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Think Piece

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The Mining Predator's Ball

Marriages Made in Heaven (or Hell)

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+ There is no shortage of potential predators or prey in the mining space
+ Good marriages can be made that are synergistic and value-accretive for all concerned
+ The progression of the base metal space requires companies of a size that can move forward sizable projects in metals like Zinc. Juniors no longer can manage it
+ Predators will most likely be the cashed up or the cashflow positive but they should NOT use cash in the deals. Anything but all stock deals lays down problems for the future
+ The spin-off of new majors from existing majors will make more focused vehicles that, from 2016 onwards, will become predators in their own right
- ✘ A swathe of the biggest majors are sidelined because they are in the process of spinning off big chunks of their business (e.g. BHP-Billiton, Vale)
- ✘ Precious metals M&A is the least interesting space as quite often it is pairing up of one troubled company with another troubled entity
- ✘ Doubts remain as to whether the dreadful record of managing M&A in the sector has been remediated

The Miners' Mating Season

For a sector that has so many participants the sole goal of which is to be taken over there is remarkably little going on and what is happening seems to be capitulation to economic reality rather than any sort of bidding war like the "good ole days".

Deals have happened sporadically over recent years though the high tide(s) for mining M&A were pre-2008 and then in the 2009-2011 period. Both periods had their share of dumb deals but only really the pre-2008 period had the type of transformative deals that we favour. A good example of what we admire is the building of Xstrata out of various disparate parts, but most particularly the roll-up of Falconbridge, Noranda and MIM (amongst other assets). Then we also admired the three-way merger that created NewGold out of a bunch of small and lower second-tier companies. The company has continued on this path of "bolting on the bite-sized" while others still fancy themselves as pythons swallowing goats.

The most odious M&A deals include RTZ's acquisition of Alcan and Vale's acquisition of INCO. Both were poor timing and ill-thought out entries into new verticals, though in the case of Vale it had the added juice of machismo. While most of the assets acquired with the Alcan deal have been sold, shuttered or fallen by the wayside, at least the INCO 'adventure" may come full circle with the announcement in recent times that the assets may be "set free" again on international markets.

A failed attempt at a “merger of equals” was Lundin and HudBay in the wake of the 2008 crash. We didn’t like the sound of it at the time, and both have gone on to do good things (particularly HudBay) so we are not sure whether the failure of this deal was a good thing or not. Lundin has scarcely done any deals though (excepting the failed Inmet merger proposal) since that time. Once bitten, twice shy?

Then there are all the takeovers that were not even vaguely mergers but cases of much bigger companies taking over much smaller ones. The poster child for poor deals in this category is Kinross (see Redback, Underworld and Aurelian). Ironically though the usual fate of bad deal-doers in other sectors (getting taken over themselves) has not happened at Kinross because the past deals are still embedded in it (e.g. Tasiast) and act as a repellent for potential boarders.

And we should mention the purely nonsensical as embodied in Yamana/Agnico’s “White Clown” defence of Osisko from the overtures of Goldcorp. This transaction had no commercial logic and looked like a visceral response to an interloper shaking up the cozy world of mid-tier gold miners on the TSX.

We could also muse upon some other major transactions:

Barrick bidding for Equinox – an inappropriate non-synergistic deal that was too pricey

Pan American Silver acquiring Aquiline – overpaying for a non-starter

Eldorado acquiring Sinogold – the last blast of the China mining story for foreigners

KGHM buying FNQ – Removed one of the more interesting potential majors from the TSX

Freeport McMoran merging with Phelps Dodge – and then there was one, the ongoing decline of the US mining relevance in the corporate sphere

Molycorp merging with Neomaterials – one plus one equals a mere fraction of one

Nyrstar’s roll-up of various zinc/lead assets and takeover of Farallon – an admirable attempt at vertical integration

Glencore’s merger with Xstrata – if it ain’t broke don’t fix it…

Antofagasta taking over Duluth Metals – putting Duluth out of its misery

Divide and Replicate

One of the paradoxes of the current moment is that so many of the major potential predators are immobilized, many of their own choosing. We have BHP-Billiton, Anglogold and Vale musing aloud, or advanced, in the process of breaking up. RTZ is also in a divesting mood. The spin-out from BHP to be called, rather preposterously, South32, will have a mish-mash of base metal interests, but will be massive in its own right with a projected market cap that could be as high as $16bn, with listings in

Australia, South Africa and London. The whole process should prove a distraction but eventually (2016?) this entity might in itself become an acquirer/consolidator.

