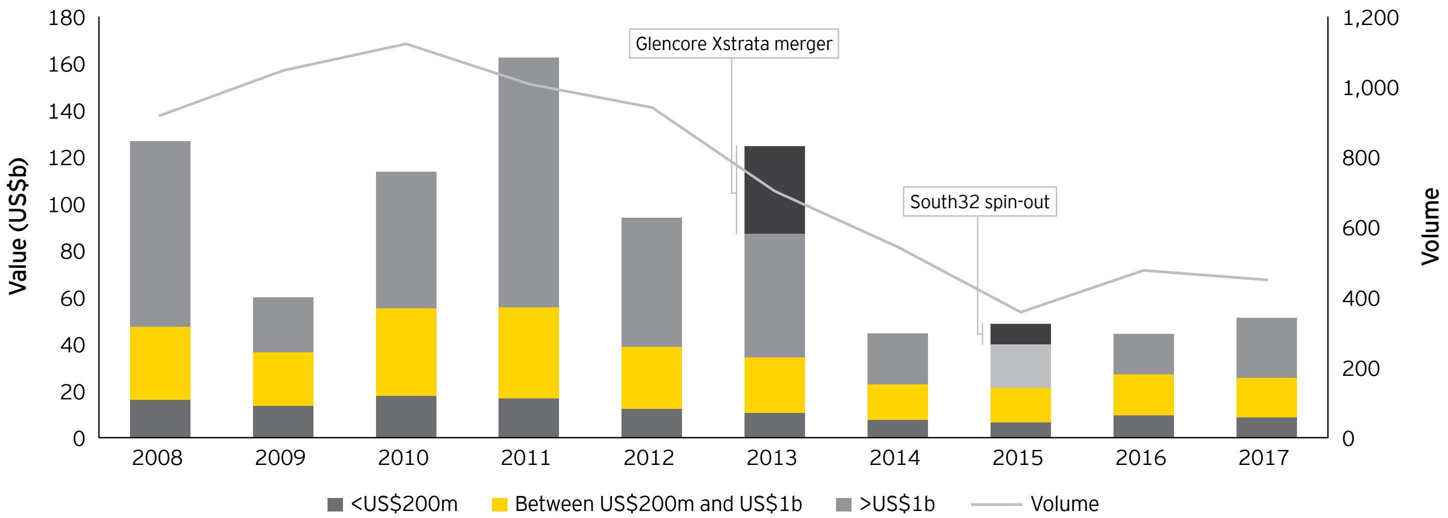


1 "Volvo cars to go all electric," *Volvo Car Group press release*, 5 July 2017.
2 "Electric cars already cheaper to own and run than petrol or diesel – study," *The Guardian*, 2 December 2017.
3 "France to ban sales of petrol and diesel cars by 2040," *The Guardian*, 6 July 2017.
4 "These countries are banning gas-powered vehicles by 2040," *Business Insider*, 23 October 2017.
5 "China sets 2019 deadline for automakers to meet green-car sales targets," *Reuters*, 29 September 2017.
6 "Carmakers' electric dreams depend on supplies of rare minerals," *The Guardian*, 30 July 2017.
7 "Cobalt – Mineral Commodity Summaries," *US Geological Survey*, January 2017.
8 "Toyota Tsusho to acquire a strategic stake in Orocobre, a successful Australian based lithium mining company, providing long term, stable supply of lithium in response to growing global demand," *Toyota Tsusho press release*, 16 January 2018.
9 "China's Great Wall Motor Company backs Pilgangoora stage 2 expansion with landmark off-take, funding deal and equity investment," *Pilbara Minerals press release*, 28 September 2017.
10 "Pala Investments launches new energy metals fund," *Pala Investments press release*, 8 August 2017.

M&A trends and outlook

There was a significant increase in deal value across the mining and metals sector in 2017, marking the highest value of completed deals since 2013. However, while deal value rose by 15% year-on-year to US$51b as deal drivers shifted from divestment led to strategically focused, the volume of transactions fell by 6% year-on-year. With metals prices largely holding up and, in certain cases, rallying through the year, cash generation remained incredibly strong across the sector, allowing leverage to be further reduced, dividends restored and significant cash returned to shareholders through buyback programs. Alongside this capital discipline, we began to see the emergence of investment strategies, with capital earmarked for organic projects and increasingly considered for acquisitions.

