Global M&A: Outlook for Mining

KPMG INTERNATIONAL

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Global Mining: Where to for M&A?

Challenges and opportunities

Mining companies are suffering from the aftershocks of the global recession. Continued volatility in demand and prices is leading to business uncertainty. It is becoming increasingly hard for companies to find new, quality, and accessible assets. Most new mines are located in challenging geographical regions, resulting in escalating extraction and delivery costs.

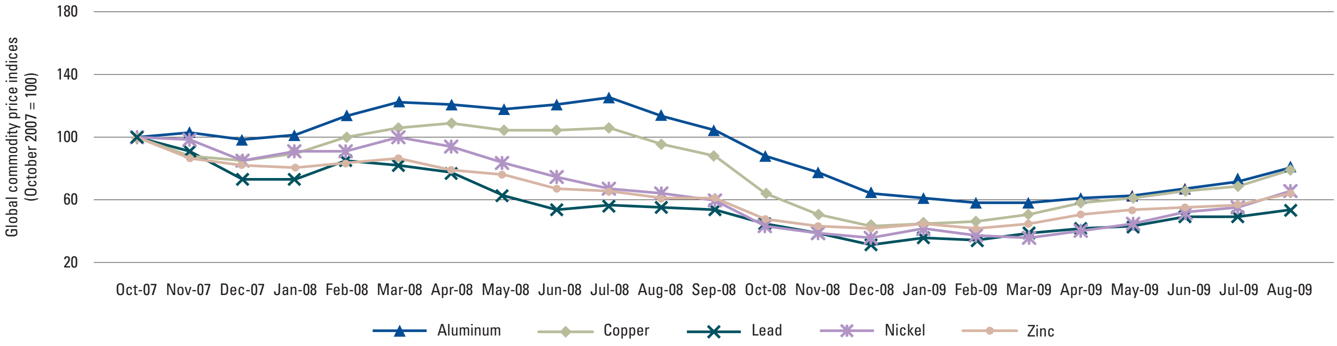
The distinctive characteristics of the mining industry mean that mergers and acquisitions (M&A) will always most likely have a place in companies' strategies, even at a time of uncertain industry prospects. Based on available data and KPMG insight, we consider how mining companies may continue to use merger or acquisition strategies to generate increased shareholder value.

Digging deeper for profits

The industry went from boom to bust in 2008 as mining companies' financial positions varied with changes in demand and commodity prices. Many major companies saw a marked deterioration in their financial position by the end of the year.

While metal commodity prices continued to decline in Q1 2009, base metal commodity prices have shown signs of stabilization in the past few months.[1, 2, 3] Spot prices for iron ore have also risen since January 2009, after falling in 2008. According to Malcolm Southwood, of Goldman Sachs, there is "*scope for further strength in spot iron ore prices over the next six to 12 months*" because of continued strength in Chinese steel output and because of "*a recent improvement in demand for contract deliveries from non-Chinese steel mills.*"[4] A recovery in the prices of platinum, silver and palladium has bolstered the mining industry.[5, 6, 7]

Figure 1: Global commodity price indices, October 2007 – July 2009 (October 2007 = 100)



Source: IMF Primary Commodity Prices, IMF, Last updated 6 August 2009; World Carbon Steel Composite Price and Index, worldsteelprices.com

As the economic downturn takes its toll on profits, mining companies are focusing on costs. This includes slashing production, reducing operating costs and increasing efficiency, trends which KPMG's Global Mining Partner Sean Tiernan sees continuing in the short term. "*Although the prices of base metals have recovered substantially, mining companies are not convinced that the end of the downturn has arrived,*" he says. "*Companies are factoring this uncertainty into the way they manage their balance sheets and their businesses.*"

Mining's ongoing need for M&A

In order to conserve cash and given the lack of access to credit, most mining companies have scaled back on their capital programs and are focusing only on their most important strategic projects. The total value of M&A deals in the mining industry fell from US$88.9 billion in the 12 months to June 2008 to US$49.8 billion in the 12 months to June 2009, and the number of deals fell from 149 to 94 over the same period.

