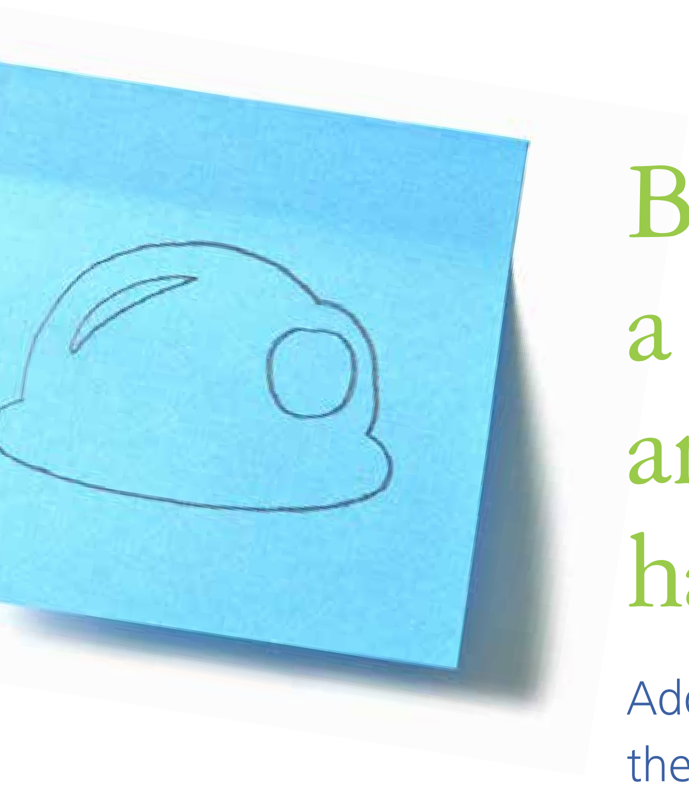

Between a rock and a hard place

Addressing distress in the mining industry

In today's turbulent economic climate, mining companies are taking a beating. Admittedly, it's not like the industry was ever easy. To get off the ground, mining companies require significant capitalization – and that's just at the exploration stage. Once a mine comes on-line, it assumes a host of additional costs for everything from development to operations and maintenance. To support this investment, miners have traditionally relied on capital markets supported by commodity price buoyancy and expectations of massive demand out of countries like China and India. Yet, while these forces held true in the past, in recent years the headwinds have shifted.

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Volatility is the new normal

The perfect storm

Commodity prices are hitting new levels of volatility, with many dropping to significantly lower levels than witnessed over the past few years. Demand fundamentals, while still forecast to remain strong over time, have stuttered in recent months, particularly as China comes off its ultra-high growth rates. Resource nationalism has resurged in mining jurisdictions around the world, as governments continue to raise tax and royalty rates aimed at the industry. And through it all, costs continue to escalate.

As a result, share prices are suffering, companies are taking massive impairments, executive management is being replaced, boards are increasingly leery and regulators have become more vigilant. Conditions in the industry have deteriorated in response; marginal mines are being shuttered, development projects are being re-sequenced and deferred, and some distressed companies are even entering into formal restructuring proceedings.

