ICRA Indonesia Comment

April 2015

Mining Sector Has Long Way to Recovery

Contact:

Pradnya Desai
Manager - Analyst
Corporate Ratings
desai.pradnya@icraindonesia.com

+62 21 576 1516

www.icraindonesia.com

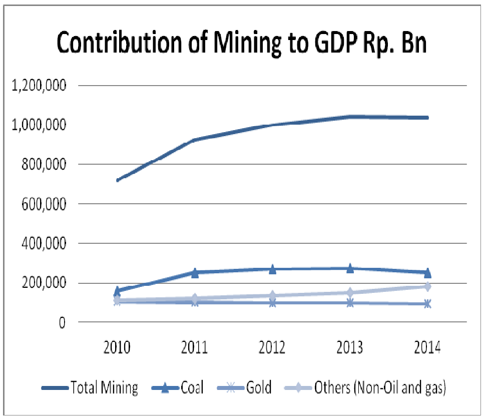
Overview

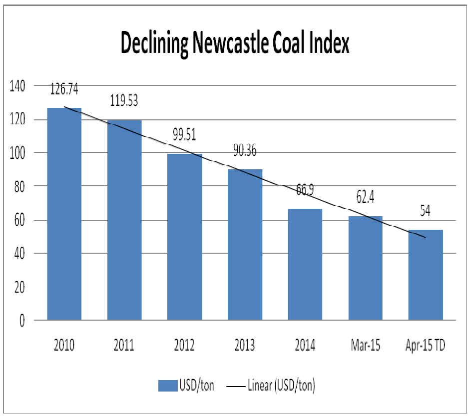
Mining sector witnessed a challenging operating environment in 2014 on account of a slowdown in global economy and the resultant cyclicality in the demand for metals and minerals. Despite enjoying the market position as one of the cost competent players in the world, the decline in demand from major customers such as China and India impacted Indonesian miners adversely. Overall, this has lead to unfavorable revenue, profitability and liquidity profile of mining companies.

In ICRA Indonesia's opinion, mining industry will remain subdued in 2015 on account of sluggish recovery in the consumer countries. The performance will also be impacted by volatility in the currency. While mining activity includes several minerals, ICRA Indonesia's view on mining is comprised of key minerals, viz, coal, nickel, tin and copper.

Coal, by far the largest contributor to the mining sector, has witnessed lowering realizations despite gradual increase in the month on month (mom) volumes. With exception of nickel and tin, the mining is slated to witness marginal growth in 2015, also attributable partially to the ban on raw mineral export implemented in January 2014.

Focus Area





(Source: BI, Indexmundi – coal prices USD per Ton)

Lackluster 2014 performance

- Mining's contribution (including quarry, iron ore, coal, metals and oil&gas) to the country's GDP has declined. As compared to 2013, the year 2014 saw a decline in contribution by 1% to 9.8%. The decline could be attributed partially to the ban on raw mineral exports imposed in January 2014 in addition to the impact of overall subdued global economy and resultant weak demand.

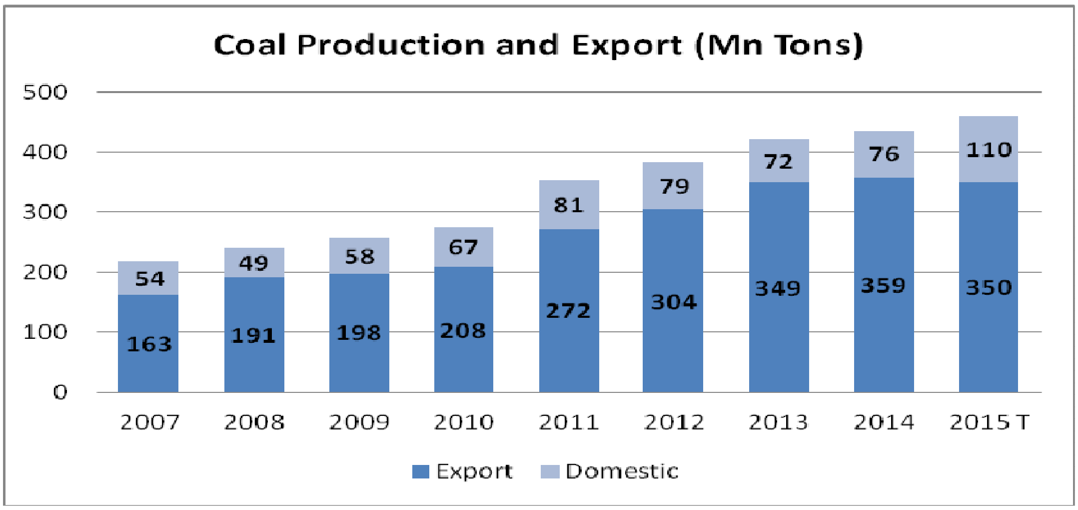
- Coal's contribution to GDP too declined by almost 10% to 2.4%, prompted by global bearish coal outlook which lead to declining prices by around 35% year on year.

- Higher fixed and operating costs have contributed to shrinking cash flows and lower profitability of miners.

