Industry Top Trends 2020
Metals and Mining
Cautious pessimism greets the second downturn in five years

What’s changed?

Prices and volumes have dropped amid weak indicators. Our revenue expectations for 2020 remain fairly weak, after declining almost across the board in 2019 for base and bulk metals, as a result of slower auto production and weak construction.

Market conditions are eating into credit buffers. Weaker cash flows in 2019 and 2020 will arrest the improvement in debt leverage since the 2015-2016 downturn.

The outlook bias has shifted negative again. Negative outlooks exceed positive outlooks in metals and mining, reversing a brief positive bias in 2018.

What to look for in the sector in 2020?

Production cuts must take hold. With a tepid demand outlook for 2020, output reductions that rebalance consumption and inventories could be key to a pickup in prices and profits, particularly in steel and aluminum.

Blockbuster M&A is giving way to asset reshuffling. The decline in metals and mining equities in 2019 has slowed M&A to a trickle. That said, the gold sector looks primed for asset transactions, with large miners looking to shed less productive assets after major acquisitions in the past year.

Tariffs are reducing steel and aluminum imports, but prices are still tumbling. Tariffs into the EU and U.S. insulated domestic volumes, but trade barriers haven’t prevented a sharp downturn in global prices in 2019.

What are the key medium-term credit drivers?

Capex and acquisitions adjust the competitive landscape. Issuers aim to bolster their businesses by investing, acquiring, or pruning.

Maturity wall looms for spec-grade companies. Debt maturities escalate quickly in 2022 and 2023, and the metals and mining sector has among the highest proportion of speculative-grade issuers in our ratings universe.

ESG is core to credit ratings. In addition to headline-grabbing catastrophic failures that prompt rating actions, our ratings on steel producers provide a good indicator of competitive assessment differentiation and financial costs caused by ESG factors.
Several key indicators turned negative in 2019, most notably the net outlook bias, increasing pressure on a low-rated sector. The 'B' category accounts for two-thirds of our ratings in metals and mining, which indicates our view of those issuers’ inherent volatility and capricious access to capital markets. That said, pressure on credit may be less acute this time around because many issuers had curtailed less profitable output, lowered capex, and reduced debt in 2018, leaving little opportunity for the debt-funded corporate development activity that provoked downgrades in previous cycles. On the other hand, low returns over the past decade are causing tighter capital budgets that could weaken the sustainability of operations.
Industry Outlook

Key assumptions

1. Lower prices and volumes from slowing economic growth

Global trade and macroeconomic concerns have contributed to a weaker outlook for several metals and mining commodities tracked by S&P Global Ratings. In addition to plunging prices in 2019, metal demand and consumption appear to be declining, which is remarkable and could indicate economic weakness instead of just an industry downturn.

2. Organic growth and asset sales will temper cost inflation

We expect modest cost inflation to continue across much of the metals and mining sector, likely in the low single-digit percentage area. Efficiency initiatives have become core to most issuers' operating strategies and, in certain cases, yielded meaningful cost savings.

3. Balance-sheet repair should ease the downside

We believe the majority of metals and mining companies are better positioned to manage this price downturn than the previous one in 2015-2016 because of lower debt leverage from a concerted effort to reduce debt across the sector.

Lower debt levels should cushion profit decline

Lower demand, partially caused by global trade friction, is combining with another U.S. political hot button, as the dollar strengthens and pinches export competitiveness. It is difficult to conclude that tariffs have insulated any producers in the U.S. or Europe from supply in Asia that can ultimately find its way into protected markets.

The phase of balance-sheet repair in 2017-2018 contributed to the only positive bias in six years, and weaker earnings prospects are driving this down heading into 2020. The current 5%-10% negative bias is nowhere near the depths of almost 40% in the two years 2016 and 2017, which occurred because the commodity downturn coincided with heavy debt loads and capital commitments in a buoyant economy.

The weak price environment for most metals follows the strength that persisted through the first half of 2019. For example, copper prices averaged close to US$3.00 per pound (/lb) earlier this year before a steady descent to below $2.60/lb over the past few months. We expect modest supply growth across most of the sector. Barring a weaker macroeconomic climate, we believe relatively balanced supply/demand fundamentals should limit sustained price declines for most metals and mining commodities tracked by S&P Global (see “S&P Global Ratings Cuts Copper and Zinc Price Assumptions And Lifts Those On Nickel And Gold,” Oct. 9, 2019, for our most recent price assumptions).

