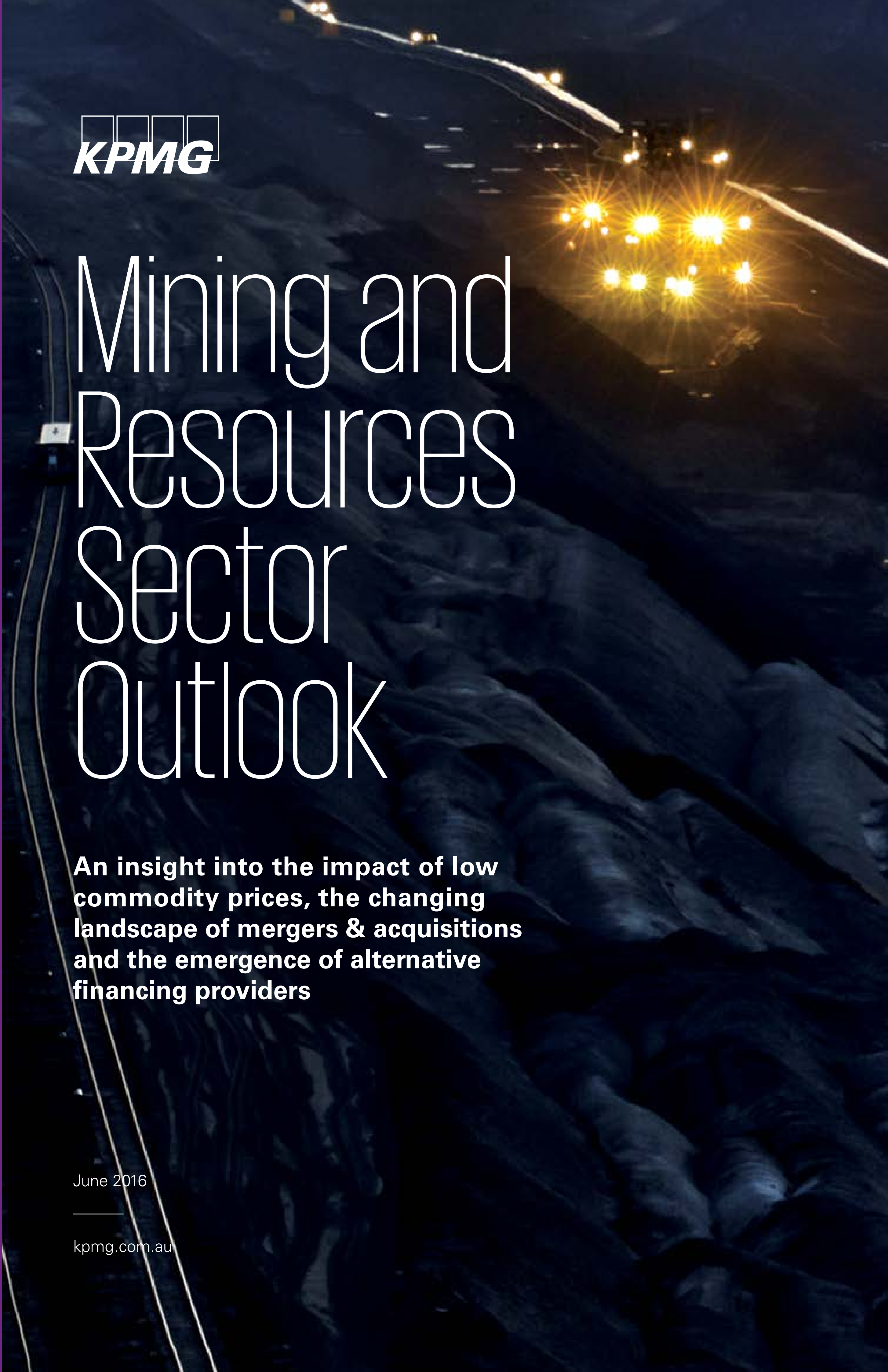


KPMG

Mining and Resources Sector Outlook

An insight into the impact of low commodity prices, the changing landscape of mergers & acquisitions and the emergence of alternative financing providers

June 2016

kpmg.com.au

The Australian mining boom has passed and the sector is finding its way forward amid an environment of excess supply, low commodity prices and a nervous traditional lending sector seeking to minimise its exposure to risk.

