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INVESTMENT NOTE **11 FEBRUARY 2015**

HERMES: MINERS MAY FACE CHOICE BETWEEN DOWNGRADE OR DIVIDEND CUT

By Jon Brager, Senior Credit Analyst at Hermes Investment Management

Glencore results relief
Glencore's Q4 quarter production update this morning should provide relief to both equity and credit investors. Production in its key divisions of copper, zinc and coal were in line with consensus estimates – but the main headline was the reduction in capex guidance for 2015, which was cut due to the 'volatile market backdrop'.

The mining giant now expects 2015 capex to be in the $6.5bn-$6.8bn range, versus previous guidance of $7.9bn made at its recent investor day in December 2014. Glencore also revealed its marketing business performed 'in line with expectations in 2014', and noted S&P's affirmation of its BBB Stable rating last week.

Downgrade or dividend cut?
While limited on financial data and market colour, the production release highlights the growing tension within the financial policies of the major mining groups. If current spot prices remain low for an extended period of time, and we believe they will, it will become increasingly difficult for these firms to maintain current dividend policies and credit ratings at the same time.

Of all the miners, Glencore is the most vocal about its commitment to a 'strong BBB rating'. And it should. As of June last year, Glencore had $57.7bn of gross debt on its balance sheet, with $3bn-$5bn of capital market debt maturing every year. Should Glencore's credit ratings be downgraded to junk, it will have a very hard time issuing this quantum of debt on a regular basis. But at the same time, management and directors are reluctant to cut the dividend, seen as sacrosanct amongst the mining majors and one of the last pillars supporting flagging share prices. Something has to give.

Capex drop positive
The compromise, at least thus far, has been significant reductions in capital expenditure. The 15 major mining groups we cover collectively spent $100bn in capex in 2012 (Chart 1). This figure is estimated to drop to $75bn in 2014, and will likely fall further this year. This phenomena is positive for both equity and credit investors for a number of reasons.

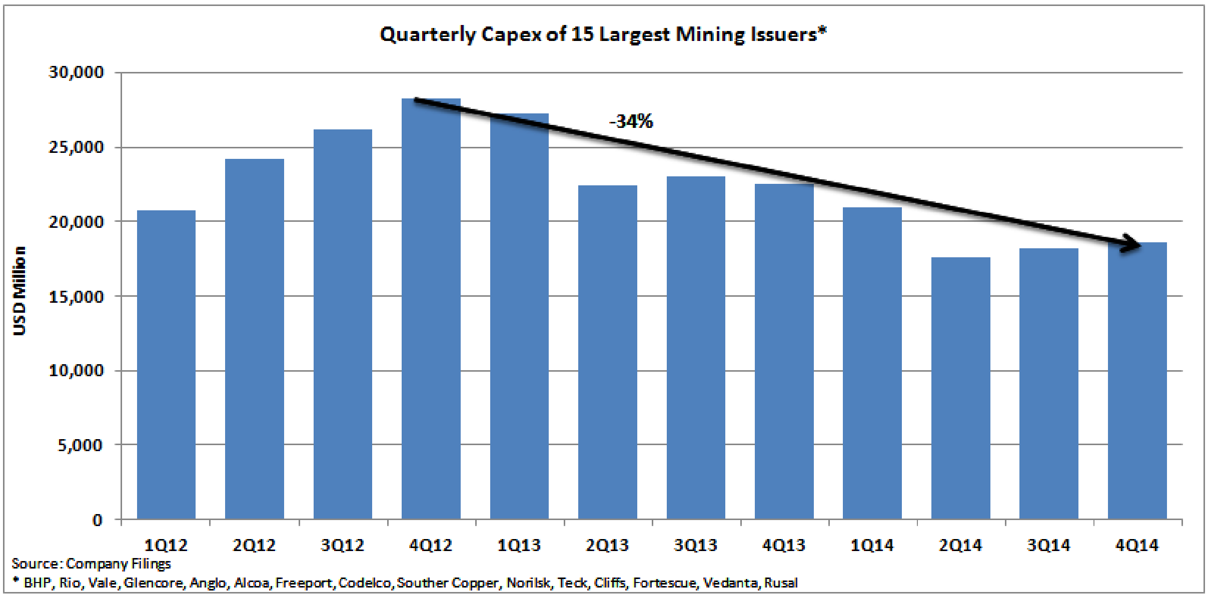
Most obviously, for every $1 less spent on capex there is a 1-for-1 increase in free cash flow. This reduces the pressure on credit ratings and makes the dividend more sustainable. Secondly, lower expansionary capex reduces execution risk. Instead of worrying about operational issues of ramping up a greenfield mine in a remote part of Africa – management can hone attention on getting the most out of existing assets, cutting costs, and focusing on generating free cash flow.

Perhaps most importantly, lower capex implies lower future production growth, which in turn should be supportive of commodity prices over the long term. Indeed, one of the drivers behind lagging commodity prices is oversupply, particularly in iron ore and crude oil.

Balance sheet priority
Reductions in capital expenditure are the first defensive step for mining groups looking to balance the demands of shareholders and creditors. But if commodity prices continue to fall, capex cuts are unlikely to be enough considering how much has already been trimmed.

We tend to think mining groups can live with a low investment grade rating (Baa3 at Moody's, BBB- at S&P), but these business models and capital structures do not function well as a high yield issuer. If the price of iron ore and copper decline further in 2015, we believe balance sheets will eventually take priority and we could see dividends cuts and potentially even issue new equity to shore up liquidity.

Chart 1:



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Notes to Editors:

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