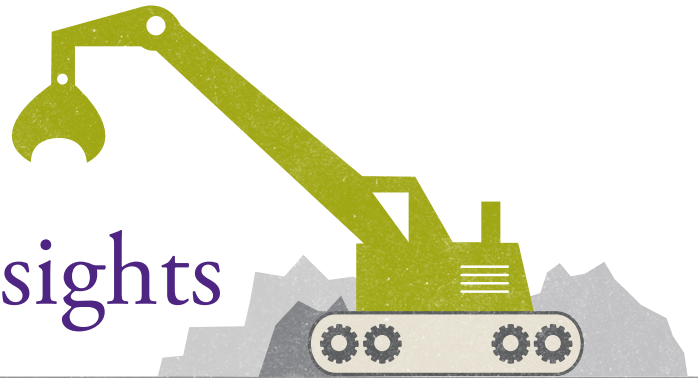




Grant Thornton

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Mining Services Pulse Survey - Insights



Introduction

Over the past 10 years the mining services industry has enjoyed enviable market conditions, with major capital investment fuelling new resource projects, project expansions and a customer focus heavily weighted to getting the job done, rather than on pricing. Many mining equipment, technology and services (METS) companies expanded rapidly to meet demand, and strong performers enjoyed healthy profits, whether or not they had robust financial and corporate management practices in place. Of course, the tide has since turned. The METS sector has experienced over two consecutive years of contractions and seen significant shifts in customer priorities and behaviours. Volatile and declining commodity prices and softening demand from China have further tightened conditions.

Most METS businesses have already made considerable adjustments; however, this last financial year has been particularly tough. Rapid declines in coal and iron ore pricing (in particular) have forced the closure of many marginal mines and driven an extreme focus on cost reductions and productivity improvements.

Unfortunately the outlook looks set for further challenges. Moody's Investors Service recently noted:

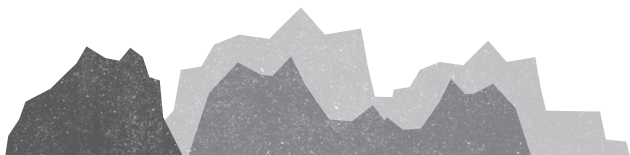
The credit profiles of Australian mining services companies will weaken further over the next 12–18 months, as mining companies reduce spending amid weakness in prices and supply-demand fundamentals for most commodities. We expect Australian mining companies to cut investments and operating costs further in the next 12 months ... the fall in forecast investment comes on top of considerable spending reductions miners have already made to preserve margins and liquidity. Contract renegotiations and in-housing of projects by miners will further pressure the profitability of mining services companies.

Grant Thornton Australia was interested to better understand the industry's challenges and opportunities in more detail. From May to July 2015 we met with key METS CEOs and directors, also large corporate bankers to the sector, to gain further insight into current trading conditions, challenges and opportunities.

Using qualitative research, we examined the competitive landscape and assessed the impact of the downturn, the pressures being experienced by customers and suppliers, the dynamically changing market conditions, the importance of innovation and growth opportunities.

In numerous interviews with METS businesses across the country we found that many have responded well to changing market conditions, with robust strategies in place for the future; however, others remain in a relatively fragile state. Our key findings are discussed in this paper.

¹ Moody's Investor Services 2015, Mining Services Australia: Risk of Default Rises as Miners Reduce Spending, accessed 12 August 2015.

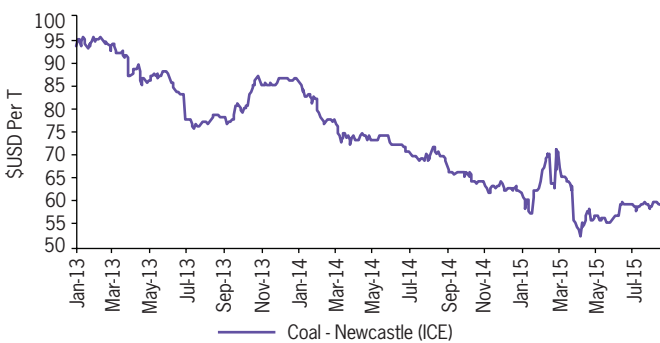


Impacts of the downturn

It is clear that the end of the mining boom hit METS companies hard and fast. Many saw revenue decline dramatically, in the order of 40–50% over a one to two-year period. Austmine's METS National Survey of over 400 METS companies (conducted in early 2015), found that revenue declined on average 31% during this period. Declining revenues inevitably drove declining profits, with margins further battered by miners' radical cost reductions, discussed in more detail below.