- With exception of tin and nickel which have clocked in steady performance, the mining sector saw de-growth in revenues on average by 2% and a decline in operating margin by 3.5% on average. The net profit has declined by 1.5% on average.

- Though leverage remained moderate at less than 1.5x on average, a bearish outlook on coal translated into lower availability of refinancing options and further exacerbated the situation, leading to restructuring of some coal players.

2015 Demand and Supply



(Source: ESDM)

- The industry has de-grown in 2014 by 2% on average in absolute terms as an impact of the weak global outlook. Demand from China and US remained subdued on account of slower economic recovery which impacted the overall demand sentiment.
- Commodity prices have been declining, currency values have been volatile and the government has imposed ban on raw mineral export. All these factors have contributed to the declining performance of mining industry in varying degrees.
- Supply of some commodities such as copper and aluminum has been affected on account of the ban on raw mineral exports.

- Coal prices are expected to remain below USD 65/ton on average for year 2015. This is somewhat higher as compared to current levels of around USD 54/ton, based on the expectation that the economy will commence its recovery during 2015. The demand is not expected to decline following factors such as commissioning of several power plants within Asia, which is the predominant consumer of Indonesian coal. The recovery, though, may take place only gradually.The recovery in price is contingent upon recovery in global demand, more particularly from China and US. The price recovery will be gradual.
- Nickel and in particular tin are the minerals/metals where the supply is expected to be short over the medium term and whose prices therefore will witness a gradual uptrend.
- Overall, the outlook for year 2015is expected to remain subdued. For 2015, ICRA Indonesia expects the industry overall to clock in a growth performance of less than 5%.
- A recovery in second half of 2015 can take place subject to revival of Chinese demand in particular. However, China's numbers need to be consistently improving over the near term, which is yet to be seen.

Competition

Mining remains a price taker sector on account of fragmented market – consisting of numerous small as well as big players across the globe. The competition however is not on absolute basis as the quality of mineral changes with respect to changes in the geographical conditions. The quality in turn determines specific end use and price. Further proximity to manufacturing and shipping location is a key element in determining the coal demand. However, locally there exists large number of miners competing to meet this demand.

Diversification

The industry is characterized by adequate geographical diversification. Commodities are being exported to various countries across the world. In case of the largest contributor to exports, viz coal, China is largest importing country, accounting for 31% (2014).

Regulatory Framework

- The government imposed a ban on export of raw minerals effective January 12, 2014. The ban is fully applicable to bauxite, nickel, tin, chromium, gold and silver, while minerals such as copper, iron, lead, manganese and zinc have been allowed to be exported in present/semi-processed form till 2017 on paying export tax. This regulation had brought export activity for a majority of minerals (except coal) to a standstill. Ever since there have been thoughts of partially opening up bauxite so that the exporters use export funds to build smelters. Copper production has commenced after the copper majors Freeport Indonesia and Newmont Nusa Tenggara, which constitute about 97% of total copper production, have settled their disputes with the government due to the ban. However, the discontinuation of production for few months has impacted the industry. Further, the government continues to control the industry tightly.
- The government had proposed to increase the coal royalties payable by Ijin Usaha Pertambangan (IUP) license holders to 13.5% by end of first quarter this year. This is almost doubling the existing royalties of around 7% based on higher calorific value. For lower calorific values too the rate has been proposed to change to 9% from 5% and 7% from 3%. Such increase will impact the profitability levels of the IUP holder coal players, making their coal costlier as compared to other local players. While this may support prices, it is subject to competitive dynamics.

Capital Intensity

Mining is a highly capital intensive sector with investment requirements in licensing of mines, payment of royalties and heavy operating costs.

Profitability

- The industry has been principally affected by the weak outlook on coal prices. Coal constitutes about 50% of mining production (excluding oil & gas) and more than 80% of mining exports (excluding oil & gas). The coal producers have been increasing mom production in order to maintain operating cost levels. However, continued decline in the prices has seriously impacted their performance. The earlier high profitability levels have recently declined. Some coal players also registered a sales de-growth. Additionally, the volatility in profit levels is substantial on account of currency fluctuation.
- Profitability as indicated by operating profit before depreciation, interest, tax and amortisation (OPBDITA) margin has declined on average by 3.5%. Net profits have declined on average by 1.5%, while the return on equity and return on assets (ROE and ROA) stand lower by 2-6% indicating a deteriorated performance.
- Overall, the profitability has reduced substantially while on the other hand debt increased. This in turn has further affected profitability to accommodate the rising financial costs. Debt levels are actually moderate for large players. However, higher cost of debt coupled with declined operating performance has created unfavorable financial picture for the sector.

Conclusion

ICRA Indonesia expects the mining industry to remain subdued and witness a marginal growth of less than 5% in 2015. The prices are expected to gradually revive in the second half, towards end of 2015 beginning of2016 based on the current expectation of improving demand from consumer countries. While ban on raw minerals is not a principal contributor to the decline in sales of the sector, it has resulted in slowdown within individual industries till such time the smelters come up. Nickel and tin on the other hand have witnessed a supply shortage and hence have remained stable.