A study of Energy & Resources M&A activity by mergermarket, in association with Squire Sanders

GLOBAL M&A SERIES
ENERGY & RESOURCES
2012

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SQUIRE SANDERS

CONTENTS

FOREWORD

Welcome to Squire Sanders' inaugural edition of the Global M&A Series. Drawing from extensive data on M&A activity in the energy & resources sector, this report offers insight into the challenges and opportunities facing the industry on a global scale.

Energy & resources M&A over the past several years has been driven by large-scale consolidation in North America, steady investment flows into renewable energy and mega-mergers in the mining industry. Deal flow remained incredibly resilient despite a difficult financing environment, and private equity investors continue to scout for new opportunities and exit their portfolio companies successfully.

Still, despite being a good year for M&A, 2011 has served as a stark reminder of the industry's sensitivity to external pressures. Sovereign debt worries in Greece, Italy, Portugal, Spain and Ireland, and populist uprisings in the Arab world, combined to fuel volatility in global economies and commodities markets, which in turn caused investors to flock to gold, and many energy & resources businesses to halt or re-evaluate their strategies.

As far as future developments are concerned, an increased focus on renewable energy – solar, wind, hydro, photovoltaic (PV) – has been an important driver of M&A in the industry, and will play an ever more important role as Japan's Fukushima disaster caused an even sharper focus on environmentally sound energy sources.

Shale gas likewise holds incredible potential for the industry, but a big question mark still hovers over the extraction and distribution processes. Indeed, hydraulic fracturing has been a divisive issue, causing starkly different policies in different countries. Yet despite the controversy and uncertainty hovering over the shale industry, corporate and private equity acquirers continue to invest in lucrative shale projects, particularly in the US, generating several multi-billion M&A transactions in the process.

Each report in this Global M&A Series focuses on a specific sector – in this case energy & resources – to gain perspective into the factors fuelling investment and consolidation in the industry. We hope you find this first edition both interesting and informative – and as always, we welcome your feedback.

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ENERGY & RESOURCES OVERVIEW

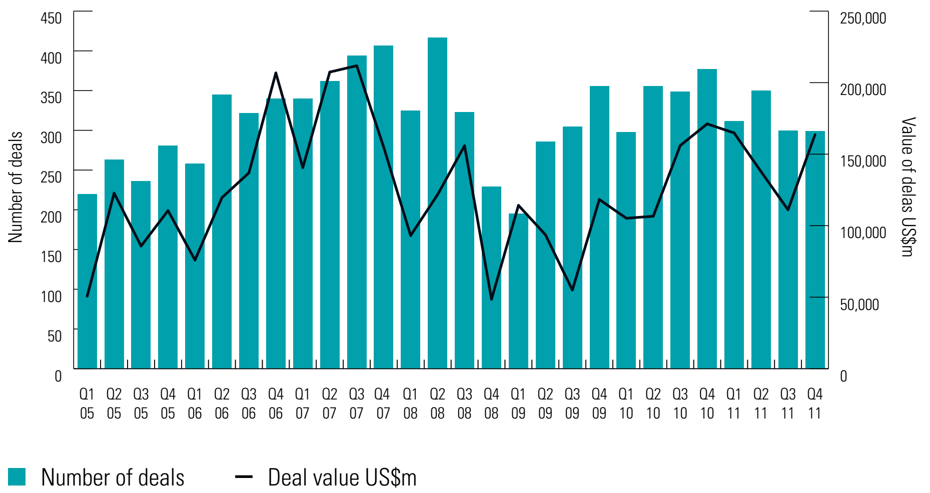
Despite depressed M&A in most other sectors, the energy & resources sector continues to be one of the busiest and most high-profile M&A markets in the world. The sector – which spans energy, mining and utilities – saw 1,261 deals globally worth a combined US$577.3bn in 2011, up from 1,380 deals worth US$539bn in 2010. This marks a 7% increase in deal value and a 9% drop in deal volume.

Showcasing the sector's resilience, larger-scale energy & resources transactions were not dissuaded by economic volatility and constrained bank lending. In fact, deal flow in the US$500m-plus category has risen steadily since 2009: deals worth more than US$500m increased from 198 in 2010 to 208 in 2011, which is incredibly close to the peak of 209 deals in 2007.

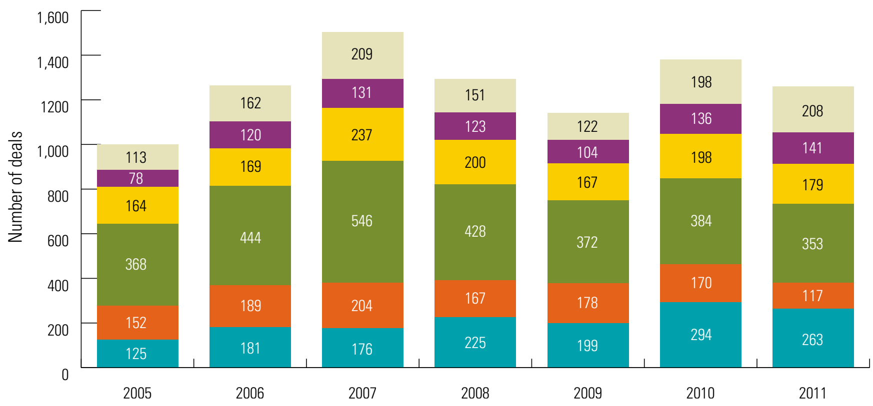
Private equity activity has slowed somewhat, with a slight dip in buyout volume from 2010 to 2011. Even still, the total value of buyouts more than doubled from US$17.6bn to US$38bn during this period thanks to a handful of large deals including the buyout of Samson Investment Company by a consortium led by Kohlberg Kravis Roberts & Co (KKR) and Japan-based Itochu Corporation.

Private equity exit figures are less encouraging, which is to be expected given the gap between buyer and seller expectations, and the commodity price volatility, that characterised much of 2011. The year saw 52 exits worth US$14.7bn, marking a 27% dip in value against last year's US$20.1bn and a negligible change in volume – but it is worth noting that the numbers are trending upward from 37 exits worth US$3.7bn in 2009. KKR, already involved in the year's largest buyout, was also involved in the year's largest exit, with its US$3.5bn sale of Hilcorp Resources to Marathon Oil Corporation.

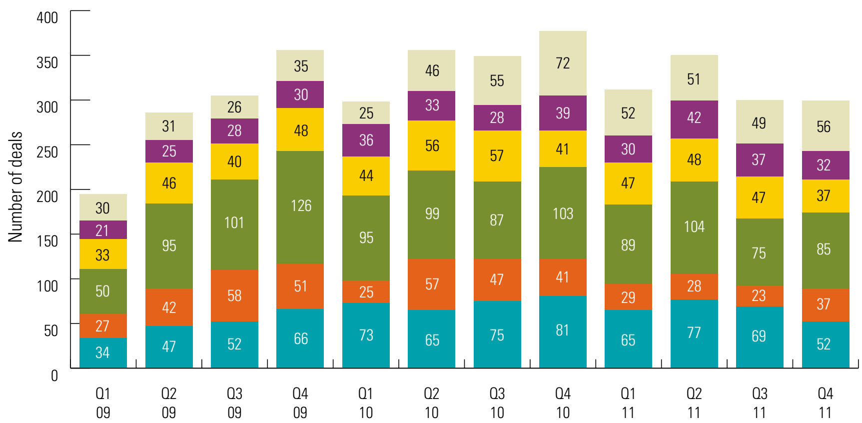
Energy & Resources global M&A



Energy & Resources deal size split by year



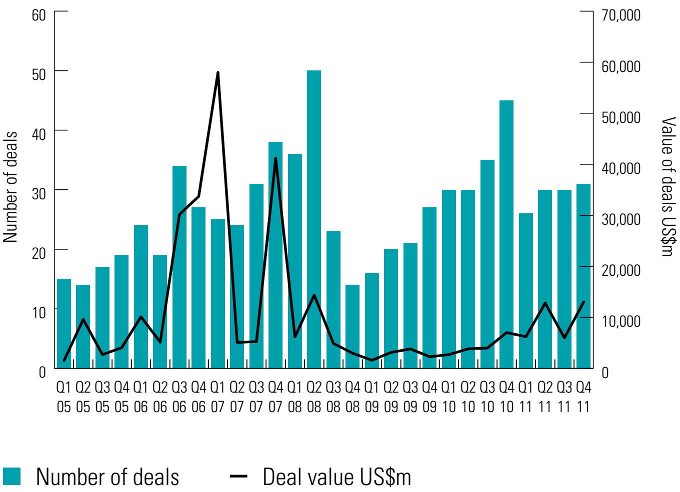
Energy & Resources deal size split by quarter