Those miners heavily exposed to coal (Figure 1) and iron ore (Figure 2) have been worst affected. At current commodity prices, many mines are marginal and it is extremely tough to generate returns for investors and summon the courage to invest further.

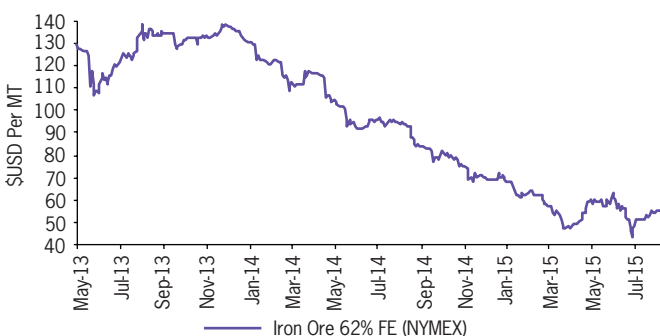
Figure 1: Coal price summary



Conditions are particularly challenging at the smaller end of the mining sector. Junior miners and exploration companies having suffered years of limited investor interest and consequently have very low liquidity. Many of them have stopped using the services of METS companies almost entirely, with remaining cash conserved as far as possible.

The drilling industry has been impacted particularly hard, with exploration expenditure now running at levels below those seen at the depths of the GFC. Those METS companies who can afford to do so are offering services for equity in projects, with gold projects the most attractive, reflecting a view that there may be gold 'at the bottom of the cycle' (Figure 3).

Figure 2: Iron ore price summary



Pressures from customers

The balance of power has firmly shifted in the mining industry and METS organisations are now at the mercy of their customers. Many METS companies we spoke to made reference to the unprecedented market control wielded by mining companies.

Miners have responded to declining commodity prices by tightening expenditure and boosting productivity. Purchasing decisions are now being driven by price rather than quality or service, and cheaper imported products are providing stiff competition. Those METS companies that have been unable to differentiate themselves sufficiently from their competitors have been caught in a spiral of falling margins in a pricing race to the bottom.

Contracts that may have been fine in the good times are under increased scrutiny. Survey respondents said it sometimes felt as if every cent was a negotiation, with disputes over delays and contract variations commonplace. At a time when reducing costs is uppermost in many minds, the costs associated with legal proceedings or hiring in-house lawyers is an additional unwanted burden. Further, many major mining companies have pushed out payment terms to their suppliers, some to 90 days, adding further working capital pressures to METS businesses, particularly those that are capital and labour intensive.

We found some METS organisations in the equipment rental space are now pricing jobs based on supplying used equipment, as the high costs associated with new equipment are no longer commercially viable. In some instances contactors are doing work on spec just to utilise idle or older fleet and are, in effect, operating without recovery.

An increasing emphasis on productivity has led to mining companies seeking innovative solutions to enable periods between shutdowns to be extended to longer intervals. Many mining companies have moved from scheduled maintenance of equipment to a 'break-fix' model, which in turn has reduced visibility over timing of supplies and compounded falling demand for products and services in the short term.

Financing pressures



“The exposure of the major Australian banks to the sector is greater than might initially be expected and most banks harbour concerns.”

There has been a number of mining service business failures in recent times, which have resulted in significant losses for the banks that funded them. Many Australian banks have exposure to the mining sector, not just from the miners and the METS companies but also from the very broad range of businesses in regional mining areas that have been impacted by the mining downturn. The exposure of the major Australian banks to the sector is therefore greater than might initially be expected and most banks harbour concerns.

As a result, METS companies with debt are now facing a higher level of scrutiny from their bankers – much higher than anything previously experienced. Most METS companies collaborating with bankers and funders disclose cash-flow issues upfront, for example regarding disputes and potential delayed payments, but while many say their banks are supportive and willing to work with them through the foreseeable future, appetite to increase debt to fund growth appears very limited.

Those fortunate to be debt free or with only low levels of debt are better placed to take advantage of growth opportunities. Mining service companies that paid down debt before the current downturn generally did not then expand by buying equipment at high prices and are therefore not facing the consequences of financing idle equipment. Some of the more financially secure companies are starting to look at acquisition opportunities and we see numerous opportunities for these companies to grow.

High regulatory costs are a hand brake on an already suffering industry



“Changes to regulatory and ownership rules are acting as a hand brake on an already suffering industry.”