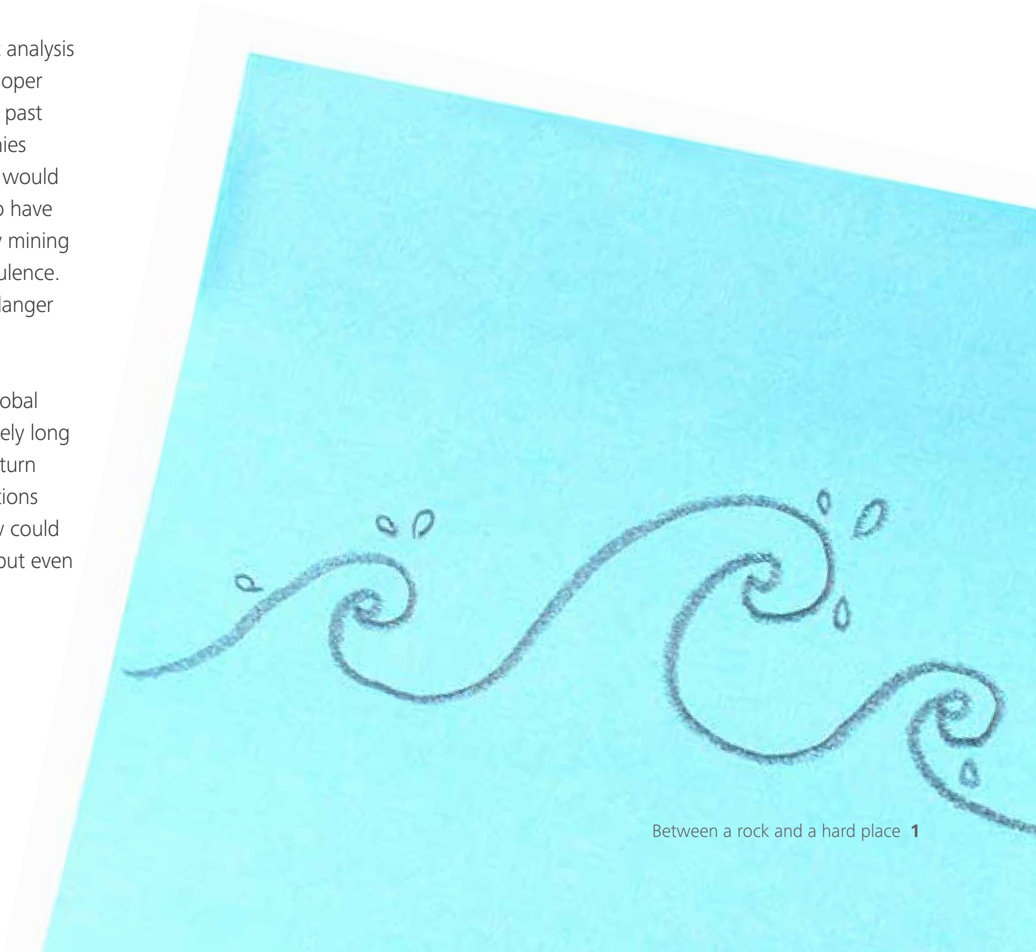
The dangers of inaction

The worst may not be behind us. According to recent analysis by Deloitte, the median Vancouver producer or developer experienced a 35% decline in cash resources over the past two years while the number of mining sector companies with over $5 million in debt increased by 68%. These would be challenging waters to navigate even by teams who have seen similar conditions in the past. Unfortunately, few mining management teams have ever faced this level of turbulence. Uncertain of what actions to take, companies are in danger of taking no action at all.

The ramifications of this inaction can be fatal. With global operations, immense capital expenditures and extremely long time horizons, mining companies are too complex to turn on a dime. Failure to actively consider all available options or pursue opportunities to staunch current losses now could hamper not only future productivity and profitability, but even long-term operational viability.

If you run out of cash,
you run out of options.

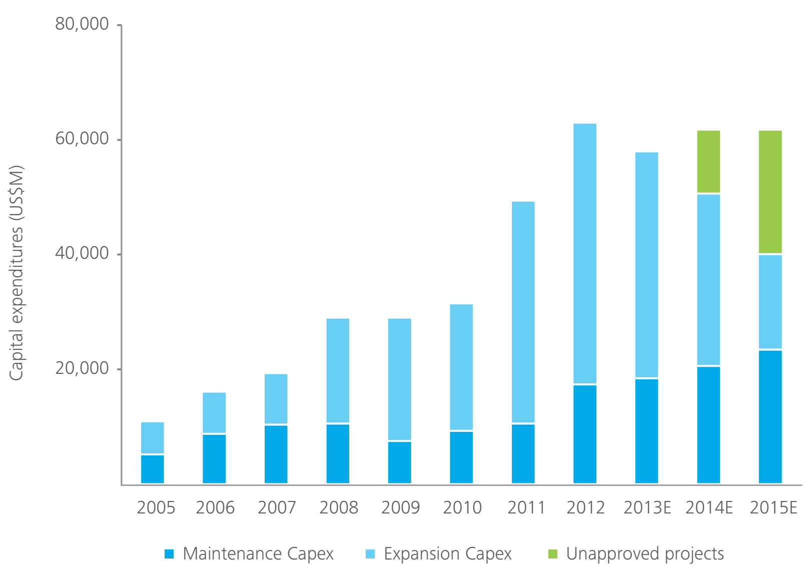
The time to act is now.