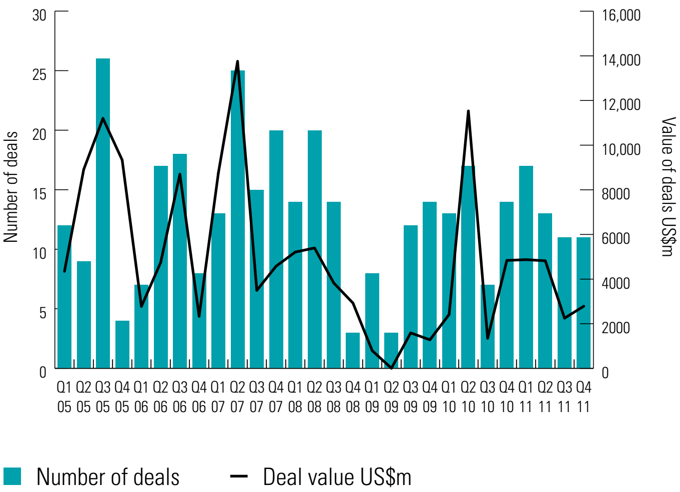
Key for above two graphs:

Not disclosed | <US$15m | US$15m-US$100m
US$101m-US$250m | US$251m-US$500m | >US$500m

Energy & Resources private equity buyouts



Energy & Resources private equity exits



Top 10 Global Energy & Resources Deals, 2011

Announced date	Status	Target company	Target sector	Target country	Bidder company	Bidder country	Seller company	Seller country	Deal value US$m
Oct-11	P	El Paso Corporation	Energy	USA	Kinder Morgan Inc	USA			37,439
Jan-11	P	Progress Energy Inc	Utilities	USA	Duke Energy Corporation	USA			25,825
Jul-11	C	Petrohawk Energy Corporation	Energy	USA	BHP Billiton Ltd	Australia			14,760
Jan-11	C	Marathon Petroleum Corporation	Energy	USA	Marathon Oil Corporation (Shareholders)	USA	Marathon Oil Corporation	USA	14,667
Apr-11	P	Constellation Energy Group, Inc	Energy	USA	Exelon Corporation	USA			10,410
Jun-11	C	OJSC Polyus Gold	Mining	Russia	Polyus Gold International Ltd	Kazakhstan			10,390
Jun-11	P	Southern Union Company	Energy	USA	Energy Transfer Equity LP	USA			9,037
Feb-11	C	Pride International Inc	Energy	USA	ENSCO International Inc	United Kingdom			8,735
Jan-11	C	Massey Energy Company	Mining	USA	Alpha Natural Resources Inc	USA			8,156
Aug-11	C	Northumbrian Water Group plc	Utilities	United Kingdom	Cheung Kong Infrastructure Holdings Ltd	Hong Kong			7,786

C = Complete; P = Pending

Energy & resources industry snapshots

Breaking the sector into its three main components – energy, mining and utilities – shows the energy industry (including oil, gas, power and renewables) to be the liveliest M&A market, surpassing both mining and utilities in value and volume terms. In 2011, energy deals totalled US$396.5bn, compared to US$127.8bn in mining and US$53bn in utilities. All three subsectors saw a dip in deal volumes from 2010 to 2011.

Energy deals were fuelled largely by consolidation in the US, with the US$37.4bn acquisition of El Paso Corporation by Kinder Morgan Inc – the largest independent transporter of refined petroleum products, and the largest independent terminal operator, among other accolades – being a case in point. The US$10.4bn acquisition of Constellation Energy Group by Exelon Corporation also created a new energy behemoth, with the combined entity eyeing a larger customer base, as well as a sharper focus on clean and sustainable solutions, going forward.

Investments into renewable energy, while still dwarfed by oil transactions, have played an important part in driving deal activity with M&A transactions in the space totalling 265 worth US$34.4bn, a drop in volume but an increase in value from the 309 deals worth US$21.5bn registered last year.

Europe has historically been the busiest market for renewable energy M&A deals, with Holland, Spain, Germany and a handful of other eurozone countries spearheading the use of renewables – particularly

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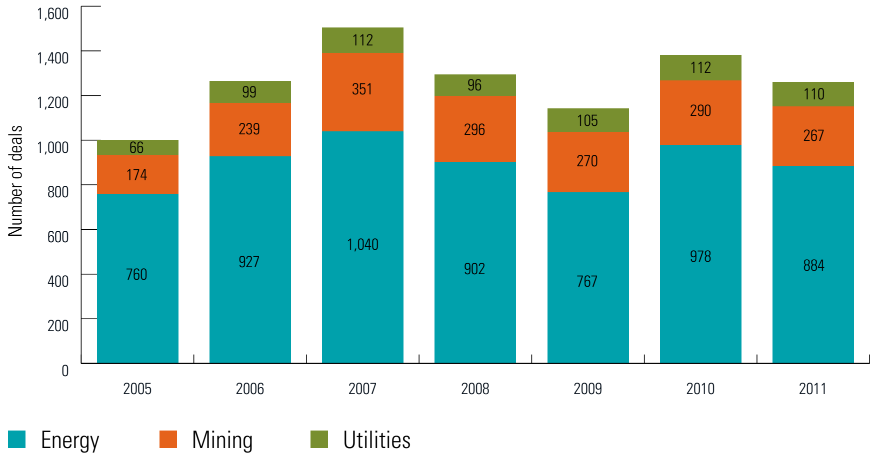
wind – long before the issue was tangled into broader political and environmental debates.

The year's largest renewable energy deal saw the Russian Government acquire a 23.56% stake in RusHydro OAO – a sign that even the world's most prominent oil producers are turning their attention to renewables. Several large transactions also came from solar and wind projects. In France, Electricite de France SA acquired full control of EDF Energies Nouvelles, whose core operations are wind and solar, through the acquisition of the 50% stake which it did not already own for US$1.2bn. Total SA, also based in France, acquired a 60% stake in US-based SunPower Corporation in a US$1bn deal. Private equity plays a pivotal role in this industry too, with Terra Firma and The Carlyle Group being two of the most active buyout funds of recent years. International banks have also stepped up their fundraising efforts, even while they scale back other non-core operations, with BBVA and Credit Agricole being two examples of banks whose renewable energy-focused investment vehicles were launched in the past three years.

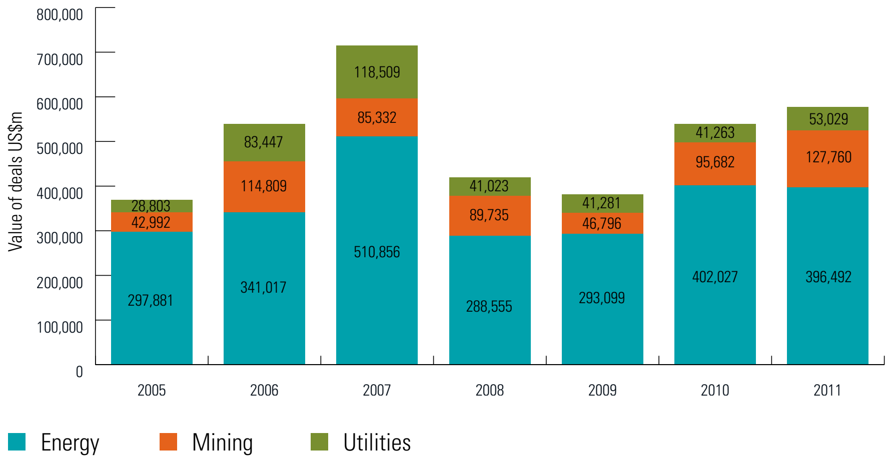
The utilities subsector is also seeing its fair share of consolidation, as illustrated by the US$25.8bn acquisition of Progress Energy Inc by Duke Energy Corporation. Asian investors also played an important role in utilities M&A: in the UK, Northumbrian Water Group was acquired by Hong Kong-based Cheung Kong Infrastructure Holdings in a US$7.8bn deal; in Portugal, China Three Gorges Group acquired a 21.35% stake, valued at US$3.5bn, in Energias de Portugal from the Portuguese government.

In the famously capital-intensive mining industry, M&A seemed to mirror the broader gold rush phenomena of 2011, when investors responded to widespread uncertainty by taking shelter in gold, driving prices upward as a result. The €10.4bn acquisition of Russia-based OJSC Polyus Gold by Kazakhstani group Polyus Gold International marked the year's largest mining deal, followed by Canada-based Barrick Gold Corporation's acquisition of Canada-based Equinox Minerals Limited for US$7.4bn.