M&A – value and volume (2008–2017)

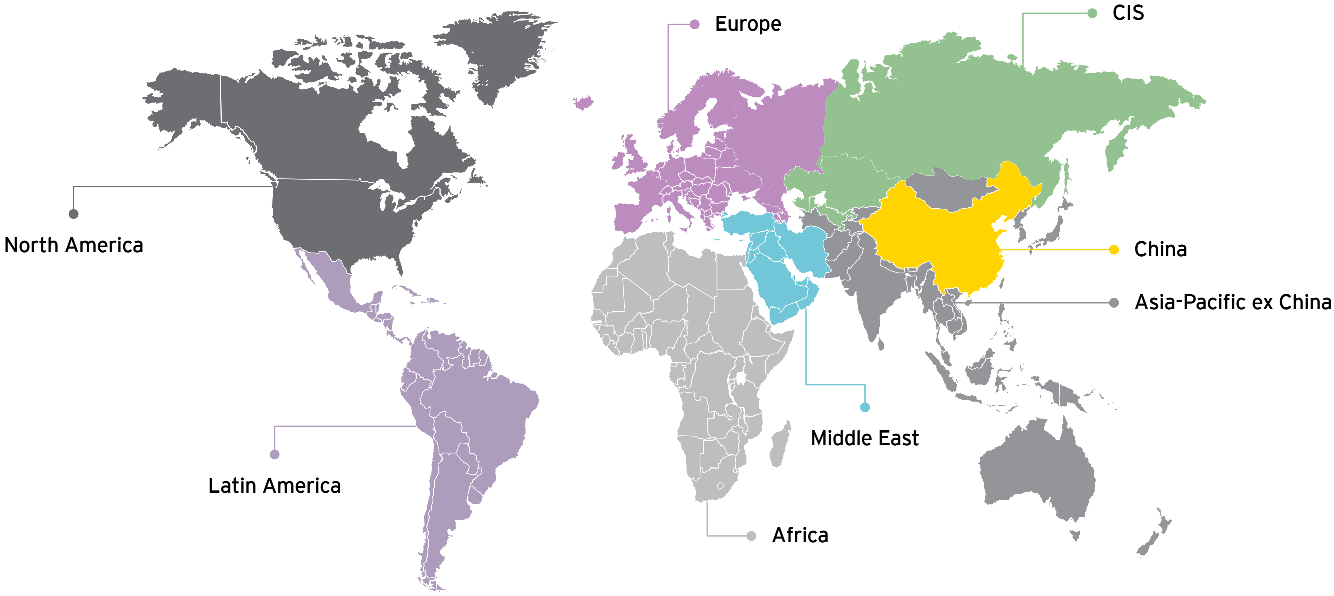


China tops activity

China continued to be a key driver of activity, leading deals by value both as an acquirer (US$18.7b, 36.6%) and as a target (US$13.6b, 26.6%). These were mainly domestic steel and aluminium mergers aimed at industry consolidation to drive efficiency across the metals sector. Outside of China, North American participants were active in US$16.2b worth of deals (32% of global value) as either a target or acquirer, totaling 188 deals.

> "Last year we saw fewer deals but at better values. In 2018, we expect to see more deals supported by investment-led strategies to diversify by commodity or region. Some of this activity will be to shape portfolios for future growth and sustain shareholder returns."
>
> **Lee Downham**
> EY Global Mining and Metals Transactions

Deal activity by region (2017)



	North America	Change Y-o-Y	Latin America	Change Y-o-Y	Africa	Change Y-o-Y	Europe	Change Y-o-Y	Middle East	Change Y-o-Y	CIS	Change Y-o-Y	Asia-Pacific (ex-China)	Change Y-o-Y	China	Change Y-o-Y
Value (US$b)	16.2	▲ 18.1%	6.2	▲ 110.7%	5.2	▼ 10.9%	8.2	▲ 254.7%	0	▼ 100%	0.97	▼ 46%	9.9	▼ 9.7%	18.7	▲ 15.2%
Volume	188	▼ 3.1%	53	▲ 20.5%	33	▼ 21.4%	56	▼ 3.4%	0	▼ 100%	10	0.0%	164	▲ 9.3%	78	▼ 15.2%

