The Telegraph

Miners pray the commodities collapse has hit rock-bottom

Life in Australia's gold pits are not what it once was, but dealmakers in the ailing sector are ready to strike after betting on a turnaround

A dump truck carrying gold bearing ore, begins it's long trek from the bottom of an eerily lit Super Pit at Kalgoorlie, 595 kms east of Perth, 05 June 2001. Photo: AFP/Getty Images

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10 Comments

At the height of the mining boom, lorry drivers working in Western Australia's Pilbara iron ore belt would have expected to take home something in the region of £100,000 a year in basic salary as China's demand for commodities countinued unabated. Nowadays, mining companies Down Under have even cut steak sauce off the menu and cancelled the free staff barbecues to cut costs. The days of mineworkers earning salaries and bonuses comparable to a fully qualified doctor are long gone.

Capital expenditure among the world’s top 10 mining companies is expected to fall to around $64bn (£42bn) this year, down from almost $80.1bn two years ago when the industry really started to wake up to the scale of the slowdown in commodities demand, especially in Asia.

The Super Pit at Kalgoorlie, 595 kms east of Perth (Greg Wood/AFP)

The biggest mining companies, such as BHP Billiton, Rio Tinto, Anglo American and Vale, are all streamlining aggressively, while junior miners are racing to bring projects into production, or offload assets to generate much needed cash to service their debt or just weather the storm.

Five years ago, mining companies across the globe loaded up on debt to dramatically crank up production of base metals and bulk commodities to feed China’s insatiable appetite for raw materials. But that strategy has unravelled in the recent downturn, with the cost of insuring debt against default across the industry starting to rise and ratings agencies sharpening their pens for downgrades.

Nobody in the mining industry saw the downturn coming until it was almost too late to react. The Bloomberg Commodity Index of 22 raw materials hit a 12-year low in January, led by steep declines in major commodities such as iron ore, coal and copper.

However, tentative signs are emerging that could signal that the mining industry and commodities sector are reaching the bottom of the curve, where investors could soon return in search of opportunities.

“The aggressive sell-off in commodities during the second half saw the mining sector deliver its fourth consecutive year of negative returns,” wrote Olivia Markham, from the BlackRock natural resources team, in a recent note to investors.

“We are now in uncharted territory, with the mid-to-late ’90s seeing three years of consecutive negative returns, before the next 'up-cycle’ began in the early 2000s. As we enter 2015, a number of data points suggest that we are reaching an inflection point.”

A key sign that the market could be poised to begin the long process of turnaround will be the first major deal announced since the fallout. Ivan Glasenberg, chief executive of Glencore and one of the industry’s most prolific dealmakers, tried his

hand late last year with an audacious attempt to engineer a £100bn mega-merger with Rio Tinto.
The deal, which would have created the world's largest integrated miner, may have been dismissed out of hand by Rio's chief executive, Sam Walsh, but Glencore remains ready to pounce should the right deal emerge.
Up until this point in the cycle the major stumbling block for deals has been valuations, with chief executives unwilling to offload assets at bargain prices, only to be accused of selling the business short in a few years when commodity markets inevitably rebound.

Miners have waited to see who blinks first before restructuring

Although mining companies have talked a lot about offloading non-core assets and shrinking down, little has actually happened to change the shape of the industry significantly, with bosses waiting to see who blinks first.
That could all be about to change after Mick Davis succeeded last week in raising a $5.6bn (£3.6bn) "war chest" for his new mining company, X2 Resources. With access to debt financing, this could give the vehicle easily more than $10bn in cash for acquisitions in bulk commodities and base metals.
Formed by Mr Davis – known as "Big Mick" in the industry – following the $30bn sale of Xstrata to Glencore in 2013, X2 has been waiting for the right moment to strike its first major deal.
"Nobody rings the bell at the right point at the bottom of the cycle," Thras Moraitis, principal and a founder at X2 Resources, said. "If anyone claims they can time their investments at that precise point, then they're deluding themselves. What we can say is that valuations, and more importantly expectations, are becoming more reasonable."
Given the trend of major mining companies to focus on core assets and produce bigger quantities of commodities such as iron ore, coal and copper at smaller costs, there is no shortage of targets for X2 Resources to aim for.
Mr Moraitis believes the opportunity to strike deals at the right price is nearing.
"A lot of the commodities are trading close to their marginal costs or well into the cost curves and we have seen a very big cutback in capex by the majors and of course

the juniors can't raise any capital," he said. "We're not the kind of team that sits around. If you agree that you're in the zone and that you can't time these things perfectly, then you have to be opportunistic around that. Hopefully, over the next two or three years or so we will be able to make most of our investments."