Profit turnaround is key for refinancing in 12-18 months

Metals prices in a few cases are approaching decade lows, and numerous assets globally are operating near cash breakeven, which typically incentivizes production cuts. The key issue for corporate profitability at the lowest end of the rating spectrum could be the persistence of this downturn, rather than the depth, because we believe that liquidity is adequate to support a quick downturn, but debt maturities in 2021 loom. Prices swing regularly, with a sharp drop most recently in 2015-2016 amid still growing demand volumes, but industrial metals volumes haven’t actually dropped on a year-over-year basis since the financial crisis. In our view, softer demand fundamentals remain a key risk for industrial-linked mining commodities, namely aluminum, copper, zinc, and iron.
ore. Much of this reflects the increased likelihood of slowing economic growth, notably impacted by the trade disputes between the U.S. and China that have negatively affected global trade flows. Interest rate reductions in the U.S. and elsewhere have followed, and contributed to the resurgence in gold prices from a multi-year lull.

Credit markets in the second half of 2019 have been poor for speculative-grade metals issuers; about 85%-90% of the issuers in this sector have speculative-grade ratings, and about two-thirds of the debt is high-yield. We expect that many would access markets at an early opportunity because of impending maturities in this sector and among most industrials.

We expect most issuers to have greater capacity to manage a protracted period of weaker prices before ratings are jeopardized, and lower debt reduces the relative sensitivity of weaker earnings and cash flow on credit measures. Moreover, restrained capital commitments and growth investing should preserve some cash flow cushion in a downturn. In a lower price scenario, we expect issuers to curtail shareholder returns, which had increased materially over the past year but were funded from windfall free cash flow rather than higher debt. In our view, this reflects the commitment across much of the sector to maintain or, in certain instances, reduce long-term leverage targets.

We assume material unit cost improvement will prove elusive for most issuers: steadily higher labor rates, consumables price inflation, and the impact of declining grades across certain commodity segments remain key headwinds. Issuers engaged in significant development projects that accelerate organic growth present opportunities to stabilize or trim cash and all-in sustaining costs. We expect certain miners to sell assets with cost profiles that exceed their consolidated average, although the benefits will likely be less pronounced for globally diversified players.
Key risks and opportunities

1. Sharp economic downturn causes lower prices for longer
We are forecasting slower global economic growth in 2020, and a sharper decline could worsen the deterioration in metals markets. China’s GDP growth slowed to 6.0% in Q3 2019, the slowest in 27 years.

2. Shareholder returns or new investments consume precious capital
After several years of pushing back costs and optimizing capex, we might see an increase in capital allocation toward share repurchases and dividends, as well as companies pursuing acquisitions to increase portfolio diversification and to optimize energy use.

3. Steel profitability could bounce back
We estimate average steel producer margins will improve modestly in 2020 from currently weak levels. Steel prices deteriorated sharply through 2019, and we expect that production cutbacks could boost prices from depressed levels.

China’s metal demand slows
Growth in China’s infrastructure investment was 4.5% year to date in September 2019, much lower than the 20% growth three years ago due to the government’s deleveraging initiatives. Further, we believe the government will take this opportunity to transform the economy by reducing risk from high debt and phasing out inefficient and uncompetitive companies from industries that are over capacity, which will put downward pressure on overall demand. We assume most metal prices will remain stable or improve in 2020, but inherent volatility and economic sensitivity could cause prices to fall even further, leading to shortfalls in cash flow and capacity closures. Most issuers have high operating leverage that would be affected by relatively small changes in prices, particularly at currently low levels. As such, prices modestly below our current assumptions could have a meaningful impact on our estimates and potentially start moving credit ratings down.

Leading miners return capital to shareholders
The growing concerns in the market will mean conservatism continues into 2020. After the top five global miners reached or even exceeded their gearing objectives, all except Vale shifted to shareholder returns. We are now forecasting total returns to shareholders of close to $40 billion in 2020 by the big miners compared to slightly less than $30 billion in 2019. However, this level is unlikely to be sustainable, as lower commodity prices, namely iron ore and coking coal, will translate into lower free cash flows. In this respect, with companies’ comfortable debt positions and low appetite for investments, commodity prices are becoming slightly less important. A movement of $10 per ton for iron ore will translate into a direct change in the returns to shareholders, and this would change only if commodity prices fell materially.