Note: Deal numbers are where the regions is either the target or acquirer

Portfolio management the key driver

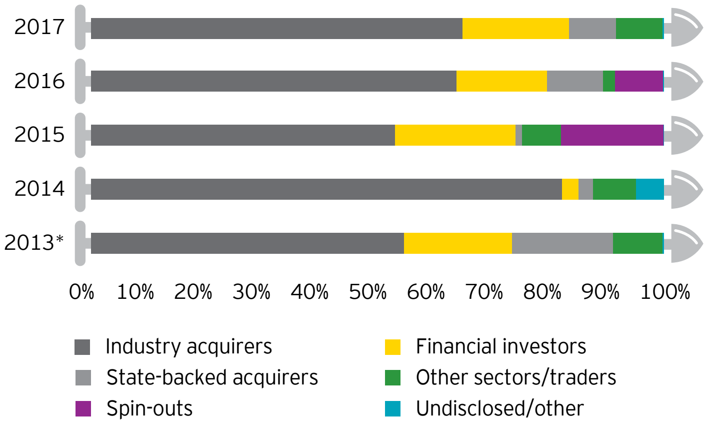
Improving market conditions in 2017 underpinned a number of large transactions with a strategic focus. Sibanye Gold's acquisition of US producer Stillwater Mining for example, demonstrated a desire to geographically diversify and execute a volume growth strategy. Headlines were made as Volcan Investments, a privately held family trust of Anil Agarwal, acquired a position in Anglo American during the year.

Portfolio realignment was also prominent as the diversified producers looked to divest those assets no longer considered core to the business and to free up capital. This included the Rio Tinto disposal of its Coal & Allied assets to Yancoal as it looked to reduce its thermal coal exposure.

Investors starting to return to the sector

Industry participants completed almost 70% of the year's deals by volume. However, financial investors, who were responsible for 22.4% of deals during 2017, returned to the market, undertaking US$9.5b worth of deals.

Share of deal value by acquirer type



* Excluding the Glencore Xstrata merger

Commodities diverge

Coal and steel were the main drivers of deal value, with coal acquisitions up 156% on 2016 to US$8.5b. However, volume fell by 27% to 30 in the year. This, in part, reflects a number of thermal coal divestments from the large, listed producers looking to reduce exposure as the energy mix moves toward renewables.

Steel transactions doubled in value to US$13.3b, the bulk of which (US$9.3b) comprised the large Chinese mergers and divestments in Latin America, such as Thyssenkrupp's disposal of its Brazilian steel mill to Ternium.

Gold deals declined in 2017, falling 34% by value to US$7.3b. Goldcorp was particularly active during the year, buying stakes in the Cerro Casale project in Chile from Barrick Gold and Kinross Gold and acquiring Exeter Resource Corp., an explorer focused on precious and base metals projects in Chile. Barrick Gold continued to realign its portfolio with the divestment of a 50% stake in the Veladero mine to Shandong Gold Mining for US$960m.

There was renewed activity for exploration stage assets, with deals increasing significantly to 31 deals totaling US$72m in 2017. This comes off a historically low base of six deals, valued at US$9.4m the previous year. Roughly 75% of the deals targeted assets in low risk jurisdictions, such as North America and Australia, with prospects generally focused on exploring for precious metals.

Deal activity by commodity (2017)

Aluminium

		Change Y-o-Y
Value (US$b)	3.1	▼ 8%
Volume	10	▼ 38%

Coal

		Change Y-o-Y
Value (US$b)	8.5	▲ 156%
Volume	30	▼ 27%

Copper

		Change Y-o-Y
Value (US$b)	3.1	▼ 54%
Volume	29	▼ 6%

Gold

		Change Y-o-Y
Value (US$b)	7.3	▼ 34%
Volume	134	▼ 13%

Iron ore

		Change Y-o-Y
Value (US$b)	0.5	▲ 127%
Volume	9	▲ 50%

Nickel

		Change Y-o-Y
Value (US$b)	0.1	▼ 89%
Volume	3	▼ 50%

Potash/phosphate

		Change Y-o-Y
Value (US$b)	0.2	▼ 70%
Volume	4	▼ 33%

Silver/lead/zinc

		Change Y-o-Y
Value (US$b)	2.7	▲ 32%
Volume	30	▼ 17%

Steel

		Change Y-o-Y
Value (US$b)	13.3	▲ 101%
Volume	42	▼ 9%

Outlook for 2018

With stronger balance sheets across the sector, miners are increasingly returning to an investment-led strategy, which is driving a renewed focus on building portfolios that deliver sustainable shareholder returns. Inevitably, deals will continue to shift from divestment-led to investment-led with the key drivers being pipeline replenishment, synergistic volume growth and next-generation mineral demand. Activist investors, meanwhile, will continue to shape miners' strategies, affecting the choice of commodity portfolio and volume of ambitions.