The triggers of distress

Market fundamentals in the mining industry have been shifting for years. Yet only in recent months has their impact been felt. While mining companies could likely counter these challenges if they arose individually, collectively they threaten to be debilitating.

Figure 1: **Mining Capital Expenditures**



Source: Metals Economics Group/Deloitte Analysis

1 Skyrocketing costs

Mining has always been an expensive industry, but cost inflation has taken industry expenditures to new heights. Maintenance capital expenditures alone rose over 100% between 2005 and 2013. Yet that pales in comparison to expansion capital expenditures, which spiked roughly 400% in the same time period. Cost overruns on construction projects in the energy and resource sector (including mining) typically exceed 30%.

2 Commodity price volatility

Whether occasioned by the European debt crisis, U.S. market weakness or China's slower economic growth, macro-economic factors are wreaking havoc with traditional mining industry projections. Commodity prices have plummeted as a result. Gold, for example, fell from over $1,800 per ounce in 2011 down to under $1,200 in December 2013, before ticking back up. The drop represented gold's steepest decline in 30 years. Future projections for other key commodities such as silver, copper and zinc are also weak, calling mining industry profitability into question.

3 An inability to finance

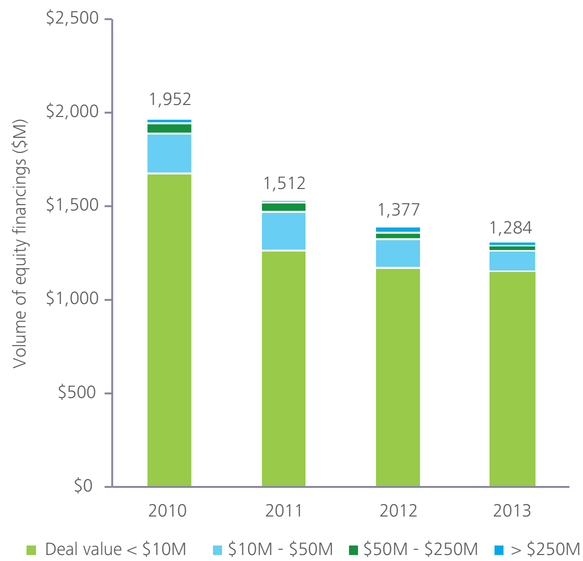
As mining company valuations dip, access to finance has become scarcer. This is true in both the debt and equity markets. While the majors have been able to turn to bond markets, the same is not true for junior miners, who have been hit particularly hard. Equity financings are dwindling. Between 2010 and 2012, TSX mining equity financings fell by 30%, with both the number of deals and deal values shrinking. Even more notable, TSX mining IPOs dropped 70% over the same time period, from $1.2 billion in 2010 to under $400 million in 2012. Without access to funds, many mining companies find themselves severely cash-strapped and in danger of running out of money before the markets turn.

4 Geographic risk

Mining companies need to operate where the commodities are located. As easier deposits are mined out, companies have expanded to increasingly remote locations across South America, Asia and Africa. This raises a host of geographic risks. On the one hand, many mining regions lack stable economic regimes, resulting in shifting taxation and royalty regimes in the face of mounting resource nationalism. In many cases, this geopolitical risk has interfered with the economic viability of projects already in production.

