Executive summary

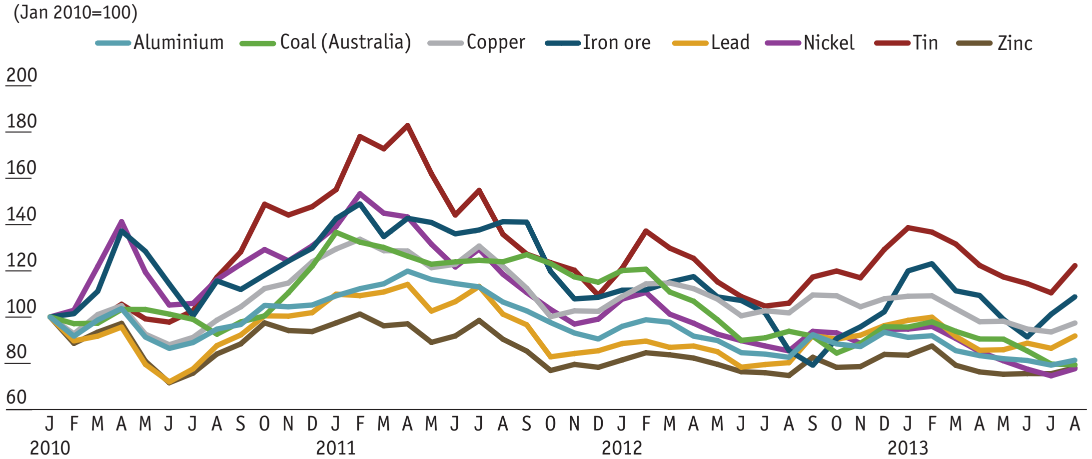
Companies in the industrial raw materials sector are facing a new era. For years, miners of resources such as iron ore, base metals and coal enjoyed a boom driven by incredible demand from China and other emerging markets that were urbanising and investing heavily in infrastructure. Since a peak in 2011, however, prices of many commodities have fallen and concerns have grown about the end of the current "supercycle" (Figure 1). Projects that were once profitable are now unviable. Planned capital expenditure has been slashed. By 2012, as Figure 2 shows, mining companies' revenue growth had disappeared and profitability had plummeted. Consequently, firms across the sector have revamped their management teams,

Figure 1

End of an era?

Price indices, selected commodities

(Jan 2010=100)



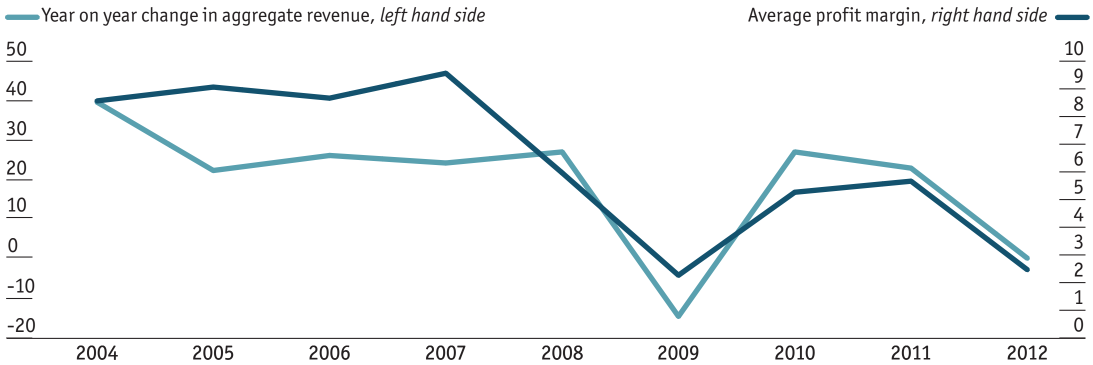
Source: World Bank/Haver Analytics

	Aluminium	Coal (Australia)	Copper	Iron ore	Lead	Nickel	Tin	Zinc
Post-financial-crisis peak	2011 - Apr	2011 - Jan	2011 - Feb	2011 - Feb	2011 - Apr	2011 - Feb	2011 - Apr	2011 - Feb
% change from peak to August 2013	-32.1%	-41.9%	-27.1%	-27.0%	-19.5%	-49.3%	-33.1%	-23.0%

Source: World Bank/Haver Analytics

Figure 2

Not so happy now
Mining company performance 2004-12
(%)



Source: EIU, Orbis/BVDEP. Annual data from 413 companies with more than 100 employees from mining and associated industries (NACE Rev.2 codes 05, 07, 08, 099)

divested assets and adjusted their strategies as shareholders have grown unhappier about falling stock prices.

This is the commonly accepted narrative, but it is far from uniform across all hard commodities, nor across all companies in the industry. Though many accept that the incredible boom of the post-financial-crisis years is over, consensus on whether recent price movements indicate the end of the supercycle—or even on whether such a phenomenon exists—is lacking. Some point to the natural cycles that hugely capital-intensive industries experience, as projects planned years ago come on stream, affecting the supply-demand balance. Others see the current fear about slowing demand (particularly in China) as exactly the right time to plough money into new ventures, to take advantage of the next upturn.