With the buzz around new world critical minerals and battery technology, deals in lithium, copper and cobalt are expected to feature high on the agenda of management teams across the industry. Continued pressure to reduce the reliance on fossil fuels will lead to further divestments or spin-offs. In China, having seen the completion of large-scale steel mergers, similar merger activity in coal is also expected as the country starts to target raw materials in its environmental initiatives.

Strategies will also be influenced by geopolitical factors. President Trump's recent order to reduce reliance on imported critical minerals may spark activity by US miners to consider exploration assets both in and outside of North America, as well as upstream and downstream collaborative ventures. The desire to shift from higher to lower risk jurisdictions may also influence portfolio adjustment, particularly for precious metals.
For lithium, investors in new assets are expected to prioritize South American and Australian assets, considered to be of lower political risk.

Capital raising trends and outlook

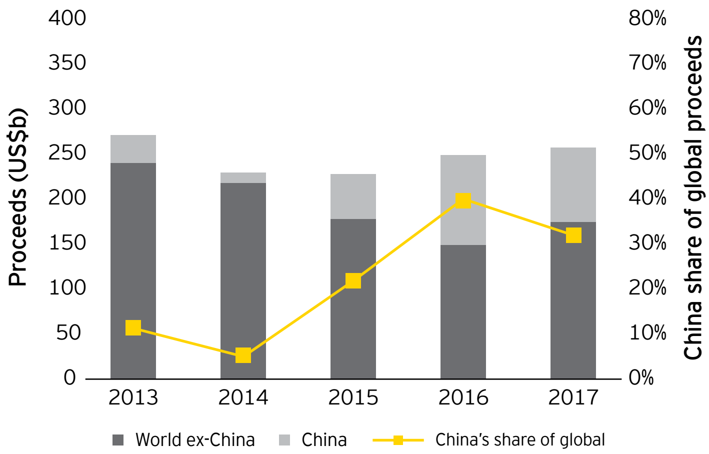
Access to capital improves as mining and metals companies' performance mirrors firming commodity prices

Mining and metals companies maintained capital discipline in 2017 as they continued to control expenditure on growth, sustain capital and minimize operational costs. Despite improved access to capital, the focus was largely on short-term needs, such as working capital and refinancing requirements. Consequently, global aggregate capital raised increased by just 3% in 2017 compared to the previous year.

In 2017, we saw a broad distribution of capital raising activity globally, marking a departure from the previous year where China dominated. China was responsible for just under a third of capital raised, down from 40% year-on-year. On the back of stronger valuations, equity instruments continued to gain popularity over debt.

Demand for alternative sources of financing, such as streaming, royalties and offtake agreements, softened in 2017. These had become popular during the low cycle (2012 to 2016) as companies faced financial stress and a poor credit outlook. However, strengthening fundamentals and availability of cheaper options have reversed the trend in 2017, with most industry participants once again opting for more flexible, traditional financial instruments.

Capital raised — regional split (2013–2017)



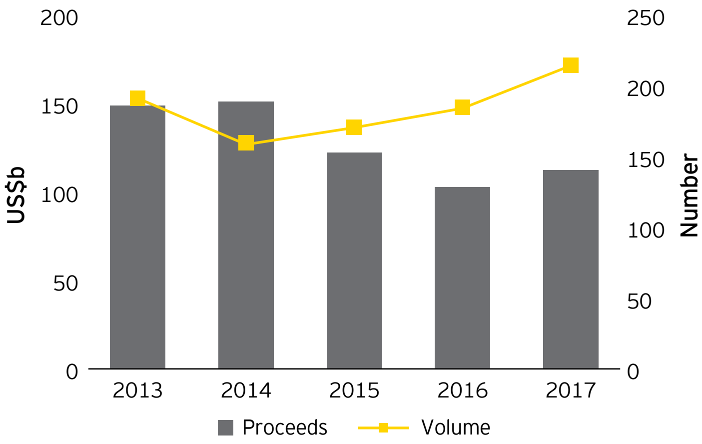
> "Access to capital improved significantly in 2017. In 2018, we expect stronger demand for financing and flexibility to remain important as the sector seeks to maintain a balanced and efficient capital structure."
>
> **Hopewell Mauwa**
> EY Global Mining & Metals Transactions

Spotlight on capital structure and return to growth

Mining and metals companies have significantly de-leveraged, using cash proceeds from the recovery of commodity prices in 2016. While there is still scope to retire expensive instruments in favor of cheaper and flexible facilities, further reduction of debt at the pace of recent years is unlikely. Already, debt/equity ratios for most players have fallen below 30%, raising questions on the efficiency of capital structures and, in turn, raising the likelihood of further share buyback programs.