From a rating perspective, we assume that major miners will maintain ample rating headroom in 2020. Under our stress test, an extended price shock doesn’t lead to downgrades (see “How Would The Top Five Global Miners Fare In A Downturn?” July 9, 2018). However, this is not going to be the case for small miners. The current weakness in commodity prices and some pressure on costs has already started to pressure their cash flows and liquidity, causing several negative rating actions in 2019.

In contrast to previous commodity cycles, these companies have refrained from large acquisitions or multiple ambitious greenfield projects. We believe that the big five, like most other companies in the mining sector, will continue to focus on organic growth and improving cost profiles. Most producers view prospective acquisitions as too expensive
relative to brownfield expansion projects, nor do most acquisitions fit portfolios for reasons like country risk or exposure to specific commodities. Based on recent capex guidance, spending in 2020 and 2021 should remain fairly flat.

Highlighting the portfolio pruning in late 2019, Barrick agreed to sell its 50% joint-venture interest in its long-held Kalgoorlie mining operation for $750 million. Meanwhile, mid-tier producers are aiming to bolster production and reserves amid progressively difficult opportunities for organic growth. Issuers remain wary of the long-term benefit of large transactions with debt-funded premiums because meaningful cost or revenue synergies and incremental returns have proven difficult to achieve in this capital-intensive commodity industry. Returns on capital for gold miners have been dismal despite a decade of elevated gold prices and good margins, because capital investments to sustain production and for M&A have yielded single-digit returns, at best. Several large and midsize gold producers will consider a range of scenarios that extract cost synergies at operations, none of which would include much additional debt.

Steel and aluminum makers aim to deleverage and develop their businesses

The deleveraging trend that started with the largest global miners hasn’t skipped metal producers. However, unlike the miners, most companies couldn’t meet their targets because of the sharp and quick downturn in steel and aluminum, despite trade barriers meant to insulate these companies.

Slower demand is a key risk facing steel producers, and may not be offset sufficiently by capacity curtailment. In our view, integrated steel producers (blast furnace operators) are the most susceptible to weaker prices; the price of iron ore, a critical input for integrated steelmaking, remains elevated and we assume only a slight moderation in 2020. In contrast, we believe electric arc furnace (EAF) steel producers should sustain relatively stable margins given the historically tight correlation with steel scrap, its primary raw material. However, steel spreads (a benchmark of hot-rolled coil minus scrap steel) have tightened recently to $275-$300/st compared with an average of $480/st in 2018 because of unusually high steel prices averaging $830/st. We note that if prices remain at this level or steel spreads tighten further for several quarters, companies may experience short-term pressure on credit metrics in 2020. This is not our base case, as margins should benefit from reduced supply following several rounds of production cuts and a potential pickup in infrastructure investment. Prices for long steel products, mainly used in construction-related sectors, remained flat year-on-year during the first half.

Steelmakers in the U.S. are making their boldest push in decades, spending $5 billion-$6 billion in the next few years and adding debt to build primary steelmaking capacity at mini-mills and at integrated facilities. Notably, Steel Dynamics, Inc. is investing $1.9 billion in a new flat roll mill in Stinton, Texas, while Nucor Corp. is constructing a $1.35 billion greenfield plate mill in Kentucky. U.S. Steel Corp. is undergoing a $1.2 billion expansion of its Mon Valley Works facility, and recently invested $700 million to acquire a 49.9% interest in Big River Steel LLC, which owns and operates an EAF mini-mill. Big River itself is investing $700 million to double capacity at its mill. All of this incremental capacity might not compete directly in terms of regional location and product type; the increased volumes could squeeze out marginal-cost domestic capacity or imports.

Apart from that, most companies will continue to focus on deleveraging and meeting their public gearing objectives, but it will take more time. For example, ArcelorMittal in late 2017 announced its commitment to reducing net debt to $6 billion from about $10 billion. Since the initial announcement, and following the change in market conditions, the negative outlook incorporates our revised projection for the company’s timeline of achieving this target in 2021 instead of 2019.