The Vale spin-out, of what we are calling INCO Redux, is being talked about as maybe having a market cap as high as $35bn. This shall probably not be an acquirer for a while either, except if maybe to balance away from the preponderance of nickel. The Anglogold deal is on-again, off-again but made a lot of sense to get away from the death-like grip of the meddling South African authorities. Do not be surprised to see it resurface. RTZ had mooted selling its diamond business in a move which made a lot of sense and then backtracked. The company now has the added complication of a vaguely menacing (though ultimately unserious) Glencore. The bigger RTZ remains, the easier it will be for it to claim that a merged group will be overly dominant, particularly as BHP-Billiton gets smaller.

We also have Barrick suffering from post-traumatic stress disorder related to Pascua Lama which has paralysed any thoughts it may have had of opportunistic buying the current slump. If anything its copper business (the former Equinox Minerals) may be the next item to be spun out as a standalone vehicle as African Barrick (now Acacia Mining) was several years ago.

The Vale Deal – Undoing Last Decade's Mistake

The Vale deal intrigues us most because it potentially creates a base metal major on the TSX to partly compensate for the ravages of the last 15 years on the ranks of majors in that market. Such a listing on the TSX would fill a gaping hole that has been evident since Noranda, Falconbridge and INCO were taken out of the market.

The idea of the INCO assets being liberated from the dead hand of Vale and returned to the international markets as a standalone nickel play has long been something we have sought. We had some talks this time last year with someone that tipped us off that Vale was pondering how to exit. Now it seems those plans are gaining traction with press reports that Vale is considering listing part of its global base metals business. This would be a way to liberate capital while iron ore is in the dumpster. Unfortunately, the chatter also said that Vale was likely to retain a majority interest in the new entity if it proceeds with the plan, whereas we would have preferred a full liberation.

Apparently the plans are to list this "new" entity in Toronto and London. Since INCO's departure the global mining markets have lacked a nickel major, with the exception of Norilsk and the mixed bag of Sherritt. Vale's non-iron ore businesses contributed 38% of its gross revenues in the third quarter. These included the nickel assets in Canada, Indonesia and New Caledonia, coal mines in Australia and Mozambique (which is up for sale) as well as copper projects in Canada, Brazil and Zambia.

We somehow doubt the coal assets will be tossed into the mix (as Mitsui have just announced acquiring an interest in the Mozambican coalfields and infrastructure projects of Vale), so it will essentially be producing nickel and putative copper in the mix. We can't help recalling that Royal Nickel's management are all essentially INCO refugees and it might not be a bad idea to fold that asset into the new entity to reincorporate the old team.

PREDATORS & PREY

The Predators

Glencore – we might as well start off with the 800-lb gorilla and state (again) that despite its rattling of its cage in RTZ's direction, we do not feel it has a snowflake's chance in hell of taking over RTZ OR anything else of substance. The Xtsrata deal was only permitted by regulators at the price of substantial divestments (Las Bambas going to MMG and the unwinding of the relationship with Nyrstar) and we are sure the Chinese do not want to have Glencore too dominant and thus would resist vigorously. We interpret its takeover talk as machismo gone wild.

MMG – Can the Las Bambas acquisition be the end-game for MMG? Somehow we doubt it. The problem here is that the Peruvian mega-project sucks in cash like a black hole leaving little spare lying about for humbler adventures. With the rundown in Zinc production (via closure of the Century mine) while copper production will soar with the Las Bambas start-up, the company will swing wildly from one exciting metal to a humdrum one. Taking over Talvivaara or Nyrstar or even Lundin could make sense.

Trafigura - the major trader, Trafigura, which ranks second only to Glencore in the metals space. This company has made some strategic investments and bought some mines outright (Coricancha in Peru) however, we senses that they are champing at the bit to "do a Glencore". In this we suspect they are more likely to follow the Glencore Mark 1 Model with a satellite entity (such as Xstrata) rather than create something like an internal entity (as Glencore is post-takeover of Xstrata). The existing mining interests could be folded into a public vehicle that would then have a symbiotic relationship with the trader much as Xstrata used to do with Glencore. It recently acquired stake in Nyrstar could provide the vehicle to achieve these goals. Acquisition of only a minor stake has allowed it to already precipitate a management spill.

