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HD **Mining: Next Aussie mining M&A wave to dig deep**

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Deals in Australia's resources sector have a high failure rate. Lessons learnt from the past will bring a new era of smaller deals led by private buyers.

The next big wave of foreign investment into Australia's mining sector will be driven by nimble private companies taking advantage of depressed prices and stalled projects, according to M&A watchers. The targets are likely to be struggling mining companies that have plenty of potential but not enough cash to reach first production.

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This focus on smaller deals led by private acquirers will make this round of deals look very different from the previous wave, which ended when commodity prices slumped in mid-2010, says Adam Goern, director of advisory firm TPA & Co in Hong Kong.

Goern is currently advising an early stage private investment vehicle targeting the resources sector, and says the latest wave could surprise on the upside, bringing a higher rate of success as buyers apply lessons from the past.

'It will contain buyers and sellers with more experience and the deals will focus more on physical returns rather than purely financial returns,' says Goern. 'Similarly, I see an increase in the number of deals that can be scaled up and become part of the fabric of the existing business relationship.'

Typical of this trend is Kingho Energy's current takeover offer for coal companyCarabella Resources. Kingho is a privately owned Chinese mining company ready to spread its wings overseas, while Carabella is sitting on an untapped deposit of hard coking coal in Queensland's Bowen Basin region.

The price tag of Adollars 71 million (USdollars 62 million) is paltry in comparison to the mega-deals of the past, but Kingho is expected to spend up to dollars 900 million to bring Carabella's various projects to completion.

Starting out small and conducting proper risk assessment could be key to improving the run-rate on successful acquisitions. Australia's mining sector is strewn with aborted cross-border deals from Chinalco's attempt to buy a dollars 19.5 billion stake in Rio Tinto in 2009 to Sichuan Hanlong's dollars 1.2 billion pitch for Sundance Resources in April last year. It is estimated that between mid-2008 and mid-2013 as many as 42% of all mining deals by value ended in failure, according to data compiled by Bloomberg.

Foreign investors have been rattled by Australia's tough industrial relations and environmental rules, and it can also be expensive to build the necessary infrastructure to transport materials from site to ship. Citic Pacific's Sino Iron project in Western Australia is a case in point. In January this year it made its first shipment of ore concentrate - four years behind schedule and dollars 6 billion over budget.

Andrew Low, founder of inbound M&A firm RedBridge Grant Samuel, is working on a research project with Sydney University to review about 120 recent investments into Australia (with a deal value of dollars 20 million or above) to find out how successful they have been.

Low says deals that fail usually suffer from poor due diligence. 'Some overseas buyers assume the regulatory and cultural environment is similar to their home market but Australia's labour laws and environmental rules are strict, by comparison, and the government isn't obliged or likely to help out if things go sour.'

The reason future success may lie in smaller deals - like Kingho's tilt for Carabella - is that small to mid-cap companies are easier to digest. And this is where the need for capital is greatest.

Matthew Moore, senior analyst at Moody's, says smaller companies are suffering from earnings compression and face project execution challenges. 'There are issues with increased project costs, schedule delays and difficulties ramping up existing **operations** to achieve higher production and recovery rates,' he says, indicating that smaller companies have fewer opportunities to reduce costs and capital expenditure.

'All of this requires smaller companies to have an adequate liquidity buffer,' he says. 'If they are liquidity constrained and in the middle of trying to reach first shipment on a project then bringing in an investor is one way of ensuring completion.'

Moore says the financial profiles of junior miners are certainly under pressure. However, the sector is more stressed than distressed, says Jay Leary, partner and co-head of Herbert Smith Freehills' **mining** practice. 'The market was expecting a mass of insolvencies, but this hasn't eventuated,' says Leary. 'Demand for key commodities remains strong, and even though prices have come off from their pre-crisis highs, the demand/supply equation continues to favour producers.'

Low believes the sweet spot for potential buyers is in companies that are sitting on a mineral deposit but don't have enough money to connect their projects to a railway or port. 'This is where the demand for capital injections is greatest,' he says.

Still, not every junior miner in this predicament is a good buy. Low recommends pinpointing assets with sufficiently high quality deposits to avoid a blow out in extraction budgets. 'With commodity prices jumping around, high extraction costs can quickly erode profitability.' Low also cautions against assets in hard to reach corners of the country. 'Whatever you think it might cost to build connecting infrastructure, it could in fact cost multiples of that,' he said.

While the next wave of investment will bring new targets, it could also see the rise of a new type of buyer - not large state-owned enterprises but more agile private buyers. One such display of agility was seen in March last year when **China**'s Chengdu Tianqi beat a much larger US **company**, Rockwood, in the auction of West Australian lithium producer Talison. Tianqi played its cards well by lining up financing and approvals ahead of time. Then, just eight months after the initial transaction, Tianqi sold down 49% of Talison to Rockwood for Adollars 1.2 **billion**, pocketing about Adollars 200 **million** on the **sale**.

'Some recent transactions have demonstrated a higher level of sophistication in their execution and deals are now being driven by privately owned companies that can sometimes move more quickly and flexibly than the larger state-owned companies,' says Low at RedBridge. 'The National Development and Reform Commission has been working to relax the approval process for outbound acquisitions which will smooth the way for **Chinese** bidders to be more competitive with others.'

The new breed of private buyer might also include financial sponsors. Traditionally, private **equity** firms have preferred **mining** services companies over investing directly in mines and taking commodity risk. However, attitudes are changing. One of the owners in Talison before Tianqi bought the business was Noonday Asset Management, a San Francisco-based asset manager that was rebranded to Farallon Capital in November last year.

Another example of private **equity** participation in direct **mining** is **Hong Kong**-based private **equity** fund Sprint Capital's investment in Stanmore **Coal**. In 2012, Sprint injected Adollars 36 **million** in **equity** and zero-coupon notes for a 25% **stake** in the **coal** developer.

Looking ahead, Leary at Herbert Smith Freehills hopes to see an increase in the number of deals that actually reach completion. Last year up to 85% of the **mining** deals the law **firm** worked on didn't get signed.

'There was no urgency around many of the deals and there was often a price gap between what the vendors wanted and what the buyers were prepared to pay,' he says. 'This year we expect to see a more structured sales processes. There is a much stronger group of buyers out there and we have already been fielding new enquiries from **Chinese**, Japanese, Korean and Indian companies.'

42% - Failure rate of all **mining** deals mid-2008 to mid-2013

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