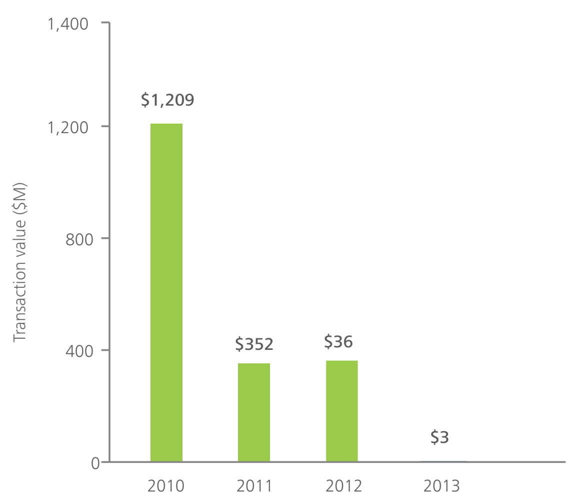
On the other hand, as companies move farther afield, grow their operations and establish regional headquarters, direct oversight of remote operations gets harder, creating a disconnect between head office management and local mine planners. This disconnect may be partly to blame for recent years of runaway increases in operating and capital costs.

Figure 2: **TSX Mining Equity Financings**



Source: Capital IQ/Deloitte analysis

Figure 3: **TSX Mining IPOs**



Source: Capital IQ/Deloitte analysis

What's at risk?

As mining industry volatility ramps up, the risk of corporate distress rises as well. Across Canada – and indeed, around the world – mining companies are already experiencing:

- **Stock price declines** and plummeting market capitalizations
- **Reduced profitability** due to commodity price volatility, cost overruns and weak governance practices, resulting in massive impairments and further limiting access to financing
- **Stuttering operations** as companies cut staff and exploration budgets, put marginal mines into care and maintenance, close projects and shelve expansion plans
- **Debt covenant defaults** or missed supplier payments, which may lead some creditors to force liquidation
- **Potential action from governments** or labour unions against companies that fail to pay taxes or payroll, or that lack the cash to meet environmental compliance or other regulatory obligations. These breaches can do more than interfere with a company's license to operate; they can also expose mining companies to significant fines and even personal liability for management and directors
- **Insolvency** as Canadian mining companies file for protection under the Companies' Creditors Arrangement Act (CCAA) or the Bankruptcy and Insolvency Act (BIA)

Where do you stand?

Despite significant industry distress, not all mining companies are at the precipice. But that doesn’t mean they’re safe either. Given current market challenges, it’s imperative that mining companies take a good, hard look at their operational realities and the runway of liquidity available to them.

Junior miners that don’t have producing assets may be at risk of burning through their cash reserves simply to finance existing general and administrative expenditures and exploration activities.

Companies that are still at the development stage and have some equity but little or no debt may be able to halt or slow the pace of development, or try to raise money from alternative sources. Finding financing to complete construction has become extremely difficult. While companies can stop building part-way through construction, the cost of calling a mid-stream halt can be enough to cause distress on its own. Shutdowns alone can cost tens of millions, with near-equivalent investments to start up again.

Larger companies and other operating companies may have more of a buffer, particularly if they’re sitting on cash reserves and/or have profitable operations. In these cases, it may make sense to put marginal projects into care and maintenance. The key is to avoid becoming too risk averse. Companies that fail to pursue new projects can find themselves underperforming as market forces shift.

Questions to ask

Understand your options

No matter where you fall along the spectrum of distress, your greatest enemy is time. Even large mining companies with strong balance sheets must answer to investors who continue to expect corporate payouts despite weak economic trends.

This may explain why many majors have already adopted cost containment strategies and are exploring the viability of data analytics and working capital optimization to strengthen future performance. Of course, companies battling for survival need more immediate response strategies. Companies in imminent danger of running out of cash must assess their options now. Avoiding worst case scenarios, such as insolvency, is much more feasible for companies that act from a position of relative strength. The earlier you address the signs of distress, the more options you have available. The good news is that worst case scenarios do not need to be your default. There are numerous options for remediation if you act in time. These include:

Debt restructuring

While mining companies typically run on equity rather than debt, companies facing distress may benefit from a debt infusion. The key is to find lenders that understand the industry and are willing to work with you to restructure – a task that can be complicated by the global nature of the mining industry. That's why it helps to work with financial advisors who have strong relationships with both local and global lenders.