In 2017, most majors began restoring dividends; however, returning cash alone will not be sufficient in the journey toward sustainable value creation. Mining and metals companies will look to growth either through investing in pipeline projects or through acquisition of other assets, provided they complement existing portfolios. This will likely trigger equity raising through both initial listings and secondary equity offerings. While past experiences may cap the appetite for new debt, inefficient capital structures will support moderate expansion of debt financing in 2018.

Loan volume and proceeds (2013–2017)



Capital raising by deal type

Loans

Loan proceeds rebounded in 2017 following two consecutive years of double-digit declines, rising by 9% year-on-year. Transactions increased to US$112b during the year, still 40% behind the US$187b recorded at the end of the super cycle in 2011. While risk aversion by lenders characterized dwindling transactions in 2015 and 2016, it was the mining and metals companies that preferred not to expand credit in 2017. In response to a strengthening sector credit outlook, banks loosened conditions for access to term loans. The volume of transactions actually increased, rising 17% year-on-year to 215 deals. Loans were primarily geared for short-term liquidity, with requirements for working capital and existing loan refinancing accounting for over 83% of the issued loans.

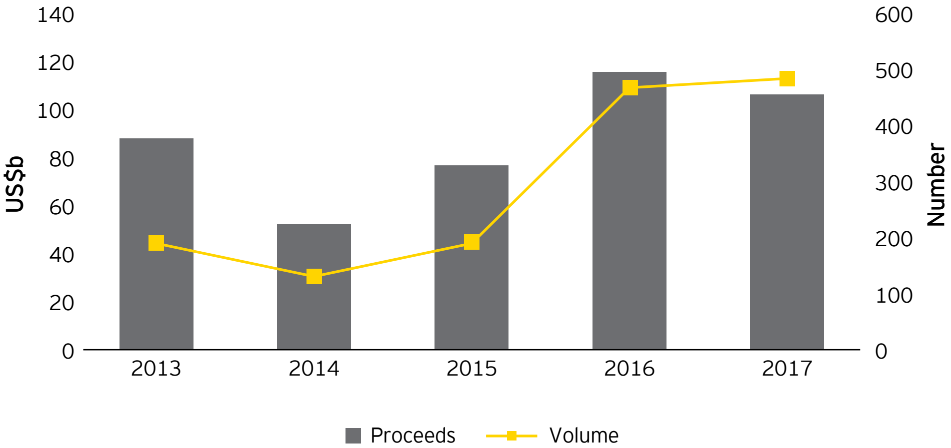
Outlook for 2018

As focus shifts from debt reduction to creating shareholder value, companies' lending requirements will also adjust. Increasing productivity as demand for metals improves will mean more working capital requirements for many companies, while others may refinance high cost facilities negotiated during the distress period.

Bonds

Bond proceeds declined by 8% in 2017 to US$106b, with the bulk of transactions used to refinance existing instruments (buybacks). The volume of deals remained almost unchanged year-on-year at 484 in 2017 (467 in 2016). China remained the major issuer of bonds, responsible for almost two-thirds of issues globally. Of the bonds issued in China, coal deals accounted for over 61% of transaction value.

Bond volume and proceeds (2013–2017)