Figure 2: Mining sector M&A – number of deals, 2005 – 09*

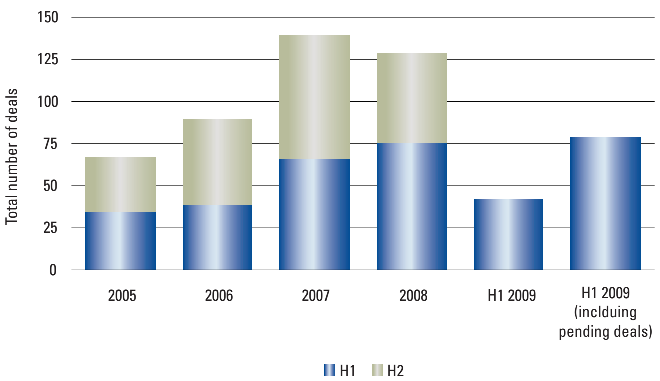
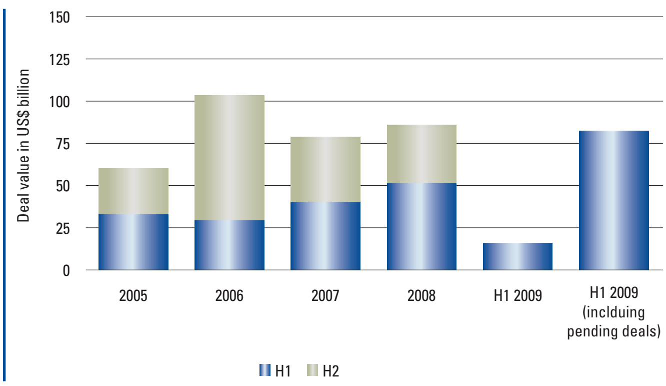


Figure 3: Mining sector M&A – value of deals, 2005 – 09*



Source: Thomson SDC website accessed on 30 July 2009

2009 figures are from January to June
Includes completed deals worth US$50 million and above

Despite the recent fall in deals, four key M&A drivers remain in place and are expected to prompt future deals.

- **Diversification** – Many mining companies protect themselves against volatility by holding a portfolio of assets in different metals.
- **Scale** – Companies wanting to do business in massive markets such as China need large-scale operations both to negotiate on a level playing field and to be taken seriously.
- **Synergies** – Dual ownership – in which two companies share adjacent assets, equipment and procurement – can reduce infrastructure duplication and the costs of getting the minerals to market. Substantial head office savings are also typical in such combinations. On 5 June 2009, Rio Tinto and BHP Billiton signed an agreement to establish Western Australian Iron Ore production joint venture. The synergies from this combination are expected to save US$10 billion for both the firms.[8]
- **Hunger for assets** – Mining companies need to continually replace depleting reserves. In many situations it can be easier and cheaper for them to buy existing operations than to explore and build new mines.

Bright prospects from Asia

The **Americas** accounted for the largest share of deals both as a target and acquirer region in the year to June 2009. The value of deals closed by American buyers rose in the 12 months to June 2009, as did the average deal value. Canada attracted 65 percent (US$19 billion) of total deal value in the region, followed by Brazil with 16 percent (US$4.6 billion).[9]

Future deals are likely to continue to focus on Canada, and on Latin America, which is particularly rich in copper and iron ore. Political risk will likely, however, continue to be a problem in countries such as Venezuela and Bolivia.

Deal values and numbers in the **Central Asia/Asia Pacific** region fell in the 12 months to June 2009. However China emerged as a major buyer during the period, accounting for 26.2 percent (US$4.0 billion) of the total value of the region's acquisitions. China also increased its share in the total value of cross-border deals.[10]

"Chinese companies are expected to continue to buy other mining companies on the international market as they secure raw materials for future use."