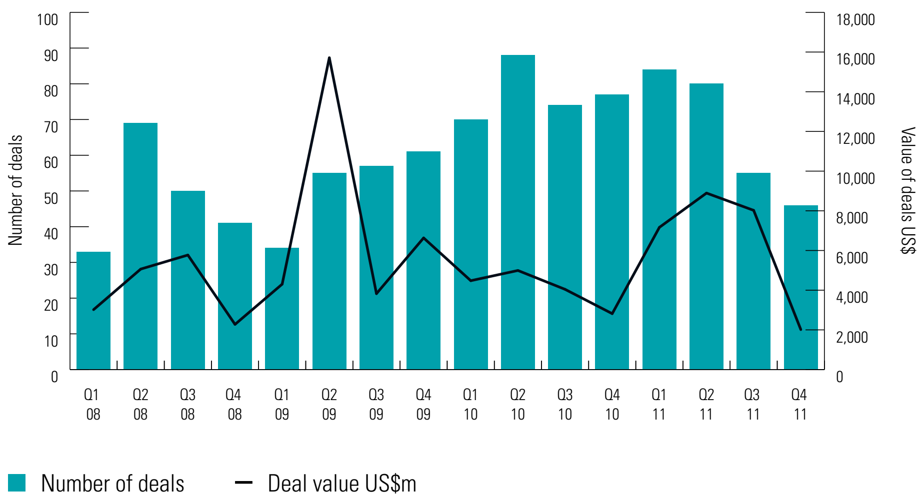
Subsector split by deal volume



Subsector split by deal value



Renewable M&A tends



Regional perspectives

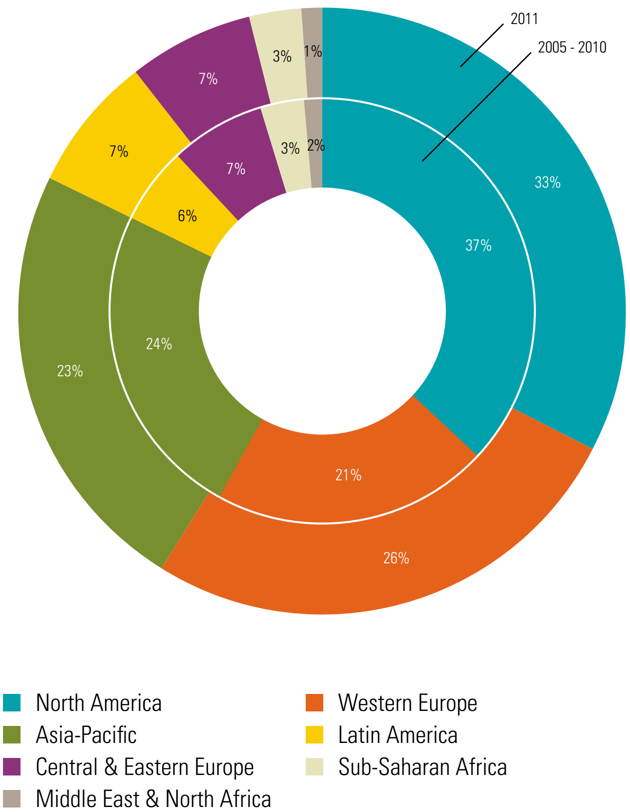
Regional breakdowns of M&A activity reflect the trends outlined above, with strategic consolidation in the US and outbound M&A from China boosting North America and Asia-Pacific deal values, respectively. In 2011, more than half of global deal value (51%) went to North American targets, followed by Western European and Asia-Pacific targets which represent 20% and 12% of global deal value, respectively. Most of the money behind M&A transactions also came from North American bidders, who accounted for 44% of M&A deals in 2011, followed by Asia-Pacific and Western European acquirers who accounted for one-quarter and one-fifth of deal values, respectively. Volume data shows that activity is more evenly spread across the three regions, though North America continues to take the top place with about one-third of deal volumes coming from the region.

While North America retains its firm grip on the global energy & resources market, a closer look at the data highlights the growing importance of the Asia-Pacific region. A remarkable 25% of global deal value in 2011 came from Asian investors, representing a considerably higher figure than their 19% share from 2005 to 2010.

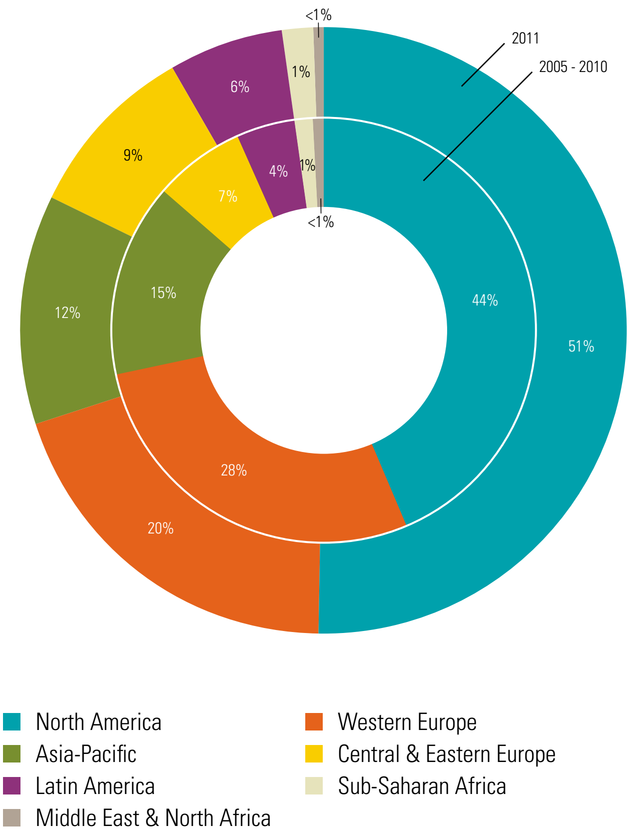
China tends to attract the most media attention for its large-scale investments into foreign energy, mining and utilities projects, but it should not overshadow other parts of the region. Southeast Asia, for instance, is raising its profile in the M&A market place thanks to strong outbound investment flows and domestic consolidation. Southeast Asia saw 48 deals worth US$16.4bn in 2011 compared to 42 worth US$12.3bn in 2010 and 41 worth US$8.3bn in the previous year.

Of course, Asia-Pacific deal flow is also underpinned by Australia's mining industry. For the past decade, lucrative projects in Western Australia – including Gorgon, Wheatstone, Pluto and Northwest Shelf – have drawn interest from international oil majors of the Chevron, ExxonMobil and Apache variety.

M&A volume split by target dominant region



M&A value split by target dominant region



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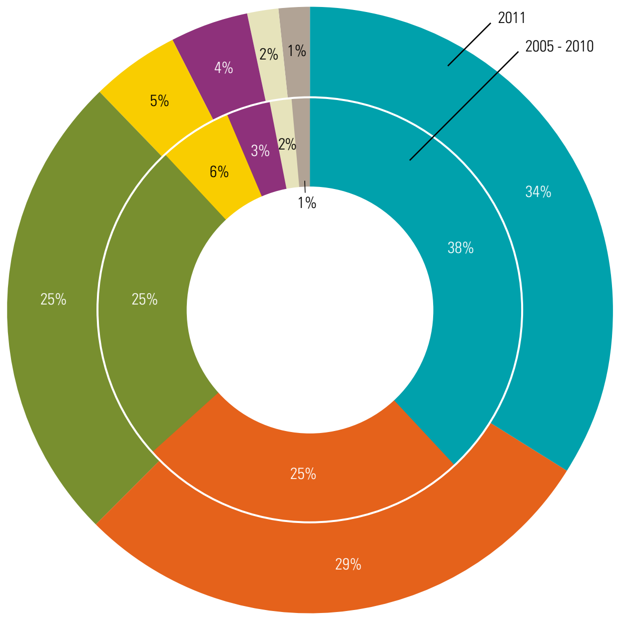
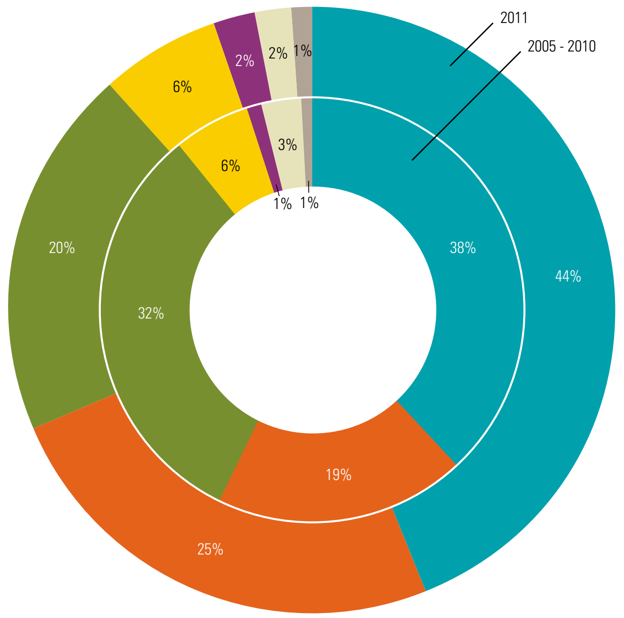
M&A volume split by bidder dominant region



- North America
- Asia-Pacific
- Latin America
- Middle East & North Africa
- Western Europe
- Central & Eastern Europe
- Sub-Saharan Africa

M&A value split by bidder dominant region



- North America
- Western Europe
- Middle East & North Africa
- Sub-Saharan Africa
- Asia-Pacific
- Central & Eastern Europe
- Latin America

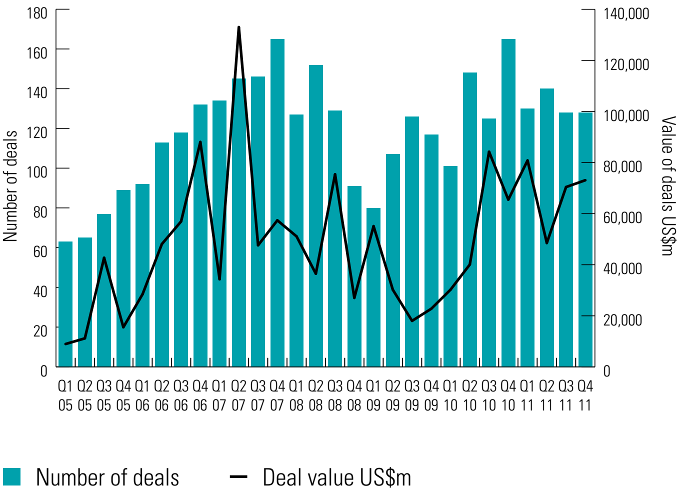
Cross-border

One of the most pronounced features of energy, mining and utilities M&A globally is its increasingly international nature. The share of cross-border versus domestic M&A reached its highest level on record in 2011, in both value and volume terms – and even more tellingly, cross-border M&A value and volume are more closely correlated than ever before, showing that regional boundaries in the global energy sector are starting to dissipate.

