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Rough market terrain hobbles metals and mining sector

Companies in the metals and mining sector continue to battle major economic headwinds that have resulted in many high-profile Chapter 11 bankruptcy filings in the past two years—particularly in the coal subsector. But companies can improve their chances of surviving this prolonged stretch of distressed conditions and increase the likelihood of long-term viability by a decisive, targeted, and proactive focus on cash, cost structure, and debt management.

The numbers show that 2015 was an especially difficult year for the metals and mining sector, and 2016 is shaping up to be even tougher. The industry suffered the highest issuer-denominated default rate in 2015 (figure 1), at 6.5%, with oil & gas a close second, at 6.3%. Metals and mining accounted for 14% of all defaults.[1] Arch Coal's Chapter 11 filing in January[2] continued the wave of distressed activity in 2016, marked most recently by Peabody Energy's filing in mid-April.[3] Those two follow large-scale 2015 filings by Alpha Natural Resources,[4] Walter Energy,[5] and Patriot Coal (its second filing since 2012),[6] as well as defaults by Berau Coal Energy[7] and Ferrexpo,[8] among others. Though the coal subsector was especially hard hit in 2015 and at the start of 2016, other metals and mining companies also began formal restructurings. They include US-based Molycorp (rare earths),[9] Magnetation (iron ore),[10] Canada-based Essar Steel Algoma,[11] and Noranda Aluminum.[12]

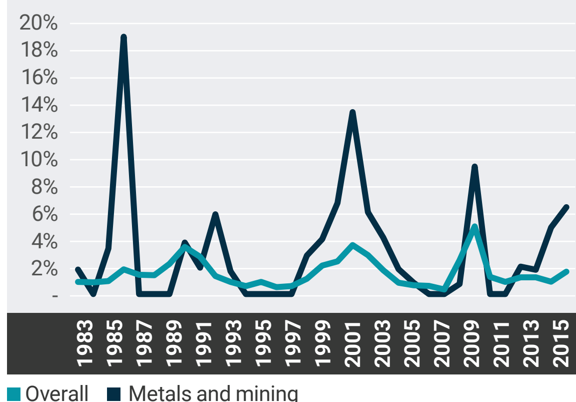
PROLONGED DOWNTURN WILL LIKELY CONTINUE

Metals and mining companies generally are capital-intensive businesses with high fixed operating costs. They typically have long histories that can mean high legacy costs, such as retiree benefits, union-related expenses, pension costs, and environmental obligations. Legacy costs represent a major reason the industry's default rate is outpacing the broader market's.

Most of the recent restructuring activity involves North American operations, but global factors affect the entire industry. Economic growth in China and high metals and commodities prices from 2010 to 2012 prompted many companies to invest in new production capacity, much of it financed through new debt.

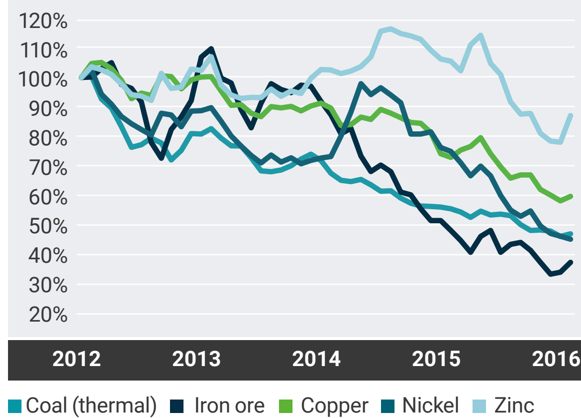
China, which had been mining 95% of the world's rare earth minerals, in 2010 announced a 40% reduction in its own export quotas.[13] The announcement spurred a global wave of investment in rare earth mining capacity. Molycorp reopened its Mountain Pass mine in California, which had been idled since 2002,[14] and other rare earth miners in Australia and Malaysia expanded.[15] In the coal sector, historically high metallurgical coal prices encouraged new projects, including additional capacity in Australia[16] —primarily to serve the Asian metals markets.[17] In a specific example, Walter Energy—to increase its access to Pacific and Atlantic basin markets—in 2011 bought Western Coal, a metallurgical coal miner with operations in western Canada, West Virginia, and the United Kingdom.[18]

FIGURE 1: US ISSUER-DENOMINATED DEFAULT RATES, 1983 TO 2015



Source: Moodys

FIGURE 2: SELECTED ORE PRICING, 2012 TO 2016 (JANUARY 2012 = 100)