In addition to supplier and financing pressures there are various external constraints operating on mining services organisations. These include the high costs of meeting regulatory obligations such as OH&S requirements, environmental regulations and the Personal Property Securities Register (PPSR). METS companies reported significant increases in operational and capital costs to meet OH&S requirements, with the unfortunate consequence of a lack of competitiveness in the Australian mining industry. Since the PPSR legislation came into effect, the increased time and cost incurred by contractors in monitoring the register and ensuring their interests are protected has been deemed an administrative burden by many, with the changes to traditional rules of ownership a hand brake on an already suffering industry.

Australian METS also face exchange rate risk through global currency movements impacting local margins where companies haven't managed to de-risk, for example by expanding revenues overseas in other currencies to offer a natural hedge.

Finally, commodity price volatility can mean customers make quick decisions on projects and contracts are often terminated with little notice.

Adapting to market conditions

The good news is that there have been positive outcomes from the downturn. For example, METS organisations are fast becoming much more agile and are implementing stronger business practices. Most companies have already been through a major review of internal costs and are now running much leaner businesses. Increasing innovation – offering greater value to both new and existing clients to secure key supplier positions – was also reported.

Diversification is on the agenda for many companies that have transferrable and scalable skills beyond the constraints of the mining industry. Identifying those skills that are competitively viable can be time consuming and even when opportunities are identified, it can take considerable energy for companies to re-adjust their focus. Some METS are actively pursuing new customer markets and product development opportunities, while others are still researching options. However, it is important to recognise that not all want to diversify; many METS companies are determined to remain focused on their core market due to their strong understanding of the mining sector and their customer relationships. These companies will need to work harder to identify growth opportunities.

Exporting has also become more attractive to METS companies, not only because the current downturn in the mining sector in Australia is limiting the market size, but also because there is a perception of more friendly regulatory environments and lower business costs in many jurisdictions overseas. Austmine's 2015 METS National Survey supports this finding: 66% of METS companies it surveyed are currently exporting, although over half of those companies earn less than 20% of revenue from exports, so there is plenty of room for growth. Top export markets identified by Austmine were South East Asia, Oceania, South America and North America.

However, many METS companies remain cautious about expanding overseas, particularly where access to additional funding for growth is constrained. These companies should take advantage of the significant support offered by government bodies and industry associations who have various methods of supporting Australian companies to increase exports and establish new operations overseas.

Strengthening corporate management

As noted, many METS companies grew rapidly during the mining boom, but often their corporate management practices lagged behind the increasing scale and complexity of the organisation. We have seen many private companies in the sector operating with financial procedures inadequate for the size of the business, resulting in management being unable to access reliable, timely financial information to make key operating and business decisions. Pleasingly, a consistent theme amongst those surveyed is the increasing emphasis on improving internal processes or working on in-house capabilities.

The better-performing METS companies inevitably have deeper pockets, a stronger emphasis on strategic planning and more diversified operations and boards, so they are better positioned to forecast future demand and respond quickly and appropriately to new challenges and opportunities.

Importance of innovation



“Many METS companies are focusing heavily on innovation, developing technologies that offer smarter, more efficient equipment or processes.”

Many METS companies have focused on innovation for a number of years. However, for numerous others, the mining boom provided opportunities for fantastic revenue growth and attractive margins without the need to be particularly innovative. In current market conditions innovation is vital to the future of METS organisations and almost every METS company we spoke to felt that innovation was critical to their business going forward. Most said key priorities included technology improvements and innovation in methods and techniques were driving ideas that could add significant value to their customers.

Most METS companies are heavily focusing their innovation on meeting the core customer objectives of cost reductions and productivity improvements. They are developing technologies to offer smarter, more efficient equipment or processes. Improved utilisation of equipment and people is also a common trend across all service providers.

However, at a time when mining companies are demanding cost reductions and productivity improvement solutions, many are unwilling to collaborate fully with METS companies on innovation in the early stages. Generally, METS companies we spoke to said that miners were happy to test new products or improved methodologies once developed, but the METS provider was expected to drive the innovation, incur the costs and take the risks.

Further, many mining companies are reluctant to increase capital expenditure to cover the cost of improved technology, being characteristically risk averse and reluctant to adopt new methods or approaches. Additionally, in the major mining companies, the complexities of the businesses and their procurement processes can mean access to decision makers is limited.

Growth opportunities

Most METS companies operating overseas have seen greater growth opportunities in their chosen international markets than within Australia. One of the reasons for this is the increasing cost of compliance in Australia, a finding which is consistent with Austmine's 2015 METS National Survey: 46% of respondents attributed the cost of operating a business in Australia as one of the three biggest challenges facing METS companies.