X2 – the glacial pace of Mick Davis's acquisition plans for his post-Xstrata reincarnation has many frustrated who hoped he would be an indiscriminate shopper in the mining bazaar. That was never likely to happen anyway. Though the sheer absence of meaningful deals means he is under some pressure to show his investors some action, particularly as it is now that the most convincing bargains are lying around like shells on the beach. The budget here is in the low billions but it is also unlikely it will be splurged on one deal. The Nickel West business that BHP-Billiton put up for sale (and now has put on the backshelf) might have been a start. Amongst the financially stricken, Talvivaara is sitting there awaiting an acquirer while Mercator's Mineral Park or Thompson Creek could also be bite-sized targets. It could also be really counter-cyclical and make a bet on iron ore in the form of the recently bankrupted Northlands.

We (and many others) had great hopes that X2 wading into the market would be a catalyst for change and movement. The slow pace has led some to wonder whether Davis has lost his mojo. In searching for the perfect deal to pull back the curtain on, the entity seems to have come down with chronic performance anxiety. At this point with so many bargains lying around he should just swallow a blue pill and get on with it.

First Quantum – the issue here is whether this company has fully digested its last feast, the takeover of Inmet which we had hailed as the potential creation of a new Canadian major. This structure still lacks the heft to really move into the top league. If Barrick spins out its copper activities then they would make an interesting target for a merger with First Quantum.

HudBay – this company has turned out to be a sleeping giant. Coming out of the 2008 crash cashed to the gills, and narrowly escaping a Lundin merger offer, proved to be the making of the company. The old management bit the dust and a new (old) major was the result. Its acquisition of Norsemont brought the capex heavy Constantia mine in Peru onto the radar while projects like Lalor in Manitoba started to hit their stride. It recently won the bid for Augusta Resources, with its planned operations in Arizona. We are somewhat surprised that the interest in Arizona did not manifest itself in the company making a run at Mercator Minerals, or at least the assets of this stricken company. The most bite-sized target for the company is probably VMS Ventures which owns 30% of the copper-producing Reed Mine in Manitoba, with HudBay owning the rest.

Lundin – this company is one of the second tier players that is most desperately in need of a transaction. It has been left at the altar twice since 2008 with the mergers with HudBay and Inmet both coming to grief. Merging with Nyrstar would make a lot of sense. This would make Lundin into a totally vertically integrated player in the lead and Zinc space and bring on board a fistful of mines that it could probably run better than Nystar has. With its big exposure to Tenke Fungurume and the recent purchase of Freeport's Candelaria Mine in Chile the group has swung towards a large copper bias. Excepting Nyrstar we cannot see how (with few zinc projects coming alon) that it can make anoy other acquisition besides Nyrstar that makes a difference.

NewGold – this company is always a daring mover but with a slow and steady accumulation of bite-sized targets rather than biting off more than it can chew. Rainy River was the most recent bargain buy, though the company followed that up by mopping up shares in Bayfield Ventures that owned adjoining exploration territory. Newgold always surprises with its buys so we cannot begin to imagine what it might grasp at next.

Magris – This group appeared from the shadows a few months back when it announced it was paying IAMgold some $500 million in cash to get its hands on Niobec, the only Niobium miner outside Brazil. Magris is not necessarily mistaken in making its first major move upon a specialty metal mine rather than the old Bay Street object of desire, a precious metals mine.

The Magris-led group includes Singapore's Temasek Holdings and CEF Holdings Ltd, a Hong Kong-based investment company owned by Canadian Imperial Bank of Commerce and billionaire Li Ka-shing's Cheung Kong Holdings Ltd. Aaron Regent set up Magris Resources after he was ousted as chief executive of Barrick Gold in 2012. He was one of a cluster of industry figures who raised private funds to invest in mining, reasoning that public companies would sell unwanted assets at attractive prices during an industry slump.