Source: World Bank Commodity Outlook

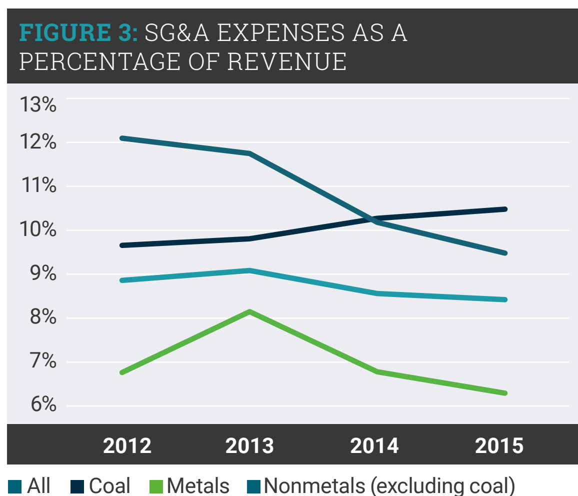
It takes time for metals and mining companies to create new capacity, as it does in most high-capital and high-fixed-cost businesses. When expansion happens, though, it happens on a large scale. By 2015, market conditions had already declined as most new capacity came on line, and due to slower Chinese and Brazilian economic growth, demand dropped as supply grew. The situation created two major effects: First, reduced investment in oil & gas exploration lowered demand for steel, which in turn reduced demand for metallurgical coal, iron ore, and other steelmaking components. During the past four years, steel prices have fallen by approximately 35%, from approximately $700 per metric ton in January 2012 to approximately $450 per ton in April 2016.[19] Second, lower oil & gas prices improved contribution margins for miners but also reduced the cost of substitutes for steel (aluminum and plastics) and steam coal (natural gas). That put further pressure on the demand for metals and coal and led to intense pricing pressure. Since 2012, thermal coal and iron ore prices have fallen by approximately 33% and 31%, respectively (figure 2).

In this pricing environment, debt-heavy capital structures aren't sustainable in the long term, as was demonstrated by the recent spate of restructuring activity. Mining and production capacity take time to create and tend to be sticky—and tough to cut back quickly when demand and prices fall. High-fixed costs mean that contribution margins can remain positive even for higher-cost capacity, even if the enterprise operates at a loss. And because idling and retirement costs are high, operating at a cash loss may be more attractive than a more costly shutdown.

Reductions in overhead costs have barely kept pace with revenue declines—particularly in the coal sector. An AlixPartners analysis of 97 publicly traded metals and mining companies with annual revenues of at least $500 million showed minimal declines in selling, general, and administrative expenses (SG&A) as a percentage of revenue in the past four years (figure 3). The average went from a median of 8.8% in 2012 to 8.4% in 2015. Revenues for these companies actually fell by a compound annual rate of minus 8.0% in the same period.

In the coal subsector, SG&A as a percentage of revenue actually increased from a median of 9.6% in 2012 to 10.5% in 2015, though revenue declines outpace the broader metals and mining sector by an average of minus 9.4% per year.

FIGURE 3: SG&A EXPENSES AS A PERCENTAGE OF REVENUE



Source: Capital IQ

A CHALLENGING NEAR-TERM OUTLOOK

The shakeout for the sector will likely be protracted, with more balance sheet restructuring activity accompanying the industrywide recalibration of supply and demand. All signs point toward continued elevated default levels for 2016.

Of the 97 companies analyzed, 57 (55%) had Altman Z-scores of less than 1.8, indicating a high likelihood of filing for bankruptcy unless immediate and significant measures are taken. Another 20 (22%) had scores of 1.8 to 3.0, indicating some level of financial stress (figure 4).

Within the coal subsector, the level of financial health is even lower, with 36 of 49 (73%) of the scores indicating distress and an additional 6 companies' scores (12%) indicating stress.

