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London – global hub for mining finance

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The London market – the major player for the major players

London is long-established as the financial capital for the global mining industry. The certainty of contract, rule of law and ease of doing business, alongside relative political and economic stability, all combine to make London a solid, active market. What's more, London plays host to a whole industry of experts – investment bankers, brokers, fund managers, lawyers, financial advisers, accountants and more – who understand the specifics of the sector. Add to this that London is an attractive place for the senior management of mining companies to come to live and work, and it's easy to see why the UK capital is the place to be for mining companies looking for finance.

But will that remain the case? As the industry starts to recover from the lowest point of the commodities super-cycle, it's possible that we'll see some of the majors reduce their footprint in the capital. Cost-reduction has been a key feature of the recent operational improvements made by many of the top mining houses, so it's unsurprising to find the premium that comes with having a base in London called into question.

There are alternative places to list, but perhaps none are quite as compelling as the LSE. New York is not only a largely domestic exchange, but mining companies also represent a very small proportion of the total market. Canada and Australia have healthy exchanges, but are better suited to early-stage venture mining businesses, and have a much higher proportion of retail investors. We see no end to the practice of companies, once they've grown and become strong in Toronto or Australia, moving their listing to London or adding a London listing to access capital and get a higher rating to improve their share price.

It would be remiss not to mention the referendum result. So, what impact might Brexit have on London's importance to the mining industry? Well, not much. The mining sector should prove to be a very good example of the resilience of London. Companies listed here have their operations almost entirely outside the EU; there is very little inflow of investment that is EU-related.

From everyone we've spoken to on the subject, opinions vary from Brexit being at worst a non-issue to it even being slightly advantageous, as companies will find it attractive to have a large, well-established financing hub that stands alone from other countries.

Plus ça change…

It can be dangerous to predict the future by looking at the past, but a useful place to start is the alternative funding strategies discussed in the Deloitte *Tracking the Trends in Mining 2016* report.

Reducing debt levels has worked very well for mining groups that became bloated in the 2009/10 stage of the super-cycle and needed to demonstrate that they could get their finances under control. Many have significantly reduced debt by improving their financing terms, undergoing deep cost-cutting exercises and streamlining their portfolios by operating across fewer commodities.

There has also been a move towards commercialising non-core assets, with companies looking to bring net debt down by offloading assets they don't need, and making better use of the assets they've retained. This has taken place against a backdrop of increasing pressure from governments to 'use it or lose it' – the prospect of mining rights being taken away if the companies are not seen to be developing those rights and exploiting them.

Balanced against this, in a rising price environment, the immediacy of the need to sell these assets is reducing, and the valuation gap between buyers and sellers makes it hard to strike a deal.

What we have seen instead, in response to greater scrutiny on net debt numbers in the first half of 2016, is people seeking to optimise working capital, leading to simpler structures than those we witnessed in 2015. These techniques – including offtake agreements, streaming and factoring – are being used to stretch the working capital cycle, but are more of a short-term sticking plaster than a long-term solution. The more sustainable way to react to a margin squeeze is to take cost out, and to make the business leaner by identifying which assets to keep and which to let go.

Collaboration is also on the up. Billion-dollar projects are often too big even for the majors, so finding a partner for schemes that are 'too big to fail' is common; by sharing the project they halve the risk and double the know-how, with plenty of upside left to go around. Collaboration is also seen between smaller and larger mining groups, with the former getting the cash to fund their exploration activities, and the latter getting a strategic stake in what could be the next big thing (not to mention protecting their own reserves). However, joint ventures are not without risk – in return for the benefits of pooling resources, companies relinquish an element of control.

So, what does all this mean?

There's no doubt that appetite to invest in the mining sector is coming back. Few would argue that commodity prices will go lower; indeed, over the past 12 months many have started to recover. Investing in the underlying commodity may be tempting to some, but with that strategy comes a greater exposure to volatility. The smart money still goes into the mining company itself – particularly those investing for the long term.

There's no avoiding the fact that there's an increasing demand for mining product. Base metals – copper, iron ore, aluminium – are all used in so many consumer products that we "can't do without"; gold continues to be a great store of value; diamonds are starting to recover too. The list goes on.

But the grades of many mines are declining. The quality of ore bodies or coal seams are not as rich as they were, and grades are nothing like what they were back in the 1920s. So, the imperative to drive out operating costs becomes all the more acute; those who succeed in improving efficiency will be the ones able to pursue lower-quality ore bodies at a profit.

Meanwhile, as the majors have sought to strengthen their balance sheets, they've been very quick to turn off the tap at operations that are not cash-positive. This has shrunk supply and contributed to price recovery; however, the multiplier effect of an improving cash situation with reduced costs and increased prices may add to the volatility of commodity prices as producers bring more supply back to the market.

On the other side of the equation, dialogue is starting to change among investors and analysts, who are starting to ask where the growth is coming from. And they're right; you can't cost-cut your way to growth.