Chinese companies are expected to continue to buy other mining companies on the international market as they secure raw materials for future use. In July 2009, China Investment Corp completed its acquisition of a 17.2 percent stake in Teck Resources Limited for US$1.5 billion to strengthen its position in the commodities market.[11, 12] This strategy has the backing of the Chinese government, which is permitting state-owned banks to make finance available.[13] China is also setting up funds to acquire international entities.[14,15] In addition, Japanese and Korean companies will continue to buy mining assets to secure access to natural resources.[16] Below mentioned are some examples:

- On 6 July 2009, Korean Electrical Power Corp (KEPCO) acquired a 17 percent stake in Denison Mines, a Canadian uranium miner, for US$68 million.[17]
- On 30 April 2009, Sumitomo Metal Mining raised its share from 51 percent to 91 percent in Pogo Mine Project, a Delta Junction-based gold mining company, for a deal value of US$245 million.[18]
- On 17 October 2008, a Japanese investor group acquired a 40 percent stake in Nacionale Minerios SA (NM), an iron ore mining company for US$3.12 billion.[19]

Indian mining companies have been buying overseas mining assets, and this trend is likely to continue. Inbound investment is needed to boost the country's capital and technical expertise; however practical issues, political issues, and tight rules on foreign investment mean there is unlikely to be a short-term increase in overseas investment in Indian mining companies.

While Russia has some large mining companies, many of these are currently carrying too much debt to engage in M&As. Current resistance from the Russian government to foreigners taking over natural resources may change as the need for capital to drive exploitation becomes clearer.

Deal values and numbers fell in the **Europe, Middle East and Africa** region in the 12 months to June 2009. Future deals may possibly be driven by Middle East sovereign wealth funds purchasing mining assets.

Figure 4: Global M&As in the mining sector by target region, July 2008 – June 2009 (by value)

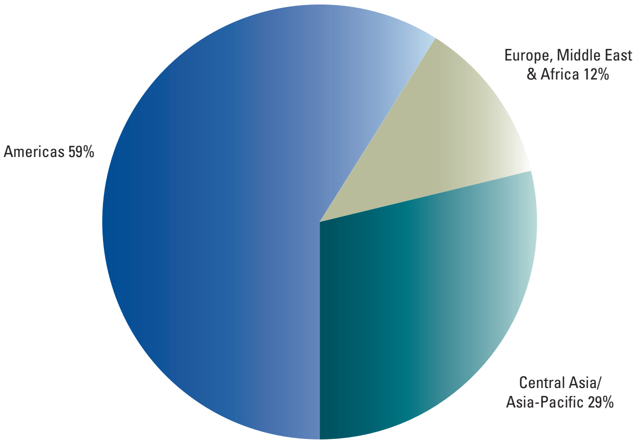
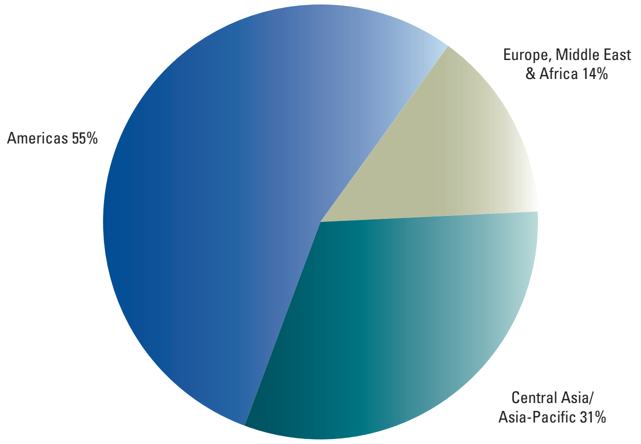


Figure 5: Global M&As in the mining sector by acquirer region, July 2008 – June 2009 (by value)



Source: Thomson SDC website accessed on 30 July 2009

Golden opportunities

"Gold is becoming very expensive to mine and the supply of gold is falling. These factors point to high future prices and increased M&A activity in this sector.

— Sean Tiernan, KPMG's Global Mining Partner, on increased M&A activity in gold."