With Niobec being the only deal so far, it’s tough to try and work out which way this group will jump next. Clearly cashflow is a major interest though. We suspect its deals for now will need to be sub-$1bn in size and in light of Barrick’s travails with mine-builds in recent times, we doubt Regent will be gung-ho piling into projects over producers. Thus Magris is a wild card in the M&A space.

Goldcorp – this gold major is suffering from a severe ego-bruising having been beaten out by two mid-size companies in the battle for Osisko. It’s like a T-Rex being seen off by two velociraptors. The obvious candidate, as we have written several times in recent months, is Chesapeake Gold where it already has a toehold. Goldcorp does NOT need a producing asset at this time. This means it can do a purchase of an advanced explorer work the project up to production and then slot the extra goldflow in when its own peak is reached several years out from now.

OZ Minerals – This company has a large mature asset in Prominent Hill and a potential massive new project in Carapateena but the latter is going to be years in the making. It has a couple of very puny JVs outside Australia that scarcely move the dial. The company has the resources to potentially splurge on a copper project (or gold/copper) in the more than billion dollar range, but it would need to be in production or very near. Which limits the field quite significantly.

Sherritt – this company is both predator and prey. Having recently ditched its coal division, it is now very substantially weighted back towards nickel and cobalt. It was mooted as a potential buyer of BHP-Billiton’s Nickel West division, which would have brought in into the Australian market. That would NOT have brought more cobalt, which we are more bullish about than nickel. The NICO project of Fortune Minerals in the NWT (and Saskatchewan) looks to have many synergies with Sherritt’s refining activities in the Plains States and its mainly gold/copper/cobalt. Not too much further afield there is Polymet in Minnesota, still soldiering on as the Last of the Mohicans now that Duluth has fallen to Antofagasta. However, the US is no-go territory for Sherritt with the Helms-Burton “problem” it has.

Teck – this company suffered bulimia in the last decade with a binge on assets before the 2008 that then resulted in a very violent and wrenching disgorgement post-crash. The acquisition of Fording of the eve of the debacle meant it was the asset that caused the problem and yet the one it could not let go of. It ended up being, like Sherritt, being overly exposed to coal.

Antofagasta – this company is probably out of the marriage market for the short-term with its major international effort being the takeover of Duluth. Antofagasta never probably imagined they could get Duluth for such a snip and unfortunately neither did Duluth (or its shareholders).

Norilsk – this player from the past is not a player this time around as the general weight of sanctions against Russia will see groups like this retreating rather than advancing. Evidence of this is the sale of some of its producing nickel assets in Australia and Botswana in recent months.

The Prey

Anything and everything beneath a certain size is potential prey …..but then again why pay an exploration junior when you can take their asset away via a rock-bottom earn-in deal?

Talvivaara – the stricken Finnish miner is the most obvious candidate to be taken out in the short term. Any resolution of the problems here would be helpful for Nyrstar. In fact if Nyrstar was in better condition we would see it as the party most likely to step in here..

Sherritt – as a target Sherritt does have somewhat of a force-field in the form of its "relations" with the US government over the matter of Cuba.

Thompson Creek – The market slump has been brutal for Thompson Creek with Moly hardly ever staging a decent rally since 2011. The attempt to diversify in buying Mount Milligan did little to ameliorate the pain despite its significant rebalancing of the company from Moly to Copper/Gold. Recent weeks have brought the announcement of a stoppage of work at Endako due to high costs (rather than low Moly prices). The company now resembles a turtle on its back waving its legs in the air unable to get traction or right itself.. This will either prove fatal or an overwhelmingly temptation for a predator. Names that are interesting to conjure with here are X2, Magris or Trafigura.

Nyrstar – Trafigura has worked itself out a pretty nifty relationship with Nyrstar, but the problem is that Nyrstar might not be similarly so thrilled with the way it is playing out. Market reports indicate that Trafigura started in September to build a stake which now amounts to at least 15%, making it the company's largest shareholder. Of course a merger between the two would make the most sense, as it would be synergistic and create a stronger competitor for Glencore, which dominates the Zinc trading space. However those with longer memories will recall that competition authorities forced Glencore to divest its stake in Nyrstar and unravel some trading relationships with Nyrstar when it took over Xstrata in the process becoming even more dominant in the metals Nyrstar smelts. Thus one could see that maybe pressure would be put on Trafigura in a proper merger with Nyrstar to reduce its strong position also.

