

DBRS Canada Newsletter

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WHAT A DIFFERENCE A YEAR MAKES! HAS THE MINING SECTOR CHANGED FOREVER?

A year ago most people were lost. Some, in hindsight, were clairvoyant and made investments that have since reaped large rewards, but think back to December 2008 and January 2009. Can you remember the uncertainty? The sense of panic that prevailed, the concern over what was the next shoe to drop following the Lehman Brothers collapse in September 2008, the speed-of-light shift from a resource boom that wouldn't quit to a liquidity crunch and the worries over where next month's payroll or debt payment was going to come from? The simple contrast from the heady days of all-time record commodity prices in 2007-2008 to no customers and collapsing markets in the fall of 2008 was dramatic and scary.

The mood is much less tense a year later. Many financial institutions have failed, and some have been rescued by a merger of sorts or a government bail-out. In the mining sector, companies have been put through the operational and financial wringer, but most have survived and some are even beginning to prosper again. Fears remain that a tenuous recovery, largely based upon the strength of commodity demand from China, could easily falter and reverse into a second downturn, but that is more of a cycle issue and a far cry from the worldwide financial collapse some were predicting in December 2008 and January 2009. In a difficult year, good mining credits kept their financial house in order.

Mining companies showed their resilience over the last year. DBRS has an underlying belief that the need for basic commodities is persistent and that it takes a very long time or extraordinary circumstances to make that need disappear. If there is an observable pattern, it tends to favour the discovery of new markets and uses for specific commodities, rather than a rapid and permanent loss of customers. Growing world population and trade combined with growing wealth in developing nations support a thesis of persistent demand for commodities. That said, mining is a cyclical business and has long been recognized as such. Short-term supply and demand issues can create large demand and price variations, which can easily be fatal for a company not prepared, but, over time, if you have a competitive mineral operation it will generate cash flow. Despite the extreme volatility of the last year, most major mining companies weathered the storm.

The 2007-2008 commodity price bubble was extraordinary. The post year 2000 time period represented one of the more prolonged periods of economic growth and consumption demand for a wide range of commodities as underdeveloped countries grew at a rapid pace. The advance of financial markets and changing attitudes towards risk and risk sharing added a speculative aspect to the growing demand for commodities, while supplies lagged following a long period of under-investment in the late 1990s. The confluence of steady demand growth and under-investment came to a classic price bubble in 2007-2008 when incremental supply could not keep pace with demand and commodity prices were bid up spectacularly. The price bubble of 2007-2008 was no more a part of the norm than was the collapse of commodity demand in the fourth quarter of 2008. Neither was sustainable. Our expectation at that time was that if markets were allowed to operate, corrective forces would realign both the bubble and the crash. We call it "rating through the cycle." Although we recognize that secular changes can and do take place, the prescription for resource companies that need to deal with ongoing cyclical change remains largely the same as those that might have to deal with more dramatic events.

Commodity Metals Price Index 2005 = 100



Note: Includes copper, aluminum, iron ore, tin, nickel, zinc, lead, lead and uranium indices.
Source: International Monetary Fund

Great ore bodies make great mining companies. One of the fundamental prescriptions for resource producers is to operate the best mineral deposit, meaning mineral deposits that by the nature of their size, grade, location, political jurisdiction, etc., will allow the company to deliver mineral products to customers over a long period of time at a cost lower than its competitors. Mine development usually requires large capital outlays before revenue is generated. Cost competitiveness is key in being able to generate positive returns at prices at which competitors are breaking even or losing money. In addition, a low-cost operation will reap larger rewards when prices are high and even poor operations are making money. A large, competitive resource base and its location (absent changing tax and regulatory environments) often allow a company to bridge down cycles with low or even negative returns and to benefit on upturns.

Diversification mitigates risks. It is difficult to assess which commodity might become the darling of the markets and which might be the dud. The self-correcting mechanism of market cycles discourages investment in productive capacity in oversupplied commodities through low prices that might drive high-cost producers out of business or through high prices that encourage added supply. In addition, even if a company operates as a low-cost producer, if it has a single operation or depends on a single transportation corridor or is subject to a single political jurisdiction, the risk of supply interruption can be heightened. The supply curve of most commodities is deep, with many producers providing productive capacity. Hence, production from multiple operations can be as effective as being a single operation, low-cost producer.

Financial prudence is critical. Downturns come at the most inconvenient times. One of the lessons that the economic collapse in 2008 has reinforced is those that had their financial house in order may have suffered and had to scramble, but they were successful in weathering the storm. Some even found opportunity in the chaos. Those that did not have their financial house in order were hurt even though they may have had a base of excellent, well-diversified operations. These companies had either made a large acquisition, were spending capital at rates above and beyond record cash flows without properly matching the term of their financing needs with a prudent view on the term of the expected returns of the investments they were making, or they had a large debt maturity at hand without refinancing in place. When the collapse came and the equity markets crashed, new lenders were virtually non-existent and even the ability to raise funds by selling assets virtually disappeared. We rated those that were prudent through the cycle with confidence that a recovery would come. Others suffered downgrades as the risk of debt repayment increased beyond their rating or because survival measures were sufficiently

drastic to alter business profiles going forward. The downturn of the last year provided an excellent “stress test” to see how mining companies could react to rapid change. In some cases, undetected strengths or flaws were revealed. The resilience of the survivors despite the volatility helped most miners retain their ratings through the downturn.

The future remains much the same as the past. DBRS maintains the belief that the commodity sector (mining industry) has companies that are good and sustainable quality investments for debt investors. Mining products will remain a part of our daily lives for many years. The industry has benefited from the continued growth of lesser developed countries, which use commodities much more intensely than developed countries. We recognize the cyclical nature of the business and that the very significant recovery of many commodity prices throughout 2009 has been overwhelmingly led by demand from China. North America, Europe and other countries have been slow to resume a growth trajectory. Even though some mining sub-sectors may not have as yet reflected the full impact of the economic downturn due to the timing of contract price settlements (done in the first half of 2009), the risks that remain are normal cyclical risks.

The dramatic market shifts of the last year have had their benefits. Most companies have re-affirmed the importance of fiscal prudence and are focused on making operations more competitive, better matching capital spending to cash availability and dealing with weaknesses in their liquidity requirements and balance sheets. This makes them better able to meet any relapse of the economy into malaise. On the upside, the broadening of the economic recovery and its continued growth places miners as a group in good stead to benefit from their leaner operations. In addition, we remain vigilant for those structural changes that could impair the industry or its components such as restraints on world trade, political instability in key producing or consuming countries or the impact of undue environmental restrictions.

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