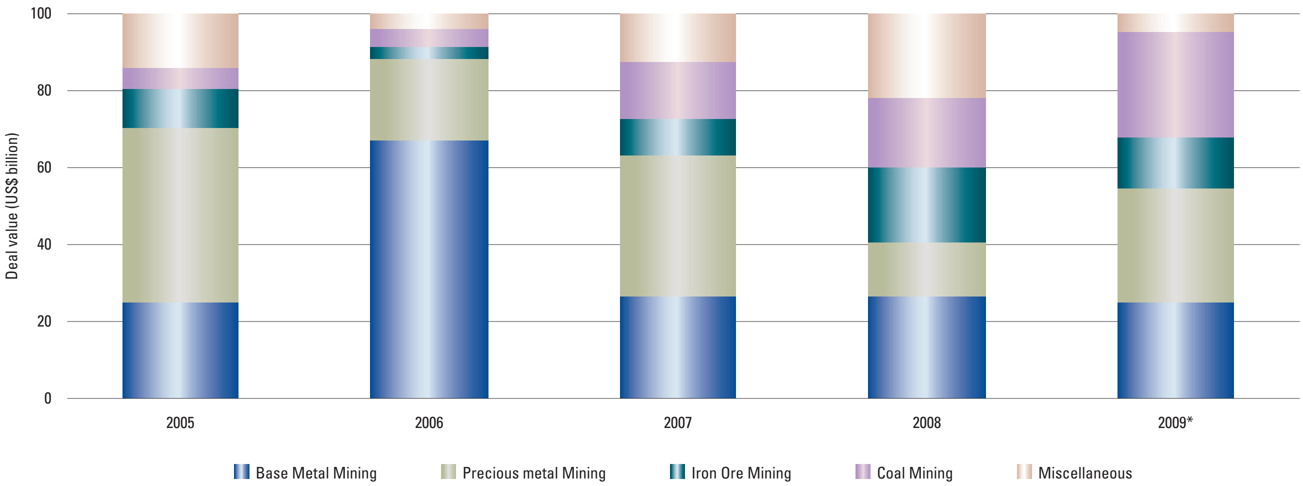
The rising gold price has led to increased interest in the **precious metals mining** sub-sector. Companies aiming to acquire high quality gold reserves drove M&A in the year to June 2009.[20, 21, 22] Several large deals — Paulson & Co's acquisition of an 11.3 percent stake in AngloGold Ashanti for US$1.28 billion, Goldcorp's acquisition of Gold Eagle Mines for US$1.3 billion and Newmont Mining's acquisition of the remaining 33.3 percent stake in Boddington Gold Project for US$1.1 billion — boosted the total deal value.[23]

Investment demand in gold rose by 46 percent in Q2 2009 over Q1 2009, due to the weak dollar value. This is pushing the demand for gold, as investment is used to hedge against the declining dollar.[24] In addition to the current weakness of the dollar, the longer-term scarcity of gold is expected to keep prices high. KPMG's Sean Tiernan points out that "*gold is becoming very expensive to mine and the supply of gold is falling. These factors point to high future prices and increased M&A activity in this sector*." Gold mining suppliers are slashing their exploration budgets, which is expected to restrain future production of gold. This is expected to further push the prices of gold higher.[25]

The share of deals in the **coal mining** and **iron ore mining** sub-sectors both fell only slightly in the 12 months to June 2009. The largest deals in the coal sector were the BHP Billiton Mitsubishi Alliance US$2.38 billion acquisition of New Saraji Project, and Xstrata's purchase of the Prodeco business of Glencore International AG for US$1.9 billion. China and India collectively accounted for 43.7 percent of the total number of deals in the iron ore sub-sector, as companies in these countries look to control iron ore supplies.[26, 27] One of the reasons that this sub-sector has fared relatively well has been due to relative price stability, and the consequent high margins for low-cost procedures. The positive long-term prospects for iron ore are expected to promote increased M&A activity.

The total number of deals and the total value of deals both fell substantially in the **base metal mining** sub-sector during the 12 months to June 2008.[28] M&A activity in this sub-sector faces a mixed future. The demand for copper is forecast to outstrip supply, suggesting further medium-term upside in price and increased acquisitions for this metal. Also, potash and uranium mining companies have attracted investments. Rosatom (Russian state-owned nuclear group) acquired a 17 percent stake in Uranium One[29] and Cia Vale do Rio Doce SA (CV) acquired Rio Tinto's potash assets located in the provinces of Mendoza and Neuquen.[30] In contrast, a demand-supply analysis suggests a less rosy outlook for metals such as nickel, lead, and zinc.[31, 32, 33]

Figure 6: Breakdown of global M&A value by sub-sector, 2005 – 09*



Source: Thomson SDC website accessed on 30 July 2009

* January to June

Corporates lead the way

Mining companies increased their share in mining M&A activity in the 12 months to June 2009 at the expense of financial investors, even as the total value of deals fell. Teck Cominco's acquisition of Fording Canadian Coal Trust for US$13.6 billion, before the onset of the global financial crisis, accounted for approximately 40 percent of the total value in the period.[34]

"Companies outside China which find it difficult to raise the capital needed to finance M&A deals may follow the proposed Rio Tinto-BHP Billiton example and opt for alliances or joint ventures instead."