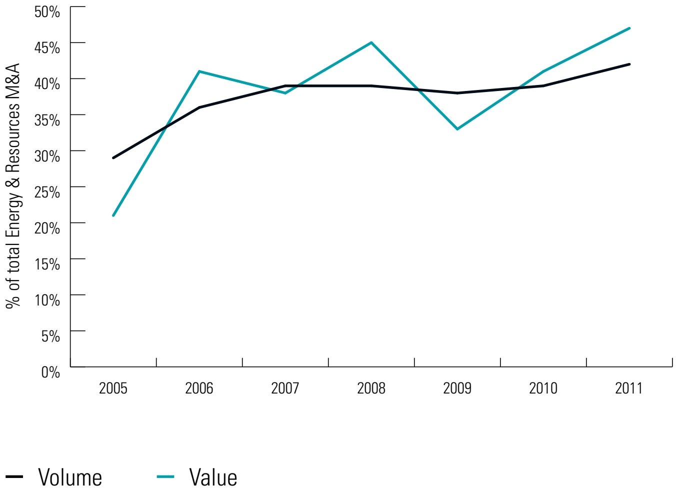
In 2011, cross-border deals accounted for 42% of M&A all announced deals, compared to 39% the previous year. Cross-border transactions are also representing an ever larger slice of aggregate deal values, up from 33% in 2009, to 41% in 2010, to an impressive 47% in 2011.

Cross-border deal values and volumes increasingly come from stake acquisitions rather than outright acquisitions: in 2011 more than half (52%) of all cross-border deals were stake purchases and 61% of cross-border deal value globally came from these types of transactions.

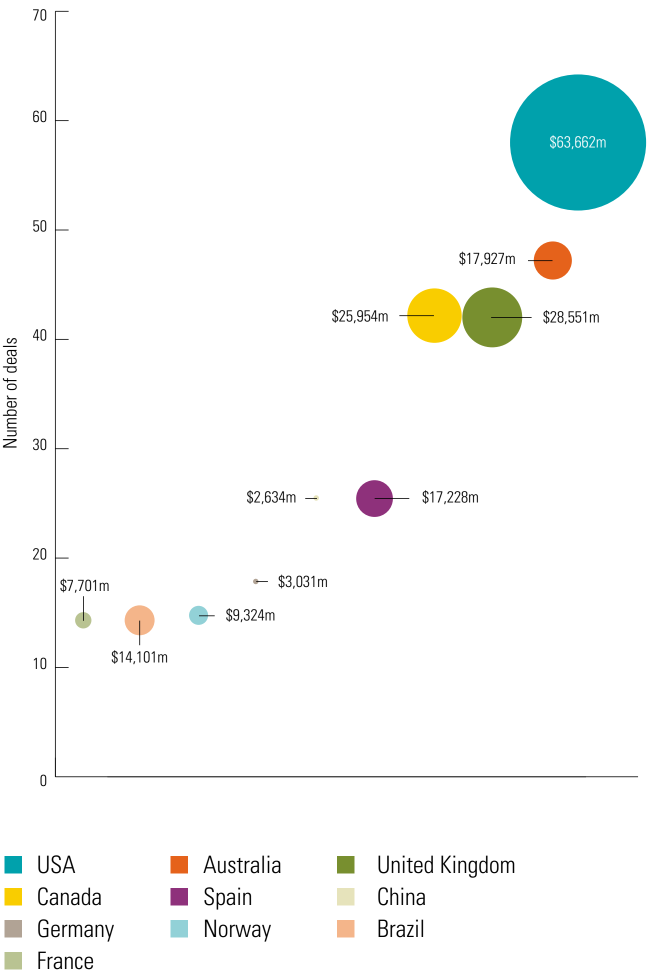
Energy & Resources cross-border M&A trends



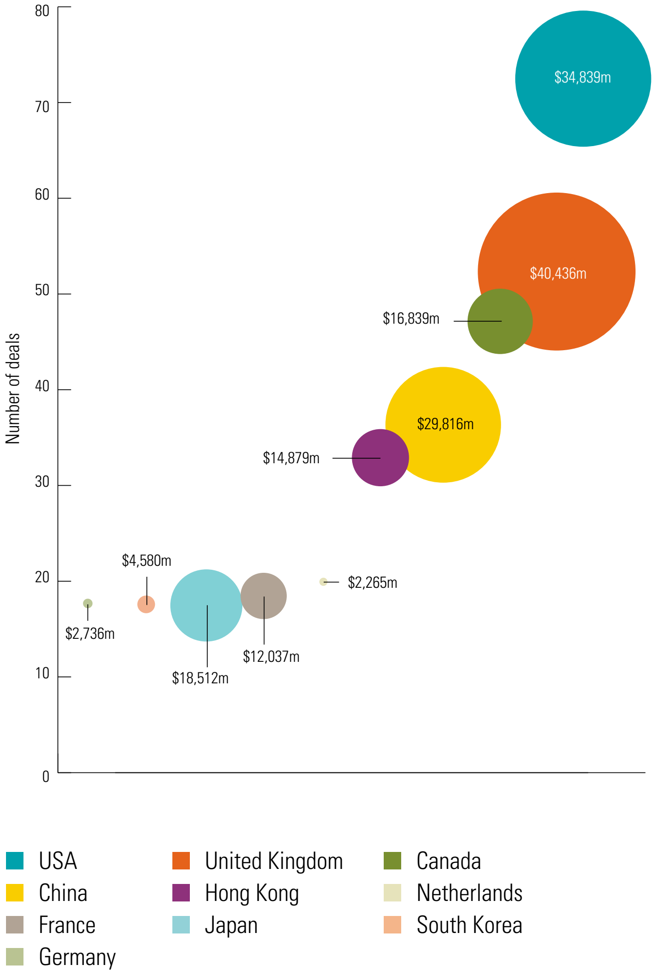
Cross-border share of Energy & Resources M&A



Top 10 cross-border target markets, 2011



Top 10 cross-border bidder markets, 2011



ENERGY & RESOURCES OVERVIEW

Top 10 Global Energy & Resources Deals, 2011

Announced date	Status	Target company	Target sector	Target country	Bidder company	Bidder country	Seller company	Seller country	Deal value US$m
Jul-11	C	Petrohawk Energy Corporation	Energy	USA	BHP Billiton Ltd	Australia			14,760
Jun-11	C	OJSC Polyus Gold	Mining	Russia	Polyus Gold International Ltd	Kazakhstan			10,390
Feb-11	C	Pride International Inc	Energy	USA	ENSCO International Inc	United Kingdom			8,735
Aug-11	C	Northumbrian Water Group plc	Utilities	United Kingdom	Cheung Kong Infrastructure Holdings Ltd	Hong Kong			7,786
Feb-11	C	Compania Espanola de Petroleos SA (52.94% Stake)	Energy	Spain	International Petroleum Investment Company	United Arab Emirates	Total SA	France	7,645
Nov-11	C	Samson Investment Company	Energy	USA	Kohlberg Kravis Roberts & Co; Itochu Corporation; Natural Gas Partners LLC; Crestview Partners LP	Japan	The Schusterman family	USA	7,200
Feb-11	C	Reliance Industries Ltd (23 oil and gas production sharing contracts) (30% Stake)	Energy	India	BP plc	United Kingdom	Reliance Industries Ltd	India	7,200
Mar-11	C	Western Power Distribution	Energy	United Kingdom	Western Power Distribution LLP	USA	E.ON UK plc	United Kingdom	6,506
Sep-11	P	Polymetal OAO (82.85% Stake)	Mining	Russia	Polymetal International plc	Channel Islands			5,940
Nov-11	C	Anglo American Sur SA (24.5% Stake)	Mining	Chile	Mitsubishi Corporation	Japan	Anglo American plc	United Kingdom	5,390