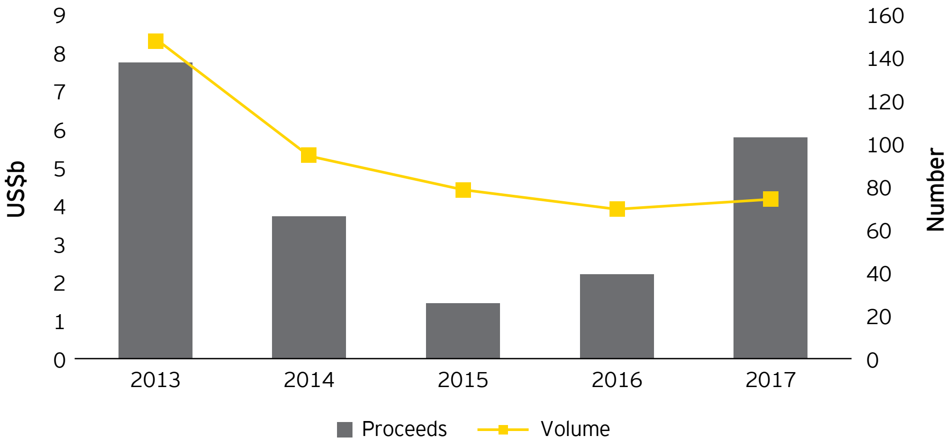
Outlook for 2018

The expected return to investment across the sector will be the major driver of new bond issuance in the near term. The case for issuing new notes will be supported by the significant de-leveraging that has taken place in recent years, arguably resulting in capital structures that are too equity heavy. Further, investor demand for bonds has improved due to better credit ratings.

Convertible bonds

Proceeds more than doubled in 2017 to US$5.7b. China and South Africa accounted for 80% of the value of global deals. In China, roughly US$3.3b worth of convertible paper was issued by steel and iron ore companies. Such companies likely sensed limited upside as both iron ore and steel prices peaked. In South Africa, platinum and gold companies transacted almost US$1b worth of deals. Usage of convertible notes could have also been driven by precious metals prices recording the lowest gains in 2017 and the need to spread and diversify country risk ahead of key South African leadership elections.

Convertible bond volume and proceeds (2013-2017)



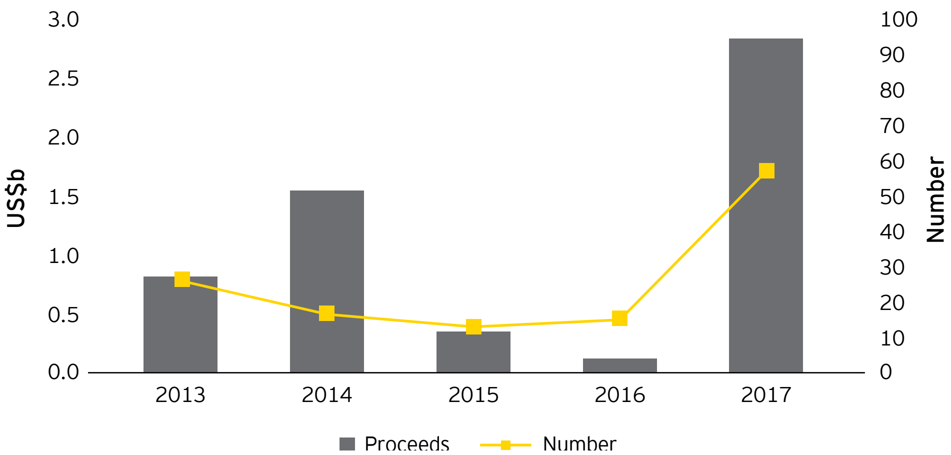
Outlook for 2018

Convertible bonds remain among the least used capital raising instruments in the sector, accounting for just 1% of new capital raised in 2017. However, as growth and acquisitions gain momentum in an uncertain pricing environment, the use of convertibles may also gain traction.

IPOs

IPO markets improved during the year amid the strengthening outlook for the sector. Global aggregate proceeds from IPOs increased to US$2.8b, the highest in six years but still far lower than the US$17b raised at the end of the super cycle in 2011. The headline deal was the US$1.5b listing of Russia's En+, an aluminium and hydropower business.[7] In the US, coal listings accounted for all of the US$397m worth of listings, whereas in China, copper IPOs accounted for more than half of the US$395m in transactions.

IPO volume and proceeds (2013–2017)