Mining companies need to consider constantly how they will replace depleting reserves. Given the location and access problems associated with new assets, M&A is likely to present a more attractive strategy for companies looking to acquire new assets than exploration and extraction. Private companies in Japan and Korea are likely to take a leading role in future acquisitions.

Companies outside China which find it difficult to raise the capital needed to finance M&A deals may follow the proposed Rio Tinto-BHP Billiton example and opt for alliances or joint ventures instead.

The total value of deals by **financial acquirers** fell substantially in the 12 months to June 2009. Volatility in the marketplace and the long-term nature of deals in this industry suggest financial investors such as private equity will be less active here over the next couple of years.

State-owned enterprises in cash-rich countries such as China will likely continue to invest in foreign mining companies. China's state-owned investment is likely to include enterprises such as the China Mining United Fund, which aims to raise CNY10 billion (US$1.4 billion) to target mining companies in Western Europe, Africa and Australia for their gold, copper and iron ore resources.[35] Once sector volatility abates, sovereign wealth funds based in the Middle East may start to take a long-term interest in the mining sector.

Table 1: Analysis of total mining M&A deals by acquirer type, July 2008 – June 2009

Acquirer type	Total value of deals (US$ million)		Total percentage share	
	July 2007 – June 2008	July 2008 – June 2009	July 2007 – June 2008	July 2008 – June 2009
Mining	44,034.1	34,564.6	49.5%	69.3%
Metal and metal products	13,783.0	4,341.4	15.5%	8.7%
Financial investors	26,352.7	9,162.7	29.6%	18.4%
Others	4,777.9	1,825.9	5.4%	3.7%
Total	**88,947.7**	**49,894.5**	**100%**	**100%**

Source: Thomson SDC website accessed on 30 July 2009

Where next?

The future of the mining sector depends heavily on the macro-economic environment, with short-term prospects for mining companies inextricably linked to the pace and strength of the global economic recovery. The current recovery in metals prices does not seem to indicate that the worst is over, suggesting mining companies will be cautious about committing to expensive deals in the short-term.

"Major deals in the future are expected to center on Central Asia/Asia Pacific countries such as China, India and Japan as buyers, with a focus on targets in Canada, Latin America and Australia."

However, the mining industry increasingly relies on acquisitions to keep a steady stream of productive assets in play. Companies with strong assets but weak balance sheets will likely therefore continue to work on their financial position, creating a favorable future environment for future M&As.

The following are likely trends from late 2009 – 2011:

- Key M&A drivers will continue to be diversification, scale, synergy and hunger for assets.
- Until confidence returns, there will be few cash deals, other than from Asian buyers.
- Non-cash mergers or joint ventures are therefore likely to increase substantially.
- Some cash deals will still be struck for distressed targets, such as cash-strapped junior mining companies.[36, 37]
- Some distressed companies will also want to sell non-core assets.
- Future major deals are expected to center on Central Asia/Asia Pacific countries such as China, India and Japan as buyers, with a focus on targets in Canada, Latin America and Australia.
- Gold and iron ore are the most likely target sectors.[38]

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Contacts

For more information contact:

Michiel Soeting
Global Chair, Energy and Natural Resources
KPMG in the UK
Tel.+44 (0) 20 7694 3052
michiel.soeting@kpmg.co.uk

Lee Hodgkinson
Global Director of Mining
KPMG in Canada
Tel.+1 416 777 3414
lhodgkinson@kpmg.ca

Pamela O'Leary
Global Executive, Energy & Natural Resources
KPMG in the UK
Tel.+44 20 73118438
pamela.o'leary@kpmg.co.uk

Designed and produced by Evalueserve

Contact: Donal O'Sullivan,
KPMG in the UK,
Tel.+44 (0) 207 311 8538

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