C = Complete; P = Pending

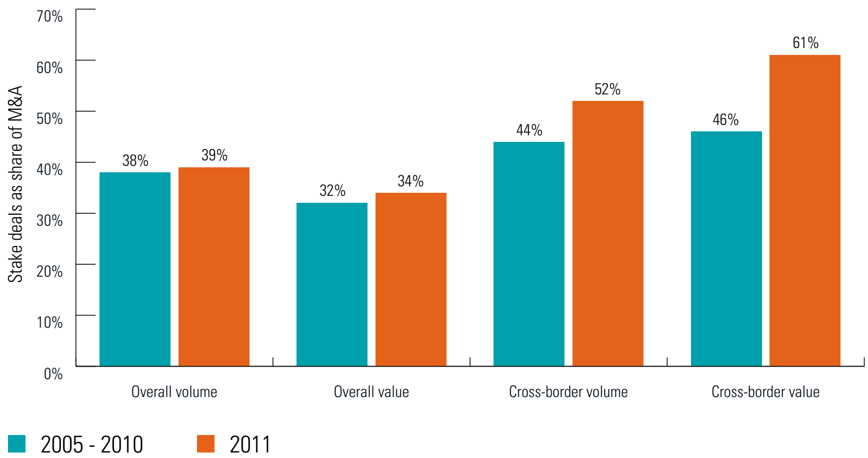
Rise of Asian buyers

The steady rise in cross-border deal making at least partly reflects Asian acquirers' appetite for natural resources, which has triggered some of the largest international transactions of the past few years. Chinese acquirers – usually in the form of state-backed funds or national oil companies (NOCs) – have been especially aggressive in this respect, turning their attention to resource-rich countries like Canada and Brazil. In 2011, China's Sinopec announced its US$4.8bn acquisition of a 30% stake in Petrogal Brasil – a move that follows Sinopec's 2010 acquisition of a 9.03% stake, valued at US$4.7bn, in Syncrude Canada from US-based ConocoPhilips Company.

Asian buyers have been equally interested in foreign utilities assets, as evidenced by the US$7.8bn acquisition of Northumbrian Water Group by Hong Kong-based Cheung Kong Infrastructure Holdings. More recently, in 2012, China Investment Corporation acquired an 8.68% stake, valued at US$779m, in Thames Water Utilities, the UK water and wastewater services company.

Japan has also driven some of the past year's largest outbound deals, though in these cases buyers tend to take the form of conglomerates rather than state-backed entities. One such conglomerate, Itochu Corporation, partnered with global buyout group KKR to acquire Samson Investment Company, a US-based energy group, for US$7.2bn, while Mitsubishi Corporation acquired a 24.5% stake in Anglo American Sur from Anglo American plc for US$5.4bn.

Stake deals as share of M&A



Stake-purchases

Understandably, in a sector where operational, regulatory and financial risks run high, deal structures aimed at minimising or sharing these risks are often preferred. As such, stake acquisitions in the energy & resources space – including joint ventures (JVs) or minority stake investments – tend to appear more regularly than outright mergers or acquisitions. Mitsubishi's investment in Anglo American Sur is a prime example, as is China Three Gorges Corporation's 21.35% stake acquisition of Energias de Portugal, the Portugal-based utilities group. These cash-rich Asian buyers are obviously keen to expand their resource bases, however acquiring a company in its entirety would leave them without all of the local operational knowledge that comes with a strategic partnership or a stake purchase. For Mitsubishi Corporation the Anglo American Sur deal represents a considerable broadening of its Chilean presence and a doubling of its copper production capacity. Likewise, buying only a stake in Energias de Portugal from the ailing Portuguese government allows China Three Gorges to acquire valuable European and South American assets whilst balancing the amount of risk it takes on.

Outlook for 2012

Going forward, M&A in energy, mining and utilities will be dictated by several important developments – not least of which is an increased focus on cleaner, more sustainable energy sources.

Global efforts to move away from fossil fuels have put the renewable industry in the spotlight, with private equity firms and international energy companies both putting money into solar, wind, photovoltaic (PV) and other projects in 'younger' corners of the market like geothermal and biomass. But the new technology and array of financial instruments underpinning these industries may still lack the track record of success for investors' comfort. At the same time, government incentive schemes and feed-in tariffs can change quickly and dramatically, and investors have understandably been wary of investing in projects whose value can be changed with the signing of a new bill.

Natural gas extracted from shale has been one of the most important developments in the energy sector in recent years, and shale continues to drive deal activity globally despite ongoing public debates about the environmental risks of hydraulic fracturing. French regulators have been exceptionally strict on fracking activities, while China has promoted shale gas production in an effort to minimise its dependency on energy imports. Meanwhile in Canada and the US shale plays like Marcellus and Eagle Ford continue to attract waves of domestic and foreign investors. Natural gas and shale initiatives will remain an important deal driver in 2012 having already encouraged a spate of deal making at the beginning of the year. January of this year saw the US$3.7bn acquisition of Provident Energy, a Canadian company focused on natural gas liquids (NGL) midstream services, by Pembina Pipeline Corp, the Canadian transporter of crude and NGL. Pembina owns and operates oil sands pipelines and has a growing presence in midstream and natural gas services sectors, and integrating the two companies' energy transport and gas processing businesses will help accelerate the combined entity's NGL activities.

Early indications suggest favourable exit conditions in 2012 will drive private equity activity in the energy & resources space. In January, US-based EnCap Investments sold Cordillera Energy Partners III, a domestic oil and gas exploration company, to Apache Corporation in a US$2.9bn trade exit. Corporate demand for offshore assets could also fuel activity: in February, The Carlyle Group and Riverstone Holdings exited Dynamic Offshore Resources in a US$1.3bn sale to US-based oil and natural gas group SandRidge Energy.

Conclusion

Across the board in the energy, mining and utilities space, the fine balance of supply and demand, on a regional and on a global basis, will always give rise to additional challenges on the M&A front. Valuation gaps, concerns about timing deals in line with the market and political risks are just a few of the factors that make M&A in this broad-sweeping sector unique from M&A in other industries. In renewable energy, government incentive schemes tend to change too quickly and dramatically for investors' comfort. For the natural gas industry, regulation surrounding shale gas development is largely unclear. In the oil industry, changing tax frameworks – for example in Brazil, or even in the UK, where companies face increased production taxes on North Sea properties – will determine how energy businesses structure their portfolios going forward.

Heat chart

In terms of geography, energy & resources deal flow will likely continue to be concentrated in the Asia-Pacific and North American regions, which both posted an exceptionally high number of companies for sale at the end of 2011, according to mergermarket's Heat Chart. Energy industry stories were highest across the board, while mining industry stories were exceptionally high in the Asia-Pacific, reflecting the strength of Australia's mining industry. The Heat Chart also suggests that mining M&A will be prevalent in Sub-Saharan Africa, which is the only region where mining is more active than energy in terms of potential targets.

Heat Chart

	Energy	Mining	Utilities	Overall
Asia-Pacific	310	228	38	576
North America	310	209	9	528
Western Europe	225	41	22	288
Latin America	83	41	3	127
Central & Eastern Europe	102	16	8	126
Sub-Saharan Africa	24	50		74
Middle East & North Africa	24	4	6	34
Overall	1,078	589	86	1,753

Key

Hot
300
250
200
150
100
50
0
Cold

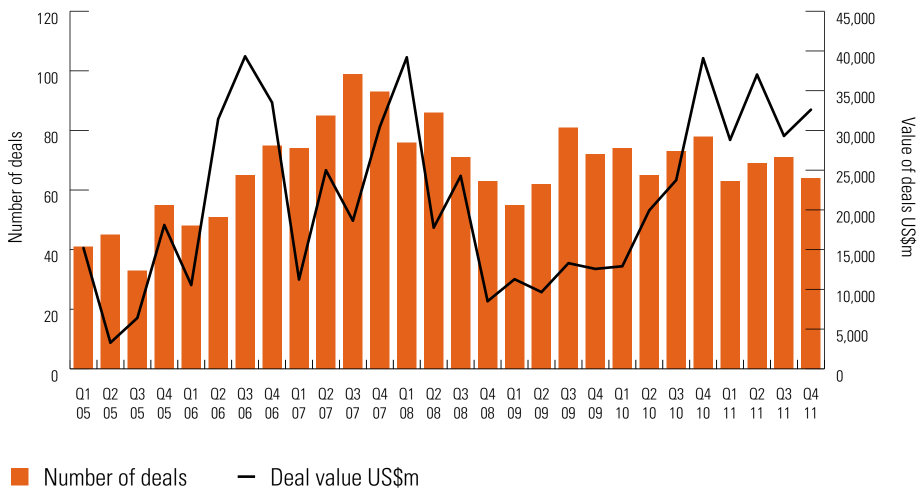
The Heat Chart is based on 'company for sale' stories tracked by mergermarket. Opportunities are tracked according to the dominant sector and geography of the target.