So at this point, the predominant sentiment seems to be "show us you can spend what we've given you wisely, and then we'll give you a bit more..."

What else might we see in 2017?

Corporate bonds are tipped by some to be the flavour of the next 12 months. Most of the leading mining companies have put to bed their financial difficulties, and bonds are a low-cost way to finance some of the bigger new projects that are coming on stream. So, for $1bn+ schemes, where there is a significant need to build out the mining and processing infrastructure, this is the way that many will go.

Aligned to this are rumours about mining IPOs coming back to market, and there are rumblings associating the bigger names with possible new ventures. The expectation is that some of these will come to pass, together with more spending on exploration.

On the downside, there is pressure from 'resource nationalism', where countries that have benefited from mining companies having exploited their natural resources now want a bigger share of the spoils – either in the form of higher taxes or increased direct royalties. The threat is that they get too greedy, which might force mining companies to move their operations out of the country altogether.

It's also worth keeping an eye on currency volatility. This is not a new phenomenon, but with most mining companies selling in US dollars but operating day to day in local currencies (the rand, the rouble, the tenge, etc), it makes the impact of currency volatility more complex than in other industries.

Many mining groups have maintained or increased profitability because of currency devaluation. At present, the currencies of many mining territories are weak against the dollar. But companies with mining operations in places such as Russia, for example, where the rouble is heavily influenced by the price of oil, need to be sure they have protected themselves so that they will continue to be profitable as the oil price recovers and currency appreciates.

Elsewhere, the effect of pressure on wages that results from local currencies improving can only effectively be limited by becoming less reliant on labour, and using the opportunity to mechanise mines – something companies are starting to look at as part of their productivity improvement innovations (see chapter two of *Tracking the Trends in Mining 2017*).

Investors will need to be assured that the miners are in control before they will be encouraged back into the sector in a meaningful way.

The plight of the juniors

Junior miners continue to find it difficult to secure traditional bank financing and to raise debt; lenders are loath to put money in when companies do not have equity in place first. There have been some positive announcements around relatively small-scale, modular projects, but there are still tough times ahead.

Juniors will be forced to look at unconventional forms of finance, including the offtake agreements and factoring mentioned earlier. And they are increasingly using trading companies to provide finance rather than the banks themselves. Mining funds have also come up with some boutique structures such as royalty streaming arrangements, but costs are high.

To make themselves more attractive to financiers, juniors need to show the operational discipline described throughout our 2017 report, and focus on collaboration, consolidation and innovation. By getting themselves into a better state to be able to manage their cashflows, they will demonstrate their viability. This means making sure that they're taking advantage of all the changes in technology and improvements that are happening in the mining sector, and that they are making smarter decisions around investing the capital they do get.

The juniors are clearly learning from mistakes in past cycles, being much more rigorous in their feasibility studies and decisions on whether or not to develop mines, and, if they do go ahead, doing so at a more cautious assumed commodity price – all of which may lessen the difficulties they face accessing finance in the future.

The impact of external stakeholders

The social and environmental issues and challenges faced by mining companies can be seen across our *Tracking the Trends in Mining 2017* report. From sustainability and energy management, to climate policies and working conditions, today's mining company needs to do the right thing and be seen to do the right thing. Although most investors recognise that a well-run organisation is a safe one and a productive one, this can be hard to demonstrate – and there's still a sense of distrust towards miners.

A skewed perspective from some parts of the Western world doesn't help. For example, electricity-generation companies are under intense pressure to shut down all coal-fired power stations, but Africa, South East Asia and South America are still massively reliant on coal for electricity. This makes it harder to switch off these power stations, but environmental pressure groups will often make little, if any, allowance for this.

So the role of the lobbyists and NGOs can't be disregarded. The safety and stability that help make London such a desirable place for mining companies in the first place also provide a safe and secure environment for protestors and pressure groups. Mining companies beware.

That said, although reputational damage will have a bearing on a company's ability to secure finance, investors are sophisticated enough to evaluate all the available information, and will make their commercial decisions based on a balanced view of the facts.

In summary

It's hard to break over 100 years of history. London was at the centre of the mining industry in the 19th century and it still is today. It's where the funds that follow mining are; it's where the expertise is. So, if you're looking to maximise your share value and if you've got a good story to tell, then London is still the natural place to be listed.

As commodity prices pick up, surely the winners will be the companies with strong management teams that can manage a portfolio of assets and bring them through to growth in a way that's value-enhancing. Sounds simple, but in the words of Deloitte UK mining leader Tim Biggs, "You'd like to think that investors would rate the best run company more highly than the worst, but there are too many factors at play to value a business purely on the quality of its management; so much is dependent on the geology, the weather, commodity prices and even luck to always be able to pick the stocks that are going to outperform."

As ever, nothing of value is easy.

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