As junior and mid-tier mining companies grapple to survive, options include cost cutting, improving operational efficiency and consolidation. With access to funding challenging, the ability to undertake mergers and acquisitions (M&A) is difficult and the nature of these deals is shifting fast.

This paper outlines trends in M&A globally and in mining, how falling commodity prices have impacted the M&A scene, the changing focus of M&A in this turbulent environment and the near 'perfect storm' of financing conditions. It explores the role of alternative financiers in this space and looks to where the mining sector is heading next.

M&A trends

The year 2015 was regarded to be an all-time high for M&A globally across all industries. This peak was driven by the announcement of number of large transactions, or 'mega deals'. Examples from different industries include the proposed US$160 billion Pfizer and Allergan merger, and the US$106 billion Anheuser-Busch InBev and SABMiller merger.

However, when a review is undertaken of the global mining industry, it paints a very different picture. In 2011, 2,863 global mining deals were announced to the total value of US$215 billion. In 2012, the value and quantity of deals experienced a modest decline, before dropping much lower in 2013, with 2,033 deals announced to the value of US$76 billion. The value of announced deals rebounded slightly in 2014, but in 2015 dropped to US$36 billion for 2,133 deals.

M&A in the Australian mining sector is in line with the global trend. In 2011, 306 deals were announced worth $US40 billion in total, while in 2015 this figure was $4 billion for 258 deals, with activity in 2015 being centred on base metals and gold. Prominent deals in base metals include Independence Group's acquisition of Sirius Resources whilst the gold sector includes Evolution Mining's acquisition of Barrick Gold's Cowal mine.

The overall subdued status in Australian mining M&A reflects the supply and demand imbalance faced by the sector, coupled with the significant drop in commodity prices.

Commodity prices setting the pace

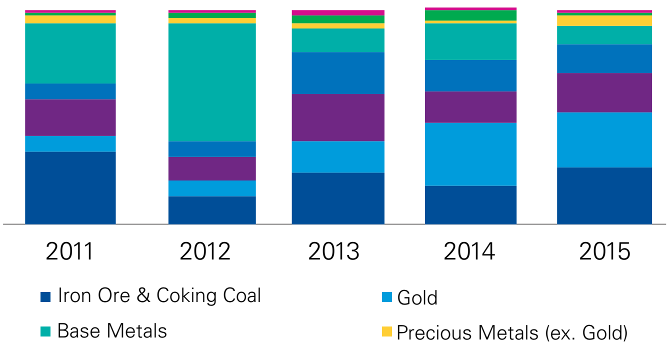
From 2003 to 2010, commodity prices boomed significantly and mining companies enjoyed a long period of 'super profits'. Price incentives were so strong that even marginal projects were able to make money and company strategies focused on acquiring production and developing projects.

In 2008 to 2010, commodity prices crashed, initiating a period of balance sheet repairs. However, mining companies continued to chase production. From 2010 to 2013, shareholders of the major global mining companies were displeased that too much cash generated was reinvested back into the company. They demanded to see a return of capital to shareholders, resulting in a focus on dividend distribution and share buy-backs.

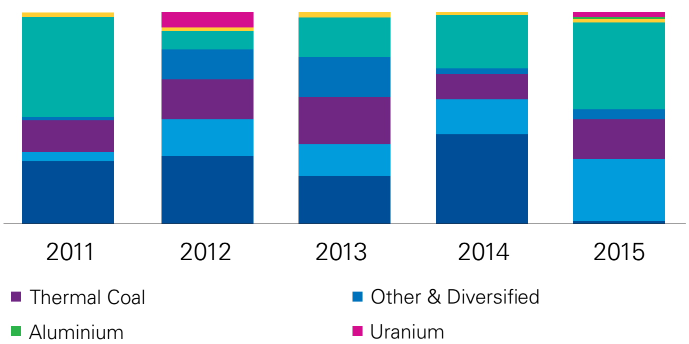
From 2013 until now, this period has been characterised by the realisation that the price boom has come to an end with sustained fall in commodity prices. There became a shift to focus on cost reduction, improvement in productivity and more recently, deleveraging excessive debt levels accumulated from before.