M&A SPOTLIGHT: MINING & METALS

Similar to the pattern of dealmaking across the wider economy, mining mergers saw a rapid spree of deal announcements in recent years, but the market lost buoyancy by the summer of 2011 amid heightened economic uncertainty and a subdued growth outlook.

By the final quarter of the year, the eurozone crisis and lagging demand in leading global economies prompted many mining groups to put M&A plans on hold, while instead shoring up reserve replacements through large capital expenditure projects. Overall the number of mining deals transacted globally slipped by 8% over year-earlier levels to 267 transactions worth a combined US$127.8bn in 2011.

Mining M&A trends



The return of transformational M&A

This year, however, has kicked off with a bang. The long-awaited tie-up of Glencore and Xstrata for US$88bn in February marks the largest ever mining transaction and heralds the return of transformational M&A to the industry. The merged entity will operate as a diversified player, combining Glencore's commodities marketing business with Xstrata's extensive mining operations. If completed, the company will take a leading position in the copper, nickel, zinc and thermal coal markets and is widely expected to target acquisitions in the iron ore space, where the companies have a minimal presence.

Following Glencore's US$10.1bn initial public offering in May last year, the merged business will have ample firepower to target new buys. As such, the merger will likely spur other resource majors such as BHP, Rio Tinto and Vale to take a fresh look at their M&A plans in the face of a rising competitor. The sector may well see a fresh scramble for assets over the coming year.

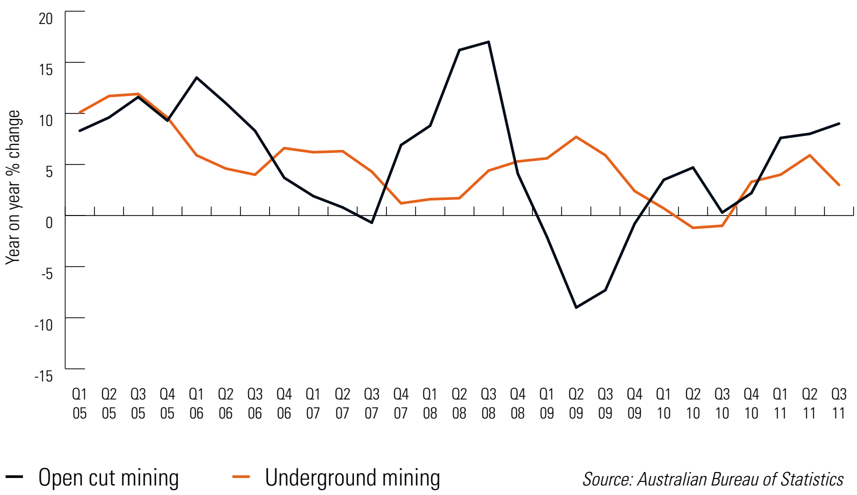
Aside from the shakeup caused by the mega-merger, there are a number of other underlying forces bubbling up in the industry, which may also provide a boost to deal flow.

Top 10 Global Mining Deals, 2011

Announced date	Status	Target company	Target country	Bidder company	Bidder country	Seller company	Seller country	Deal value US$m
Jun-11	C	OJSC Polyus Gold	Russia	Polyus Gold International Ltd	Kazakhstan			10,390
Jan-11	C	Massey Energy Company	USA	Alpha Natural Resources Inc	USA			8,156
Apr-11	C	Equinox Minerals Ltd	Canada	Barrick Gold Corporation	Canada			7,384
Sep-11	P	Polymetal OAO (82.85% Stake)	Russia	Polymetal International plc	Channel Islands			5,940
Nov-11	C	Anglo American Sur SA (24.5% Stake)	Chile	Mitsubishi Corporation	Japan	Anglo American plc	United Kingdom	5,390
Nov-11	P	De Beers Group (40% Stake)	Luxembourg	Anglo American plc	United Kingdom	Oppenheimer Family	South Africa	5,100
Jan-11	C	Consolidated Thompson Iron Mines Ltd	Canada	Cliffs Natural Resources Inc	USA			4,330
Jul-11	C	Macarthur Coal Ltd	Australia	Consortium for Macarthur Coal Ltd	USA			3,851
May-11	C	International Coal Group Inc	USA	Arch Coal Inc	USA	WL Ross & Co.	USA	3,128
Mar-11	C	Imerys SA (25.6% Stake)	France	Groupe Bruxelles Lambert SA	Belgium	Pargesa Holding SA	Switzerland	2,786

C = Complete; P = Pending

Producer price inflation in the Australian coal mining industry



Source: Australian Bureau of Statistics

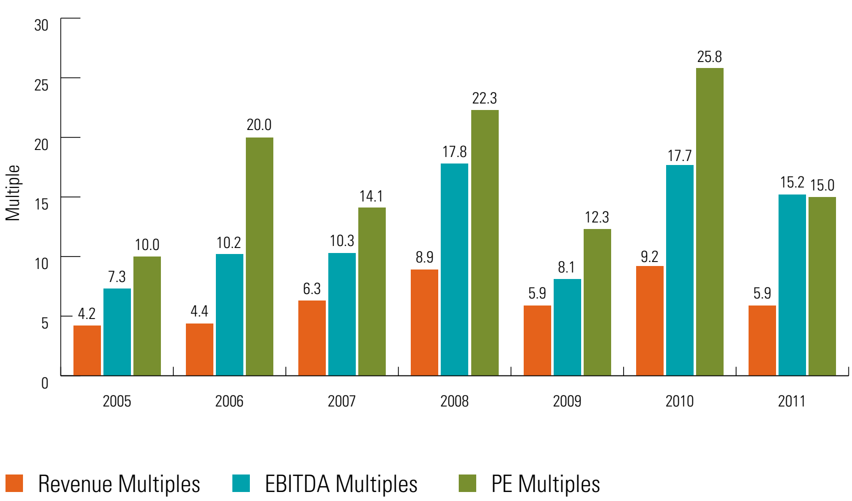
The cash rich and the cash strapped

Demand for base metals softened in line with the slowing business cycle as global growth came to a halt over the past half year, but big mining groups are still flush with cash on the back of strong profits in the post-crisis period. If markets remain unsettled, company management will likely opt to preserve an ample level of cash holdings as a buffer, rather than to pursue big-ticket deals, to redistribute cash back to shareholders or undertake share buybacks.

The big players will still be eyeing opportunistic bolt-on acquisitions, particularly for deals that offer good value or have a strong strategic rationale. Majors may target assets that fill or beef up their commodity portfolios such as Rio Tinto did in its acquisition of the Canadian uranium miner Hathor Exploration for US$493m in October. They may also move to consolidate control over quality assets in which they already have a stake such as Anglo American did in increasing its stake in De Beers from 45% to 85% in a US$5.1bn transaction in November.

On the sell-side, many of the juniors that fit the bill will be eager to bring on partners with cash as banks close their doors to new borrowers. In the eurozone, where exposure to sovereign risk is more pronounced, lenders are already showing greater selectiveness. In October, a number of leading French banks including BNP Paribas, Societe Generale and Credit Agricole even passed on a US$6bn loan to Xstrata. Increasingly, mining groups are looking more toward the bourses and debt markets of the Asia-Pacific region to raise funds.

Deal multiples, median averages



Building boom

With deal activity tapering off, many miners have turned towards expensive development projects. BHP Billiton, Rio Tinto and Fortescue Metals are three prime examples, having all recently invested in large-scale coal and iron ore mining developments in Australia, the largest M&A market for mining globally. In 2011 the country registered 59 deals worth approximately US$22bn.

A look at the numbers behind Australia's mining industry suggests that mining companies would do well to consider M&A sooner rather than later.

In the last government report released on major developments in the mineral and energy sector (April 2011), projected capital expenditure over 2012-2013 was forecast at A$73.7bn (US$78.8bn), up from an estimated A$55.5bn (US$59.3bn) for 2010-2011. On the downside, the unprecedented level of investment is exacerbating tight capacity constraints and causing capital costs to balloon.

At the same time, producer price inflation is trending upwards: last year, inflation in open cut mining hit a three-year high of 10.6% year on year in the fourth quarter, while producer inflation in underground mining remained at comparatively high levels throughout last year before moderating to 3.5% by year-end.

With producer prices likely to remain elevated for mine expansion projects for some time to come and assets prices comparatively cheap by historical standards, it might be the right time for mining groups to put M&A back on the corporate agenda.