In our view, the Russian steelmakers (such as PAO Severstal, Novolipetsk Steel) are exceptions. They have already achieved robust balance sheets and they are well positioned to absorb the pressure on the ratings from lower profitability and cash flows.
In the U.S., we continue to view refinancing and liquidity concerns as some of the more influential factors for credit quality in the next few months. Large maturity walls have been reduced by nearly one-half: $3 billion or about 25% of the sector’s outstanding debt is due by 2021 compared to $6 billion last year. This change should provide some cushion in the next downturn. Credit quality among some of the largest U.S. steel producers remains strong even in the weakening pricing environment. We think Nucor will generate adjusted EBITDA of about $2.5 billion-$3.0 billion in 2020, while maintaining leverage of 1.0x-1.5x due to its highly variable cost structure and low-cost asset profile. Steel Dynamics, recently upgraded to ‘BBB-’ from ‘BB+’, has publicly committed to maintaining net leverage below 2x debt to EBITDA. In our view, it will likely maintain this target given its commitment to fund most of its capex and future share repurchases from free operating cash flow.

Several M&A transactions that were announced in early 2018 were rejected by the European regulator, or experienced delays. This means that the steel industry will likely remain fragmented. The planned merger of Tata Steel and TK to create two market leaders with ArcelorMittal’s acquisition of Italian steelmaker Ilva was envisaged as a key change in the European flat steel market. But the merger was denied and more recently ArcelorMittal has canceled the acquisition due to legal issues. We believe that the European regulator’s hard stance could lead companies to pursue organic growth rather than business combinations.

**ESG Looms Large In This Risky Sector**

Integrated steel producers in Western Europe and North America face increasing pressure to invest significantly to reduce heavy GHG emissions from coal-fired blast furnaces, while their often higher-rated mini-mill competitors use electricity to reduce scrap steel into saleable metal.

The transition to lower-carbon emission sources for electricity generation, especially in the U.S. and Europe is the key driver of declining demand and weakening profit margins for U.S. thermal coal companies. Scrutiny of tailings facilities has increased dramatically after Vale’s second dam collapse in Brazil. Several upstream dams in Brazil, prohibited in other countries, were obliged to be decommissioned quickly or converted to dry waste. We have highlighted our concerns with board oversight of ESG risks and companies’ abilities to map, control, and mitigate these risks. Some companies have made niche investments aimed at improving energy efficiency and pollution, which is another factor that could lead to the closure of less efficient mills.

A sharp drop in prices for international metallurgical and thermal coal since late 2018 has contributed to at least six U.S. coal producers filing for bankruptcy this year, as looming maturities appear insurmountable. In addition to the price decline, U.S. thermal coal demand continues to drop due to coal plant retirements with utilities transitioning to lower-carbon emission sources for electricity generation such as natural gas and renewables.
Related Research

- Rising Gold Prices Bring A Shine To The Industry, But Upgrades Aren't Likely For Gold Issuers Oct-22-2019
- Metal Bashing: European Steel Is Going Through The Mill (Again) Oct-11-2019
- S&P Global Ratings Cuts Copper And Zinc Price Assumptions And Lifts Those On Nickel And Gold, Oct-09-2019
- Research Update: Steel Dynamics Inc. Upgraded To 'BBB-' On Strong Credit Measures and Favorable Financial Policy; Outlook Stable Oct-09-2019
- Research Update: World's Largest Steel Producer ArcelorMittal Outlook Revised To Negative; 'BBB-' Rating Affirmed, Oct-04-2019
- Research Update: U.S. Steel Corp. Outlook Revised To Negative On Debt-Financed Big River Acquisition; Ratings Affirmed, Oct-01-2019
- The Top Five Global Miners Remain Sensitive To Environmental And Social Risks Jun-18-2019
- ESG Industry Report Card: Metals And Mining, Jun-03-2019

This report does not constitute a rating action.
Industry forecasts

Global Metals and Mining

Chart 7
Revenue growth (local currency)

Chart 8
Capex growth

Chart 9
Debt / EBITDA (median, adjusted)

Chart 10
FFO / Debt (median, adjusted)

Source: S&P Global Ratings. Revenue growth shows local currency growth weighted by prior-year common-currency revenue-share. All other figures are converted into U.S. Dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO = Funds from operations.
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