METS companies are focusing on overseas expansion: South America, West Africa, Chile and Papua New Guinea are markets where large-scale projects are underway and where labour costs and compliance requirements are considerably lower than in Australia.

The strength of the METS sector has been recognised by the Australian Government. It selected METS as one of five industries in which Australia already has a comparative advantage and will be supported as part of the Industry Growth Centres Initiative.

While market conditions point to strong opportunities for consolidation in the sector, only a few companies stated they are actively looking for acquisitions. Financing growth may not be straightforward as banks and investors are generally taking a negative view. However, if financing can be secured or innovative approaches can be taken to structuring transactions, there are significant opportunities for better-performing METS companies to grow scale, extend customer relationships and add additional products and capabilities through acquisition. Diversification into complementary sectors or products is also on the cards for some operators.

The outlook



“...in our view the outlook for mining services must remain negative and for the next year conditions are likely to be worse than the last...”

The end of the mining boom brought with it considerable distress for the METS sector, with many companies continuing to struggle to adapt. Following recent significant declines in commodity prices and falling demand for commodities such as coal and iron ore, miners will remain focused on productivity and cost cutting, including procurement and performance management of their suppliers. The recent decline in the Australian Dollar has been welcome news for many in the sector but this alone is no cure for the post mining boom ills with the outlook for key commodity prices remaining flat.

With this in mind, in our view the outlook for mining services must remain negative and for the next year conditions are likely to be worse than the last. We anticipate that the METS sector will see:

- An increasing constriction on funding, both investment and financing.
- Increased pressure from miners as they manage down the supply chain in search of costs savings.
- Increasing challenges in accommodating the demands of miners, having already taken the easy gains on costs and productivity improvements.
- Difficulties in expanding and diversifying offshore as the depreciating Australian dollar reduces the effectiveness of capital reserves for this purpose amongst domestic based operators.

The outcome for the year ahead must be increased rationalisation of what is a fairly fragmented sector through consolidation and failure. The better performing METS companies that are sufficiently funded, have strong management teams and can be nimble have real opportunities to increase market share organically and by acquisition.

The medium to longer term offers the potential for a more positive outcome for the sector overall, assuming increasing efficiencies and global competitiveness. The successful participants in the sector will typically have demonstrated:

- Maintenance of lower leverage
- Likely access to capital and/or funding
- Superior management
- Success in innovation, collaboration and diversification strategies.

Recommendations

There will no doubt be significant pain in this sector dominated by private, family-owned businesses and that disruption is not to be underestimated. While there will be ongoing frustration for many METS companies in the short term, there still remain significant opportunities for the best-managed companies to grow and potentially flourish.

Our key recommendations for mining services companies are:

- Be **agile**, ready to respond quickly to opportunities, changing customer needs and demands.
- **Innovate to add value to your products and services** to secure your position as a key supplier to your customers and avoid severe margin erosion.
- Spot **opportunities for growth**. Identify acquisition opportunities while valuations are at a low point in the cycle.
- **Target new markets**. Identify opportunities to leverage your existing products and services to supply to new customers in other sectors or locations.
- Implement **quality financial management systems and practices**. Ensure you have up-to-date, quality financial information to make decisions, including detailed KPI reporting and robust financial forecasts.
- Identify and **reduce risks**. In such an ever-changing environment a risk review should occur frequently.
- **Get advice**. It is strength, not a weakness, to seek expert commercial advice, particularly when that advice could position the business on a more profitable path. There are many organisations well placed to assist, from industry bodies such as Austmine to professional service companies who can help with a broad range of issues like strategy, operational improvements, best practice financial management, technology challenges and risk mitigation.
- Develop a **strong working relationship with your bank/financiers/investors**. High communication levels plus organisational transparency equals no nasty surprises!

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Contacts

Holly Stiles
National Head of Energy & Resources
T +61 2 8297 2484
E holly.stiles@au.gt.com

Adelaide
Justin Humphrey
Partner - Audit & Assurance
T +61 8 8372 6621
E justin.humphrey@au.gt.com

Brisbane
Tim Hands
Partner - Tax
T +61 7 3222 0367
E tim.hands@au.gt.com

Cairns
Gerry Mier
Market Leader - Cairns
T +61 7 4046 8800
E gerry.meir@au.gt.com

Melbourne
Brad Taylor
Partner - Audit & Assurance
T +61 3 8663 6137
E brad.taylor@au.gt.com

Perth
Mitesh Ramji
Partner - Corporate Finance
T +61 8 9480 2110
E mitesh.ramji@au.gt.com



www.granthornton.com.au

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