Strategic partnering

By working with a cash-rich partner, either through public equity ownership or at the project level, mining companies can often receive the cash injection they need to finance project development. Many international companies interested in securing supply can be optimal partners, although it takes both time and connections to identify viable partners, conduct negotiations, review transaction risks and close the deal.

Alternative financing

With equity markets all but closed, mining companies must consider alternative sources of financing. Some options include:

- Raising funds internationally – there are still global partners interested in taking minority stakes in Canadian mining companies. By tapping global networks, miners may be able to secure financing from investors in countries like China, Japan, India or Korea that have shown a disposition to invest in the sector.

- Private equity investment – while private equity firms have not historically invested in the mining sector due to its volatility, technical complexity, the cash investment required and its long time horizons, private equity interest is picking up now that valuations have fallen. To improve the odds of success, look for private equity firms that have begun building industry expertise or set up resource-specific funds.

- Other alternative financing options in the mining sector include royalty and streaming arrangements, off-take deals, joint ventures and equipment financing.

Mergers and acquisitions (M&A)

While survival M&A in the mining industry is on the rise globally, transaction values are generally higher the earlier you begin the process. Whether you are thinking of selling the company or divesting only certain assets, speed is imperative. To avoid missteps – or mismatches – it makes sense to work with transaction advisors with mining industry experience who can help with strategic assessment, corporate modeling, transaction execution and valuation on an accelerated basis.

Working capital optimization

In any distressed environment, cash is king, which is why mining companies must realistically determine their cash burn rates and be honest if they are in danger of running out of money. One quick way to free up cash is through working capital optimization. By negotiating with suppliers, mining companies can often extend their payables to bridge the cash flow gap. The key is to maintain open and honest communications with creditors to prevent any surprises that may damage trust. Similarly, companies can look to improve their accounts receivable and inventory levels through proper planning and by tying working capital optimization into incentive programs.

Cost cutting

Companies can benefit by considering operational restructuring through cost reduction programs. By reviewing operations, mining companies can often realize immediate savings by cutting headcount, deferring projects or simplifying their portfolios. Effective cost cutting, however, is about more than just trimming the fat. To ensure cost reductions stick, rather than having them creep back in over time, mining companies must foster a cost-conscious culture. To do this, they need to track all the key business drivers that affect costs and understand their interconnections. In some cases, raising costs in one area (such as mine automation) can vastly reduce overall production costs. To determine which lever to pull, companies need processes, policies and reporting systems that deliver an enterprise-wide view. Data analytics can help in this regard by delivering granular information about specific cost drivers.

Capital project rationalization

Mining companies have a long history of exceeding capital project budgets. To rein in these costs, it’s time for companies to adopt more robust project scoping processes, governance systems and risk and control mechanisms. This may include improving project management expertise in areas that often lag, such as project scheduling, contractor readiness and project tracking; retaining external mining engineers to provide risk assurance around mine planning; refining risk modeling to improve future forecasts; and even entirely restructuring mine plans on new projects to reduce structural costs from the outset.

Formal restructuring

Mining companies that have exhausted their options may ultimately need to file an insolvency proceeding under the CCAA or BIA. While this would not be an option of first resort, it can be a very strategic way to divest corporate assets. That’s because mining companies can often sell the mine or their assets under these provisions without any liabilities attached, sweetening the deal for potential buyers. Even without a sale, these proposal provisions give companies breathing room by preventing creditors from taking action against them. While it can be unpalatable to consider this option, ignoring it only increases the risk, particularly if the company continues to falter with each passing week. By proactively considering formal restructuring as an option, mine management and boards may discover viable alternatives to reduce liabilities and preserve shareholder value.

Help is at hand

Whether your company has experienced only marginal performance slips or is in serious distress, there are a range of options to help you regain profitability and productivity. By acting quickly and decisively, you can do more than avert disaster, you can also strengthen your operational foundation, create value despite negative market forces and position your company for growth once industry fundamentals pick up.

Contact

To analyze the options available to your company and get answers to your pressing questions, consider getting help from people who've been there before.

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