Prospecting for bargains

Turning to the stock market, the argument for strategic M&A – targeting cost savings and operational synergies – becomes even stronger. Due partly to an overall slowdown in the global business cycle, revenue, EBITDA and price

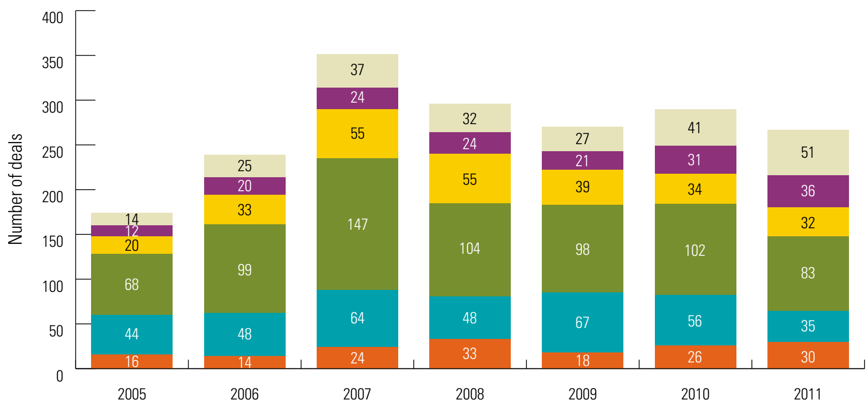
M&A SPOTLIGHT: MINING & METALS

earnings multiples were all down considerably in 2011 compared to 2010. However, looking at the benchmark FTSE 350 Index for mining stocks shows that share prices are starting a healthy recovery this year – meaning buyers will soon have to pay higher price tags as valuations begin to reflect this. With the value of mining stocks comparatively cheap at the moment, it may be a good time for acquirers to strike bargains on good value deals.

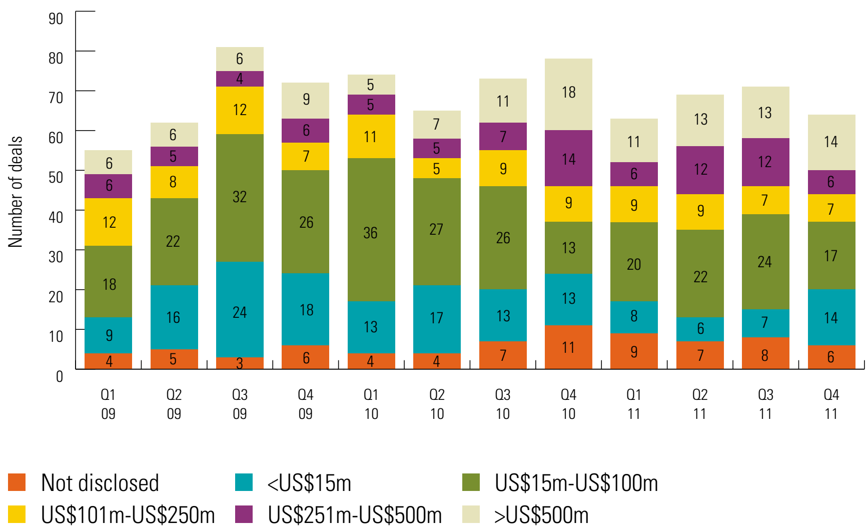
The M&A Outlook

Barring a severe worsening in the eurozone crisis, the slowdown in mining deal activity in 2011 is likely to prove a short-term transitory phenomenon, rather than a long-term trend. The tie-up of Glencore and Xstrata may invigorate activity in the market this year as rivals scramble for deals in order to maintain market share. Big players' cash positions are strong and valuations are comparatively attractive and they may become even more so if capital costs for mine expansion projects continue to rise. Looking to the longer-term, the sector's fundamentals are even sounder as the growth in emerging market appetite for raw materials is acting as a strong buy-side driver, while also spurring industrial conglomerates to move on upstream opportunities as they arise.

Mining deal size split by year

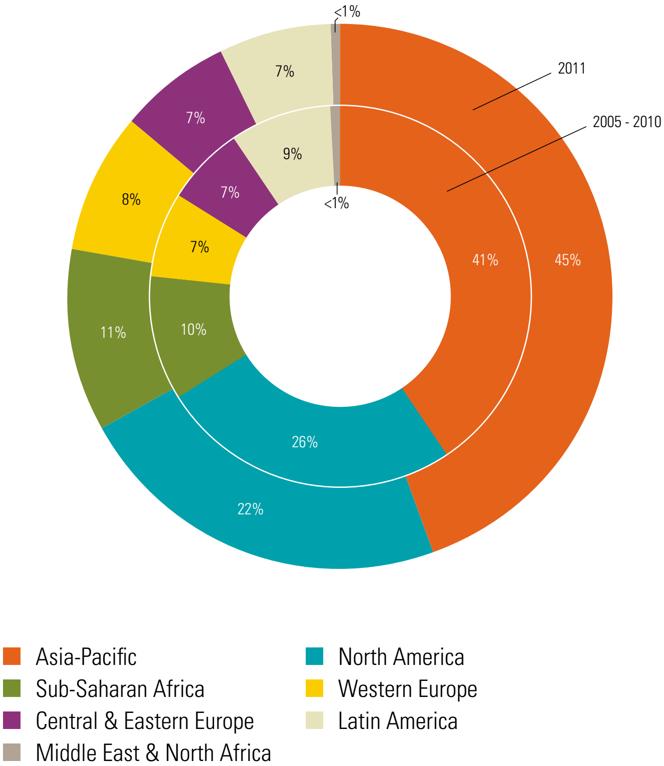


Mining deal size split by quarter

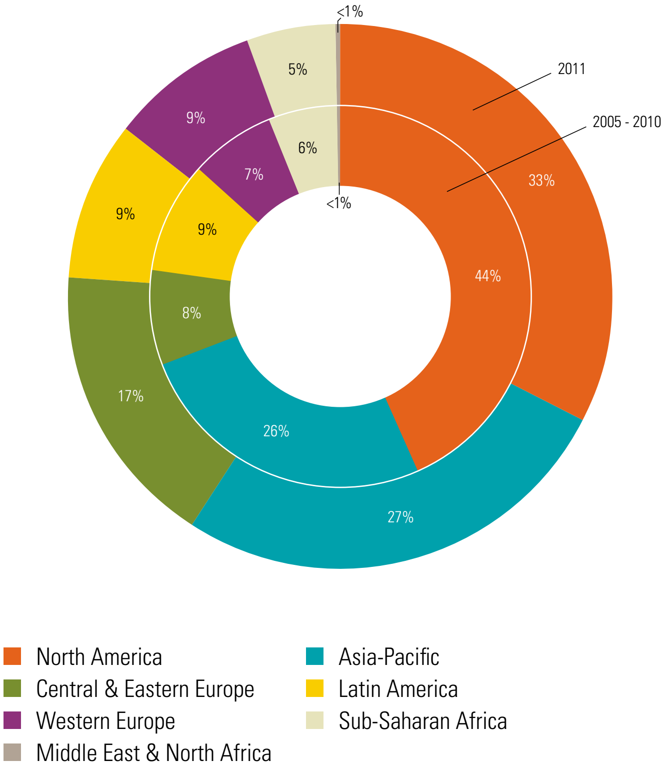


Cross-border share of Mining M&A

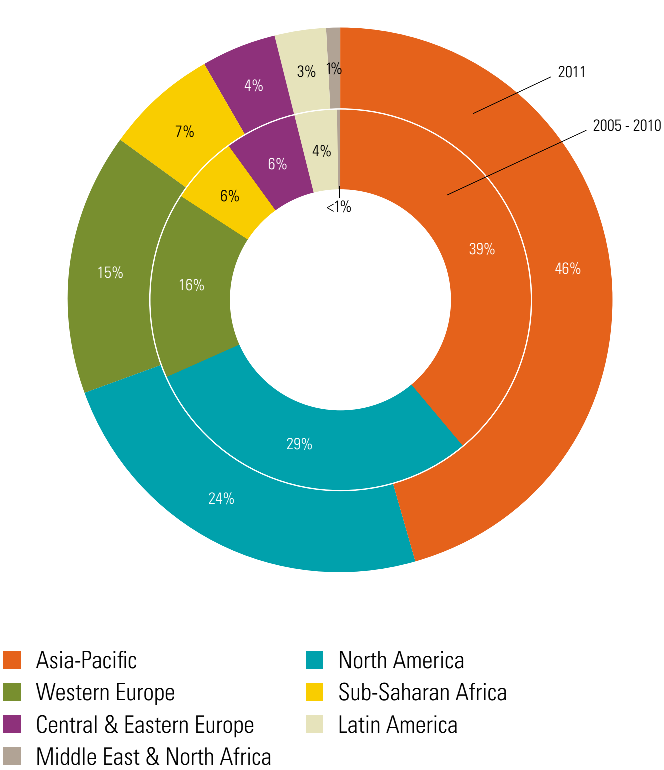
Mining deal volume split by target dominant region