Nyrstar though should be of attraction to others, despite Trafigura's headstart. X2 would be a good candidate as it could then move on Talvivaara as well. Revenge would also be sweet as it would make X2 one of Glencore's major competitors. Teck are veterans at the smelting game and thus it would also be a good fit geographically and otherwise with their Trail smelter. And as we mentioned before, it would be a good fit with Lundin which must already be sending some of its European zinc output to Nyrstar's facilities.

Chesapeake Gold – This is another target that has the name of the predator written all over it, with Goldcorp already having a share foothold (of over 9%) and a director in common. Compared to any of the other potential buys out there, Chesapeake represents the best way of Goldcorp plugging a production decline in its mid-term outlook. Other majors have more pressing production declines and thus need to outbid Goldcorp to plug those gaps. Goldcorp on the other hand has the time to develop Metates to fill a future need IF it moves in the next year to eighteen months.

The rationales can we put forward for Goldcorp going after Chesapeake are:

- ✓ Cheap, cheap, cheap
- ✓ Familiarity with the story
- ✓ Confidence in the CEO
- ✓ Mexico being familiar territory
- ✓ Substantial size of gold resource
- ✓ Extensive mine-life

Yamana – We see the Osisko "white clown" rescue as having weakened Yamana. The spin-off of the Brazilian assets into a structure called Brio Gold, makes Yamana less of a gold company and thus potentially of more interest to any number of copper players that would like to have their hands on the Alumbrera property and the shamefully underdeveloped Agua Rica polymetallic deposit in Argentina that is near Alumbrera. The sheer incompetence of Yamana's management should be enough to set off Blue Light Special signs flashing around it. A takeover of Yamana could put Osisko back in play or force Agnico to undertake a proper merger with Osisko to save its own skin. X2 could gang up with Goldcorp to bring about such an outcome.

Veris Gold – the old Yukon Nevada had been sliding towards the abyss for a while. Despite management that the word "omnishambles" was invented for, the prime asset of the Jerritt Canyon mine and mill remains almost unique and a key playing piece in Nevada power games being one of only three approved refractory roasters in the state. The gormlessness of the crew in the executive suite meant that the company spent a long time unprofitably tolling ore for Newmont, making itself poorer and more dependent in the process.

Mercator Minerals – the failure of this company's announced merger with the Russian group, InterGeo had an ultimately fatal effect tipping it into bankruptcy. It is not clear to us what happens next but the Mineral Park property is a long term producer and should be of interest to someone wanting to secure one of the few producing copper mines in the US. The company also owns two properties in Mexico, including the Creston molybdenum project, which we covered several times back in its guise as the main asset of Creston Moly. It is not clear to us who has a first charge over the assets not that it is in legal limbo.

Miscellaneous – if one cannot imagine being less attractive than Mercator or Veris, then spare a thought for Centerra and Centamin. Both of these have embedded problems that should potentially scare away any predators in a way that makes dealing with companies in the bankruptcy courts look like easy pickings.

Conclusion

The fact that there are so many assets still at bargain basement prices should mean it's a happy hunting ground for majors (or at least larger miners) in the darker corners of the TSX and ASX (and the bankruptcy courts).

With big dumb majors shedding assets in rather a "baby out with bathwater" style there should be much that a cashed-up predator can hoover up. However not finding willing takers for sales in single lots (standalone mines) or job lots (like Nickel West) the majors are now resorting to a sort of reverse osmosis where they divide and replicate by carving off big chunks of their asset bases into standalone vehicles. If this results in the creation of more majors it is a welcome development in our book as the concentration at the top resulted in a near extinction of the mid-sized miner over the last ten years which goes a long way to explaining why normal Darwinian forces of rationalization and regeneration have eluded the mining sector…

However what it also does is remove those with the biggest balance sheets, cash-flows and cashpiles from the mating dance of mining M&A. Sure they may be in condition and the mood to transact when they have digested their reorganizations and listings (in 2016) which does not help the situation currently.

Despite this paralysis at the top there are more than enough predators and no end of prey further down the mining food chain. For once we would not complain if a feeding frenzy broke out…. we are long overdue for some rational exuberance…

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