Mining in a downturn: what's in it for China?

The last quarter of 2008 saw the end of a boom in the global mining industry. While some commodity analysts foresaw the collapse of mining and metal prices, very few predicted the speed of the declines or their steep descent. Record prices, net profits and expansion plans in the first half of the year suddenly gave way to falling commodity prices, reduced profits, production cuts and mine closures in the last quarter of the year and the first half of 2009.

With stronger balance sheets and an overwhelming confidence in the key supply and demand drivers of the industry, Chinese mining companies are not only finding new opportunities in the current predicament, but are also set to emerge from the crisis with an enhanced role in the global mining industry.

Different impact, different responses

With the unfolding of the financial crisis and the dramatic decline in demand, commodity prices went into free fall. This severely affected the confidence of investors, who rapidly started selling shares, resulting in a severe drop of the market value of listed mining companies (both small-caps and blue chips). According to Mine, the PwC annual report on the global mining industry, the market capitalisation of the world's top 40 mining companies last year fell 62 per cent compared to 2006 levels.

With stock prices down and limited means to generate internal cash flow from operations, the only source of funds left was equity financing. But with the credit crunch, the ability of firms to raise funds in the market became virtually impossible, resulting in reductions in exploration, divestments, difficulties in debt repayment and increasing risks of being taken over or bankruptcy. Yet this was not the case with Chinese companies.

In addition to the reserves provided by record profits achieved by Chinese mining firms in 2007 and 2008, Chinese banks and financial institutions, which had minimal exposure to subprime assets, were encouraged by the government to support their domestic champions. As a result, China's state banks lent nearly US$1.1 trillion in the first half of 2009 (the US stimulus package amounted to $800 billion), while the People's Bank of China announced that China's forex reserves had reached $2.13 trillion, the first time any country had surpassed the one trillion dollar benchmark.

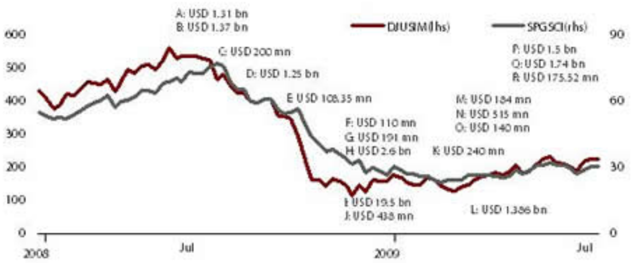
As expected, Chinese firms have not been slow to make the most of the opportunity.

Hunting for bargains

With the market value of global mining and metal stocks currently low, Chinese mining firms are eager to pursue overseas acquisitions at attractive prices. Yet from the other side of the chessboard, Chinese companies are perceived as the only fund-raising strategy available to survive the commodity cycle. For Chinese mining firms, the timing is just right.

A good example of this is CMN, a subsidiary of China Minmetals, which recently acquired the Australian miner OZ Minerals, the world's second-largest producer of zinc. OZ Minerals urgently needed cash to refinance its debt and CMN raised its bid to $1.38 billion. In another move to reduce bank debt, Canada's largest diversified mining company, Teck Resources, recently sold a 17 per cent stake to China Investment Corporation (CIC), China's $200 billion sovereign wealth fund, for $1.74 billion - the first major Chinese investment in a Canadian company. And the list goes on.

Selected Chinese Mining Investments in the Downturn



Note: Dow Jones US Industrial Metals & Mining Index (DJUSIM) is used as a benchmark for asset prices while S&P Goldman Sachs Commondity Index (SPGSCI) is used as a benchmark for commodity prices.

A: Sinosteel - Midwest (Australia)
B: MCC - Ramu Nickel (PNG)
C: Nanjinzhao - SAC (Pero)
D: Xinwen - Teresa Coal (Australia)
E: Angang - Gindalbie Metals (Australia)
F: Shougang - Mount Gibson (Australia)
G: Shenhua Energy - Coal (Australia)
H: China Union - Bong Iron (Liberia)
I: Chinalco - Rio Tinto (Australia) FAILED
J: Hunan Valin - Fortescue (Australia)
K: WISCO - Consolidated Thompson (Canada)
L: Minmetals - OZ Minerals (Australia)
M: CNMC - Lynas Corp. (Australia)
N: MCC - Waratah Coal (Australia)
O: Guangsheng - PNA (Australia)
P: Chinalco - Rio Tinto (Australia)
Q: CIC - Teck Resources (Canada)
R: WISCO - JV with Centrex (Australia)

Stockpiling fever

The Chinese are not only finding opportunities for investment but also trade. With the collapse of commodity prices in mid-2008, and considering the ample availability of credit provided by domestic banks, China started to import massive amounts of metals and minerals, setting new import records.

For example, China's iron ore imports in June hit 55.32 million tonnes, up 46.6 per cent year-on-year (also up 29.3 per cent for the first six months year-on-year), reaching the second highest level on record after April, while refined copper imports climbed to 378,943 tonnes, up 398 per cent year-on-year (also up 159 per cent for the first six months year-on-year). It was a similar story with nickel, all contributing to China's build-up of strategic stockpiles, which has enabled China to kill two birds with one stone.

Firstly, China needs resources to feed its growing economy (with GDP growing at 7.9 per cent in the second quarter of 2009) and, with current price levels, it seems to be right moment to buy. This is largely thanks to China's fiscal stimulus package of $585 billion, much of which will be spent on infrastructure and the construction of highways, roads and bridges. China's manufacturing is also expanding as the stimulus is being implemented. Secondly, the Chinese government is actively supporting the domestic mining industry. When China's State Reserve Bureau (SRB) announced in December that it would fund the acquisition of large metal stockpiles, it had to push domestic prices up again, at least high enough for local producers (miners and smelters) to get back to their production lines.

Yet this has also had some collateral effects. As spot prices have increased, some traders, speculators and domestic producers with import licences, made use of the easy lending to buy cheap ore abroad and stockpile the ore in ports, waiting for metal prices to rise again.

Aware of the unsustainability and associated risks of strategic stockpiling, representatives of China's National Development and Reform Commission (NDRC) recently announced that the government had stopped its metal stockpiling programme. This may potentially push down metal prices again over the short term and allow infrastructure projects to offset the falls.

High expectations or recovery?

Industry experts believe that the long-term fundamentals will sooner or later push metal and mineral prices up again. Yet the questions right now are: when, and how fast this will happen?

While the industry's prospects remain uncertain, depending on a substantive rebound in demand in the US, Europe and Japan, China's resource needs will remain significant in the long term and its outward investment footprint in the metals and mineral industry will likewise increase. International companies, which are able to anticipate China's expansive trends and position themselves strategically, are likely to create a significant advantage for their shareholders.

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