According to BlackRock – which has $17bn under management in natural resources – return on capital for the sector is approaching a 40-year low. The focus on cutting capital expenditure and redirecting cash to protect dividends also means that valuations are below the average levels seen for around 30 years, with the sector now trading at a significant dividend yield premium to the market.

Morgan Stanley also believes the continued focus on cost cutting among the big mining groups will eventually restore the equilibrium between supply and demand in the market, a key factor in rebuilding confidence.

"There is increasing pressure on companies to cut back capex even further, especially the larger companies that want to protect their dividend. This is key to supply discipline and should eventually lead to higher commodity prices," the investment bank stated in a recent note to investors.

X2 Resources, which is based in London, is understood to have held talks with each of the three big London-listed mining groups – BHP Billiton, Rio Tinto and Anglo American – about potential deals.

South32, the new spin-off formed from BHP Billiton's non-core assets, which will begin trading later this year, has not ruled out the possibility that it could still divest some of the mines from the portfolio bequeathed by its parent.

Anglo American has also been aggressively marketing assets, including some of its Australian coal mines, as part of a $4bn disposal programme announced by its chief executive, Mark Cutifani, last year.

"We're looking largely at operating assets, so assets that are producing both product and cash flow. We will look at brownfield expansion, or buying one or more juniors that are very close to the finish lines after the first stage of our strategy, but in the first instance we're looking to build a platform of diverse operating assets because what we would like to do is leverage the cash flows, diverse exposures and skills base that those will bring," said Mr Moraitis.

The success of X2's fundraising also shows that investors are beginning to rediscover their faith in mining, despite ongoing concerns over the strength of global demand and oversupply in certain commodities. For example, to rebalance the market for coal, Glencore said recently that it would cut Australian thermal coal output by around 15m tonnes this year. Recent data showed that China's consumption of the fuel fell in 2014 for the first time in 14 years.

Kalgoorlie's Super Pit is Australia's largest open cast gold mine (Moment Editorial/Getty Images)

Export prices for Australian thermal coal – used in power stations – fell 25pc last year and hit a new low of $57 per tonne in January. At these levels, producers are being forced to dramatically cut back on investments and in some cases close coal mines entirely.

In the iron ore space, the outlook is equally cloudy. Iron ore prices broke below $60 per tonne last week for the first time this year after the World Bank predicted that the glut in supply was set to continue.

Against this uncertain backdrop, X2 Resources was still able to raise $800m more than it had originally intended from a clutch of international investors when it finally closed its book last week. The company started raising capital in September last year when Hong Kong-based commodities trader Noble Group and private equity firm TPG together stumped up $1bn. At that time, five cornerstone investors, who each committed $500m, also conditionally agreed to provide another $250m.

Its new investors are thought to include sovereign wealth funds, which indicate the growing overall confidence in the business.

“We have 20 investors who are spread across the Americas, the Middle East, northern Europe and Asia. I think it’s fair to say that we have support of our strategy,” said Mr Moraitis.

Part of the attraction of X2 Resources and the former Xstrata team assembled by Mr Davis is its ability to move quickly on deals without the burden of public shareholders.

“Mining is a cyclical business. It’s going through one of its classical cycles and as a private company we have greater freedom to act counter-cyclically. X2 Resources is not a cyclical play per se because our investors could easily put their money in ETFs [exchange traded funds] to gain exposure to the cycle.

“But it’s good to be able to invest to gain exposure at the right point in the cycle, or broadly around the right point, as it adds additional impetus to what you can do with the assets,” said Mr Moraitis.

Whichever assets X2 Resources eventually snaps up, it’s clear its management wants a diverse business that won’t be dependent on one single commodity.

“If we could wave a magic wand and accelerate ourselves to the point when we have built this midcap mining company, then we would like to have a diversity of exposure to, let’s say hypothetically, three commodities in the main and they would be mainstream commodities such as base metals and bulks,” said Mr Moraitis.

By pursuing this diversified strategy, Mr Moraitis is confident that X2 won’t have to take the steak sauce off the staff canteen menu during the next downturn.