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Mining M&A in 2016

By Connor Cahalane, London partner in the Corporate & Securities group at Mayer Brown

The outlook for mining M&A in 2016 remains as challenging as it has been for the past few years but opportunities exist for investors prepared to take a longer term view.

In the same way that China's rapid economic expansion helped to fuel the mining M&A boom which began the mid-2000s, the dramatic slow down in demand from China, as its economy becomes more consumer focused and less commodity based, has weighted heavily on global commodity prices. This has been compounded by the continuing uncertain outlook for growth in developed economies since the global economic downturn. All this has meant that the overall appetite for investments and acquisitions in the mining sector has declined significantly.

With prices for metals and minerals reaching historic low points over the past 12 months, miners continue to focus on efficiency to protect margins: the frenzy for deals to grow resource base has been replaced by a more composed emphasis on increased productivity and capital discipline. With no clear up-turn in the cycle in sight, the majors are concentrating their attention on their best performing mines while trying to offload their "tier 2" assets. BHP Billiton, Vale, Anglo American, Barrick Gold and Newmont Mining have all completed divestments over the past few years in order to bolster their balance sheets as they dig in for what could be a sustained period of weak commodity prices.

Adjusting to the new norm in commodity markets has proved equally if not more challenging for junior miners. Traditionally these businesses in particular have looked to the public markets to provide capital. However, many of these companies have been cut off from much needed funds over the past few years as the equity markets remain closed to them. The disappointments of ill-timed acquisitions and aggressive spending during the previous mining boom remain fresh in the minds of investors.

While investors in the public markets have been giving the sector a wide berth, the capital intensive nature of mining projects and the cyclical nature of industry mean that there are private equity funds who specialise in the mining sector and see potential for making good returns on their investment if and when commodity prices rebound. PE investors can bring potentially long term capital to the table and many PE funds in this area will take a 10 year outlook, which means they can have the patience to remain invested until the cycle turns.

Mining focused PE funds have raised large amounts of capital recently. However, these funds appear to be in no hurry to deploy their investors' cash as they continue to sift through potential targets to find those who meet their strict investment criteria. Much of the investment in mining companies by PE funds recently has been growth capital rather than buyouts, and typically in private rather

Connor Cahalane
Partner, London
E: ccahalane@mayerbrown.com
T: +44 20 3130 3571

than public companies. Many mining specialist PE funds also have a particular geographic focus, while others are only be interested in particular commodities. Generalist PE funds looking for exposure to the mining sector may also look to follow investment by specialist funds, being guided by their technical know-how and experience in evaluating projects.

Even where a potential target meets a PE fund's investment criteria, agreeing a valuation has been a significant obstacle to closing investments and M&A deals in the mining sector over the past few years. Many mining PE funds look to achieve returns of at least or 2.5 to 3 times money invested over the life of the fund, with higher returns expected on projects located in perceived high risk jurisdictions, and there is often a gap between the price expectations of sellers, particularly privately owned miners, and what investors are prepared to pay.

A key factor in any investment decision will be the level of trust and confidence in the management team to deliver the project on time and within budget - there are a large number of technical, regulatory and sometimes political hurdles to navigate in order to bring a mine from concept to cash flow. PE investors, who are often not looking to take a controlling stake, will want to see a strong management team who can put their capital to work and deliver returns. Notwithstanding the premium placed on experienced management teams, discussions on management incentives packages can be a sensitive issue for mining investments and M&A as for many mining companies senior management's options are likely to be underwater given recent share price performance across the sector. The challenge of getting the right incentives package in place that aligns investors and management in the new world of commodity prices can key to the success of a deal.

As the majors continue their drive for increased efficiency, and with mining juniors struggling to find funding, it seems clear that a return to the mining M&A boom years remains unlikely. However, investors such as private equity funds who are willing to a take a longer term view of markets may find opportunities in 2016 to take advantage of the ongoing commodity price slump.