OPERATORS CAN TAKE STEPS TO REDUCE THE STRESS

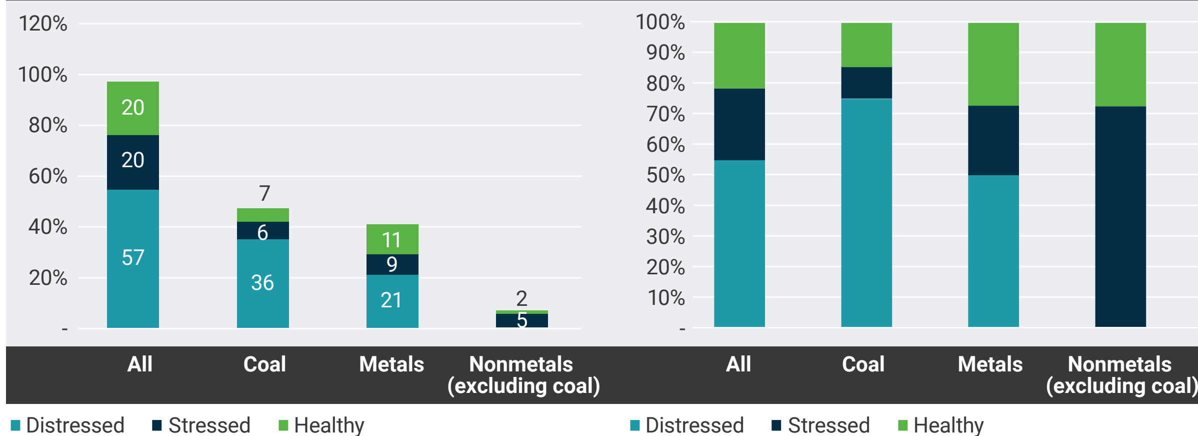
The roiling in the metals and mining sector shows little sign of abating. The sector is still plagued by a depressed pricing environment, lackluster economic growth in key markets, excess supply, and regulatory hurdles. For management and investors, the significant challenges are clear—and amplified by the asset-intensive, high-fixed-cost bases that companies need just to operate. Companies seeking to manage through the downturn need to take the following decisive steps.

Instill a cash-is-king mentality across the organization

Low worldwide prices will likely increase pressure on companies to meet covenants and service commitments. Operators should make weekly cash forecasts, which would serve to offer much-needed ongoing visibility for cash needs and potential shortfalls. Such forecasts could give operators more time and more flexibility for taking measures that would improve liquidity, such as selling off excess inventory or fixed assets. The forecasts would also help develop a cash-focused culture. Simply *implementing* a forecast process would require an organization to focus on the timing of receipts and disbursements rather than on accounting events. And getting a detailed quarterly liquidity profile would spotlight cash generation measures and cash preservation alternatives that could include pulling receipts forward by offering selected customers onetime, early-pay discounts; or pushing disbursement timing outward, thereby completely eliminating uncommitted spending; or even changing the mine or mill's operating configuration. All of these measures can help preserve liquidity and maintain the broadest possible range of options.

Additional sources of cash often are found across the balance sheet. Working-capital management becomes more important, though in some organizations it takes a backseat to traditional profitability metrics.

FIGURE 4: ALTMAN Z-SCORE CATEGORIZATION BY SUBSECTOR BY COUNT AND PERCENTAGE



Source: Capital IQ and AlixPartners

In a profit-and-loss-driven (P&L) world, selling excess inventory or fixed assets at low margins or below cost might be unthinkable. But when cash is king, managers find ways of developing creative solutions for marketing excess inventories or can find themselves willing to part with fixed assets they'd otherwise have kept for an eventual market upswing. Balance sheet review exercises also sometimes turn up opportunities that haven't been seriously considered before such as cashing in key-person insurance policies.

Drive cost reductions and operational efficiency

Minimizing costs and moving an organization down the cost curve during periods of rapidly declining prices is always daunting. It's even harder in an industry that has to shed excess production capacity. Cutting SG&A makes a start, but it's generally not a complete solution during a long-term downturn. Rigorous and continuous attention can help curb the staffing costs of direct and indirect labor. There may also be chances to renegotiate costs of supplies and services or find vendor consolidation opportunities. Considering different operating configurations may offer a clear view of potential cost levers that drive out inefficiencies, reduce unit costs, and preserve options for a time when industry conditions change.

We've witnessed a relatively high degree of vendor cooperation in pricing and payment terms as other supply chain participants recognize they, too, face the threat of financial distress in the current environment. So, potential changes to operating scenarios should be viewed on a cash basis rather than a P&L basis. For example, a decision to idle some or all production should consider the cash costs of idling versus any actual cash contribution rather than considering only P&L impact. Understanding breakeven price points and overall market supply and demand is critical, especially in determining when and under what conditions idled capacity might be turned back on.

Address capital structure issues early

A proactive focus on liquidity should also focus on other debt covenants. Companies can effectively use financial projections to identify which levels of pricing and cost scenarios could lead to possible covenant defaults and on what time horizon. Recent history shows that a severe downturn makes it much harder to refinance upcoming maturities, which often results in default. Successful management teams develop and pursue financing alternatives, and they plan for contingencies well before a default gets triggered. Engaging creditors and other constituencies such as bonding providers and state regulators might give a company more time and a wider set of options. Doing so can also dramatically improve the ability to reduce leverage and modify covenants.

Focusing on liquidity, cost structure, and capital structure can help buy time, and can ultimately position operators to thrive when the market improves; but to thrive in an upturn in the mining and metals sector, companies must first survive the downturn. A

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