This report looks beyond the short-term news cycle to assess the state of the metals and mining industry as it approaches the post-boom era. Based on extensive industry research and numerous in-depth interviews with executives from companies across the world, the report seeks to answer four questions. Is the commodities supercycle over? How has the industry's change in fortunes in recent years affected investment by mining companies—specifically capital expenditure—and what implications does this have for their future growth? What impact has the slowdown had on M&A, corporate dealmaking and industry consolidation? And finally, what strategic and operational issues do new management teams need to get to grips with to ensure their companies emerge as winners in the new environment?

The key findings of the report include:

- **The supercycle is not over—it's just not as super.**

Analysts, investors and those in the industry itself disagree over whether recent price moves mark the end of the resources supercycle. Academic research suggests that over the long term, prices of scarce commodities are likely to rise (while experiencing greater volatility). Some investors and analysts are more pessimistic, given structural changes in China's economy, while many executives in an industry accustomed to long investment cycles are inclined to downplay the theory altogether. The Economist Intelligence Unit believes continued growth in China (slower, but from a larger base), ongoing global urbanisation, and structural factors such as higher energy and extraction costs will continue to support prices in the medium term.

- **Counter-cyclical capital expenditure could prepare firms for the next upsurge in demand.**

High prices in the 2000s were partly a result of underinvestment the previous decade, leaving miners struggling to keep up with surging demand. Then over-investment in expansion, particularly by the majors, unbalanced the supply-demand equation. Meanwhile, disgruntled investors are demanding quicker returns from capital employed. Firms must therefore be more cautious and focused about the number and type of investments they make—and CAPEX is falling as a result. But some miners are investing counter-cyclically in preparation for an expected upturn. In addition, remaining resources are deeper and more costly to extract and will require more investment to prepare firms for the next upsurge in demand.

- **The era of the megadeal is over; mid-cycle consolidation will drive a more subdued M&A market.**

Aside from a small number of recent large deals that were long in the making, firms in the metals and mining sector have entered a period in which viable deals are scarce, divestments hard to offload, and further large-scale consolidation a non-starter for both financial and political reasons. The era of the mining megadeal is over, and there are few world-class assets on the market. But further consolidation can be expected among junior and mid-cap firms that need to shore up their balance sheets or find partners for projects they are no longer able to finance on their own.

- **Diversification into mid-cycle commodities is an increasingly attractive option...**

For miners with the resources to do so, buying assets in diversified commodities is one way to gain exposure to the next supercycle, likely to be driven by urban populations' insatiable demand for manufactured goods, energy and soft commodities. Several deals—for example BHP Billiton moving into potash and Freeport McMoRan buying an oil and gas firm—demonstrate the appeal of diversification.

- **...while vertical integration and strategic collaboration can also add value.**

In recent years the industry has seen more end-users and trading houses moving down the value chain into origination and producers moving up the chain into trading in order to capture more value. The former type of deal (e.g. Glencore's acquisition of Xstrata) can create value as traders know producers intimately and can extract value from struggling assets. In addition, miners can also benefit from trading larger shares of their production on open markets. Meanwhile, for junior or mid-cap miners without the resources to diversify, investment on a project basis by strategic end-users can be beneficial.

- **Resources nationalism is as strong as ever.**

As commodities prices soared and private-sector companies benefited, governments in resource-rich emerging markets pressed for larger stakes in local projects—or opted to prevent foreign firms from owning assets altogether. Although prices are now dropping, a commensurate dialing down of resource nationalism has yet to occur—as trouble over Rio Tinto's Oyu Tolgoi mine in Mongolia and stricter local-ownership regulations in Indonesia illustrate. When these countries see a steep loss of competitiveness and FDI they may make adjustments to compensate, but this hasn't happened yet.

- **How miners manage the post-boom transition internally will determine how they fare when prices pick up.**

Many mining companies have replaced their CEOs in recent months in the face of shareholder anger over the falling value of their companies, cost overruns and poorly performing projects. With resources increasingly hard to extract, leaders will require more technical geological expertise. New management teams, meanwhile, face a delicate balance of protecting balance sheets, satisfying shareholders and preparing the ground for future growth. A wholesale reprioritisation of risks is also needed: defaults from over-extended construction companies are now more likely, and risks from forex volatility are sharper. Political risk linked to resources nationalism also requires careful management.

- **"Pit to port" innovation is necessary even in a downturn.**

The competing demands on management will mean increasing pressure to justify investment decisions. Some executives think mining lags other industries in innovating along the production line, given the cyclical nature of the business. With greater investor pressure to return cash, speculative spending on innovation is likely to be the first thing to be cut. But with resources becoming ever more costly to extract, those that do innovate "from pit to port" will have a competitive advantage in future. In addition, those that opt to offload costly infrastructure assets may also be able to free up funds for innovation.