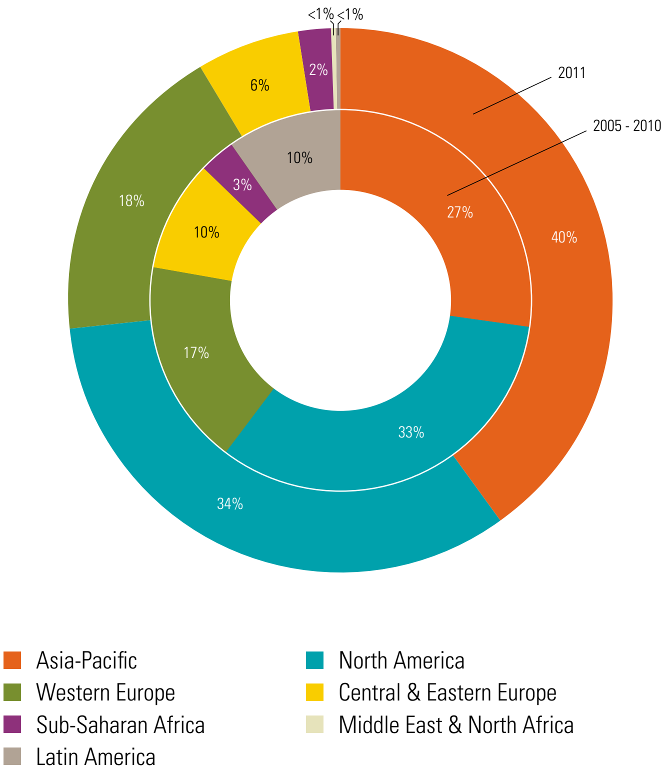
Mining deal value split by target dominant region



Mining deal volume split by bidder dominant region



Mining deal value split by bidder dominant region



Q&A

DUNCAN MACLEAN, GLOBAL INDUSTRY GROUP LEADER, ENERGY AND NATURAL RESOURCES, SQUIRE SANDERS

Duncan Maclean's corporate practice focuses on the energy & resources sector. He advises Australia-based and international mining, oil, gas and resources clients on acquisitions and divestments, due diligence, joint ventures, foreign investment and environmental matters. With an in-depth understanding of the regulatory industry in Western Australia (WA) and the Northern Territory, he represents clients in China and Southeast Asia including Indonesia, the Philippines, Thailand, Vietnam and Japan.

MM: With the global economy hitting a rough patch recently, what have been the main drivers of deals in the mining industry?

DM: Deals are being driven by the commodities, which follow a geography pattern based on deposits. In this part of the world, the strongest commodities are iron ore, coal and liquefied natural gas (LNG). The demand for these commodities, in particular, is very high. The LNG developments in Australia and particularly off the coast of Western Australia and Queensland are phenomenal. There's a tremendous amount of investing going on out here and once these projects are all on-stream, Australia's ability to supply LNG will outstrip Qatar.

MM: Who are the main investors into these projects and when are they expected to come on-stream?

DM: In terms of LNG, you've got the usual suspects. Woodside, a heavy investor in gas, operates a number of developments in Australia. Currently, they are constructing the Pluto LNG project, which is due to be up and running by the end of this year or into 2013. Then you have Chevron in a joint venture with Shell and ExxonMobil to develop the Gorgon project – a 40tcf deposit (trillion cubic feet) – due to be online by 2014. Chevron also has the Wheatstone project and INPEX and Total have just reached the financial investment decision milestone on the Ichthys LNG project that's due to be online by 2016.

MM: Are we seeing Chinese interest in the LNG area?

DM: Well, not really to date. However, there is speculation that Chinese interests are looking to acquire up to a 25% stake in the Browse LNG project from Woodside. Additionally, Sinopec looks like increasing its interest in the Australia Pacific LNG Project from 15% to 25%. The Chinese are active and did have an off-take interest in the Northwest Shelf through Guandong Dapeng LNG, but most interest and activity is coming primarily from the Japanese. We've been fortunate enough to act on behalf of a number of Japanese groups on their entry into these projects. The Koreans are also here, but in a far lesser force. There has even been interest from PTT, the Thai national oil company, and, of course, PetroVietnam is in the market trying to position itself as well.

MM: What sort of activity are we seeing outside of the LNG space?

DM: Well, to give you an idea, the production value in 1999 in resources projects out of Western Australia was running at about A$12.9bn. The production value estimated for 2015 based on the current expansion programmes and increased capacity is just shy A$70bn – so they're looking at year on year growth of around A$4.5-A$5.0bn. It's pretty significant. If you take a snapshot of the resources projects that are committed to being constructed out to 2016 from now, in Western Australia and the Northern Territory, there is around about A$180bn worth of projects. In Queensland out to 2016, there's about A$90bn. In all, it's up to about A$270bn.

MM: With so much activity going into capital expenditure on projects, will M&A activity become more limited?

DM: It depends on what you mean by M&A activity. If you're talking about traditional M&A activity, where listed companies launch takeover bids, that's slowed down in recent times. But if you're talking about it from an unregulated perspective, where companies are buying and selling interests in projects and assets, then I think that's going to increase.

The monetary risks and exposure in these projects escalates every year and companies really do need to spread their risks through joint ventures. The risk needs to be spread from a horizontal point of view in terms of competitors from their primary production markets as well as vertically so that they're capturing their customers. Often you'll see that minority stakes are offered in these projects to very large, long-term customers. And I think that's where the opportunities will continue particularly in Southeast Asia and Australia.

> The LNG developments in Australia and particularly off the coast of Western Australia and Queensland are phenomenal.

The customers are seeking to secure off take and get some exposure to the upstream. In that way, they're guaranteeing supply. And the sellers are guaranteeing that over a 15-25 year period the increased investment in infrastructure is underwritten to some extent.

MM: Looking at it on a market by market basis, what are some of the major challenges or concerns for investors entering emerging markets?

DM: I see two main risks and they ultimately come down to the same thing. The first is operational transparency. Often you have to joint venture to get access to an asset or to a market, but it can be difficult to be confident about your legal position because the judicial systems may not be as developed and you may not be dealing with a common law environment, which is something that most large companies around the world tend to prefer.

The second is adverse sovereign action. Rio Tinto's situation in Guinea is a recent example of that. They're spending billions in developing the Simandou iron ore project and the government decided to almost double its interest in the project, basically by sovereign decree. All of a sudden, the economics of the project are thrown out of the window and the confidence that these large companies have in these countries is diminished.

Within Asia, China has become a massive consumer and a massive competitor in primary products over the past 10-15 years.

MM: Yet, there's a huge amount of investment going into markets such as Africa, particularly by China. How are they mitigating these risks?
DM: The Chinese have a different strategy and philosophy for their investment. They tend to deal with sovereign risk issues government to government. So when a Chinese investment is being made into an African country, it is usually done through a government controlled enterprise. The government is really directing investment and operating at that the sovereign level to mitigate risks, but also to ensure that additional level of comfort. The model is being looked at by countries that have similar investment strategies to China such as Vietnam. Traditional mining companies operating in African countries often don't have that advantage.

MM: We're seeing more investment from private sector industrial groups in upstream assets. Is this a trend we'll see more of going forward?
DM: Absolutely. There are a couple of drivers for it. Within Asia, China has become a massive consumer and a massive competitor in primary products over the past 10-15 years. The traditional buyers in that market have been the Japanese and the Koreans who have usually done it through trading houses and trading companies such as Itochu, Mitsubishi and Mitsui, among others. They are now directly in competition with the Chinese and they are having to bid hard against the Chinese to take increasingly larger stakes in projects to secure future off take.

This is something that is also driving them to take positions in markets where they have traditionally not had much exposure, such as Latin America. Only 18 months ago, Itochu took a huge stake in a project in Brazil and you previously wouldn't have seen investment on that scale from a Japanese trading house in the region. So we are seeing competition for resources driving greater globalisation of investment.

MM: Looking at the funding environment, are there issues coming up for mining firms amid the volatility of recent months?
DM: Yes, very much so, particularly for the companies that have assets on the greenfield side of things where they're trying to run exploration projects. There is generally a reduction in the availability of capital for those more speculative and risky projects. While there remains an appetite in some of the capital markets for those projects, it really has tapered off. Increasingly, money is being sought out of the Philippines, Hong Kong, Singapore and other countries in Southeast Asia, whereas traditionally you would have expected capital flows out of the US, Canada, Australia or the United Kingdom.

Increasingly, money is being sought out of the Philippines, Hong Kong, Singapore and other countries in Southeast Asia, whereas traditionally you would have expected capital flows out of the US, Canada, Australia or the United Kingdom.

Funding is also really dependent on how progressed the asset is and how in demand the resource is. Obviously, it varies from resource to resource. As a general rule, it seems that there is a trend towards the more developed assets taking a joint venture position, rather than taking an investment position in the capital structure of the existing company. I think that is driven by a sense of risk mitigation and control.

MM: Looking ahead over the medium- to longer-term, which markets do you expect will see strong energy & resources dealmaking?
DM: Well, looking at the big picture there remains and of course there will continue to be an intense interest and focus on China. But from a business and transaction point of view it is very easy to forget about other emerging market economies. Vietnam GDP has grown at a rate of 7-8% over the last few years and they are very actively looking in international markets and trying to secure resources. Thailand will also be active, particularly in terms of energy security. And of course Indonesia, tremendously resource rich, has significantly improved the transparency of its regulatory environment, making it a far more attractive country in which to invest. All of these emerging market economies will be as important in our business going forward as China.

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