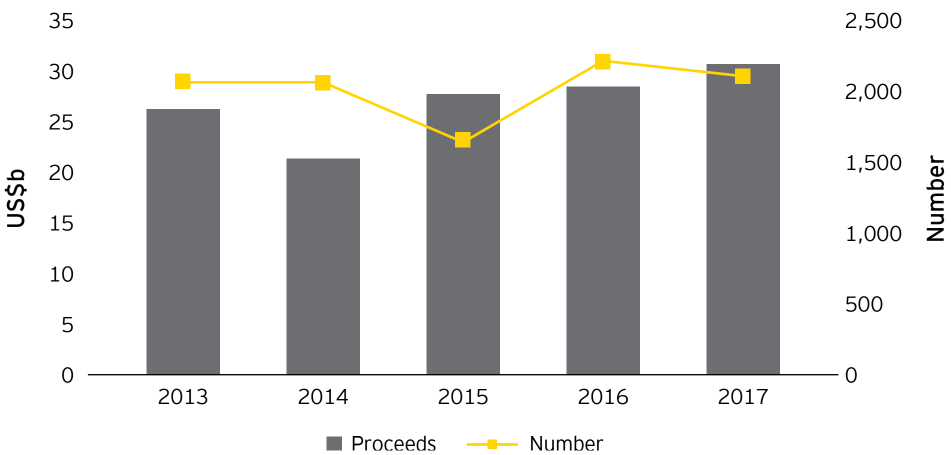
Outlook for 2018

The expected stabilization of the commodity pricing environment should fuel more equity listings across a number of commodities. Rising demand for battery technology metals is expected to drive fund-raising for project expansions in 2018, especially for development assets entering into production.

Follow-on equities

Secondary listings increased in 2017 on strong share performance across the sector. Aggregate capital raised through follow-on equity increased to a post-2011 high of US$30.7b, an 8% rise compared to 2016. Activity has spread geographically across China, Australia and Canada, which combined accounted for almost 60% of value.

Follow-on equity volume and proceeds (2013–2017)



Outlook for 2018

The return to growth and an appetite to fund development projects are expected to be the key drivers for secondary listings in 2018. Commodity prices have risen significantly since 2016, and equity valuations have appreciated accordingly.

[7] "Russia's En+ launches IPO in London and Moscow," *City AM*, 5 October 2017.

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

The sector is returning to growth but mining and metals (M&M) companies face a transformed competitive and operating landscape. The need to improve shareholder returns will drive bold strategies to accelerate productivity, improve margins and better allocate capital to achieve long-term growth. Digital innovation will be a key enabler but the industry must overcome a poor track record of technology implementations. If M&M companies are to survive and thrive in a new energy world, they must embrace digital to optimize productivity from market to mine.

EY takes a whole-of-value-chain approach to support each client to help seize the potential of digital to fast-track productivity, balance portfolios and set a clear roadmap for their new energy future.

EY area contacts

EY Global Mining & Metals Leader
Miguel Zweig
+55 11 2573 3363
miguel.zweig@br.ey.com

Africa
Wickus Botha
+27 11 772 3386
wickus.botha@za.ey.com

Brazil
Afonso Sartorio
+55 21 3263 7423
afonso.sartorio@br.ey.com

Canada
Jim MacLean
+1 416 943 3674
jim.d.maclean@ca.ey.com

Chile
María Javiera Contreras
+56 2 676 1492
maria.javiera.contreras@cl.ey.com

China and Mongolia
Peter Markey
+86 21 2228 2616
peter.markey@cn.ey.com

Commonwealth of Independent States
Boris Yatsenko
+7 495 755 98 60
boris.yatsenko@ru.ey.com

France, Luxembourg, Maghreb, MENA
Christian Mion
+33 1 46 93 65 47
christian.mion@fr.ey.com

Japan
Andrew Cowell
+81 80 2276 4048
andrew.cowell@jp.ey.com

India
Anjani Agrawal
+91 22 6192 0150
anjani.agrawal@in.ey.com

Nordics
Lasse Laurio
+35 8 405 616 140
lasse.laurio@fi.ey.com

Oceania
Scott Grimley
+61 8 9429 2409
scott.grimley@au.ey.com

United Kingdom & Ireland
Lee Downham
+44 20 7951 2178
ldownham@uk.ey.com

United States
Bob Stall
+1 404 817 5474
robert.stall@ey.com

Service line contacts

EY Global Advisory Leader
Paul Mitchell
+61 2 9248 5110
paul.mitchell@au.ey.com

EY Global Assurance Leader
Alexei Ivanov
+7 495 228 36 61
alexei.ivanov@ru.ey.com

EY Global IFRS Leader
Tracey Waring
+61 3 9288 8638
tracey.waring@au.ey.com

EY Global Tax Leader
Andrew van Dinter
+61 3 8650 7589
andrew.van.dinter@au.ey.com

EY Global Transactions Leader
Lee Downham
+44 20 7951 2178
ldownham@uk.ey.com

EYG no. 00769-184GBL

BMC Agency
GA 1006951

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ey.com/miningmetals