The impact of low commodity prices on the approach to M&A in the sector has been notable.

Global mining M&A announced transactions – by commodity



AU mining M&A announced transactions – by commodity



M&A in times of fluctuating commodity prices

The ultimate goal of M&A is to create shareholder value, however the fundamentals on how to create value through M&A changes over the different cycles of boom and bust.

Creating value through M&A during the boom: To capture the immense profit opportunities, the focus of M&A during the mining boom was to acquire production almost at all costs as every tonne acquired would result in a marginal profit. Having sufficient access to rail and port was critical for bulk commodities. For end users, security of supply became strategically important to access raw materials costs, hedge costs and for some, a desire to vertically integrate. Identifying and delivering synergies was also a key consideration.

M&A in more challenging times: Today, the focus of M&A has shifted to focus on determining cost reduction and optimisation opportunities, alternative operating models, seeking diversification in portfolio, and as in the boom period, identifying corporate and operational synergies.

Three key challenges for M&A deals in a low commodity price environment

1. A major challenge for M&A deals is assessing the challenged economics of assets and understanding the risks and value creation opportunities through due diligence
2. Another challenge is the increased focus on environmental liabilities. Due to the challenged economics of the assets, understanding the liability and required guarantees becomes a key component of these deals
3. This leads to one of the biggest challenges – the ability to access finance. The vast majority of recent assets that have been on the market have been non-core assets which are marginal in nature. With the current sentiment towards mining being poor, raising capital from the public equity markets is challenging. With the major lenders in the Australian marketplace largely focused on the mining majors, junior and mid-tier mining companies need to consider alternative funding sources for deals.

However, all of the challenges above can potentially be addressed through deal structuring.

Current conditions for mining funding

With commodity prices so low, the big four Australian banks are looking to reduce their exposure to the sector. Fuelling their retreat is pressure from equity analysts to increase disclosure of the banks' level of loans to the sector. Regulatory changes are impacting the return on equity that banks can generate, and the level of provisions for losses are being treated harshly. In addition, environmental interest groups are monitoring if banks are lending to projects that cause environmental harm. As a result, the major banks have been downsizing or restructuring their mining project advisory teams.

This shift has led to a very challenging bank funding environment for mining, with the reported value of debt transactions for financing to the sector reaching an absolute low in 2014.

Signs of activity

There has, however, been some increased loan activity to mid-tier mining by the big four banks in the last 18 months. The majority has been for refinancing of existing financing facilities rather than new project or acquisition financing.

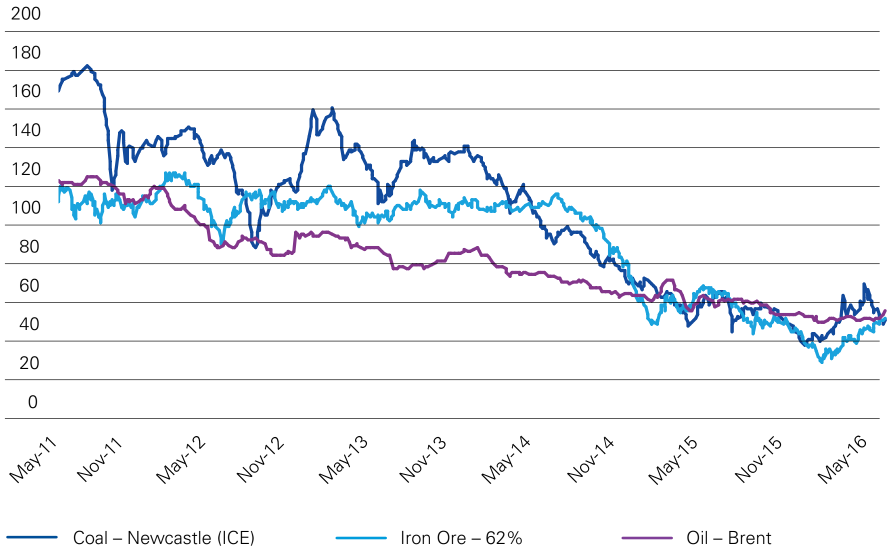
Further, loan availability is not equal across all commodities, and a small handful of bigger deals are holding up the image that a rebound in loan volumes is healthier than it really is. For example, in iron ore, there was the funding of the $1.5 billion Karara Mining deal guaranteed by Chinese steel producer Ansteel, but this was provided by Chinese lenders only.

Similarly in coal, Centennial Coal was acquired by the Thai-based mining and power company Banpu in 2010, with a financing completed in 2015 for $624 million; and Whitehaven Coal's deal of 2014 – a $1.4 billion refinancing which was completed prior to the drastic downturn in coal prices.

Commodity prices still tracking down

This chart of commodity prices shows a downward trajectory, clearly impacting the profitability of the underlying mines. While this may make banks nervous, there are alternative investors looking for opportunities and starting to see value in the markets at these significantly depressed levels.

Commodity price analysis



Ratings dive makes a further impact

Relating to the drop in commodity prices, credit rating agencies have been downgrading the ratings of mining companies significantly. Standard and Poor's have undertaken a spate of international mining company downgrades over the last 12 months, while Moody's announced in January 2016 that it was reviewing 120 international companies in the oil and gas sector for downgrade, along with 55 mining companies. The subsequent action taken has been quite severe on a number of these entities (reflecting the amended view of the commodity price life cycle).

The impact of these revisions is starting to show. The rating downgrades not only affect the ability of the companies themselves to source capital, but there is a flow-on effect to other entities in the chain, such as infrastructure providers and service companies. It also means the ability of the major global miners to repair their balance sheets by disposing of assets at the 'bottom' of the cycle is proving difficult.

In addition, the working capital requirements of service providers to the sector are being continually stretched as the global miners seek to extend payment terms. This has an added effect on the bank's capacity to lend to the sector, as exposures are increasing from a number of different sources.

Transaction pricing pushed up

As a result of this increased counterparty risk, there has been a general move towards risk aversion. This has been partly driven by a lack of liquidity as counterparties are downgraded. Debt investors of any publicly traded instruments have been seeking to exit rapidly, dramatically affecting trading in the secondary market. However, it should be noted there has been some recent retraction on these adverse movements, demonstrating a possible return of some liquidity. These movements are creating opportunities for other providers of capital to also become more active.

The important role of alternative financiers

The last 12-18 months have seen a good number of transactions announced and completed with financing provided from non-traditional sources of funding, such as institutional money, resource specific loan funds, and export credit agencies, among other options.

Many alternative financiers have money available for the right transactions, but are able to be very selective about which deals they seek to pursue and are being quite opportunistic.

The success or otherwise of such deals relies on the achievement of the borrower's stated strategies and forecasts, and appropriate debt structuring – including relevant tenor, pricing (including sufficient returns for the risk taken by the providers of the capital) and tight financial covenants (for protection and early warning systems for financiers to consider alternatives).

What is next?

This near 'perfect storm' of low commodity prices, risk aversion by traditional lenders and the struggle of the mining companies has opened the door for new financiers to move into the sector.

We believe there are a number of deals still able to be financed, with willing vendors seeking to consider their involvement in legacy businesses. Consideration of all available alternative providers of capital will allow the right deals to still be successfully achieved.

"We have been seeing an increasing level of activity over the past 12 months however, completing transactions in this environment can be challenging. There has been a strong focus by major miners needing to deleverage and protect their credit ratings. A lot of assets have been put onto the market, so I think that we will continue to see more deals being done this year. Most recently we have seen some investor confidence return to the junior end of the market driven by healthy returns in the gold sector and I expect this to continue."

Greg Evans, Partner, Global Leader Mining M&A, KPMG

Contact us

Scott Mesley
Partner in Charge
Debt Advisory Services
T: +61 3 9288 6748
E: smesley@kpmg.com.au

Greg Evans
Partner
Global Leader Mining M&A
T: +61 8 9263 7487
E: gevans1@kpmg.com.au

Conrad Hall
Director
Debt Advisory Services
T: +61 7 3434 9105
E: conradhall@kpmg.com.au

Gabriel Ho
Associate Director
National Mergers and Acquisitions
T: +61 7 3233 9314
E: gabho@kpmg.com.au

kpmg.com.au

May 2016. VIC N14058LOB